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FINANCIAL SECTOR PROGRAM

ANNUAL WORKPLAN OCTOBER 2009 – SEPTEMBER 2010

September 2009

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Contract No. 674-M-00-08-00043-00

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ACRONYMS AND ABBREVIATIONS

BA	Banking Association
BDS	Business Development Services
BDSP	Business Development Services Provider
BEE	Black Economic Empowerment
BSO	Business Services Organization
BSSA	Business Skills for South Africa Foundation
BUSA	Business Unity South Africa
CCRD	Consumer and Corporate Regulation Division of dti
CIPRO	Companies and Intellectual Property Registration Office
DCA	Development Credit Authority
DCA ODC	Development Credit Authority Office of Development Credit
DFI	Development Financial Institutions
dti	Department of Trade and Industry
EDC	Enterprise Development Centre of ABSA bank
FABCOS	Foundation for African Business and Consumer Services
FI	Financial Intermediary
FSP	Financial Sector Program
GSA	Government of South Africa
HDE	Historically Disadvantaged Enterprise
IBA	Institute of Business Advisors
ICSB	International Council for Small Business
IDF	Identity Development Fund
IFC	International Finance Corporation
IPPC	Intellectual Property Protection Committee
IRBA	Independent Regulatory Board for Auditors
JEF	Johannesburg Equity Fund
KM	Knowledge Management
LOI	Letter of Intent
NCA	National Credit Act
NCR	National Credit Regulator
NRCA	National Register of Credit Agreements
NSBAC	National Small Business Advisory Council
OCIPE	Office of Companies and Intellectual Property Enforcement
OMM	Old Mutual Masisizane
POF	Purchase Order Financing
SAIBL	USAID South African International Business Linkages project
SAICA	South African Institute of Chartered Accountants
SAIPA	South African Institute of Professional Accountants
SEDA	Small Enterprise Development Agency
SOW	Scope of Work
SME	Small Medium Enterprise
TIGF	Thembani International Guarantee Fund
USAID	United States Agency for International Development
USG	United States Government

EXECUTIVE SUMMARY

The Financial Sector Program (FSP) seeks to expand access to financial services and lower financing cost for small and medium enterprises (SMEs) through reforming the legal and regulatory framework affecting the financial sector and business environment and improving the commercial viability of lending to historically disadvantaged SMEs in South Africa, thereby expanding SME access to a range of high quality and affordable financial services. The contract was awarded to the Chemonics consortium on May 22, 2008.

This annual work plan covers the period of October 1, 2009 through September 30, 2010 and details planned activities to support the four project components – SME finance, financial business development services (BDS), policy reform and knowledge management.

Building on its progress with partner financial intermediaries[1] (FIs) during Year 1, FSP will continue to expand and deepen its assistance to the FIs to diversify and expand their **SME finance** portfolios. This requires a combination of interventions designed to introduce innovative and demand-driven products, train credit providers' staff in improved delivery mechanisms and examine options for loan guarantee schemes to stimulate lending in the higher risk SME sector. ABSA Bank and key medium scale financial intermediaries -- such as WIZZIT, Blue Financial Services and Old Mutual Masisizane -- are active FSP partners targeting the SME sector. FSP will continue capacity building efforts to further transform these institutions into the "go to" pioneer FIs for a more inclusive approach to SME finance emphasizing cash flow as opposed to collateral-only security. Through them, FSP is demonstrating to the industry that SME finance is not only viable, but profitable and worthy of significant investment by a growing pool of SME-friendly sources of financial services. FSP will continue to expand on the products developed and rolled out in Year 1 and explore applicability and marketing of other new financial products including factoring, leasing and supplier credit. Additionally, FSP is developing specific loan product for key industries, initially panel beaters and commercial construction.

In addition, FSP will continue to take a leading role in promoting and implementing the USAID Development Credit Authority (DCA) facilities with partner FIs. With two DCA agreements approved and at least four applications in the pipeline, FSP activities will balance its efforts between expanding the DCA to more FIs and building the capacity among the existing banks to fully take advantage of the guarantee mechanism to reach down to a wider pool of SMEs, increasing the additionality of the guarantee to the extent possible. Aiding these FIs in developing better credit scoring methodologies, new or refined financial products and streamlined procedures should all lead to greater utilization of the DCA.

Banks and other FIs often complain about the financial acumen of their SME clients and cite it as a significant hindrance to expanding their SME portfolios. In an effort to make SMEs more bankable, FSP will pilot several interventions with private sector **business services providers –** including FIs themselves and an SME incubator offering comprehensive business mentoring and capacity development services. To increase the quality of BDS, FSP will introduce an industry standards program that will grade business development services providers (BDSPs) thereby assuring SMEs that the advice and consulting services they seek will provide a solid return on their investment. To further link the provision of financial BDS

[1]Financial Intermediary is defined herein as any organization engaged in the provision of financial services, be it a bank, non-bank credit provider or a private financing fund.

with potential enterprise growth, FSP will collaborate with key BDS organizations and FIs to formally link appropriate Business Development Services with access to finance. By directly correlating the service provision with the FIs' due diligence requirements, SMEs will see the inherent value in BDS and gain much needed practical financial management advice and skills; and at the same time FIs will receive finance applications that are well supported and more easily bankable. In Year 1, FSP recognized that many of the historically disadvantaged businesses actually require more information on what financing is available and applicable to enterprises at varying levels of development. Therefore, FSP will also promote financial literacy by developing educational materials and launching a pilot financial literacy campaign focused on improving awareness of SME financial products and awareness as a precursor to firm-level sustainability and growth.

The private sector can only succeed within an **enabling policy environment** that fosters cost effective delivery of financial services, as well as well-functioning enterprises. The FSP policy component will work with public and private sector partners to develop solutions to overcome specific policy hurdles. Together FSP and its partners will proactively analyze policies, propose alternatives to existing gaps or constraints, draft appropriate legislative or regulatory remedies, and build the capacity of key SME advocacy groups to develop these same skills. After the business re-engineering exercise with the National Credit Regulator in Year 1, FSP will continue to support NCR as it examines specific policy actions to promote access to financial services and lower financing costs for SMEs. With the Department of Trade and Industry (dti), project staff will assist with drafting SME-friendly regulations under the Companies Act. The Companies Act will impact all formal businesses in South Africa but specifically it will endeavor to minimize the cost and administrative burden implicit in incorporating and maintaining an SME. Additional activities will address inequities in the real estate sector to create additional business opportunities and support National Treasury in piloting and institutionalizing a regulatory impact assessment tool so both public and private sector stakeholders are fully aware of the consequences of proposed or existing regulations. Finally, as a precursor to proposing new financial products and services through the Banking Association and FI partners, FSP will examine the regulatory environment to determine if any legal obstacles or limitations exist that would inhibit implementation of such a product and propose possible solutions that would unlock opportunities to further grow the SME sector.

FSP's final component is a cross-cutting intervention to improve the SME finance **knowledge management** of SME data, finance opportunities, successful approaches to SME development, donor and government programs, and tools for FIs and BDSPs to use in SME capacity building efforts. FSP is in negotiations with the Banking Association to provide a web-based access point for information, data, research, and tools that bring the shared experiences of SME finance practitioners and clients in South Africa complemented by best practices from around the world. The goal is to develop a jointly used and maintained home for this information and a portal for accessing it. During this period, the coalition of stakeholders will be assembled and the knowledge management mechanism will be operationalized.

SECTION I
INTRODUCTION TO THE FINANCIAL SECTOR PROGRAM

A. Contract Background

The Financial Sector Program (FSP) is a USAID/Southern Africa-financed program awarded to Chemonics International on May 22, 2008 under the GSA Contract GS-23F-0127P and USAID Blanket Purchasing Agreement EEM-E-00-05-00006-00; provided for under USAID task order 674-M-00-08-00043-00. This award has a base period (30 months) and an option period (30 months). The total cost of the contract was originally $14,297,997 with $7,929,353 allocated for the base period and $6,368,644 for the option period. However, on September 16, 2009 a modification was finalized increasing the base period contract by $200,000 to support an additional technical element. As a result, the total contract price is now $14,497,997. Additionally, FSP has been informed that, subject to the availability of funds, it is the intention of the USAID/Southern Africa Economic Growth Team to exercise the option period extending the completion date though May 21, 2013.

Chemonics Consortium

Prime:
- Chemonics International Inc.

Subcontractors:
- Crimson Capital
- Shorebank Advisory Services
- Khulisa Management Services

FSP was designed to support the accomplishment of the U.S. Government's Economic Growth Objective in South Africa. This program is one of three main vehicles to promote vibrant growth of historically-disadvantaged small and medium enterprises (SMEs) and reduce unemployment and poverty — generating rapid, sustained and broad-based economic growth in South Africa.

The objective of FSP is to expand access to financial services and lower financing costs for small and medium enterprises (SMEs), primarily those historically-disadvantaged, through reforming the legal and regulatory framework affecting the financial sector and business environment and improving the commercial viability of lending to SMEs in South Africa. The ultimate result is to mitigate market credit risk leading to increased SME access to a range of quality, affordable financial services.

This annual work plan builds on the partnerships established and successes seen in Year 1 of the project and covers the period October 1, 2009 through September 30, 2010.

B. Program Description and Approach

South Africa is Africa's largest economy, with strong financial, legal, energy, communications, and manufacturing sectors, abundant natural resources, and a thriving tourism industry. Yet underneath South Africa's developed economy lies a "second economy," comprised mostly of poor, historically-disadvantaged communities. A legacy of Apartheid, this second economy can be seen in the townships and outskirts of South Africa's cities and in rural areas where large numbers of the population live in shacks with little to no access to electricity, transport, or modern water or sewage systems.

FSP will actively engage in activities which will help to integrate this second economy of historically-disadvantaged groups into South Africa's larger economy and specifically assist small and medium enterprises (SMEs) fulfill their critical roles as drivers of the economy.

Activities under FSP will focus on improving and expanding financial services and products; managing and mitigating financial risk and transaction costs; improving bankability of SMEs and business services by linking financial services with business service activities that can build SME capacity, productivity and competitiveness, as well as improve the capacity of financial advisory services to serve SMEs; support the emergence of an efficient credit industry regulator that promotes an enabling environment for financial intermediation and risk management, and boosts the private sector's role and participation in the provision of financial services to SMEs; promote reforms to commercial laws, regulations, and administrative practices affecting the private sector and SME development; and, improve knowledge management through an accessible repository of knowledge about SMEs and finance in South Africa.

To that end, FSP will undertake a four-pronged approach to increase SME access to a range of quality, affordable financial services to facilitate business growth and catalyze increased employment and incomes:

1) Improve financial intermediaries' capacity to serve SMEs in South Africa
2) Improve the "bankability" of SMEs
3) Reform the legal and regulatory framework affecting the financial sector and business environment stimulating SME growth
4) Strengthen the SME finance knowledge management system.

As any project progresses, its operating environment – economic, and political, regulatory realities – continuously evolve often impacting planned activities and proposed partnerships. For FSP, each of these realities present challenges, but also open up new opportunities.

Global financial crisis: While many South African companies and financial institutions have suffered over the past year, the SME finance sector appears to have escaped much of the damage. Overall, past due loans are up, but not in crisis proportions. This is undoubtedly due to the unfortunate reality that credit for SMEs was already frozen to a great extent. During the crisis a few FSP small to medium scale FI partners showed greater interest in portable loan guarantees in an effort to access more wholesale funding to on-lend. But with the perception that the crisis is waning, wholesale credit appears to be opening up again. Smaller FIs are still keen to pursue the portable guarantees, but medium scale FIs are rethinking their strategy and needs.

In response, during the height of the crisis, FSP held a workshop for FIs on loan strategies for weathering with the crisis. As a result, two FIs modified their practices for reviewing their portfolios and defining what constitutes a "red flag", leading to closer loan monitoring. During Year 2, FSP will concentrate on follow up training to FIs and assisting the dti to prepare for an inevitable cyclical crisis. FSP will work with dti to address the inability to disaggregate SME financial data from consumer data. This impedes the Government's ability to reasonably assess the impact of a financial crisis on the SME sector and launch an appropriate response.

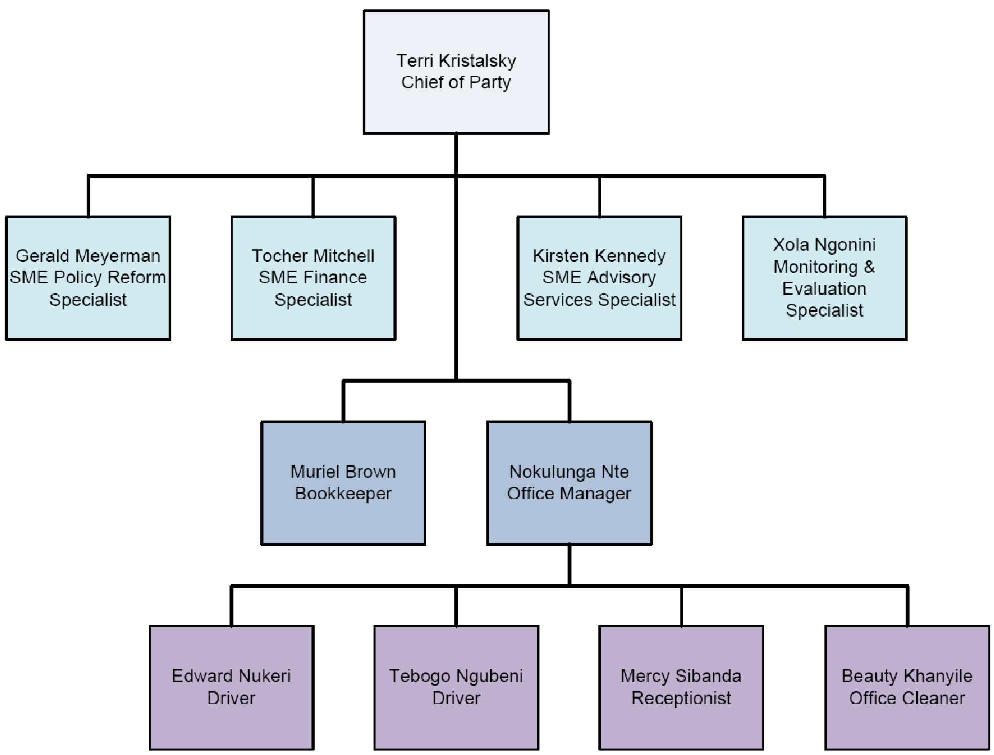
No single voice speaks for the SME sector: South Africa is rife with SME associations representing narrow technical, geographic or racial subsectors of the SME market. This impedes full engagement in policy dialogues and dilutes the impact of any one association as an advocacy body. In the initial draft of the Companies Act, for example, there was no mention of SMEs and their unique needs.

In response, FSP in Year 2 will build on information collected in its SME survey to identify key leadership in the SME sector and work with the National Small Business Advisory Council to revitalize their advocacy role supported by policy analysis.

Government response to market failures: In an effort to address market failures, such as the perceived high cost of BDS for SMEs, GSA has proposed Government subsidized programs to provide lower cost services. This often has a dual effect – lowering the costs, which is welcomed in SME sector, but simultaneously crowding out private sector providers who may provide high quality expertise.

In response, FSP continues to encourage that Government response should be focused and narrow to be effective and ensure its program is filling gaps but not crowding out. FSP engagement with specific programs, such as Khula involves including them in all capacity building efforts to disseminate best practices in BDS, lending practices and loan guarantees.

C. FSP Program Team -Exhibit 1

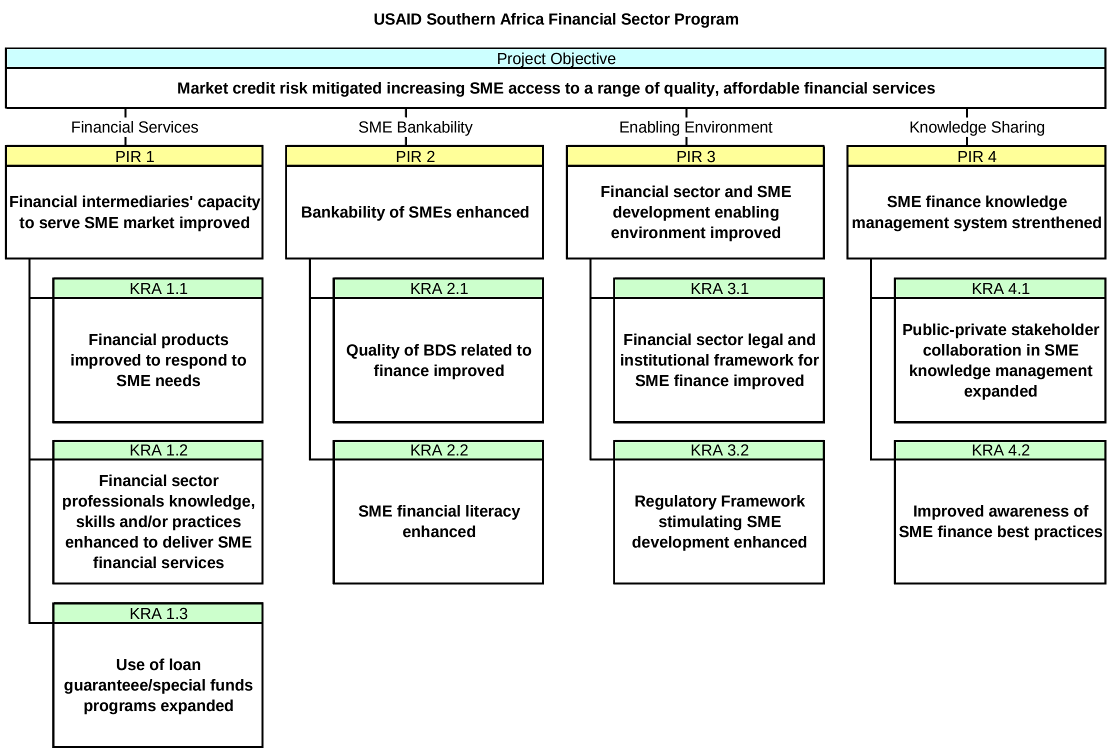


D. FSP Results Framework

FSP has been designed to support the achievement of the U.S. Government Economic Growth Objective in South Africa. This program is contributing to the objective to help improve SME access to a range of quality, affordable financial services. Within the Economic Growth objective, FSP will help to mitigate market credit risk increasing SME access to a range of financial services (see Exhibit 2, Results Framework).

The results from each level of the framework support the achievement of the results on the level above – culminating in achieving the Mission Economic Growth objective of increased access to finance by SMEs. For each of the four Project Intermediate Results (PIRs), FSP has elaborated Key Result Areas (KRAs) that are representative of the overall strategies for achieving the intermediate results. These KRAs will guide project staff in its activity planning and they provide the basic structure for performance monitoring, evaluation and reporting. Each KRA has a technical leader, a set of activities, associated tasks, defined resources, and benchmarks for this interim work plan. These are detailed in the text in Section II and timelines in **Annex A**.

E. FSP Results Framework – Exhibit 2



SECTION II
WORKPLAN BY TECHNICAL COMPONENT

A. Project Intermediate Result (PIR) 1: Financial Intermediaries' Capacity to Serve SME Market Improved

South African financial intermediaries (FIs) have addressed the finance needs of large corporate businesses and micro-enterprises adequately. However, there remains a significant gap in the country in meeting the financing needs of SMEs, particularly those considered historically disadvantaged enterprises (HDEs). Although there is significant SME demand for finance, few SMEs successfully access finance. FSP fully acknowledges the challenges inherent in SME financing particularly in light of the global finance crisis. Many SMEs lack traditional forms of collateral typically required for finance. SMEs often appear less transparent, with many lacking credible financial statements and have poorly prepared loan applications and limited financial literacy and expertise. Further, the line of demarcation between individual/personal assets and business assets can be indistinguishable. Given these apparent risks, FIs must develop rating/scoring mechanisms and financial products and procedures designed to reduce risks and share risks with the borrowers. SMEs form a large segment of the business community. By taking actions to reduce the risk, FIs can enjoy an often untapped potential for expanded intermediation. FSP through PIR 1 will address the supply side of finance – the FIs' ability to engage with such businesses, while PIR 2 seeks to enhance the demand side -- the SME's ability to mitigate these deficiencies and become loan worthy.

On the supply side, the FIs, particularly the big four South African banks, historically have considered SME lending to be too risky in general, and their approach to the segment needs repositioning. FSP, during Year 1, identified FIs that appear to be more entrepreneurial in pursuit of a wider client base and willingness to include SMEs, including medium-scale FIs and private funds. FSP will continue to work with dynamic FIs to build the business case for the potential profitability of the SME market. To increase SME access to finance, during Year 2 FSP will build the capacity of partner FIs to improve/simplify SME financing approval procedures, develop or refine credit scoring systems, introduce new financing products that are suitable for the SME segment and develop or refine SME loan guarantee scheme approval processes.

PIR 1 Benchmarks

- Finance approval processes of 3 FIs improved
- 3 financing products developed or refined
- 1 credit scoring model developed or refined
- Staff of 3 FIs trained
- 4 DCA Action Packages submitted for approval to CRB
- 1 guarantee scheme approval process refined or developed

FSP's approach to the FIs evolved during Year 1. Initially targeting the big four banks who were tangentially involved in providing SME loans, there was skepticism in recognizing the need to reevaluate their approaches to be more inclusive, emphasize cash flow as opposed to collateral comfort, introduce new products or recognize SMEs as a key growth sector. ABSA Bank proved to be the exception to this rule, expressing interest in expanding its SME loan portfolio, innovating its approach and investing in its Enterprise Development Centres to improve entrepreneur development. A much more enthusiastic response also came from medium-scale FIs and private funds, such as Sasfin Bank, Blue Financial Services, Old Mutual Masisizane and WIZZIT, who seek out new product ideas, and welcome technical assistance to refine their credit risk analysis systems and procedures. Therefore, FSP decided to target these more dynamic FIs as partners. Continued outreach to new partners and deepening of relationships with existing partners will lead to a significant increase in the number and volume of loans and equity investments in SMEs, shorter finance approval times, a greater number of suitable finance products to meet the needs of SMEs and a more appropriate (although still prudent) risk profile on the part of South African SME financiers. By demonstrating the feasibility and profitability of SME finance with these partners during Year 2, FSP anticipates greater adoption of SME best practices in the entire sector by project end.

Three Key Results Areas (KRAs) support PIR 1:

KRA 1.1 - Financial products improved to respond to SME needs
KRA 1.2 - Financial sector professionals' knowledge, skills and/or practices enhanced to deliver SME financial services
KRA 1.3 - Use of loan guarantees/special funds programs expanded

Each of these KRAs is detailed in the following pages in terms of its overall strategy, key activities, implementation resources/partners, and interim benchmarks. Specific tasks and timing are indicated on the timelines that follow the text in Annex A.

KRA 1.1 Financial products improved to respond to SME needs

KRA Strategy:
To enhance the array of financing products available to SMEs, FSP will work with its FI partners to help diversify product offerings. However, new products are but one innovation that is needed. FSP will take a holistic approach to capacity building in SME lending, emphasizing not only appropriate financial products but identifying distinctive products for high value sectors, improved credit risk analysis, risk management systems and enhanced customer service to fully engage the sector. The activities under this KRA also are aimed at making the FIs' finance approval processes more streamlined/efficient and yet thorough, so that SMEs can have their financing applications approved more quickly, prudently and in a fair and consistent manner. Thereby the FIs will be able to meet SME clients' needs that were not addressed previously and the FIs will be able to establish themselves better in this market segment.

As the project progress beyond 2010, FSP's FI partners will most likely further diversify their finance product offerings. Several of these partners are new to SME finance and, sensibly, have launched with only a "vanilla" set of products. The private funds, for example, only offer medium or long term investment loans. Adding working capital financing and other products will be possible with FSP assistance in the later years of the project. WIZZIT has commenced its "productive lending" with only two loan products, term loans of up to three years to finance equipment and working capital loans of up to six months. As success builds, WIZZIT too, may add other finance products, such as purchase order finance.

Activities:
1.1.1 SME finance approval processes improved. Several of FSP's FI partners need to upgrade their finance approval processes in order to better screen finance applications, improve their approaches to credit analysis, apply a more consistent approach and respond more quickly to SME finance applications. This activity addresses these shortcomings; it will lead to more SME loans and equity investments being approved in a timely manner, allowing

the FIs to focus on financing applications that are worthy of their attention and ensure the applications are better vetted.

FSP will build on Year 1 activities with partners for while FSP already developed loan products and refined approval processes, these partners require further assistance to implement other FSP recommendations. In that regard, FSP will assess the progress of the ABSA Bank purchase order financing product aimed at SMEs supplying larger companies and provide technical assistance to review and refine the product and approval processes if required. FSP will also continue to develop the processes for approval and expansion of the SME loans developed for WIZZIT bank.

FSP will also continue to nurture new relationships and to explore opportunities with Khula Direct, which is seeking assistance with setting up its loan approval process.

1.1.2 Develop or refine finance products (including DCA related finance products). Most of FSP's FI partners have a relatively limited offering of financing products. This is either because they are nascent FIs or have deliberately limited the scope of their operations. For instance, Blue Financial Services (Blue), Thembani International Guarantee Fund (TIGF), True Group and all four of FSP's private fund partners have as their mission to provide investment financing primarily for HDE SMEs. Although their operations may be limited in scope, diversifying their product offerings may more fully meet the overall financing needs of their SME clientele. In this regard, FSP will investigate with Blue the possibility of offering short term, working capital loans and/or construction loans in addition to the investment term loans it now provides. To date, Blue has had to refer its clients who need working capital financing to other lenders. Similarly, Mettle Administrative Services (Mettle), with whom FSP currently is developing a DCA guarantee facility, has only financed the accounts receivable of its "panel beater" (auto body shop) clients. FSP will work with Mettle to develop a loan product aimed at financing auto parts and materials as well. This sector specific product may eventually be of interest to other FIs if a solid business case is proven. As a first step in this initiative, FSP will recruit a consultant to carry out a panel beater sector study.

Product Promotion

To stimulate opportunities for SMEs to access products suitable to their needs, FSP will review the policy environment and incentives for the promotion of alternative modes of finance. Such areas to be explored include:

- Leasing
- Purchase Order Finance
- Asset based finance
- Warehouse Receipts
- Factoring
- Supplier Credit
- Construction Lending

Following an assessment of the policy environment to assess possibilities to expand use of alternative modes of finance, such as leasing and factoring, FSP will work with selected FI partners as appropriate to develop these types of finance products.

As demand for new products increases and new SME market segments are accessed, FSP anticipates an associated rise in the need to fine-tune and streamline FI approval and risk assessment competencies, as products such as leasing, factoring, accounts receivable financing come on line.

"Doing Business"

A tool to focus attention for SMEs

The recent World Bank "Doing Business" report showing South Africa's ranking "slipping" drew major media and government attention. *Doing Business* builds indicators of government regulation of business across 181 countries. It covers regulation - from start up to closing a business - and ranks countries based on 10 indicators of business regulation that track the time and cost to meet government requirements.

A number of criteria, including "starting a business", "getting credit", "licenses", "paying taxes" are directly relevant to the SME area. The dti is interested in stopping and reversing this slippage in future years. FSP will assist in identifying methodologies to achieve this by removing obstacles to doing business – especially in our target area, SME access to credit.

By comparing the Survey results, and especially the raw data, year over year it allows FSP to identify impact - are things improving? -- and where FSP should focus attention.

KRA 1.2 Financial sector professionals knowledge, skills and/or practices enhanced to deliver SME financial services

KRA Strategy:
The activities in this KRA also aim to streamline the FIs' loan approval processes and simultaneously improve the capacity of their staff, resulting in an increase in the number and amount of loans/equity investments without sacrificing portfolio quality. An additional goal is to improve the ability of FI loan officers to assess special types of SME finance applications, such as purchase order financing, leasing, factoring, warehouse receipt financing and construction loans.

Activities:
1.2.1 Expand the use of credit scoring. The approval processes for SME loans generally need to be more streamlined and standardized for SME loans as opposed to the very detailed due diligence required for large, corporate borrowers. Credit scoring, a semi-automated method of evaluating loan applications, can address this challenge. It standardizes the loan approval process by applying the same set of weighted criteria to all loan applications. Scoring can be statistically based, which requires a substantial database analysis of bad loans over several years. However, a judgmental credit scoring system, which presents a lower resource alternative, uses as criteria various financial ratios, the client's loan repayment history, the size of the client's deposits and the client's character. These are weighted and scored, and if the total score is above a certain threshold, the loan is approved. Credit scoring can be a good approach for an FI new to SME lending because advanced credit analysis techniques are not needed and it works well for the simple loan products that SMEs typically require. FSP will continue to work with FI partners to develop credit scoring systems or refine existing scoring models. Once established, the outcome of credit scoring can be a greatly expanded SME loan portfolio. Blue Financial is interested in having FSP review its credit scoring system with a view to validate its effectiveness. Once WIZZIT's SME lending operations are well established, FSP anticipates developing a credit scoring system for that FI too.

1.2.2 Provide capacity building for FIs. During Year One, FSP successfully carried out two training programs for its FI partners on SME Due Diligence/Valuation and SME Problem Loan Management. The former was aimed primarily at the private funds, whose operations are relatively new and needed remedial help. The latter was beneficial for all Project's FI partners given the current recession and many techniques were adopted by participants. To help the FIs maintain high loan approval and monitoring standards, FSP will continue to carry out demand driven capacity building, both in a workshop setting and through institution –specific mentoring. As new products and procedures are developed, capacity building efforts will follow to ensure success within the FI and target clientele.

As many of its partners are in the early stages of building their loan portfolios, FSP plans to support their capacity for adept client management. Such training will ensure that the FIs have high retention rates, closely monitor their borrowers' repayments and anticipate any further financing needs their clients may have. With WIZZIT, FSP will build on its product development activities from Year 1, and enhance WIZZIT's credit risk management function as a crucial component to that FI's SME lending initiative.

KRA 1.3 Use of loan guarantees/special funds programs expanded

KRA Strategy:
There is a long standing perception among the major South African FIs that lending to SMEs entails somewhat higher risk. However with appropriate credit analysis, product development and risk management tools, there are real opportunities. To entice the FIs to extend their SME lending risk profile, SME loan guarantee schemes such as USAID's DCA Portfolio Guarantee facilities can play a key role. In addition, given the current tight credit conditions in South Africa, many SME financiers have had difficulty in obtaining new or even renewing their existing long term funding. Especially under these circumstances, DCA Loan, Bond and Portable guarantees can be used to help support such funding. FSP will continue to actively promote the consideration of many types of credit indemnity schemes, leveraging funds and promoting the appropriate use of DCA guarantees to support SME credit expansion and consider DCA facilities that support lending to SMEs in priority sectors, e.g. agriculture, construction, automotive and marine oil and gas.

Under existing BEE codes the benefit factor for issuance of guarantees is illogically low. During Year 2 FSP is encouraging dti to raise that benefit factor, which would likely stimulate formation of more guarantee schemes, in turn allowing for the increased leveraging of development funds. If the benefit factor is raised, in subsequent project years, FSP intends to provide assistance toward the establishment of local guarantee schemes. Experience in other countries has shown that such schemes do much better than national guarantee schemes at providing access to finance for smaller, rural SMEs. For example, during 2006-2008, the USAID Croatia Enhancing Small Business Performance Project helped 12 regional development agencies (RDAs) establish SME loan guarantee schemes which proved to be better attuned to the financing needs of small SMEs in their areas. The RDAs knew the SMEs in their regions better than the national guarantee scheme as they had in many cases incubated and nurtured them. A similar situation has been observed in Vermont, U.S.A., where the Vermont Industrial Development Authority, because it has better coverage and knowledge of local conditions, is more adept than the U.S. Small Business Administration in fostering access to finance for the SMEs in its state. Following this lead, FSP will work to enhance the use, depth and breadth of guarantee schemes.

Activities:
***1.3.1 Promote utilization of USAID DCA guarantee facilities* –** Two DCA facilities were approved by the USAID Credit Review Board (CRB) during project Year 1. In September 2009, Blue commenced using its DCA Loan Portfolio guarantee. Sasfin Bank currently is negotiating for a loan from Nedbank, which would be supported by the approved USAID Portable Guarantee. FSP is developing at least four additional DCA Loan, Bond and/or Portable Guarantee facilities, all of which will support funding for on-lending primarily to HDE SMEs. Several other FIs have made enquiries about these types of DCA facilities. Given the increasing number of DCA applications and the fact that DCA funds are limited, FSP's first step in Year 2 will be to finalize its strategic approach to DCA guarantee facility development.

After setting priorities, FSP will proceed to develop the DCA facilities that benefit the highest priority sectors and segments of the South African SME market.

1.3.2 Improve/develop other South African guarantee schemes: TIGF has requested FSP for assistance in streamlining its guarantee approval process. Such enhancement will enable this guarantee fund, which is aimed at supporting investment financing for rural-based agricultural SMEs/cooperatives, to increase its guarantee volume. During much of Year 1 TIGF was focused on rehabilitating problem loans that it has guaranteed, but it is now prepared to re-engage in the SME market. It is expected that the initiative described above can be started at the end of the first quarter. As a part of the guarantee approval process review, FSP will continue to facilitate meetings for TIGF with FIs as TIGF seeks to work with institutions to accept its loan guarantees under conditions more favorable than currently available in the marketplace.

Under current dti BEE code regulations, the benefit factor assigned to loan guarantees to BEE SMEs is only 3% of the amount guaranteed.[2] This low percentage is not logical given the fact that a guarantor is liable for 100% of the loan guarantee amount. As well, such a low benefit factor provides a powerful disincentive for potential SME financiers to utilize a guarantee mechanism, which would enable them to leverage their capital much further than making direct loans. Therefore, FSP intends to encourage the dti to increase the benefit factor substantially for issuance of guarantees. Assuming this change can be made, the project will then endeavor to work with private funds and other SME financiers to establish guarantee schemes as a better alternative to loan funds.

Lastly, FSP will continue to dialogue with Khula Enterprise about reviewing its guarantee approval process and criteria. FSP approached Khula during Year 1, but at that time it did not see technical assistance as a priority. Given the large size of its operations and potential broad outreach, however, continued attention is warranted.

B. PIR 2: Bankability of SMEs Enhanced

PIR 2 Benchmarks

- BSO partners identified for capacity building initiative
- 2 BDS interventions designed and implemented
- BDSP grading standards designed
- Strategy for BDSP grading developed
- Financial literacy content developed and packaged
- SME financial literacy program delivered to market

FSP's PIR2 interventions are based on the premise that if SMEs want to access finance, they may require access to relevant and affordable business development services and information which will enable them to make informed decisions about their finance needs, as well as meet the requirements of the finance provider.

While finance providers may vary in what they look for in order to finance an SME, it is clear that bankability of an SME does not depend on financial statements, or the presentation of a business plan alone. In order to access finance, several factors are considered, including the viability of the business idea, the realistic assessment of market potential, the entrepreneurial qualities of the SME owner themselves – as well as the SME owner's ability to manage the accounts, cash flow

[2] On the other hand loans are accorded benefit factors of between 70 and 100% of amounts lent, depending on the loan conditions.

and finances of the business. In this respect, SME bankability (and awarding finance) is as much to do with the ability of the SME to manage their enterprise and their finances once they have *secured* finance, as it to do with their ability to demonstrate that their enterprise is viable *before* they (or in order to) secure finance. This was a major realization affecting the FSP approach in this area during Year 1.

The problem in the market remains however, that in general, there are few BDS providers who are particularly well equipped or qualified to help SMEs manage their finances successfully or truly understand what finance providers need. Compounding this lack of external expertise, many SMEs as well as BDS providers have low levels of financial literacy and little understanding about what options for accessing finance exist.

The development challenge is therefore to identify ways to increase the availability and services of quality BDS providers, particularly those with finance related skills, as well as stimulate the demand for high quality financial BDS creating a sense of “value” that SMEs are willing to pay for.

FSP’s activities are designed to address these challenges. During Year 1, much effort was expended in identifying a consortium of partners with whom to engage around these activities with an exclusive focus on financial BDS. This proved to be more challenging than anticipated as few organizations outside of financial institutions focus exclusively or primarily on preparing SMEs to access finance, and those that did, were less than ready to commit at the time to FSP’s proposed activities. In addition to this, FSP found the market to be dominated by government funded agencies where services are subsidized and where, by their own admission, delivery and uptake of services is weak.

A strategy shift has therefore taken place to govern the activities proposed in Year 2. FSP has elected to build partnerships with leading private sector and non government players, including, Raizcorp, and the Institute of Business Advisors, as well as FI partners such as Blue, ABSA and Standard Bank who are committed to actively include financial BDS into their tool chest of BDS provision as well as form plausible links between the services they offer and supporting access to finance. Additionally, a survey identifying the existing hurdles faced by FIs in the provision of finance to SME will inform the strategic approaches undertaken in Year 2.

FSP will be a driving force behind the provision of financial literacy directed to SMEs via BDSPs. A FSP financial literacy gap analysis undertaken in Year 1 clearly identified that while the general market supports information dissemination on consumer financial literacy, the only financial literacy materials directed toward SMEs are either focused on development of financial management skills of SMEs or of the marketing variety promoting products and services from individual suppliers.

Two Key Results Areas (KRAs) support PIR 2:

KRA 2.1 — Quality of BDS related to finance improved
KRA 2.2 — SME Financial Literacy Enhanced

Each of these KRAs is detailed in the following pages in terms of its key activities, implementation resources/partners, and interim benchmarks. Specific tasks and timing are indicated on the timelines that follow the text in Annex A.

KRA 2.1 Quality of BDS related to finance improved

<u>KRA Strategy:</u>
To promote the quality of finance related BDS in the market place, FSP will take a multi-layer approach.

FSP will focus on opportunities to strengthen the capacity of partner business development services organizations' BDSPs to offer finance related BDS to their SME clients FSP will identify the topics, methods and possible approaches to help to provide capacity building to BDSOs as well as BDSPs to better serve their SME clients and help them to access finance.

FSP will concurrently examine what FIs cite as their limitation of SME credit provision and design broad as well as institutionally specific interventions to help overcome those challenges. FSP will collaborate with FIs to promote financial management practices as supported by the study undertaken in year 1. The project will pilot programs with several FI partners, including ABSA and Blue Financial Services to improve their business development products and services for SME clients. By targeting these specific partners, FSP aims to ensure that the quantity of financial BDS increases, the quality of BDS that is offered in the market improves and more SMEs become bankable.

To improve the quality of BDS related to accessing and managing finance, FSP will work with a private sector business service organization, Raizcorp, to implement a grading framework facilitating increased provision of quality BDS to the market and improving the capacity of BDSPs to offer finance related BDS.

While in Year 2 the focus will be on designing, testing and piloting these interventions, the objective will be to scale up and replicate these activities by year's end and in subsequent project years roll out in other provinces in the country.

<u>Activities:</u>
KRA 2.1.1: Build Capacity of BDSPs: With the wide network of business service organizations that FSP has built up during the past year, this activity will focus on securing their participation in year 2 activities and identifying additional areas for capacity building specific to their individual needs. As shown in the table below, numerous and diverse BDOs have been identified for possible collaboration. As assessment of their immediate and medium term interests were identified; the most immediate opportunity is in the area of building the capacity of their members and/or employees who offer business development services to SMEs to promote financial literacy to their clients.

FSP will work with the BSO's interested in improving their BDS offering to the market, particularly in the area of financial literacy and will meet individually with those selected as well as a few FI partners in order to solicit their comment on and secure interest in the proposed financial literacy program. These meetings will be used to ask key informants to prioritize the kind of content the program should contain and prioritize in order to address the knowledge and information needs of BDSPs to assist SMEs. In addition, FSP will invite them to identify a format of delivery for the program which is most appropriate to their needs.

The outcome of this activity is to develop a shortlist of BSO partners committed to implementing financial literacy in partnership with FSP. Confirmed agreements and commitments to activities will enable FSP to further identify areas with their partners in which capacity building is needed and will enable FSP to investigate the need of these partners for assistance to monitor uptake of the program and impact in terms of number of financial advisory providers assisted/trained, and the number of SMEs that they, in turn, assist and which go on to access finance.

Business Service Organizations and Financial Intermediaries with whom FSP has held discussions: areas identified for potential collaboration under PIR2

Name of Institution	Type of Registration	Type of Institution	Access to Credit	Grading	FINANCIAL LITERACY	
					Knowledge & Information	Skills Development
ABSA/EDCs	Private	Both	Yes	x	x	x
Barloworld Siyakhula	CSI	FI	Yes			x
Blue Financial Services	Private	Both	Yes			x
Business Partners	Private	BSO	Yes	x		
Business Skills SA	Public	BSO	No		x	
Dept Economic Development	Govt	FI	Yes		x	
Enablis	NGO	Both	Yes		x	
Enterprise Room	Private	BSO	No		x	
FABCOS	Member based	Both	Yes	x	x	
Gauteng Enterprise Propeller	Govt	BSO	Yes	x	x	
GroFin/Optima	Private	Both	Yes	x		x
Instititute of Business Advisors	Member based	BSO	No		x	
Identity Development Fund	Govt	FI	Yes			x
Khula Direct	Govt	FI	Yes	x	x	
OMM	CSI	FI	Yes			x
PPC Ntsika	CSI	FI	Yes			x
Raizcorp	Private	BSO	No	x		
SAIPA	Member based	BSO	No		x	
SEDA	Govt	BSO	No	x	x	
The Business Place	NGO	BSO	No		x	
TIGF	NGO	FI	Yes		x	x
Wizzit	Private	FI	Yes		x	

KRA 2.1.2: Improve finance-related BDS offered through FI partners. FSP's global study on *Models of financial business services* provided lessons learned in what has been effective approaches for FIs supporting finance related business development services (fBDS) for SMEs. Results support the approach implemented by several South African FIs, namely proving credit and non-credit support services as a successful method for mitigating the risks associated with SME lending.

FSP's survey of hurdles to providing finance to SMEs faced by banks and private funds will permit FSP to inform financial BDS providers of the deficits of their SME clients creating a barrier to finance, as well as FI's of new approaches to evaluating their SME clients and possible financial products better suited to this market segment.

FSP will present the generic survey findings and possible interventions to participating institutions and stakeholders (such as BSOs, the dti, the NCR, etc.). This event will be hosted by the Banking Association providing an opportunity for dialogue among numerous public and private sector stakeholders and potentially opening the door for further intervention with FI partners.

Following the survey, FSP will engage the Banking Association to determine what opportunity exists for the Banking Association to offer support to SMEs and any assistance it would require from FSP to do this.

In parallel with building the capacity of BSO's in the area of financial literacy, FSP will continue to identify and work with specific FI's to determine interventions required to develop or improve the BDS they offer which is linked to pre- and/or post finance support of their SME clients. Opportunities for collaboration will be explored specifically with ABSA, Standard Bank and Blue Financial Services, although other FI's will be invited, where appropriate, to participate in, for example, FSP's financial literacy program.

In support of ABSA's intention to implement process and value add efficiencies to their Enterprise Development Centres (EDCs), and to improve the quality advice and support offered to their existing and new SME client base, FSP will work with ABSA to improve the benefit and positioning of EDCs.

The opportunity exists to offer two levels of service through the EDCs: improving financial literacy of SME clients who need to make informed decisions about what financing option to select; and providing BDS to SMEs to help them manage the finance they receive from ABSA, assuring the bank of effective loan management and repayment. FSP will assist ABSA identify how they can improve the BDS offered through the EDCs.

Several FI's, including Blue Financial Services, offer training and mentorship which is tied to the award of finance. FSP will develop a program of "Successful Financial Management for SMEs" which will be used by Blue to improve the loan performance of their clients and will explore the opportunity of enhancing the content of FI-based BDS programs in a similar way, in order to improve the bankability of SME clients.

KRA 2.1.3: Facilitate implementation of grading of BDSPs. Over a year ago, FSP's proposal to develop a national grading framework for BDSPs was met with clear support by the SME Committee of the Banking Association. Support for this approach was endorsed when FSP hosted a dialogue among a number of stakeholders, including business service organizations and a private fund. However, it became evident that firms have developed their own criteria for selecting BDSPs based on personal and professional recommendations and that implementing a national framework in the South African context would be a complex and time consuming exercise with limited uptake.

As an alternative approach, FSP will support the design of a comprehensive framework for grading to be hosted within one organization, Raizcorp, an international award winning company offering incubator services to SMEs. Over the years, the success of Raizcorp's SME clients has depended on its unique approach which ensures that each client is linked to the specialists it needs to provide business development support. Since its inception in 2002, Raizcorp has supported over 500 businesses through incubation and training. With operations in several provinces, they are set up to expand beyond Gauteng and replicate its approach elsewhere in the country and establish additional sites. With FSP support, Raizcorp can deepen expertise in building the BDS capacity in the market, specifically related to access to finance.

Raizcorp will define areas in which standards will be set, and against which BDSPs will be graded. These areas may include, for example, technical expertise, industry or sector knowledge, educational qualification (or recognition of prior learning), experience in managing a business as well as consulting to a business. The intention is not to duplicate existing professional standards, but to incorporate these into the grading framework.

An assessment mechanism will be designed and used to determine the grade of BDSPs as well as to develop their ability to deliver high quality services. The proposal is to focus initially on the grading of BDSPs who will be developed to assist SMEs to access finance. Ongoing assessments will be used to ensure compliance to standards as well as to monitor BDSP performance – in this case, the number of SMEs assisted to access finance. Once the grading and assessment system is designed, FSP will develop a strategy with Raizcorp in which they can replicate the system for use with other BDSPs and so expand the provision of quality BDS throughout the market.

In order to build demand for BDSP grading, FSP will assist Raizcorp in soliciting Banking Association endorsement and international accreditation for its Guiding Academy. The rationale for this is that users of BDSPs, such as FI's, BSO's and SMEs will recognize the brand and quality associated with highly graded providers when seeking BDS assistance, select those graded and place higher credibility in their support for those SMEs seeking finance.

KRA 2.2 SME financial literacy enhanced

KRA Strategy:
From the *Development of strategy options for SME financial literacy* study undertaken during Year 1, it became evident that most financial literacy programs are targeted at consumers and little has been developed for SMEs. Furthermore, any programs targeting SME financial literacy are linked to an individual finance provider as a marketing exercise promoting a product or service within their institution, or is focused on developing the internal financial management capacity of an SME.

FSP Definition of Financial Literacy

A financially literate SME owner/manager understands basic financial concepts and knows what the most suitable financing and financial management options are for his/her business at the various growth stages of the business; s/he knows where to obtain the most suitable products and services; and s/he interacts with confidence with the suppliers of these products and services. S/he is familiar with the legal and regulatory framework and his/hers rights and recourse.

FSP's financial literacy intervention will focus purely on the need for information by SMEs to help them access finance (see the text box for the definition adopted for the purpose of this activity) initially providing this information via business advisors. A modular approach to the financial literacy program will be adopted, enabling users to select elements of the program when needed and make the content more accessible and user friendly. The content will be grounded in case studies to ensure optimal learning. The potential therefore exists to develop additional content modules on a repeat basis, in order to deepen the information available to the market as the project continues.

Activities:
KRA 2.2.1: Develop financial literacy program for SMEs: In order to make information available to BSO and FI partners, FSP will develop the content for a financial literacy program for SMEs.

FSP will develop a framework for the content and have it endorsed by several partners wanting to participate in the program. The framework for the program will consist of five sections based on the process SMEs go through when seeking finance:

- Identifying the need for finance;

- Identifying the type of finance that best suits the need;
- Identifying sources of finance;
- Understanding those financiers; and
- How to approach a financier/ complete the application process.

The intention is to develop the content of a series of modules which can be released into the market as a comprehensive program for use by FSP partners. FSP will identify what methods of distribution would be most effective to enhance SME financial literacy and could be monitored for impact and based on BSO and FI preferences for this program, will develop a roadmap for the development of the program, as well as a roadmap for the packaging and delivery of the program

An initial sample of modules will be developed in order to refine the content in consultation with the BSO's and FI's committed to partnering in the program. This initial development of material will also be used as the basis to clarify the process of engaging a materials developer and web developer.

In addition to this, FSP has identified several institutions who may be interested to host a web-based financial literacy program and /or training program. FSP will engage with them to identify which would be a suitable custodian for the program.

KRA 2.2.2: Implement a financial literacy program for SME access to finance: In an informal survey done collaboratively with SAIBL, SME clients indicated that their preference for receiving information is in person through training seminars or from business advisors.

FSP's consultant has identified three possible options for delivering a financial literacy program to the market: via

- A one- or two-day workshop aimed at increasing the knowledge of business advisors: In this scenario, FSP will develop the content, package it into a workshop, and facilitate the training of, for example, IBA and SAIPA members who will use the information to advise their SME clients;
- An information seminar that business service organizations and business advisors can use as a resource to assist their SME clients. With this option, FSP would develop the content, package it into a workshop, and facilitate a training of trainers for the likes of IBA, FABCOS and Khula Direct enabling them to offer this as a program to their SME clients;
- A web-based toolkit or guide, aimed primarily at business advisors, but also accessible to their SME clients. FSP's involvement would be to develop the content, and build a website around the concept of a guide to the world of finance, for use by partners such as the IBA, SAIPA, FABCOS and Khula Direct.

FSP will determine which option is likely to have greatest impact and greatest potential for sustainability and implement this through the partners who commit to delivering the program. FSP's roadmap will guide the piloting of the program in one provincial centre and the roll-out of it in other centers. In addition, FSP will facilitate marketing of the program through BSO's to raise awareness of their members throughout the country, and will consider hosting an event to launch the program and raise SME and stakeholder awareness of its existence.

As interest in the program is already high, FSP anticipates the potential to roll this program out widely across the country, bring on board new partners, and scale up its activities in the coming years. As demand for the program grows, FSP anticipates developing subsequent levels of modules to deepen the knowledge available to the market and its understanding of how – most effectively – to engage with finance providers and access finance.

C. PIR 3: Financial Sector and SME Development Enabling Environment Improved

The best intentions of private sector actors to expand SME opportunities can falter without the development of an enabling environment for SMEs -- one that focuses efforts to help implement legal, regulatory and institutional reforms that will contribute to expanding access to credit for SMEs, especially historically disadvantaged SMEs. During Year 1, the FSP team established excellent working relationships with the Department of Trade and Industry (dti) and the National Credit Regulator (NCR) as well as key stakeholders including the Banking Association, Business Unity South Africa (BUSA), South African Institute of Professional Accountants (SAIPA), South African Institute of Chartered Accountants (SAICA) and a number of policy stakeholder groups.

FSP includes components which directly deal with issues of access to credit, SME bankability and knowledge management. All components interface with a legislative environment which in many cases is not necessarily enabling under current circumstances. Government policy, no matter how well intentioned may have serious unintended consequences constituting obstacles to SME formation, their evolution to formality and ability to grow and flourish. SMEs rarely succeed unless they have access to credit at critical junctures in their growth cycle. Yet reserve provisions, banking laws and regulations, tax laws, excessive red tape, administrative complexities and well intentioned subsidized lending programs, frequently discourage banks from developing SME lending. Such legal and administrative hurdles also push SMEs towards informality and, as such, further from access to credit.

PIR 3 Benchmarks

- SME debt renegotiation/debt restructuring gap report completed
- 2 applied research working papers completed
- Companies Act regulations drafted
- Companies Act regulations published in Gazette
- Fee schedule for Companies Commission drafted and published
- RIA framework completed
- Real estate policy paper presented
- Real Estate and Mortgage Agents and Brokers Bill drafted

In assessing the flaws and gaps in the legal, institutional and regulatory framework, it is easy to be misled by the initial perception that South Africa is a developed economy with an exceptionally comprehensive legal and regulatory framework to govern its sophisticated economy. That belies the reality however – especially for historically disadvantaged SMEs. FSP, jointly with the GSA, will identify and address any flaws and gaps in the legal, institutional and regulatory environment. FSP will prioritize those issues specifically applicable to 1) FIs which undertake SME lending or 2) impact the financial instruments most appropriate to SME lending. FSP also recognizes that SMEs, and especially historically disadvantaged, BEE-eligible entrepreneurs, must have equitable access to markets as well as the financial resources necessary to enter and succeed.

The potential scope of work for this component far exceeds the ability of FSP to respond in one operating year and, as such we have, and will continue to have, detailed discussions with critical partners and stakeholders to identify and set priorities. Key amongst this group is our extensive and productive working relationship with various divisions within the dti and especially CCRD, NCR and National Treasury; their interest and priorities are clearly reflected in this work plan.

Two Key Results Areas (KRAs) support PIR 3:

KRA 3.1 — Financial sector legal and institutional framework improved
KRA 3.2 — Regulatory environment stimulating SME development enhanced

Each of these KRAs detailed below addresses one or more of these issues and related policy areas. In the following pages the overall strategy, key activities, implementation resources/partners, and benchmarks are detailed. Specific tasks and timing are indicated on the timelines that follow the text in Annex A.

KRA 3.1 Financial sector legal and institutional framework improved

KRA Strategy:

FSP's goal is to strengthen the capacity of financial sector stakeholders to conform with internationally-established SME standards and best practices. During Year 1, FSP supported the NCR to provide better and broader information to credit providers and mitigate risks associated with lending to SMEs. It is anticipated that upon the Parliamentary approval for the establishment of the NCRA that FSP will continue to play a major follow up role during the implementation stage most likely to occur during Years 3-5 of FSP , always assuring the Registry enhances SME access to credit. By supporting the activities below, the NCR will continue to evolve and strengthen the NCA to realize the shared objective of maximizing the access to credit for SMEs through the evolving application of the NCA.

Regulatory Development and a Functioning Public-Private Dialogue

FSP is deeply involved in a fundamental reform of the laws and regulations affecting all corporate life in South Africa by undertaking the policy identification and drafting with the dti of the Companies Act Regulations. This transforming policy reform has drawn the interest of the financial sector, the professions, investors, entrepreneurs and academics.

Working closely with the dti team and BUSA, FSP stimulated a detailed dialogue on narrow but complex policy issues as well as a full day, well attended workshop to stimulate a public private dialogue prior to the drafting of the Regulations. The transparent involvement of frequently competing stakeholders before the Regulations were drafted was seen as an important and positive step demonstration the Government's openness and commitment to dialogue resulting in stakeholders making a concrete contribution to resolving many complex issues.

FSP intends to follow this level of transparency and collaboration through its Year 2 activities.

In addition, FSP has identified a number of areas where the various public and private sector stakeholders would benefit from accessing international best practice as it applies to specific issues under consideration. The goal is to provide such applicable best practice information to inform and enrich public-private dialogue on such issues. Every Working Paper will address a specific and narrowly defined topic relevant to the objectives of increasing access to credit for SMEs, especially those historically disadvantaged. In each case, policy alternatives and options will be described. It is anticipated that the re-focused NSBC and other SME stakeholder organizations, will be interested in sponsoring public-private dialogues to convert the FSP working papers into a well considered, widely consulted Policy Papers. Every effort will be made to select timely and pressing policy areas in consultation with the dti, the NSBC and other stakeholders. The objective will be that these Working Papers be produced largely by FSP staff with limited input as required by national and international consultants. Policy Papers produced by this process will, as time and resources permit, lead FSP into cooperative efforts with the public and private stakeholders involved, into thoroughly analyzed and focused legislative programs designed to address specific obstacles in the SME business environment. In each case, FSP will work to take identified obstacles, develop sound policies to address such obstacles and assist stakeholders in the implementation of sound solutions. As the process progresses during Years 3-5 of FSP, stakeholders will assume responsibility for performing the analysis, conducting the public-private dialogues and effectively communicating the new policies to the public.

Activities:

3.1.1: Support the National Credit Regulator (NCR) in making the NCA more user friendly and stimulate Access to Credit for SMEs. FSP has contributed to the design of the National Register of Credit Agreements (NRCA) resulting in the NCR submitting to the dti a detailed proposal for the establishment and operation of the NRCA based on this work. Legislative and regulatory changes will be required and the total proposal, has been presented for Government consideration and, if agreed, for submission to Parliament. The NCR indicates that no additional steps on establishing the NCRA can likely be taken until late 2010 following the dti full review and assessment. Provided Parliament approves the proposal, FSP plans to resume collaboration with the NCR in promoting access to financial services and lowering financing costs for small and medium enterprises through the establishment of NCRA.

Assist the NCR in defining the scope and application of the NCA and its interaction with the provisions of the Companies Act to identify gaps in the application of the debt renegotiation/ debt restructuring provisions under the two Acts. The NCA contains a number of “consumer credit protection” provisions dealing with reckless lending, limitations on interest rates and charges, marketing limitations as well as over-indebtedness and consequent debt renegotiation/ reduction mechanisms. Those provisions however do not apply to SMEs[3]under the NCA. Under the new Companies Act, there are detailed procedures for “Business Rescue and Compromise with Creditors” but these are only applicable to companies registered under the Act. In summary, consumers are protected under the NCA, companies (including *incorporated* juristic persons under the NCA) are protected by the Companies Act but other SMEs including partnerships, associations, trustees or “other body of persons … unincorporated...” have no protection under either piece of legislation. FSP will work with the NCR and dti to review both Acts as well as any other ancillary legislation, define, describe and propose policy alternatives for the extension of such protection to SMEs; creating clarity for the benefit of debtors and creditors.

Follow up support to the NCR Business Process Review. FSP successfully completed a detailed, two stage, Business Process Re-Engineering for NCR. As a follow up, NCR will undertake a supplementary, comprehensive review of its business processes leading to a new Information and Communications Technology (ICT) strategy. The NCR has requested additional, limited assistance from FSP to assure that this ICT strategy is conceived and developed in a manner consistent with the Business Process Re-Engineering undertaken by the FSP team.

[3] Defined under the NCA as “juristic persons”, including partnerships, associations, trustees or “other body of persons, corporate or unincorporated...”.

With NCR conduct an internal review of the NCA in preparation for the five year review mandated in the NCA by Parliament. The NCA was enacted in 2005 and came into effect progressively in 2006 and 2007 and as such is approaching the mandated five year review period. Experience with the implementation of the NCA has disclosed a need to ensure inclusion of SME –specific provisions. Specific attention will need to be paid to assure that SMEs are recognized as an important and clearly defined category of borrowers. Additionally, the NCA must clearly differentiate loans made for the purpose of generating income from loans made to consumers for household consumption. Reporting standards, the NCRA and other provisions of the NCA will be reviewed to assure that SME access to credit is enhanced in accordance with Government policy in this regard.

3.1.2: Applied research on reforms required to enhance SME business environment. To open the way to policy dialogue and reform and stimulate increased participation of SME organizations in policy formation, FSP will produce brief Working Papers that analyze the current SME policy environment. Such Working Papers will document applicable international best practice for consideration by South African stakeholders and opinion leaders. The applied (as distinct from academic) research agenda will be developed in consultation with the dti, NCR, the NSBC, BA and other stakeholders. An initial research outline will be developed for each selected topic, clearly establishing linkages to increasing SME finance and the proposed scope of the Working Paper.

Potential Applied Research Topics

- The Companies Act and Regulations and their impact on the SME sector
- Factoring for SMEs
- BEE Codes preferential treatment of loans over guarantees as an obstacle to increased SME access to credit
- Economic risk management strategies to minimize the impact on the SME sector of macro shocks
- Debt renegotiation and liquidation for SMEs under the SA legislation
- Competition policy, abuse of dominance and the level playing field – no SME credit without markets
- “Doing Business” as a tool for enhancing SME access to FDI.
- Corporate governance for SMEs
- SME policy to promote non-traditional exports and technology
- South Africa’s preferential procurement policy and benefits to SMEs

For each topic, appropriate South African stakeholders and an institutional champion to lead public private dialogs on specific issues will be incorporated. Both the dti and NCR have identified areas for potential cooperation and priority attention will be paid to areas of research identified by these agencies with the capacity to influence policy formation and implementation. As an integral part of the NCR the FSP applied research program will identify several areas where the NCR can champion policy development and implementation either alone or in association with other stakeholders. Areas identified include the Real Estate and Mortgage Brokers & Agents law, Economic risk management strategies to minimize the impact on the SME sector of macro shocks and Competition policy, abuse of dominance and the level playing field – no SME credit without markets.

The Working Papers are expected to form the basis for identifying required legislative, administrative or policy initiatives to improve the SME business environment and access to credit. In each case, the Working Paper will be subjected to peer review and will be jointly evaluated with the policy champion and form the basis for public private dialog events. FSP will assist the champion to finalize a Policy Paper with concrete recommendations. Through web portals, publication, outreach, the work will be widely disseminated and designed to stimulate greater SME participation in policy formation. In each case FSP will follow up on such policy initiatives to determine a potential FSP role in policy design and implementation. Other possible topics for such analysis are listed in the text box to the right.

KRA 3.2 Regulatory environment stimulating SME development enhanced

KRA Strategy: Financing SMEs presents specific challenges, not limited to traditional issues such as the higher SME failure rate than larger firms, relatively less transparency and inadequate financial information. Government policy, laws and regulations frequently do not adequately distinguish between large and small firms and, in failing to do so, such well intentioned policies frequently discourage financial institutions from developing SME lending. Frequently such issues are flagged and identified through the implementation of other FSP components. FSP has identified a number of activities which are expected to have a major and long lasting impact on the corporate sector with specific attention and emphasis to the needs of SMEs and their access to markets and credit. The work undertaken by FSP in the design and drafting of Regulations under the new Companies Act widely exceeds the scope of actions narrowly focused on the SME, access to finance objective. It is difficult to overestimate the scope, complexity and impact of the Companies Act and Regulations on all aspects of economic life but, by FSP taking on this major role an opportunity has been created to enhance awareness within the dti, Treasury, the professions and other key stakeholders about the importance of including the SME agenda in all aspects of policy making and reform and, as such will have a lasting effect on SME policy and access to credit.

Activities:
3.2.1: Draft regulations for the Companies Act. The FSP team is currently heavily involved in assisting dti in preparing the Regulations under the new Companies Act. A time table established by dti calls for the Companies Act and Regulations to come into effect in June/July 2010 and continuing assistance is planned throughout this period. Interviews with key stakeholders of the public and private sectors drive the development of the regulations which have been presented in a workshop. Before the final text will be sent to the Parliamentary Portfolio Committee for review and subsequent Ministerial approval, a full public comment with further extensive public-private dialogue will take place. The new Companies Act requires detailed regulation of all aspects of corporate organization and management. Its broad scope also includes fundamental reforms in such areas as governance and transparency; shareholder rights and obligations; financial reporting standards, emission and trading in stocks; mergers and acquisitions, business rescue and restructuring (similar to "Chapter 11" in the US) as well as all aspects of the administration, remedies and enforcement under the Companies Act and Regulations, including the establishment of a new Takeover Regulations Panel and a Companies Tribunal. The Act and Regulations will also eliminate the traditional vehicle for SME incorporation – the "Closed Corporation" and FSP has been key in assuring that the new Companies Act and Regulations are fully "scalable" and designed and implemented in such a manner as to minimize the cost and administrative burden implicit in incorporating and maintaining a corporation for SMEs. By making it possible to transition from informality to incorporation in a simple and inexpensive manner, and by creating a scaled framework for compliance with ever stricter standards of financial reporting and corporate governance as the company grows, incorporated SMEs will become platforms for economic growth and will progressively enhance their access to credit.

3.2.2: Develop proposed fee structure for the new Companies and Intellectual Property Commission. FSP has worked closely with CCRD in the dti on the design and "business case" for the establishment of the Companies Act and Intellectual Property Commission (Commission). The creation of the Commission will have a major impact on the business environment and specifically encourage "entrepreneurship and enterprise efficiency, creating flexibility and simplicity in the formation and maintenance of companies and streamlining the registration process". An integral part of this process, not previously addressed, is to create a fee structure designed to minimize costs of incorporating and annual filings for companies, while, at the same time, creating an adequate cash flow to cover the costs to Government of the Commission, including the implementation of it advisory and education functions. FSP will together with the dti develop the fee structure which will need to be approved by Treasury. It will be incorporated into the Draft Companies Act Regulations and Published in the Gazette for public comment. Following the public comment period, amendments may be necessary and assistance will be provided by FSP to develop the final Fee Structure for Ministerial approval and publication.

3.2.3 Support to the Government of South Africa Regulatory Impact Assessment (RIA) program. National Treasury has requested FSP technical assistance to help with capacity building in its Regulatory Impact Assessment (RIA) Program since there is currently limited availability of skilled people to conduct the types of valuations and analysis required for RIA in South Africa.

The RIA tool is used to assess the likely consequences of proposed regulations and the actual consequences of existing regulations in order to assist those engaged in planning, approving, and implementing improvements in the regulatory system. FSP jointly with Treasury is currently completing the RIA implementation plan. Together with Treasury and the dti a regulatory impact assessment of the new Companies Act and Regulations as well as their proposed implementation by the newly created Companies and Intellectual Property Commission (Companies Commission) will be undertaken. Treasury specifically focused this review on both the positive and potentially negative impact of the Act and Regulations on the SME sector. FSP will support the Treasury/dti team in conducting the RIA. In order to assure sustainability an RIA web portal will be developed by Treasury and RIA knowledge management tools made available to future RIA teams. FSP will also assist Treasury in developing practice guidelines for the Implementation of RIAs in South Africa.

3.2.4 Draft Real Estate and Mortgage Agents and Brokers Bill.
The dti has requested that FSP support the Real Estate and Mortgage Agent and Brokers reform. Currently, the estate agents are regulated by an inadequate 30-year old Act and the so called "bond originators" are entirely unregulated. Building on the USAID funded work undertaken by the International Real Property Foundation (IRPF) in close affiliation with the US National Association of Realtors (NAR) in combating the large discrepancies in opportunities between the traditional and newly emerging historically disadvantaged real estate community, FSP proposes staged and limited assistance to develop appropriate policies and draft a Bill for parliamentary consideration in close cooperation with CCRD/dti and relevant stakeholders. The broad objective of this initiative is to protect the public against unethical practices of brokers and agents and encourage broader historically disadvantaged participation and equity in this industry.

While FSP promotes SME cash flow-based lending and alternatives to collateral wherever possible, financial intermediaries still rely on collateral-based security- most often property. If no other source of finance becomes available, SME owners can enhance their credit worthiness through property ownership and use their personal property as collateral for credit. The NCR has pointed out the important role real estate security plays in providing of credit to SMEs and the need for reform in South Africa. In addition, with the stabilization of the real estate market, there is significant potential for the greater participation of SME's in this growing service industry. The market for real estate services, according to industry statistics, now includes a greater than fifty percent demand from historically disadvantaged persons yet less than three percent of the professionals serving this industry fall in this category. The downturn in the real estate market has quickly reduced the number of agents and brokers (from 88,000 in 2005 to 22,000 this year). Discussions with the Banking Association have indicated that its members have specifically indentified those SMEs engaged in the real estate sector as potential clients for credit.

D. PIR 4: SME Finance Knowledge Management System Strengthened

Both the supply and demand side of finance – FIs and SMEs – operate with a dearth of information on the possibilities SME finance can provide for increased profits and expanded markets. The FSP knowledge management component seeks to strengthen SME finance related knowledge management, share innovative financing options and opportunities; disseminate successful approaches for SME development in collaboration with the private sector and donor and government programs.

Currently, much of the literature and work undertaken on accessing financial services tends to focus on consumers and in most cases blurs the distinction between an SME and a consumer. FIs often lack the adequate risk analysis tools to feel comfortable extending credit under different terms and conditions. At the same time, SMEs face credit officers whose lending guidelines are designed for large companies or individual consumers and not appropriate to the needs of an SME. These enterprises consistently encounter numerous constraints including onerous collateral and compliance requirements, limited management capacity, and difficulties in accessing much-needed information about different SME financing mechanisms available in the market or changes in policies that may affect their operations. SMEs also need basic information on SME-friendly suppliers of financial services. They need tools to evaluate the cost and potential benefit of the financial and/or business related services provided. Therefore, lack of awareness by entrepreneurs of available financial business development support further aggravates the capacity problem and accentuates their lack of credit-worthiness.

PIR 4 Benchmarks

- SME finance knowledge management forum piloted
- Knowledge management system launched

To this end, FSP will work with multiple stakeholders to capture, codify and share valuable knowledge but also facilitate knowledge creation. A recent study by FSP revealed that a large number of financial sector stakeholders produce valuable knowledge products, but such activities lack integration or widespread dissemination. In addition to the innovations and improvements launched by FSP and its partner FIs, the project will build on existing databases and access portals. FSP will support the collection, collation of and facilitate dissemination of tools and approaches to SME finance and financial BDS, lessons learned within South Africa and elsewhere, and success stories that can be replicated. The outcome of this component will be an accessible repository of SME finance knowledge – about what works, what does not work and how policies and practices can be improved to expand opportunities in South Africa.

Two Key Results Areas support PIR 4:
KRA 4.1: Public-private stakeholder collaboration in SME knowledge management expanded
KRA 4:2: Improved awareness of SME finance best practices

Each of these KRAs is detailed in the following pages in terms of overall strategy, key activities, implementation resources/partners, interim benchmarks as well as link to program objectives. Specific tasks and timing are indicated on the timelines that follow the text in Annex A.

KRA 4.1 Public/private stakeholder collaboration in SME knowledge management expanded

KRA Strategy:
To expand public/private stakeholder collaboration, FSP with its partners will identify contributors to and users of a knowledge management database for sharing information on SME finance best practice developed globally and locally. Additionally, FSP will facilitate the establishments of a public platform for presentation, information dissemination, and interactive learning, thereby deepening information sharing and learning practices about financial services available to SMEs and continually tapping into new partners and sources of information for dissemination.

Activities:
4.1.1 Facilitate SME financing dialogue: With the SME working committee of the BA and other collaborating partners, FSP will identify stakeholders to sponsor and/or establish cyber linkages with other institutions in the SME financing market. FSP research findings indicate that implementation of technological tools to facilitate knowledge sharing has been a hurdle to the establishment of a broad SME dialogue forum. Currently, many financial intermediaries have developed sophisticated knowledge management systems, which face severe challenges ranging from their inappropriateness for understanding the HD SME market are out of date. Therefore, through the SME working committee, FSP will identify appropriate contributors to and users of SME finance knowledge sharing and dissemination techniques suitable to the South Africa context. Collaborating partners will develop content and new formats for dissemination of SME finance and financial literacy information. Dissemination includes pushing knowledge to its users and users pulling the knowledge they need -- resulting in both increased awareness of SME finance, successful practices as well as adoption by other stakeholders.

KRA 4.2 Improve awareness of SME finance best practices

KRA Strategy:
In order to improve awareness of SME finance best practices, FSP will engage partners/stakeholders including donors, networks, national and global players; examine partner governance structures, management processes, historical evolution of institutions; and foster linkages within and across organizations. A collaborative framework will enable identified partners to share industry best practice information, and lessons learned.

Activities:
4.2.1 Facilitate access to SME financing information: Research has revealed that a large number of financial sector stakeholders generate knowledge about SME financing mechanisms, but that such knowledge is not integrated into a publicly accessible knowledge-sharing repository. Ongoing discussions with the Banking Association of South Africa (BA) have confirmed the need for institutionalization of information on SME lending best practices to increase access via a knowledge management system which publically displays an array of SME lending concept options available for FIs to adapt. Empowered with the appropriate information on SME financing, BSOs and financial BDSPs have higher probability to assist SMEs successfully apply for the correct and relevant services and products while FIs will have the latest information on SME capacity building efforts as well as various peer-reviewed products to choose from to finance SMEs.

FSP will provide assistance in adapting and modernizing an existing website to include key information, list serves and hyperlinks creating conduits to innovative local and international best practices, technical briefs and user-friendly sector diagnostics. FSP will consult with the USAID FS Share project to ensure a link with their findings, knowledge management tools, list serves and other SME finance resources.