The Frontier Strom – The rural Finance Story
By Chris Höck

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Introduction

This is the story of Rural Finance, the developmental micro-lender that I founded in 1991 and led for ten years. Rural Finance worked on the frontier of finance in South Africa. Started as an NGO during apartheid, it grew into a significant finance company in the early years of democracy. In addition to disbursing 30,000 loans worth over R200m (US$20m) during its life, Rural Finance played a role in shaping the family of development finance institutions established by the first democratic government led by Nelson Mandela. The company was liquidated in 2001.

I wrote the Rural Finance story in order to try to extract the lessons from our experience, so that they can be put to good use. It takes a lot of passion, skill, leadership, financial resources and luck to build a socially useful financial institution that prospers and grows fast. This is the story of how these elements came together for a while on our part of the frontier. The best place to start is 1998, four years into South Africa's fledging democracy. A micro-credit boom (which started the same time as democracy, 1994) was surging towards its peak while SMME finance was as scarce as ever. Commercial micro-lenders had probably already overtaken donor-funded developmental micro-lenders, despite the work of two major new players, the National Housing Finance Corporation (NHFC) and Khula Enterprise Finance. Rural Finance Facility (RFF), was seven years old and one of SA's leading micro-enterprise and low-income housing financiers. It was unique in its combination of a strong development mission and professional financial management.

The Development Finance Landscape

Development finance enjoyed high priority with the first democratic South African government. Two new development finance institutions were established to join old titans of the Land Bank, the Industrial Development Corporation and the newer titan, the Development Bank of SA. The National Housing Finance Corporation (NHFC) is still a key part of housing policy. Its mandate is to fund and support specialist retail intermediaries (such as Rural Finance), and to demonstrate to the commercial banks that the real risk in the low-income housing market is not unrealistically high. Incorporated as a company with a single shareholder (the Department of Housing), it is well capitalized (R1.4b, US$ 144m), enjoys significant concessions (exemption from many banking regulations) and does not need to earn a return on equity (it's primarily concerned with impact and capital preservation). Similarly, Khula Enterprise Finance Ltd. was set up by the department of Trade and Industry. With a similar mission to NHFC, but less than a quarter of NHFC's capital, Khula has struggled with numerous problems, not least the ability to attract good staff. Nevertheless it is endowed with considerable resources and has dominated its market, not least because of its virtual monopoly on start-up funding for developmental micro-finance.

Structure & Governance

Rural Finance's grew from the conviction that formal financial services could make a significant difference for the majority of South African's, particularly the rural poor. We were convinced that with innovation and discipline, financial services could be provided which were both socially positive and sustainable (profitable). Rural Finance was made up of two closely linked companies, Rural Finance Facility (RFF) and, growing out of it, Rural Housing Finance (RHF). RFF was established as a non-profit company in 1991. By 1998 its total client base was over 10,000 and it operated nationally with a total staff of over 100 people. RFF provided rural women with micro-enterprise loans, mainly for informal retail trade. RFF loans were group based, stepped, unsecured working capital loans. RHF started as the housing finance division of RHF and grew into a separate, wholly owned subsidiary. It was registered as a for-profit company in order to be able to attract equity investors. RFF's highest decision making body was the board of directors. The CEO reported to the board that met six to eight times per year. Only in the last year did other senior staff also attend board meetings. RHF's board included one staff member and there was considerable overlap with the RFF board.

The founding RFF board members were invited by the CEO, chosen for their ability to make a contribution and their interest in the RFF mission. Over the years board members recommended new directors to expand the board and to replace those who resigned (after a three-year term). There was no formal selection process. Board members included Bernard Agier (former CEO of French Bank SA), Sue Lund (Land Affairs official), Mrs. Zanele Mbeki, Caesar Molebatsi (head of YMCA in South Africa), Shirley Moulder (SA Council of Churches) and Prof. Richard Tomlinson. The first and longest serving chairman was Anthony Asher (Professor of actuarial studies at Wits, advisor to government and labour movement, chairman of the first trade union owned investment fund).

Most of this diverse group had corporate governance experience and thus no formal board training or orientation was undertaken. The board's role was not formally/explicitly stated, it was informally assumed to be to strategic decision making. We often said their job was to guard the mission of RFF and to employ the CEO. In-evitably the line between operational and strategic decisions was crossed, although not always negative for RFF. With hindsight there was not enough emphasis on formal strategic planning (only one strategic planning session for the board was held, during the penultimate year of RFF's existence). Board members gave generously of their time, expertise and their contacts. They were not active in fund raising or public relations. One director spent a few weeks helping to sort out our company secretarial matters (legal compliance). RFF had no wealthy philanthropists as directors and no directors ever contributed their own funds. Attendance was fairly good at board meetings, although the meetings were often cut short by the time constraints of one or two members. The board did not have a formal performance measurement process until its role was almost over. The board did not visit RFF branches or met clients.

Products

RFF and RHF were narrowly focussed. Both relied on only one loan product. RFF provided a Grameen style group loan for rural enterprise, RHF provided an incremental building loan for lower-income formally employed workers (mostly urban factory workers). Loans were secured by provident fund (retirement savings) and were repaid by way of payroll deduction. We strove to provide low-income clients the kind of personal and professional service that middle income people have given up expecting from a bank. This entailed lots of borrower education, personal calls at all hours and endless handholding of clients, many of whom had never had a loan before. One female loan officer used to ask clients to blindfold her before she would walk through a change-room full of showering men to the office used to write up loans. One client whom we helped sort out an estate claim, showed us a letter in which a bank had rejected his provident fund as collateral (his provident fund was bigger than the bank that had rejected it!) Our service dedication enabled us to build trust and loyalty that, we hoped, would be an investment that could be re-couped over years. It also kept us unprofitable for too long. Most of our clients did return for repeat loans. The special relationship we created and the fact that we took on smaller loan sizes and smaller employers enabled RHF to compete successfully with banks. We competed purely on service, as we could never match the banks on price. Our cost structure was higher due to a smaller client base and our more expensive working capital. I used to think we were pioneering and uniquely pro-poor.
Now I believe we were also in-efficient.

Not only were our loan delivered in an unusual way, they also had a significant impact on our clients lives. Most clients built additional rooms, improved kitchens and bathrooms, or security. One client thanked us because his loan allowed him to get some sleep. He built an inside toilet so that is wife would no longer wake him up in the middle of the night to accompany her to the outdoor toilet. One January a decidedly downcast man entered our offices looking for a building loan. His wife had berated him over Christmas because unlike his neighbour (who had a RHF loan), he was not building. I am very interested in the interaction between business and society, between the private and public sector. When I had started RFF the mainstream financial services sector was not interested in providing financial services to our target market. I set up RFF as a business-like development finance NGO. Gradually it transformed into a socially positive low-income housing and micro-enterprise financier. As the company weakened and died I was afraid that this meant there was no middle ground, no synergy in the convergence of development and business.

Culture

We started as a tiny band of idealists without capital, a brand, a big brother or a distribution network. We had passion, skills and commitment. We were convinced that poor people deserved better financial services than they were getting and that that it was possible to provide these on a sustainable (i.e. profitable) basis on large scale. We were inspired by the opportunity for national reconstruction and development, and for the personal growth which our staff and clients were able to access. Rural Finance was always about more than just making loans. From inception in 1991, I assembled an unusual team of ex-activists, trade unionists and bankers. We worked hard to create a new culture based on fundamental respect for everyone. While common to the NGO movement, this was a radical break from the hierarchical management style typical of South African business. Similarly we adopted financial professionalism which, while common in the business world, was very unusual in the NGO community. Racism was, and still is, unavoidable in South Africa. In our struggle to liberate ourselves from it we found that respect was the key. It became the touchstone for our culture. Everyone was required to treat and be treated with respect. This was important for managers of all colours who often adopted the traditional SA management style (harsh authoritarianism). It was also an important guide when staff sought to play the old games of South African organizational life. One new staff member who tried to do this was shocked to discover that he couldn’t rely on racial solidarity to cover up his theft of company property. Our black managers rounded on him as forcefully as the white ones did. RFF and RHF was 80 % black and 50% female. This ratio was fairly consistent at all levels of the organization except senior management (20% black and 60% female).

The other key value was teamwork. All staff had a say in decisions but the team leader had the last word (and took responsibility for the result). This participative approach appealed to me, not least because it is also the old African way. We applied this rule throughout the organization, sometimes exasperating new staff who came from more commercial backgrounds. We also overdid it. The high tide mark was probably when I tried to get our sales staff to set their own salaries. I was attempting to fast-forward the painfully slow, incremental approach of Richardo Semler. In his book “Maverick” he explains how hard it is to build a participative decision making culture. One of his innovations was to give all staff feedback to enable them to see the financial impact of their decisions. I had called a sales team meeting and carefully set out the link between output and earnings. Most of the team could not handle it. They opted out by choosing the have-my-cakeand-eat-it approach. They wanted the top performance salaries, not linked to performance.

I was very proud of how RFF and RHF developed people. I loved spotting unlikely people with potential and watching them blossom. A tea lady who joined us as a data capture clerk and worked her way up the organization until she was one of our best loan officers, calmly and superbly handling one of our biggest portfolios and training new staff at the same time. We had waiters who became financial service's professionals, shop stewards and union organizers who applied their negotiating skill to new ends. At one stage the office cleaner job had the best promotion opportunities in the whole organization, clearly this was overdoing it. By promoting too quickly we often put the promoted person and his/her managers under unnecessary pressure. This took its toll on the management team. We also underestimated the social pressures that come with rapid promotion. This was especially true for women whose (often unemployed) partners were often very threatened by their success. On one occasion I had to mediate between our best system administrator and her husband, furiously maintaining that her long hours were concealing an affair with a colleague. Another time our general office assistant was 'persuaded' to steal fax toner by her ex-partner who then passed it to the police and tried to get her dismissed for theft. When the police arrived she showed us where he had stabbed her previously. My biggest mistake in over-promoting is described in more detail later. Giving real responsibility to staff worked well for us with respect to clients, almost all of whom were black. However, it was often not accepted by their conservative employers, almost exclusively white. I like to think we got the message through to employers. Perhaps the best illustration of this was when one employer said “Ja, Rural Finance is a black company – but I trust them!” RFF grew out of the NGO movement and carried within it many of the blindspot’s of that movement and the time. Our T-shirt slogan “democratic credit” summed up the chasm we sought to bridge. *Democratic* for the bright hope of the new South Africa, freedom, equality, respect, equal access to resources. *Credit* for the traditional discipline of finance, careful, and skillful use of money for productive purposes. We applied the “commercial” values that most NGOs rejected at the time (and quietly embraced a few years later).

I steered this middle road mostly by intuition until I chanced on a great book, ”What a way to run a railroad” by Comedia, a radical British writers collective. It is a brutally honest comparison of business thinking (they used “In search of Excellence”) with a socialist view. It opened my eyes to the absurd and sometimes hilarious peculiarities of the milieu in which I found myself. A key lesson stuck: democratic management’s lack of formal hierarchy leads to informal hierarchy, which is un-accountable and therefore does not learn easily from its mistakes. Many visitors (from customers to auditors) commented on the unusual atmosphere that pervaded RFF. We had enthusiasm, energy, lots of laughter, easy informality, a can-do atmosphere and none of the baggage that retards so much social interaction in the South African workplace. New staff learned quickly, but none so fast as my PA who, on her first day heard another new staff member use an officious tone with a third person, and gently said she didn’t think that that was how things where done at RFF. On occasion this spirit rose to special heights. We sang at most office parties (and we had many - I am convinced of the value of celebrating milestones). We would sing old favorites, mostly in Zulu and Xhosa. When the mood took us, we danced in the slow graceful style that President Mandela was by then making world famous. On one occasion a hardened ex-activist who had sat through hours of singing was finally moved to get up and dance.

Equity Stakes

Spring 1998 - One of SA’s most successful investors and financial entrepreneurs beamed at me across a gleaming boardroom table around which were seated a group of young finance stars. We had met twice before and this was to be the final meeting to agree terms to purchase a controlling share of RHF. I felt like a lamb-to-the-slaughter. With hindsight I think it was mostly nerves and naivete. The deal was discussed at lighting speed. The deal-maker proposed acquiring 67.5% in return for an injection of R50m in near-equity into RHF and an option to buy a further 10% for R2m, RFF’s chairman’s company (Letsema) would to get a chance to earn a stake (of up to 7.5%) for providing project management advice on our information technology development project. This would provide RHF with the capital and systems to grow to strong profitability. I understood the investors to be driven primarily by return of equity. However, I was never clear about their interest in low-income housing. A blur of coffee soaked meetings followed at all hours. Although I enjoyed some of this frenetic activity and the steep learning curve, it was also intensely stressful. I tried to represent four parties, RHF's owner (RFF, who needed to realize a good price), RHF itself (needing capital to grow), my key team (who were not directly involved in the negotiations and were very nervous) and myself. At one stage two directors advised me to forget about my key team, as my insistence on a fair deal for them was threatening the deal. I ignored them. One another occasion one of my managers informed me that he was quitting. He could not accept the "insult" of his potential equity stake. I gave him my word that he would get a fair deal, he asked for this in writing and I said take my word for it - or leave. He stayed.

The sudden realization that RHF was potentially very valuable was very gratifying for those who had worked hard to build it up. However, it also had negative effects, especially on the key management team and the board of directors. It became extremely hard to maintain the detachment of a director while trying to negotiate with a very skilled and highly successful equity investor. I produced spreadsheets showing the potential value of the stakeholder's interests. With hindsight they are comical reminders of the overheated climate in which they were drafted. Board attendance improved sharply as the chance of owning a valuable equity stake increased. Everybody's motives came under implicit (if not explicit) scrutiny. We all had to question our reason for doing this work in the first place. My view, endorsed (and enhanced by the then chairman, Isaac Shongwe), was that we should make a strong social impact and build a good business (wellmanaged, service standard setter with strong, profitable growth). Finally the roller coaster was called to a halt by our advisors (PriceWaterhouseCoopers). In a poorly attended meeting (board burnout had set in by this stage) they said that while the offer may be the right deal for RHF, it was not for RFF (the owner of RHF). Other potential investors followed (African Harvest, Capital Alliance, FutureGrowth, Vantaris, Merit Asset Managers and Business Partners). We began to dread the words due diligence. Only one other offer was made, just before the final curtain.

NON - OPERATIONAL

I should have read the signs during the Rolling Mass Action Tour. Our 1998 annual end of year party was a memorable event, a 3 day bus trip through our Mpumalanga branches. I delegated the organization to the RFF’s ops manager, and the result was not untypical of the outcome of his other managerial activities. Our first day was filled with activities, but poorly planned so we ended up exhausted, dangerously late and irrevocably committed to a dirt track which had never before had a large bus on its narrow confines. Our singing dropped to a murmur, we were willing the bus to make it through, and it almost did. 500 meters from the lodge we crunched to a halt against a rock. The rest of the evening continued in similar fashion. A day later the bus driver finally cracked a smile when I reminded him of how we had literally sung the bus through the obstacles of the night.

Unfortunately we couldn’t sing our way out of all our trouble. Early in 1999 it was clear to me that our operations manager was out of his depth. His optimistic expansion of the RFF loan book was floundering on weak oversight of branch managers. Repayment rates began to drop (on-time repayment dropped from 90% to below 40%). We moved fast to implement a comprehensive turnaround strategy with the help of external advisors, Calmeadow and Ntinga MSP (a World Education funded micro-finance support organization). The key elements of the plan were a review of all operational systems, improvement and formal drafting of ops procedures, retraining field staff and signing performance contracts. The ops manager also underwent a performance management process including (in August 1999) attendance at the respected Operations Manager course at the Economics Institute in Colorado. He returned saying “I am surprised that I still have this job”. He did not have it for much longer.

In Jan 2000, we changed our arrears reporting format from commercial aging to the micro-finance convention. The new report was clearly explained to Khula who did not comment on our letter.
Finding a new operations manager started early in 2000 and took nine months. By June Yvonne Radinku of the Get Ahead Foundation had agreed to join us but it was October before she was only able to join us. She brought a wealth of appropriate experience, quiet confidence and calm energy. Her first move was to freeze loan disbursement for all loan officers whose portfolios were below 80% on-time repayment. This freeze exposed some loan officer fraud:‘rolling” loans (new loans "disbursed" to keep bad loan's repayments going) and ghost clients. The on-time repayment rate dropped significantly. Then she changed that arrears report format –excluding loans with installments overdue more than 120 days. I now believe that this was the start of our trouble with Khula. Their subsequent actions can only be explained in the light of their (erroneously) linking of the changed format to the falling repayment rates (due to the disbursement freeze). Such errors can happen. However, in the light of our long relationship it is much more difficult to understand why they made no effort to check this assumption. No phone call, no letter, no urgent audit or inspection (to which they were legally entitled). It seems as if they judged us guilty without bothering to make an allegation or hear us out. They allowed this impression to grow in their minds and in the minds of their board, and to inform all their subsequent decisions about RFF.

Proposed Merger with GAFS In the last quarter of 2000, we had heard that Khula was finally closing the long ailing Get Ahead Financial Services (GAFS), the micro-finance part of Get Ahead Foundation. At a chance meeting with the Khula CEO at the Wits Business School I suggested to that RFF may be able to assist Khula in the collection of the GAFS loan book. He welcomed the idea and asked for a written proposal.

RFF and GAFS looked like a good fit. RFF had strong financial systems and was struggling with operational management. GAFS was the opposite (good field staff, weak head office). In Yvonne we had a strong leader who was by then familiar with both organizations. She was appointed CEO of RFF (I stepped down to focus on RHF). Together with our Calmeadow advisors (who also knew GAFS very well), we drafted a merger proposal for Khula, ensuring continued service to ex-GAFS clients, providing cost savings to Khula and enabling us to take on most ex-GAFS staff. We presented the proposal to Khula in early December 2000. I pointed out that although RFF was in the midst of a turn-around strategy we believed that there was a solid rational for the merger. A distinctly hostile Khula manager said they wanted the GAFS book collected at minimal cost and they did not want to fund the proposed merger. A month later we were informed that the process was to go to tender and later, that our proposal has been rejected (no reasons were given).

The merger off, we concentrated on our turn-around strategy. All field staff was retrained and signed performance contracts. We developed a standard operational procedure manual, dismissed the ops manger and secured a Ford Foundation grant of US$ 150,000 (R1.3m). All the while we waited for an indication from Khula on our funding application for $312,500 (R2,5m) to complete our funding for the year. No word came, calls and letters remained unanswered. While waiting for a response from Khula we received two adverse decisions from Triodos Bank (Netherlands) who had made a small loan to us in association with HIVOS, one of our oldest and best funders. Triodos informed us that they had turned down our application for further loan, and that they had decided to recall their existing loan to us with immediate effect due to our failure to meet all the performance targets in the loan agreement. We were not impressed with the way in which the decision was communicated but we could understand it. Anyway the impact (we thought) would be small. The loan was not significant (it amounted to less than 3 months of normal disbursements), we had the cash on hand to repay and we had sufficient loanable funds capacity in our Khula credit line. After we had repaid Triodos we discovered that Khula would not re-finance this portion of our loan book, even though they had originally agreed to fund the whole book (and the Triodos loan was a bonus which we had added later)

After many frustrating delays we finally got a meeting with Khula's decisionmakers. My chairman and I finally sat down in the Khula boardroom in March 2000. An unusually large number of Khula staff took their seats around the board table. The Khula CEO opened the meeting with the following words directed at me, “Before we start I just want to say that I am very disappointed in you”. He went on to say (in a roundabout way) that he believed RFF had deliberately distorted arrears reports to make things look better than they were. I was astonished and angry at the message and the way in which it was delivered. I made my views very clear. RFF had always maintained the highest level of financial reporting. I gave them a clear picture of the strengths of RFF (owning a significant asset in RHF, with good prospects and a share option in Johnnic - a listed media company, acquired by RFF through an empowerment structure set up to benefit service NGOs of good standing, at the time this option was worth about R1.5m). The Khula people sat stonily through this, making no comment. Afterwards my chairman upbraided me for my heated response. This set the tone for the end game – me always on the edge of explosion at the outrageous manner in which RFF was being treated, but held back by the advice of other, cooler heads. We will never know who was right.

UNRAVELING

Acquiesce – a harmless little word, but as it came from the lips of the lawyer sitting on the hills above southern Pretoria, I felt my knees weaken. By agreeing to all Khula's un-contractual actions RFF had acquiesced and now had no basis for complaining. All the last months of co-operation were flung back in my face. We had just heard that Khula insisted on the repayment of their start-up loan, effectively bankrupting RFF and, ultimately knocking over RHF too. During the previous months we had bent over backwards to help Khula ensure a smooth hand-over of the RFF loan book to Marang Financial Services, the new entity created by Khula out of a merger of GAFS and RFF. We had handed over our loan book, clients, offices and equipment and most field staff. We had made our debtor system available so that data could continue to be to updated. We even spent a precious R100,000 to prepare the debtor system for physical removal to Marang's offices. All this was done in the understanding that clients come first and that this would earn us some leeway with Khula. But Khula was adamant, RFF had not achieved performance targets and the seed loan (R2.1m) was not converted into a grant. In the end Khula implemented all our proposals, but at the cost of RHF. The new merged entity, Marang, contained the best of RFF and GAFS and quickly made progress towards the targets that had been set for RFF.

In their defense Khula had had a very bad year. Over and above the constant stream of negative press, mainly w.r.t. poor performance, and attacks from the entitlement sector (demanding soft loans because they were available under apartheid) came the shocking news that it had suffered massive losses due to fraud and mismanagement. Their financials showed a R28,5m bad debt plus further provisions of R17m (a total of US$9m). In public Khula's political boss, the Minister of Trade and Industries was supportive. In private it must have been tough. A senior staff member had had a breakdown, another suffered from a long stress-related illness.

Relationship w Board

The first real rift between the board and me started with arguments over restraints of trade, required of all key staff by our first NHFC contract and finally paid out over a year late after a bruising battle. The annual bonus discussion and the salary reviews were also difficult. The board constantly threw back at me that I hadn't put a performance bonus scheme in place and therefore must not complain when I was not paid. I had often proposed schemes that were rejected or not discussed.

CONTAIGION

During the financial year ended March 2000 RHF had embarked on an ambitious information system development program. The project entailed developing a new integrated information system to lower costs, strengthen systems and enable us to handle rapid growth. The system was almost completed but was never implemented.

In December 1999 we had indicated to NHFC that we needed to increase loanable funds (NHFC credit line) by the latest in March 2000. The NHFC had indicated that one option to achieve this was by securitizing our loan book via their subsidiary called Gateway. Gateway was keen to help but said they could only assist us by June because they were busy with a large deal with a major bank. In the meanwhile NHFC encouraged us to apply for a revolving facility of R120m to allow for expansion and to replace all previous facilities. During April 2000, we discovered a major fraud. For about 3 weeks three colluding staff members stole almost R500, 000 in cheques. We stopped the fraud quickly (our auditors commended us for picking it up so fast), but went through six months of hell, not knowing who we could trust. After weeks of investigating (at our own expense, the crime was too small for the police) we identified the culprits and recovered 80% of the stolen funds. The culprits got off scot-free because the insurers didn't think it was worth following them up. This was very frustrating but we had to let it go, by then we had bigger problems to worry about.

By May we were becoming very concerned about the delay in arranging the next facility. I took a board member and my operations director to meet the NHFC CEO and our relationship manager. We said we were worried that the application for R120m was going nowhere. I pointed out that any disruption in loan disbursement would seriously knock RHF's reputation. I suggested that we consider another plain vanilla R40m facility, like the previous two RHF had had. They agreed and we left with the impression that they had everything they needed to approve a new facility of R40m. NHFC did not submit our revised application to the May credit committee meeting. By June we were nail biting, delaying disbursements with increasingly ridiculous stories to clients ("the system is down"). My gut feel was to tell clients the truth – but I was persuaded that this would ruin our reputation. Our staff came under intolerable pressure. In KwaZulu-Natal they received death threats. This seriously knocked my belief that we had achieved a unique client-relationship that made us immune from the consequences of poor service.

It is important to point out that RHF, at any point in time, had some 500 loan applications in the pipeline, worth about R 6 million (US$ 600,000). Clients soon worked out when their loans were due to be disbursed – often calling their provident fund directly to check if their pledge had been registered. We also always had sufficient funds on-hand to pay out a month's worth of new loans. However, with the uncertainty of the drawdown we couldn't use our cash flow from loan repayments, we had to hold on to it to build up the month-end wholesale loan repayment. The tension of doing this was mindboggling.

By the end of June our application finally went to the NHFC board credit committee. After hanging on all day waiting in vain for a call, I finally called to find our relationship manager had gone home early and switched off his cellphone. The next day a breezy voice informed me that all NHFC staff was away all day on a team building workshop. In desperation I called the chair of the NHFC board credit committee. I was aware of the dangers of doing this and had always resisted using personal contacts in the past, however I believed that in this case it was justified. He was upset and said the committee had taken a decision, but he would not say what it was. I would have to get details direct on Monday. Another tough weekend.

On the Monday I was informed that credit committee had turned down our request. RHF was too risky, not profitable enough. They gave one concession, in order to improve our capital adequacy ratio, they offer to invest R10m in the form of convertible preference shares. Although the cost
was very high, about 24%p.a. We had no option but to accept. We were also told that our relationship manager had been replaced, no reason was ever given. It is ironic to record, that months later, in liquidation RHF was hugely profitable and its loan book was sold at a significant premium in a market were 40% discounts were much more common. Any new person would have struggled to get on top of the complex issues in the midst of the pressure we were under.

It took another three weeks to finalize the agreements. We cleared the final hurdle, when RHF's other semi-equity investors (SAEDF - Southern Africa Enterprise Development Fund and Libuyile Community Development Trust) approved the agreement after two rounds (the second with our legal advisor). After approval we edited, print and signed the agreement while holding NHFC ready. When we raced up the road to their office to get it in before 12.00am we were told that they could not transfer funds because it was shortly after mid-day and they had already transferred the funds into an account that they could not access. The accountant told us brightly that they couldn't hold "so much money" on daily call, since RHF might not have drawn it and NHFC would have lost the interest differential over the weekend! I think this was when I began to lose heart – a couple of basis points for 2 days were more important than our reputation.

I got this feeling again a few weeks later. We had disbursed the R10m and the squeeze was on again. Our hard won reputation in the market (and my personal credibility) was evaporating in front of my eyes. I suggested to NHFC that we be allowed to redraw on repaid capital. I pointed out that this had previously been allowed and that we had already drawn R66m on a R40m facility in this way. In my view the resultant small asset/liability mismatch was not comparable with the consequences of a second loan disbursement freeze in six months. All we needed was a one change to an existing loan agreement. Our relationship manager agreed to check it out. A few days later the message came back – no go since RHF only had R5m available on this basis. I knew the numbers by heart and immediately said that I was sure that we had R26m. I was dismayed at such a basic error. Later NHFC corrected their error but the mis-match rule was inviolate - it was still no go. These straws had a backbreaking feel. I began to suspect that we would get no assistance from Government or NHFC. If they didn't know about our plight, then I had failed by not getting our story across. If they did know, I could not understand why we could not sit down and work out a solution. I kept these thoughts to myself and soldiered on, after all private doubts are part of the territory, but the landscape began to look very bleak indeed.

ENDGAME

Early in 2001 Khula's letter of demand arrived. Now all we could do was to try and save RHF, the daughter company (a wholly owned subsidiary of RFF). Throughout this time we were in the midst of the most challenging systems development project which we had ever undertaken. I increasingly questioned our ability to handle the cost and growth imperative of this project, and on one occasion tried to put it on hold, only to be over-ruled by my board. The work of capturing all the lessons of seven years experience, and building a state of the art system fell mainly on my right hand, RHF Operations Director - Terri Bernstein. She rose to the challenge but was trying to do too much and the permanent strain took a toll on her. This brings us to my final days as CEO and RHF's final months. I had negotiated an equity investor to inject R5m in capital and trigger the refinancing of the loan book with a private sector institution (FutureGrowth), a first for RHF.

NHFC then generously offered to sub-ordinate their facility to the new investor (without charging a risk premium), a very significant concession. However, the proposal entailed a dilution of the equity conversion rights of our two debenture holders (SAEDF and Libuyile). At the meeting called to discuss this proposal the board expressed its displeasure and the meeting adjourned. I said to the chairman that I could not continue to work without the support of the board.

Friday 9th Feb 2001 - After waiting over two hours while RHF Board met in extra-ordinary session, Terri Bernstein (RHF Ops director) and I were recalled by a grim faced Isaac Shongwe, RHF chairman for the past 3 years. He informed us that the board had resolved "…in the light of the companies current difficulties, the failure to secure an equity partner, the alienation of key funders, … (he read a list of RHF's woes)… we believe that Höck is longer the right person to lead RHF". Isaac asked me to resign as MD but to stay on as a director in an undefined role.

A few weeks later the board, having been unable to come up with any way to get the NHFC to agree to an alternative, acted on what they believed was good legal advice. In order to protect RHF's other creditors from the loss of the company's only asset (the loan book which NHFC was attempting to seize) they applied for voluntary liquidation. I was very much in two minds about signing the resolution, but by then it was out of my hands. As it happens it the legal advice turned out to be wrong (RFF should have opposed the NHFC's attempt to seize the book) and could have traded (albeit in reduced form while securing other funding).

LESSONS

Governance

Balancing flexibility and formality in a governance structure is not easy, especially in a rapidly growing organization. RHF probably outgrew its governance structure two years before its demise. At that point it should have implemented a formal board policy governing member selection, training/integration, performance assessment and strategic planning. The Calmeadow board governance policy seems a good framework for dealing with these issues.

Over-promotion

RHF was over optimistic about skills development, especially at management level. We stretched some people too far, did not recognize it early enough and then took too long to fix problems. Although funding constraints explain why we lacked a training/HR manager, that is not good enough, we should have made the area a bigger priority.

Relationship with Key Funders

RHF did not stay close enough to funders. We were aware of weaknesses but were reluctant to criticize because of our dependency on the funder. It is possible that if we had given better feedback and listened more carefully we may have avoided the loss of trust which bedeviled all subsequent exchanges.

Too late to battle stations

Lawyers like to know the BATNA (best alternative to a negotiated agreement). We should have implemented ours earlier, while RHF still had more leeway. Instead of entering into the six month interim funding agreement in Sep 2000, we should have retrenched the RHF sales team and run down the loan book, a profitable strategy form a cash-flow point-of-view, even though it would have been costly in terms of reputation and staff moral. This would have enabled RHF to finish the new MIS system (and pay for it) while giving time to negotiate an equity partner.

Profit and growth

I fundamentally misjudged the relationship between profit and growth. I thought that good loan repayment, strong social impact and adequate capital justified growth. Profits could come later. I perceived a trade off between rapid growth and profit, and thought development finance emphasized impact over bottom line. RHF should not have embarked on a major information technology project without the capital needed to achieve the growth on which the project benefits depended. Without this capital, RHF did not have the means to back its willingness to accept the risk.

Tailpiece

Almost two years have passed and a few final remarks. Shortly after the demise of RHF the micro-lending industry (and indeed the SA financial sector) was rocked by a number of massive shocks. Small banks came under severe pressure and one collapsed. When its loan book was sold at a steep discount, it put into perspective the fact that RHF's loan book had been sold, in similar fire sale conditions, at a substantial premium. But what about the people who made Rural Finance special? Terri Bernstein was offered a position with the liquidator of RHF; after they saw the excellent work she did the liquidation. They asked her to continue running the business during this time (itself a great compliment). RHF's credit manager set up a clone of RHF under the wings of another small bank. He re-hired some of the best RHF team and continues to provide the same hand-made service that we pioneered. Yvonne Radinku remains CEO of Marang Financial
Services and is doing great work with this merger of RFF and Get Ahead Financial Services. Certainly Khula seems to think so, they awarded Maranga prize at their last annual awards dinner.
As for me, I am applying the above lessons in an exciting new venture at one of SA's major banks. We are building a new business to finance social housing on a large scale. Amongst other things I am advising social housing institutions on improving their corporate governance. Oh yes, and I am having lunch with Isaac Shongwe next week.

Time line

Date	RFF	RHF	1 US$ = ZAR
1993	First loan disbursed (Sep)	First loan disbursed (June)	
July 1997		Separate legal entity, SAEDF invest US$ 358,000, first R40m NHFC loan facility	
Oct-Dec 97		Libuyile investment	
Aug/Oct 98		1st equity partner negotiations	
Dec 98	Rolling mass action tour		
early 99??	Triodos pulls out		
Oct 99	New Ops Manager Installed - promoted to MD in Jan 2000		
Dec 99	Key Khula meeting		
Mar 2000	RFF operations wound down and all staff dismissed		
May 2000	Ops manager demoted, dismissed		
June 2000		Fraud uncovered, first disbursement freeze	
July 2000		Key NHFC credit committee	
Sep 2000		NHFC 6 month interim facility	
Oct 2000		NHFC results function	
Dec 2000			
9 Feb 2001		Last day as CEO	
15 Feb 2001	Khula alleges mis-representation		
1 Mar 2001		Default on NHFC bridge loan	
April 2001		Provisional Liquidation	
Sep 2001	Provisional Liquidation		