

UNITED NATIONS OFFICE OF SPECIAL ADVISER ON AFRICA

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MICROFINANCE IN AFRICA:
Overview and suggestions for Action by Stakeholders

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ABBREVIATIONS AND ACRONYMS

ADB	African Development Bank
AEMFI	The Association of Ethiopian Microfinance Institutions
AMAF	Africa Microfinance Action Forum
AML-CFT	Anti-Money-Laundering and Combating the Financing of Terrorism
BEAC	Banque des Etats de l'Afrique Centrale
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest
BWI	Bretton Woods Institutions (IMF and World Bank)
CAPAF	Programme de Renforcement des Capacités des IMF en Afrique Francophone
CEMAC	Communauté Economique et Monétaire de l'Afrique Centrale
CGAP	The Consultative Group to Assist the Poor
COBAC	Commission Bancaire de l'Afrique Centrale
DFI	Development Finance Institution
ECOWAS	Economic Community of West African States
EU	European Union
FAO	The Food and Agriculture Organization of the United Nations
FDI	Foreign Direct Investment
FSAs	Financial sector assessments
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation, World Bank Group
IMF	International Monetary Fund
ILO	International Labour Organization
IT	Information Technology
Lux Dev	Lux Developpement (Luxembourg Agency for Development Cooperation)
MDGs	Millennium Development Goals
MENA	Middle East and North Africa
MF	Microfinance
MFI	Microfinance institution
MFWFA	Making Finance Work for Africa
MIS	Management Information Systems
MIX	The Microfinance Information Exchange Market
MSME	Micro, Small and Medium Enterprise
NBFI	Non Banking Financial Institution
NEPAD	New Partnership for Africa's Development

NGO	Nongovernmental organization
OHADA	Organisation pour l'Harmonisation du Droit des Affaires en Afrique
ODA	Official Development Assistance
PADME	Association pour la Promotion et l'Appui au Développement de Microentreprises /Bénin
PAR	Portfolio at risk
PARMEC	Projet d'Appui à la Règlementation sur les Mutuelles d'Epargne et de Crédit
POSB	Post Office Savings Bank
RCBs	Rural Credit Banks
ROSCA	Rotating Savings and Credit Associations
SACCO	Savings and Credit Cooperative
SFD	Système Financier Décentralisé
SIDA	Swedish International Development Agency
SLCs	Saving and Loan Cooperatives
SME	Small and Medium Enterprise
SSA	Sub-Sahara Africa
TSP	Technical Service Provider
WAEMU	West African Economic and Monetary Union
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UN-OSAA	United Nations Office of the Special Adviser on Africa
WOCCU	World Council of Credit Unions
WWB	Women's World Banking

EXECUTIVE SUMMARY

Since about a decade ago, microfinance has received a focused attention from the United Nations, including the declaration of the year of microfinance (in 2005), and the associated studies and publications, the strengthening of the activities of its specialized fund for small-scale investment (UNCDF) and, more recently, the designation of the UN Secretary General's Special Advocate for Inclusive Finance. The UN's intense interest reflects the fact that, despite the challenges of microfinance, it has emerged as an important tool for poverty reduction in Africa. Notwithstanding the recent financial and economic crises that adversely affected many African economies, microfinance grew on the continent at a remarkable pace even at the height of the crisis in 2008. At the end of 2008, Microfinance Institutions (MFIs) in SSA reported reaching 16.5 million depositors and 6.5 million borrowers. Moreover, even when the region witnessed a slowed growth in borrowers in 2008, there was a continued and strengthened uptake for depositors, as their growth rate increased by 10 percent to reach 40 percent, which is more than for any other region.

Microfinance in Africa is developing at all three levels of the financial system (micro, meso, and macro). At the micro level (financial services providers), there are many stakeholders and growing interest from banks and private investors. Microfinance institutions (MFIs) play a predominant role, with the credit unions still dominant in terms of membership, although the bulk of savings is mobilized through the banks. At the meso level (support services suppliers), services such as training or auditing are available and some associations are playing an important role of coordinating MFIs' activities. At the macro level (policy, regulatory framework, and supervision), countries are increasingly shifting to a conducive paradigm of market based policies, while also putting in place regulatory and supervisory frameworks.

However, microfinance in Africa still lacks capacity to match the huge needs of the poor. This is because of certain challenges, which conceal the strengths and opportunities at the various levels. At the micro level, African MFIs have structural weaknesses at several levels: governance, portfolio management, internal control, human resources, and lack of financial sustainability. At the meso level, microfinance support services are rare and of unequal quality. Also, although CGAP/MIX compiles information on financial performance, the data is still limited, reflecting reporting gaps. At the macro level, the supervisory and coordinating bodies have limited resources, and the legal framework is in a state of flux. Moreover, in many low-income African countries, the legal system is too overstretched and not sufficiently reliable to help further develop the financial sector.

In light of these weaknesses, governments and external development partners have a fundamental role to play in consolidating the development and guaranteeing the sustainability of microfinance in African countries, in partnership with the government and other domestic stakeholders. The recommendations of the paper are summarized in the Summary Table below.

- At the micro level, governments and donors should help MFIs adopt appropriate practices towards building retail capacity and reducing transactions costs. In this regard, as donors operate in various countries, they have access to good practices in microfinance across the globe and should promote or help adapt them in African countries. In particular, it is essential that donors help well-performing MFIs tailor their services better, while supporting the weaker ones to clean up their portfolios by introducing sound management practices. The study also recommends that, generally, governments and donors should help MFIs improve governance, while promoting the diversification of institutions and approaches in microfinance.
- At the meso level, governments and donors could support capacity building by promoting the availability of local training that is clear, accessible, and sustainable. Governments and donors should also support the development of financial infrastructure, including the strengthening of professional associations, which can be strategic in advancing microfinance at country and regional levels; the establishment of sustainable systems for refinancing MFIs, which can help MFIs access resources and expand their capacity; and deposit insurance, which helps to protect clients and build confidence in the system¹.
- At the macro level, governments should maintain environments that are conducive to micro-finance and clarify the role that various ministries have to play in advancing microfinance at national levels. In this regard, the study supports and reflects the very pertinent recommendations that the African Union has made, including that Governments should
 - set policies that stimulate financial services for poor people at the same time as protecting deposits;
 - maintain macroeconomic stability;
 - clamp down on corruption;
 - improve the environment for micro-businesses, including access to markets and

¹ Coordination among governments and donors is a fundamental aspect in the provision of technical support (see Section IV on Partnership for Progress).

infrastructure;

- avoid interest rate caps; and
- refrain from distorting markets with subsidized, high-default loan programs that cannot be sustained

Donors should support the strengthening of country systems for establishing financial sector soundness and appropriate policy, regulatory, supervisory and legal frameworks for microfinance. The report suggests, in line with best practice, that donors should work within country systems. In this regard, the study supports the CGAP recommendations that donor grants, loans, and equity for microfinance should be temporary and used to:

- Build the capacity of microfinance providers
- Develop supporting infrastructure at the micro and meso levels
- Support experimentation

Donors should:

- Integrate microfinance with the rest of the financial system
- Use experts when designing and implementing projects
- Set clear performance targets tied to future funding
- Set a realistic exit strategy from the beginning

The recommendations reflect the fact that advancing microfinance should best be carried out as a partnership: partnership among the government, providing the enabling environment; the external development partners (or donors) providing financing and technical support; and the MFIs and meso-level players, who should take maximum advantage of the enabling environment and the support of development partners. The study recommends that such partnership should be built on the principles of the Paris Declaration and the Accra Agenda for Action.

**SUMMARY TABLE OF
SWOT ANALYSIS AND RECOMMENDATIONS OF STUDY**

MICRO SWOT	
STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> • Strong savings growth • Desire of coops and MFIs to adapt structure to environment (for more efficiency) • Increased ability to service rural areas (costs, technology) • Suitability for support to MEs and PS development (to enhance risk management, enterprise development, money management) 	<ul style="list-style-type: none"> • Structural fragility of most MFIs: Governance problems (volunteer led not ideal, some mgrs lack training and skills, favoritism in coops); Poor portfolio management (high PAR in region); Lack of internal systems and controls (poor MIS, misappropriation of funds); Scarcity of HR • Supply of credit not meeting demand (lack of guarantees, treasury bills more attractive, no incentive for med/long term loans since deposits are mostly short term) • Limited ability to meet demand from enterprises (only 15% of SMEs in Africa have access)
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> • Large number of points of service • Increased linkages among the banking sector, private sector and microfinance • Technological advances • Development of innovative financial products 	<ul style="list-style-type: none"> • Unfavorable environment and situation of clients (biz environment costly and corrupt; limited legal rights especially for women; vulnerable clients with limited knowledge of rights and financial management; more prone to disease than in other regions; informal enterprises without right docs to access fin products) • Unfavorable environment and situation of MFIs (high costs; poor and uneven quality of management; poor quality of corporate governance; poor quality of staff)
MICRO RECOMMENDATIONS	
<p>1. <i>Strengthen institutional capacity to deliver range of financial services at a reasonable cost to those with limited or no access to financial services.</i></p> <p>MFIs: clarify vision/goals/action to enhance sustainability and expand capacity through</p> <ul style="list-style-type: none"> • Improve operational management and portfolio quality by improving MIS and adopting international standards in portfolio management • Improving financial management, and structure fees and interest rates appropriately • Improve internal governance, including clarifying role of board members and technical staff and improve transparency and accountability • Strengthen HR capacity <p>Development Partners: Support MFIs to improve governance, operational management and portfolio quality (MIS, client due diligence, credit risk analysis, credit scoring)</p> <p>Governments: set policies at macro level and support development at meso level that enable MFIs to strengthen institutional capacity and set standards to ensure that they do</p>	
<p>2. <i>Promote development of range of services to meet needs of those with little or no access</i></p> <p>MFIs: learn from experiences elsewhere, conduct demand-side focused market research, invest in product innovation, reduce costs, scale distribution.</p> <p>Development Partners: disseminate knowledge from elsewhere, support research and innovation.</p> <p>Government: develop policies and regulations that support product diversification and sustainable delivery.</p>	
<p>3. <i>Facilitate participation of diverse institutional types to enhance competition, improve range and quality of services, and reduce costs.</i></p> <p>MFIs: reduce costs by investing in technology; build inter-institutional linkages to enhance access to finance; forge ties with other stakeholders.</p> <p>Development Partners: finance fora; disseminate good practices; subsidize expansion of providers into hard-to-reach areas.</p> <p>Government: remove policy barriers to profitable provision of financial services.</p>	

MESO SWOT	
STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> • Start of microfinance refinancing by banking sector. • Existence of professional associations • Initial supply of specialized training. • Interest shown in microfinance by audit firms and consultants. 	<ul style="list-style-type: none"> • Fragility of services provided to MFIs (limited number of skilled services providers; problems with accessing trainings; risk of unfair competition in training and other technical support areas; limited transfer of skills; local rating capacity and costs; uneven quality of audit and other service providers and perception of high costs) • Low capacity of national microfinance associations • Unavailability and unreliability of information in a few countries (lack of comprehensive, standardized, and regular statistics; lack of national identification systems and client information)
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> • Growing interest in mobile phone industry • Several ongoing and upcoming capacity building initiatives 	<ul style="list-style-type: none"> • Unfavorable environment and situation of service providers • Funding challenge (high cost/short-term tenor of financing; wrong perception that MFI profitability is low; negative stereotypes of foreign investors re investment climate; high cost of accessing capital markets)
MESO RECOMMENDATIONS	
<p>Government: encourage involvement of private sector and donors in building capacity of MFIs (by encouraging use of existing training facilities); advance MFI transparency (by fostering adoption of standards and disclosure and build capacity to implement); support development of industry infrastructure collaboratively (establish payment infrastructure; sustainable refinancing systems; helping to establish guarantee funds; encouraging MFIs to submit to ratings and audits; deposit insurance schemes; private credit bureaus; ensure adequate data collection and analysis on supply and demand side); accompany entrance of new players and develop enabling regulation appropriately.</p>	
<p>MFIs: strengthen national and regional associations (to help establish and uphold standards in performance, responsible finance, client protection, etc.); provide members with training and support services; advocate with government and policymakers); participate in credit bureaus and utilize rating and audit services; generate and submit quality data.</p>	
<p>Development Partners: support institutional capacity building (subsidize/finance quality trainings; make skill transfer sustainable through ToTs); promote MFI transparency (standards, disclosure, client protection, cofinancing of ratings and audits—including these in finance agreements); support development of industry infrastructure (incl. guarantee funds, rating agencies, deposit insurance, credit bureaus, associations); promote engagement of private sector players to develop and deploy low-cost distribution channels (through use of agent banking and technology amongst other strategies).</p>	

MACRO SWOT	
STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> Positive change in general environment (adoption of national mf policies consistent with good practices; proper assignment of mf within overall financial system and clarification of supervisory responsibilities) 	<ul style="list-style-type: none"> Fragilities of the general economic environment Supervision remains weak Questions about involvement and role of other ministries Ineffective legal system (no fast track or small claims) Low levels of financial literacy
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> Expanded range of institutions Agreement on key performance indicators and standards Increased interest of donors Opportunity for establishing national identification through voter registration More interest from standard setting bodies 	<ul style="list-style-type: none"> Risk of politicization in policymaking Risk of market distortions from subsidies Risk of rigid legal and regulatory frameworks (interest rate controls; overly restrictive regulations)
MACRO RECOMMENDATIONS	
<p>1. Formulate national visions and action plans and clarify roles of various stakeholders Governments: clarify national vision and strategy through streamlined and time-bound process; convene stakeholders; adopt good practice; develop and implement plan of action and assess progress. Development Partners: enhance dialogue and collaborate with other development partners under leadership of country government, share good practice experience; encourage governments to have Min of Finance/Central Bank take lead; involve other ministries in planning and coordination; include MF in development projects.</p>	
<p>2. Strengthen country systems for managing financial sector soundness Governments: ensure financial sector soundness (through appropriate monetary and fiscal policies, sound macroeconomic management and alignment between financial sector policy and budget management) Development Partners: BWIs and other donors to help design appropriate financial sector programs; BWIs to undertake financial sector assessments—FSAPs and assist with translating assessments into recommendations and strategies; build capacity for data gathering and analysis.</p>	
<p>3. Reform and implement financial sector regulations that take into account range of financial services (individuals and households, micro, small and medium enterprises, and so on) and range of providers (bank, MFI, cooperative, NBFI, other non-traditional) Governments: formulate financial sector regulation that includes range of services and range of users and communicate changes. Development Partners: assist in formulating regulation and designing regulatory and supervisory structures; build capacity of central bank to regulate.</p>	
<p>4. Build supervisory capacity Governments: establish efficient supervisory systems to protect savings; develop supervisory structure focused on protecting the financial system and public resources; build capacity of central banks to adequately supervise and maintain integrity of financial system. Development Partners: provide support to governments in drafting instructions on regulations; help build capacity of supervisory agencies (TA and equipment and lateral learning)</p>	
<p>5. Increase efforts towards client protection MFIs should adopt client protection principles and translate them into practices throughout their institution. Investors should consider client protection in their investment agreements with retail institutions and in their own practices. Governments and Development Partners should promote transparency and disclosure, promote redress mechanisms for complaints, and should consider facilitating building client capabilities. Governments should also ensure that they adequately supervise the industry. Governments and development partners could also support the development of industry infrastructure towards enhancing client protection.</p>	
<p>6. Reform the business environment Governments: establish right investment climate; ensure appropriate institutions established and functioning; establish sound legal framework (collateral, creditor rights, non-restrictive labor laws) Development Partners: capacity building towards better business environment, including modifying laws and regulations; judiciary reform.</p>	

PARTNERSHIP FOR PROGRESS

In summary, in the coming years, agenda for financial inclusion in Africa should include:

- Reducing industry fragility and building retail capacity in Microfinance
- Building domestic financial markets for microfinance
- Utilizing technology to cut costs and expand outreach
- Building industry infrastructure to enhance depth and diversity of product offerings
- Formulate country strategies and reform country mf policies, regulatory and supervisory frameworks

RECOMMENDATION ON ROLE OF GOVERNMENTS (FROM CGAP)

- Maintain macroeconomic stability through appropriate monetary and fiscal policies
- Involve the private sector in formulating poverty reduction strategies
- Adjust regulatory frameworks as needed, to permit range of financial institutions and prudential regulation focused on savings
- Invest in supervisory capacity.

GOVERNMENTS SHOULD AVOID (FROM CGAP)

- Interest rate ceilings
- Provision of credit at retail level
- Subsidized lending programs
- Political interference

ENSURING EFFECTIVENESS OF DONORS' SUPPORT: IMPLICATIONS OF THE PARIS DECLARATION PRINCIPLES AND THE ACCRA AGENDA FOR ACTION

- African countries have the primary responsibility for leading microfinance development to accelerate the fight against poverty.
- Donors should strengthen country systems, rather than bypass them.
- Donor support to microfinance development will be tailored to country circumstances.
- Donors consider weaknesses in microfinance development as symptoms of broader financial sector challenges
- Donors should pursue strategies of constructive and systemic engagement, including in high-risk environments.
- Donors should strengthen transparency in their own operations and in the programs they support through enhanced information disclosure.
- Each donor's activities in support of microfinance must be focused on delivering results, demonstrating impact and adding value compared to other donors.
- Donors should build strategic partnerships with each other to achieve common objectives.

I. INTRODUCTION

Since early 1990s, African countries have been enjoying positive economic trends, with higher economic growth becoming more widespread and more robust over time, as an increasing number of countries share in the impact of improved macroeconomic management and governance, a more conducive environment for the private sector, more open economies and higher commodity export prices, for sustained periods.

Despite the positive momentum in economic performance, the incidence of poverty remains a critical issue in most African countries, and many may fail to meet the Millennium Development Goals towards reducing the incidence of poverty and addressing its consequences by the target date 2015. Furthermore, the slowness of economic prosperity to trickle down and lift the masses in poverty is creating a dangerous inequality divide that could eventually fuel instability and threaten progress on the economic front.

Moreover, small enterprises and most of the poor population in African countries have limited access to deposit and credit facilities and other financial services provided by the formal financial institutions. This lack of access to financial services in the formal financial system is quite striking considering that in many African countries the poor represent the largest share of the population and that the informal sector is an important part of the economy.

In this context, there is renewed interest in access to financial services for the poor. In this regard, while there may still be some skeptics concerning the ability of microfinance to alleviate poverty, there is ample evidence to show that the benefits of microfinance outweigh the costs. Many development experts now agree that microfinance can economically empower individuals and microenterprises and enable them to contribute to and benefit from economic development by helping them to acquire capital to undertake investments, integrate into the economic systems of their countries and increase their incomes; ensure the creation or improvement of human capital through better education, nutrition and health; and, through insurance and pensions, smooth their incomes, protect themselves against economic shocks and better manage their enterprises and financial situations. In addition, microfinance can be combined with other social programs resulting in mutual enhancement of their cost-effectiveness. There is also evidence that microfinance is more sustainable and has greater impact than other poverty alleviation interventions such as targeted food interventions. Beyond the economic benefits, microfinance also contributes to the poor's involvement in economic development by increasing political awareness and social organization, increasing social empowerment and community participation, and reducing

gender biases in the empowering of the poor. In sum, then, while microfinance may not be a miracle solution, and no single intervention could be, it can combine very well with other economic and social programs, in a holistic approach, to meet the diverse needs of the poor. Therefore, microfinance merits attention by those concerned with Africa's development and poverty situations².

Box 1: Inclusive Finance

Inclusive Finance may be defined as "universal access, at a reasonable cost, to a wide range of financial services, provided by a variety of sound and sustainable institutions." (UNSGAR, September 2010) This term and the definition reflect the evolution in this sector from thinking about "microcredit" to "microfinance" to something that is fully integrated into the financial system, while recognizing the additional challenges and opportunities of bringing in those who are currently excluded.

'The shift from microcredit and microfinance to inclusive finance begins with the recognition that access to credit alone is insufficient for poverty eradication. A set of useful, flexible services and reliable delivery mechanisms are required to meet a range of changing economic and social needs. Inclusive finance envisions increased outreach to unserved and underserved households as well as to micro-, small and medium-sized enterprises through a continuum of financial institutions offering appropriate products and services to all segments of the population. It takes account of the numerous causes of financial exclusion, the diversity of demand for affordable financial services on the part of poor and low-income clients and the various types of financial service providers, as well as private, public and government sector considerations such as corporate governance and regulation. Inclusive finance is further characterized by sound institutions and financial and institutional sustainability (UN, August 2010)

Therefore, as explained in the Blue Book (UNCDF, May 2006), Inclusive Finance is characterized by:

- a. access at reasonable cost of all households and enterprises to a range of financial services for which they are 'bankable', including savings, credit, leasing and factoring, mortgages, insurance, pension, payments and local and international transfers;
- b. sound institutions, guided by appropriate internal management systems, industry performance standards and performance monitoring by the market, as well as by sound prudential regulation, where required;
- c. financial and institutional sustainability as a means of providing access to financial services over time; and
- d. multiple providers of financial services so as to bring cost effective and a wide variety of alternatives to customers. .

A number of important considerations need to be taken into account to realize this vision of inclusive financial sector development: the right of fair treatment of the individual in his or her society; the degree of financial literacy of the customers; the recognition of the need for some civic or government intervention to open access; the need for financial policy interventions to take a long-run view on access, regardless of short-run exigencies; and the recognition that the vision is dynamic and eclectic, allowing for the possibility of new forms of service provision arising through social, policy, technological and financial innovation.

To realize the vision of financial inclusion, financial services for the poor and low income people should be seen as an important and integral component of the financial sector. This should include a continuum of financial institutions, each with its own comparative advantages and each presenting the market with an emerging business opportunity.

Not surprisingly, therefore, the United Nations has increasingly focused attention on the importance of microfinance in alleviating poverty. In this regard, the UN designated 2005 as the International Year of Microcredit with the aim of assessing and promoting the contributions of microcredit and microfinance to the Millennium Development Goals (MDGs); increasing public

² Section II presents a more detailed review of the challenges and benefits of microfinance in poverty alleviation through household and enterprise financing.

awareness and understanding of microcredit and microfinance; promoting inclusive financial systems; supporting sustainable access to financial services; and encouraging innovation and partnership. The activities of the Year culminated in the organization of a Forum, which provided the opportunity for leaders in international finance and development to discuss and deliberate on how to increase access to financial services for poor people and to create an action plan for building inclusive financial sectors and to help bring the world closer to achieving the MDGs. The Action Plan also provided a basis and guidance for various UN entities, including the UNCDF, UNDP, UNDESA, UN-OSAA, IFAD, and the regional economic commissions (such as the UNECA), to develop programs of action to support microfinance development and strengthen partnership with the private sector, the World Bank, regional development banks (such as the African Development Bank) and other donors and stakeholders, multilateral and bilateral. Meanwhile, the agenda for microfinance has evolved to a broader platform of financial inclusion, defined as “universal access, at a reasonable cost, to a wide range of financial services, provided by a variety of sound and sustainable institutions” (see Box 1 above), which takes a broader sector-wide approach to meeting the need of the poor for financial services.

The UN Secretary General has responded to the challenge of inclusive finance by appointing Her Royal Highness Princess Máxima as the United Nations Secretary General’s Special Advocate (UNSGSA) for Inclusive Finance for Development in September 2009. Working in partnership with governments, multilateral agencies, civil society groups and others, the UNSGSA helps to advance financial inclusion. She advocates for setting appropriate policies and regulations, exploring new delivery mechanisms and innovations, and securing the data needed to make sound decisions on policies or products. She calls attention to key issues, advocates for sound policy and practice, and connects practitioners to collaborate or exchange ideas. The UNSGSA has focused on issues and initiatives that offer the greatest potential for broadening and deepening financial inclusion, and on which her input could make the most difference. The key themes for her first year have been:

- Access to a range of financial services, starting with savings;
- A continuum of inclusion, from individuals to SMEs;
- Responsible finance, with protected clients empowered to make sound choices;
- The mutually reinforcing relationship between financial integrity and financial inclusion;
and
- The importance of data for decision-making

The need to address the challenge of inclusive finance in Africa is urgent. While half of the world

has no access to bank account, Sub-Saharan Africa (SSA) is region with lowest share of banked households at 12% overall. Despite some positive developments, in that SSA increased its deposit account penetration over the last year—although from the lowest level globally (163 deposit accounts per 1,000 adults; 28 loan accounts per 1,000 adults), and has also registered significant growth in retail networks (through bank branches, Automatic Teller Machines (ATMs), and Post Office Savings (POS), (again from a low initial level -- 3 branches per 100,000 adults; 5 ATMs per 100,000 adults), the continent still has a long way to go to expand access from the low 12% of households to the majority of households³. There is also need to consider usage, which will be affected by the range of services (the type of services that meet the needs of the clients) and the quality of services (sufficient to be valued by the clients). Happily, governments are taking note of the importance of financial inclusion, with 81% of African countries having a strategy document for financial industry and 56% having a designated unit within the regulatory agency.

This study is part of UN-OSAA's programme of work in the context of its broader mandate to assist UN Member States' debates on emerging issues regarding Africa's development, particularly, in connection with NEPAD. Specifically, it is about how the agenda of inclusive finance can progress in Africa to help meet the needs of the poor and help them move out of poverty, reduce vulnerability and build assets. In this regard, the study strives to offer specific policy recommendations that can be of great use for the deliberations of all Member States (Africa and its bilateral development partners) on how to help to effectively harness the development potential of microfinance in Africa. The study will also inform other development partners supporting Africa's development, including the UN system organizations, the private sector, the academia and the NGOs. The current study will be complementary to those already undertaken by UN-OSAA in 2004-2009 analyzing the development of the private sector in Africa through the following studies: "the Contribution of the Private Sector to the Implementation of NEPAD"; "The Private Sector's Institutional Response to NEPAD"; "Small Scale Enterprise Development and FDI in Africa: Challenges and Opportunities"; and "Economic Diversification in Africa: a review of selected countries". It also deals with one of the most important challenges currently facing African countries, namely the need for private sector finance in order to improve competitiveness, economic performance and reduce poverty.

The report is, however, largely based on a desk study on the subject. In this regard, it has benefitted from several cross-section and specific country studies on the subject undertaken in the past few years, which have allowed drawing of conclusions regarding microfinance in a broad spectrum of countries, from the Fragile to the middle-income countries. In particular, the study has benefitted

³ Source: CGAP: Financial Access 2010.

greatly from inputs and reference materials from CGAP, the UNCDF, the United Nations Organization, Women's World Banking and the African Development Bank. The desk survey is complemented with field studies and face-to-face interviews with stakeholders in two African countries with relatively developed microfinance systems, namely Kenya and Senegal, but which are advancing in different contexts – regional or monetary union (Senegal) and national (Kenya).

The report is organized in five parts, including this introduction section. Section two reviews the role of microfinance, especially as a tool in poverty reduction through household and enterprise financing. Section three presents the background or context of microfinance provision in Africa, including a review of the financial sector in which the microfinance institutions (MFIs) operate and a presentation of the major stakeholders at the various levels of microfinance: the micro (or institutional) level, meso (industry or sector) level, and macro (national) level, including a description of the significance of their activities or contribution to the financial inclusion agenda. Funders, whose activities are significant at all three levels, are also treated in this section and so is a presentation of the regional dimensions. Section four makes a stylized analysis of the strengths, weaknesses, opportunities and threats (SWOT analysis) at the various levels (micro, meso and macro) of the financial inclusion agenda, with special emphasis on the implications for financing the private sector (enterprise and household finance), with appropriate recommendations for enhancing progress. Section five makes suggestions towards enhancing partnership for progress.

II. THE ROLE OF MICROFINANCE: HOUSEHOLD AND ENTERPRISE FINANCING

Poverty reduction strategies consist of a number of pillars, including (i) creating economic opportunities (through improved macroeconomic and business environments and access to larger regional and global markets); (ii) enhancing the options for the poor and empowering them to be able to seize the opportunities (through availability of finance, improved education to enhance skills, better health and nutrition to enhance the use of the poor's most valuable asset, which is labour); and (iii) addressing the risks and vulnerabilities of the poor that can wipe out their assets or affect their ability to work or run an enterprise. While African countries are creating economic opportunities through establishment of stable macroeconomic conditions and conducive business environments and access to wider regional and global markets, this section focuses on pillars two and three in the poverty reduction strategies, where microfinance can be most effective and help many achieve the benefits (and escape the negative consequences) of liberalized and competitive economic systems. It outlines the benefits, challenges and opportunities regarding microfinance in poverty reduction through financing the private sector (household and enterprise financing).

II.1. Strengths of Microfinance in Poverty Alleviation

Recent research has highlighted the importance of microfinance to poverty alleviation⁴. For example, according to Littlefield et al (2003), there is abundant support to demonstrate that microfinance can lift families out of poverty and is also able to contribute to the completion of six of the eight millennium development goals⁵. A large amount of research and practice have shown that providing access to financial services to the poor and microenterprises can help alleviate poverty and its consequences in a number of ways⁶:

⁴ See, for example, UN August 2010; CGAP: What Do We Know about the Impact of Microfinance, <http://www.cgap.org/p/site/c/template.rc/1.26.1306/>; Honohan and Beck, 2007; N. Goldberg, 2005; , K. Imboden, 2005 and Littlefield et al, 2003

⁵ The Millennium Development Goals are: (1) eradicate extreme poverty and hunger; (2) achieve universal primary education; (3) promote gender equality and empower women; (4) reduce child mortality; (5) improve maternal health; (6) combat HIV/AIDS, malaria, and other diseases; (7) ensure environmental sustainability; and (8) develop a global partnership for development.

⁶ Littlefield et al (2003) admit, however, that credible measurement of the impact of financial services is challenging. Correlation does not prove causality. For example, merely showing that clients in one village are better off than those in another village does not prove that the financial services caused them to be better off: it is possible, after all, that the financial services only attracted or selected clients who were likely to be better off in the first place, even if they had not received the service. Studies that do not deal with biases have little power to prove causality. Few studies include fully rigorous controls for selection biases, but the authors indicate that all of the

- Poor households are often plagued by fluctuations in income and the need for emergency resources, while microenterprises run by households are often vulnerable to draw on their capital to meet household consumption expenditures during seasonal lean periods or as a result of emergencies caused by human or animal sickness, natural calamities or other exogenous shocks. Access to financial services, including credit, insurance and pension, can play a vital role in 'smoothing' income flows of the poor, ensuring that the poor do not deplete their working capital, thereby reducing their vulnerability to financial and economic shocks. In this regard, according to a study by the Asian Development Bank (1997) successful and effective MFIs regard the provision of financial services to the poor as a worthwhile service in its own right. They show little concern if part of the credit finances consumption rather than production. If in doing so, they are providing asset protection rather than asset creation, this is preferable to asset loss, even if that cannot be observed. Borrowers may also use microfinance loans to settle debts with higher cost informal lenders, thus securing a reduction of their interest costs. In other cases, microfinance loans may finance lumpy expenditures for education, emigration, and housing, which often offer comparable but longer term returns than investment in microenterprises. Loans may also be used for informal on-lending, which could increase competition and lower informal lending rates. Successful MFIs recognize that the household and business finances of most poor and microenterprises are intertwined, and that efforts to restrict their use of funds to specified business purposes are not only operationally costly but also typically futile and counterproductive, as households and microenterprises can easily conceal the ultimate use of loans. Whatever the case, microfinance can enhance risk management, permit enterprise development and make for better money management. These factors are also key in building viable communities and contributing to the sustainable livelihood strategies of poor households.
- Poverty can also be reduced as access to finance, in the form of savings and credit in the hands of the poor, can enable them to run microenterprises and build assets. In particular, access to flexible, convenient, and affordable financial services empowers and equips the poor to make their own choices and find their way out of poverty in a sustained and self-determined way. In this regard, it is worth noting that the methodology of successful MFIs, especially the small, sequential loans (see

studies cited in their paper have addressed the issue by trying to select control groups whose observed characteristics were comparable except for their participation in microfinance. The authors believe that the general pattern of results sheds valid light on the question of impact.

Microfinance Methodology under Section IIB), conveniently meets the needs of poor microentrepreneurs, most of whom are looking for a working capital loan to expand an existing livelihood enterprise rather than set up a new one. Even when the intention is to start a new enterprise, it is often a simple processing or trading activity or service yielding a regular cash flow from which repayments can be made, and with little fixed capital requiring a larger, longer term investment loan. Many of these micro-enterprises may be existing enterprises that (i) are operated by women and are characterized by a high degree of concentration in activities with the lowest capital and skill-entry barriers; (ii) constitute a supplementary source of household income; and (iii) are seasonal, part-time and subject to short-term volatility (high birth and closure rates). Although some new enterprises are created, according to Liedholm and Mead (1995), the benefit of poverty-oriented microfinance is primarily an income-augmenting and not an employment-generating benefit. Second, small initial loan size and repayment in small frequent installments contribute to ease of repayment and are largely responsible for the impressive repayment record of a large number of microenterprise projects. Third, poverty-oriented microfinance is the most effective way of targeting the poor and especially women, who self-select themselves in response to loan terms and a lending technology that is not of interest to the nonpoor.

- MFIs can also leverage their activities by creating linkages with the banks as a source of wholesale finance⁷. MFIs create linkages with the wider financial system by specializing in retailing consumption and production loans to poor borrowers, as well as providing savings services to them. In this regard, while MFIs are in a better position than the banks to mobilize savings from the poor, the formal financial sector has a comparative advantage in mobilizing a much higher volume of savings from the economy, including from the MFIs. On the credit side, MFIs enjoy a comparative advantage in retailing credit to the poor, while the formal banks are better suited to 'wholesaling' it to MFIs for on-lending to the poor, or wholesaling it to groups of the poor directly. In the long run, linking the two sectors in an integrated financial system increases the efficiency of the financial system as a whole and enhances the capacity of the MFIs to provide financial services to the poor and microenterprises.
- Economic growth and job creation can be stimulated, as small business development and access to housing finance generate new cycles of accumulation and contribute to higher levels of effective demand. In this regard, according to Littlefield et al (2003)

⁷ See Asian Development Bank, 1997.

microfinance is unique among development interventions as ‘it can deliver these social benefits on an ongoing, permanent basis and on a large scale.’ They add that ‘many well-managed MFIs throughout the world provide financial services in a sustainable way, free of donor support.’ Microfinance thus offers the potential for a self-propelling cycle of sustainability and massive growth, while providing a powerful impact on the lives of the poor, even the extremely poor. They also indicate that ‘evidence shows that this impact intensifies the longer clients stay with a given program, thus deepening the power of this virtuous cycle.’

- Access to financial services also translates into better nutrition and improved health outcomes, such as higher immunization rates. It allows poor people to plan for their future and send more of their children to school for longer. The nutritional benefits are also particularly felt by children. The benefits of better health and nutrition also spill over into other areas such as schooling and employment in which the poor are in need of help.
- Microfinance also empowers women and reduces their marginalization in the socio-economic system. The empowerment of women goes beyond increasing the income of low-income women and includes enhancing their relative physical mobility, economic security, ability to make various purchases on her own, freedom from domination and violence within the family, political and legal awareness, and participation in public protests and political campaigning. Microenterprise programs can, therefore, lead to empowerment in its social as well as economic dimensions. The mobility of women and their access to information is strengthened by the process of participation in microenterprise program activities, including attendance at weekly meetings and other interactions in the public sphere that come about as a result of economic activities. Empowerment leads, in turn, to such social benefits as more education and lower fertility rates⁸. Social exclusion is also overcome by the eradication of the divide between financial 'insiders' and 'outsiders'.

According to Wright, microfinance compares favorably to other interventions particularly with regard to cost effectiveness and prospects for sustainability. An advantage of microfinance is that donor investment is recycled and reused (Wright 2000). Direct comparisons done by

⁸For Bangladesh, Schuler and Hashemi (1994) show that a positive effect on contraceptive use is discernible both among members and nonmembers in Grameen Bank villages. Contraceptive use goes up among members because they are better able to overcome the barriers to obtaining access to contraceptive services (lack of mobility, cash, information, among others). Contraceptive use goes up among nonmembers because of the diffusion effect of changing fertility norms in the village as a whole.

Khandker (1998) show that microfinance can be a more cost-effective poverty reducing tool than alternatives such as formal rural financial intermediation, targeted food interventions, and rural infrastructure development projects. Moreover, unlike many other interventions, costs for microfinance tend to diminish with the scale of outreach (Swope, 2005). Regarding the issue of sustainability, it can be said that few, if any, other development tools have the potential to become sustainable to the extent that this is possible in microfinance, where after initial start-up grants, new inputs are not required for every future client. According to Swope, there is ample evidence that MFIs targeting the poorest can fare as well financially as those that do not. There is also ample anecdotal evidence that MFIs that target poorer clients can achieve substantially higher repayment rates than those that target richer clients (Swope, 2005).

II.2. Weaknesses of Microfinance in poverty alleviation

Other researchers and academics, however, cite certain challenges of microfinance in reducing poverty (discussed in Swope, 2005), namely that

- microfinance does not reach the most vulnerable members of a population, particularly the old, sick, and disabled. A number of reasons have been suggested, including discrimination by the richer poor and the pariah status of the destitute, but also because the poorest of the poor can barely meet basic needs much less run an entire business. They also lack the necessary education, management skills, and social networks to participate in microfinance schemes⁹. They point out the fact that in a longer perspective, microenterprise promotion can never be a substitute for a variety of social sector programs such as primary health care, environmental sanitation, education, nutrition, and family planning and child care, or “structural” changes, such as land reform.
- microfinance is not financially sustainable for the MFIs, especially those that also want to serve the very poor, even if autonomy is pushed as the ultimate goal. Despite microfinance reforms, the researchers and academics point to statistics which indicate that financial sustainability eludes many MFIs as they serve the poor and vulnerable¹⁰. The poorest may pose a greater credit risk than the poor, while the unit costs of small loans tend to exceed the unit costs of larger loans.

⁹ This is not, however, as much a weakness of microfinance as it is of social and economic structures.

¹⁰ However, one should note that almost no program directed at the poor is financially sustainable. Low-income housing projects, hospital clinics for the poor, public schools, health and vocational classes, agricultural programs, and indeed any

- microfinance is potentially harmful to women as domestic abuse may result from husbands' jealousies of their wives' new financial power. However, the researchers temper this argument by admitting that cases of domestic violence, though they exist, are extremely rare. Even so, they also argue that the fact that some men may resent women's access to financial service does not mean that women should be excluded from economic opportunity, for that would only strengthen patriarchal dominance. In any case, it is also observed that many successful MFIs are led by women.
- microfinance can create a large debt for the poor. It is argued that borrowing money is always a risk, but particularly so for the poor who are already extremely vulnerable to economic shock. Sometimes all it takes is a business failure or medical emergency to plunge a poor person into severe debt and even greater poverty, and microfinance is not universal in application.
- Critics also point out that, while advocates of microfinance tend to promote the idea that all poor people are dynamic, ambitious businessmen and women just waiting for the chance to shine, if only they had access to credit, the reality is that microfinance is exclusive and that most impoverished people are poorly educated, marginalized by society, and unlikely to have the entrepreneurial drive needed to establish a business. In this regard, it is also worth noting that some experts argue that while credit alone tends to be more relevant for the "middle" poor operating livelihood enterprises, especially nonmanufacturing livelihood enterprises such as trading and agro-processing where working capital requirements are high, it is less relevant for the poorest of the poor for whom skills training and social preparation are as important, or for the borderline poor for whom training, technology upgrading, marketing assistance, and the availability of inputs may all be more important than stand-alone credit.
- It is also argued that there are usually just not enough microenterprise opportunities available to cover all the poor, given demand constraints and the lack of skills to produce products for which there is demand. In such circumstances it is not surprising that many of the poorest of the poor practice "self-exclusion," rightly perceiving that livelihood activities may not be the best answer to their livelihood problems. For this reason, wage-employment creation through agriculture intensification and rural public

works programs should also form an essential component of an antipoverty package.

Therefore, microfinance, despite its benefits, is unable to alleviate the poverty of the very destitute without some kind of additional intervention or safety net such as guaranteed employment, food aid or cash grants to ensure food security so that the beneficiary would not deplete the grant in consumption, while providing skills training and subsidized loans to allow acquisition of enterprise experience and the building of capital or creditworthiness that would facilitate graduation into regular MF loans¹¹.

II.3. Opportunities for Microfinance in poverty alleviation

Most African countries are undertaking economic reforms, including the establishment of sound macroeconomic conditions, market-based economic policies and improvements of the business environment all of which support growth of micro-enterprises in which clients of MFIs are involved. African countries are also strengthening regional arrangements and benefiting from bilateral trade preferences that are opening new markets for cooperatives and SMEs. Emerging markets provide fertile ground for entrepreneurs, thus impacting positively on the effectiveness of microfinance to reduce poverty.

Many countries are also experiencing positive growth trends and improved budgetary positions, which facilitate investments in social services, especially education and primary health. Some studies cite evidence that there are strong potential synergies between microfinance and the provision of basic social services for clients. The studies found that the impact of each can increase when they are delivered together, while the marginal cost of providing social services can be substantially reduced when the infrastructure for microfinance is already in place (MkNelly and Dunford 1998; Marcus 1999). Moreover, improvements in health care, nutritional advice and education can be sustained only when households have increased earnings and greater control over financial resources. Therefore, economic growth and improvements in social services, as is the case in many African countries, create opportunities for the effectiveness of microfinance in reducing poverty and addressing the consequences of poverty.

¹¹ See CGAP: Graduating the Poorest into Microfinance: Linking safety Nets and Financial Services, CGAP Focus Note No 34, February 2006. The paper proposes three stages in supporting the transition of the destitute into regular MFI loans: Stage 1 involves providing guaranteed employment, food aid or cash grants to ensure food security; and in Stage 2, providing skills training, opportunities to acquire small savings, and subsidized loans to support asset creation and acquire microenterprise experience that would eventually facilitate graduation into regular MF loans in stage 3.

II.4.Threats to Microfinance in poverty alleviation

The microfinance concept suffers from a number of risks that could constrain its effectiveness in poverty reduction programs. The most glaring risk is political. Microfinance is politically loaded (see Section below on macro-level threats), especially in emerging democracies, as politicians may try to use it for their own ends. There is also the widely prevalent misconception that microfinance is 'charity' or that it is somehow linked to the government's other non-commercial agendas and that could undermine the financial sustainability of the institutions.

In particular, attempts to take the politically palatable route by imposing interest rate ceilings may be counterproductive. Studies (see for example, the DTI 2004 study) have shown the dangers of interest rate ceilings, and they include the following:

- ***There is less product diversity*** in the credit products and the range of credit models offered to low income households and microenterprises in markets with interest rate ceilings
- ***Rate ceilings create credit exclusion*** for the high risk borrowers and those who cannot access the credit mainstream: A rate ceiling, particularly when combined with disincentives to default, can result in a highly risk averse lender set.
- ***Lenders may, therefore, respond to ceilings by raising access hurdles to high risk borrowers***, and low-income borrowers are generally able to obtain credit only if in secure long-term employment. Minimum loan values are set at a level significantly above that likely to be sought by those on the lowest incomes.
- ***Lenders withdraw from the market where ceilings are newly imposed***: In markets where rate ceilings are introduced, on the other hand, if the business model and pricing structures cannot be adapted to fit within the new framework, lenders tend to withdraw from the market.
- ***Alternatively, lenders may adapt pricing structures*** so that less of the ultimate cost of credit to the consumer is captured within the usury cap; in particular, interest rates become less important as a component of the total price of credit.
- ***Credit exclusion divert borrowers to second choice products***, such as pawn-broking, and to the credit mainstream
- ***The distortion of the natural patterns of consumer choice can expose borrowers***

to delinquency charging & increase default

- *On the other hand, rate ceilings appear to have no impact on the price of credit for low risk borrowers* which is determined by competition

Therefore, credit ceiling tends to hurt the very entities that they are meant to help.

In conclusion, microfinance, if properly managed, can fit well into a private sector development and poverty alleviation strategy, as it empowers clients to seize economic opportunities and manage their vulnerabilities, while also engendering advancements in the social and political spheres. Living conditions are markedly improved along with self-esteem and sense of control. Also, significantly, microfinance is an instrument that, under the right conditions, fits the needs of a broad range of the population and microenterprises. There will be need in each country for research to understand local impacts as well as need for better data on both demand side and supply side to inform decisions and investments. However, as cautioned by CGAP (1.26.1306) ‘microfinance alone will not alleviate poverty and bring about the achievement of the Millennium Development Goals. Government, donors and key stakeholders will need to work together on a series of strategies and activities to reduce poverty and achieve the MDGs, among them: education, health care, housing, transportation, improved agriculture, expanded markets, and access to information’. While microfinance is not sufficient on its own, it can combine very well with other economic and social programs, in a holistic approach, to meet the diverse needs of the poor. In particular, access to financial services does allow people to improve their own human capital (schooling, health care) and allows for the potential for improved social capital as clients become more empowered and integrated into markets. Whether they save or borrow, evidence shows that when poor people have access to financial services, they choose to invest their loans, additional earnings, or savings in a wide range of activities and assets that benefit not only their businesses but also their households. Thus access to financial services provides the poor with the means to achieve most of the MDGs—on their own terms, in a sustainable way. Such access is enhanced if interest rates are determined at fair levels to both the MFIs and the clients.

III. THE CONTECT OF MICROFINANCE IN AFRICA

The African microfinance industry is diverse and geographically dispersed. An array of approaches has been used ranging from the use of agent and village community banks and traditional group based- systems to specialised lending by various institutions. This situation is due to the nature of the financial systems in Africa, which has also influenced the evolving role of the major stakeholders of microfinance in the continent and their impact.

III.1. Features of the Financial Sector in Africa

According to Honohan and Beck (2007), the key features of the financial sector in Africa, which also impact on the provision of microfinance, especially among the low income countries in sub-Saharan Africa, include¹²:

- ***the small size of the sector***, as measured by the absolute size of liquid liabilities¹³ and the ratio of liquid liabilities to GDP. This reduces the scope for arms length relationships within the economy; is connected to low productivity and skills shortages; and can also prevent banks from exploiting scale economies or undertaking large investments into technology, especially those with high fixed costs.
- ***the shallowness of the sector***: Financial depth and efficiency, as measured by deposit resources mobilized by banks and near-bank intermediaries relative to economic activity (ratio of liquid liabilities to GDP) and credit extended (private credit to GDP) is low¹⁴. The low monetary depth is also reflected in tendency of wealth holders to hold their liquid assets outside Africa (indication of capital flight)¹⁵, while the low credit compels micro, small and medium enterprises (MSMEs) to rely less on bank financing than on internal funds and microcredit;
- ***the high exposure to economic and socio-political shocks***, including crop failures, sharp changes in prices of traded commodities, civil unrest, and unexpected changes in government or government policies not only limits the time horizon of savers and investors alike, but also reduces the horizon over which governments can plan;

¹² See also the ADB: Financial Sector Policy, Tunis, 2003 and ADB: Financial Sector Strategy and Action Plan, forthcoming, 2010.

¹³ Many African financial systems are smaller than a mid-sized bank in Continental Europe, with total assets often less than \$ 1 billion.

¹⁴ Ratio of liquid liabilities to GDP average 32% in Africa compared to 49% in East Asia and Pacific and 100% in high-income countries, while the ratio of private credit to GDP average 18% in Africa compared to 30% in South Asia (See Honohan and Beck, *ibid.*)

¹⁵ Ratio of off-shore deposits in Africa to domestic bank deposits is significantly higher in Africa than in other regions of the world.

- ***the high incidence of informality***, especially lack of documentation and formal contracts in personal, professional and business transactions excludes many households and micro-entrepreneurs from the credit markets, accentuates information asymmetries already prevalent in the system, but also makes government interventions less effective as large shares of the population might not be affected by them;
- ***governance and regulatory deficiencies***, including weaknesses in the contractual framework, high degrees of corruption, risks of expropriation, lack of capacity of the regulatory institutions and inefficient bureaucracies as well as information asymmetries put certain limits to the effectiveness of government interventions and to the extent to which the benefits from financial sector reforms can reach the majority; they also explain the focus on short-term transactions rather than long-term commitments.
- ***intermediation deficiency***: The inefficiencies, high risks and lack of effective competition result in expensive banking services, reflected by high interest rate spread and margins, high minimum deposit requirements, and high lending interest rates. Meanwhile, banks, which dominate the system, remain highly profitable and liquid.
- ***the dominance of the banking sector***, which underlines the importance of encouraging banks to be involved in the microfinance subsector. However, bank lending in general and funding of microfinance is still heavily geared towards the short end of the market for various reasons: bank balance sheets are dominated by short-term deposits; banks face acute problems of lack of information about creditworthiness of potential clients and difficulty of enforcing contracts and creditor rights that increase the risk of loan default. Weaknesses of the legal system (laws, registry, operation of courts), especially regarding property rights, limit the number of creditworthy borrowers and the capacity of financial institutions, and other deficiencies in the governance structure in many countries (high degrees of corruption, the risk of expropriation and inefficient bureaucracies)¹⁶.

III.2. Microfinance Stakeholders

Building inclusive finance (or financial systems that serve all segments of society) has been a dominant goal in many African countries, and involves a sizable number of stakeholders at the retail or provider (micro), industry (meso), and national (macro) levels in various areas of activity as shown in Table 1 and also described below:

¹⁶ Honohan Patrick and Beck *ibid*.

Table 1: Building Blocks of Domestic Financial Markets that Work for the Poor and Microenterprises

Macro-Level									
Policy, Regulations, Investment Climate	Interest rates	Financial sector policies	Regulations, supervision	Legal structures and systems	Adoption of Performance indicators such as portfolio quality, cost effectiveness, financial self-sufficiency, and outreach	Government role as an enabler, promoting economic stability, liberalized interest rates, supportive policies and private provision of microfinance	Donor Support to complement private capital for financing younger institutions, capacity building, innovation, institutional infrastructure and policy change		
Meso (or Industry) Level									
Industry Infrastructure	Domestic capital markets	Technical Service Providers	Wholesale Financial Institutions	MF Networks, Associations	Rating Agencies	Credit Bureaus	Technical applications	Payments systems	Business Services
Financing Microfinance – Domestic Capital markets		Savings mobilization	Wholesale finance	Bonds, securitization	Grants for smaller MFIs	Guarantee Mechanisms	Transpa – rency (with ratings, credit bureaus and information disclosure)	Healthy market overall with private equities and loan markets	
Micro (or Institutional) Level									
Retail Supply Capacity,	Commercial banks	Micro-finance NGOs	Regulated MFIs	Cooperatives, Credit unions	Savings institutions	Grass-roots Institutions	Others		
Product Offerings		Savings instruments	Micro-loans working capital; Agricultural loans	Insurance	Remittances; Micro-leasing				
Impact									
Impact on poor households	Income	Assets	Education, Health		Women’s decision-making power	Community participation			
Impact on microenterprises	Capital	Asset protection							

Source: Adapted from Women’s World Banking: *Expert Group + 10: Building Domestic Financial Systems that Work for the Majority*, WWB, NY, April 2005

III.2.1. Micro-Level: Providers and Products

Microfinance Retailers

Informal Providers: A large number of informal-sector intermediaries (especially those working in rural areas), and even individuals who provide financial services on a largely artisanal basis have taken root in African countries, reflecting a large informal sector and low bank penetration. Examples include the *tontines* in Cameroon, the *susus* in Ghana or “*banquiers ambulants*” in Benin, which operate in urban and peri-urban markets. These providers operate spontaneously to fill market niches and charge very high rates of interest on loans to meet the demand of mostly poor people who work and do business in the informal sector. They operate

largely without formal recognition in terms of licensing or registration. Most African countries do not have the ability to recognize these institutions due to the absence or inappropriateness of existing legislation and regulations on microfinance. By virtue of their informal nature and non-legal status, these microfinance (MF) providers have few opportunities to grow and expand¹⁷.

Credit Unions: Credit Unions or Savings and Credit Cooperative Organizations (SACCOs) or Federation of Cooperatives (as in the French-speaking countries)¹⁸ are cooperative financial institutions that provide savings and credit services to their members. Membership is based on the principle of a common bond such as a common workplace, community or producers of a particular commodity, and while they do not specifically target a specific income group, they generally serve the lower income markets. In many African SACCOs, the core financial product is savings, but credit is also provided. A variant of the credit unions is the Financial Service Associations (FSAs), which are also member-owned but driven by building equity based on shares owned by members. Whereas in SAACOs voting rights are based on a one person, one vote system, in FSAs they are proportional to shares owned. Credit Unions have grown significantly in Africa. According to the World Council of Credit Unions (WOCCU) sources, in 2008, for 22 African countries there were 18,220 credit unions with membership totaling 20.1 million, up from 3,267 credit unions with membership of 2.1 million in 2000.

Banks: Currently, there is a wide variety of banks involved in microfinance in Africa, ranging from the savings banks to the traditional commercial banks.

- *The savings banks*, including the Post Office Savings Banks (POSBs), were introduced to Africa during the colonial days and are still leveraging their wide network to serve the poor and small savers in several African countries (from North Africa to South Africa). Their low minimum required balance also makes them attractive to the poor and it is estimated that the savings banks have a total reach of more than 40 million customers in Africa (AMAF/WWB, 2010) in the lowest to middle income markets¹⁹. A few POSBs, including in Cape Verde, Kenya, Malawi, and Tanzania are reported to be active in microfinance. Most savings banks, however, limit their services to savings and transfers.
- *The Development Banks*, including the Agricultural Development Banks, are involved in the microfinance business mainly by providing wholesale finance to NGO MFIs and other NBFIs. However, it is reported (see AMAF/WWB 2010) that a few development banks (such as in

¹⁷ Although the number of informal intermediaries and customers served could be large, they still constitute a small part of the financial system due to low quantum of transactions.

¹⁸ The phenomena of cooperatives and federations of cooperatives is widespread in francophone West Africa and they are often the largest providers of microfinance services in the country (as with FECECAM in Benin, FUCEC in Togo, RCPB in Burkina, etc)

¹⁹ The highest reaches are in Egypt (11 m), Algeria (7.1m), Tunisia (2.3m), South Africa (2.1m), Morocco and Zimbabwe (1.7m each) and about a million each in Kenya, Niger, Tanzania and Cote d'Ivoire.

Mali and Burundi) are also directly involved in microfinance.

- *Rural banks and Community banks* are very well established in Ghana, where they reach about 2.3 million clients, but also in countries such as Tanzania and Sierra Leone. In Nigeria, since April 2008, the Community banks are required by law to meet a set of criteria and convert into Microfinance banks.
- *Microfinance banks*, typically found in central and southern Africa and also in Nigeria, are fully regulated commercial banks, which offer a broad range of products and services. However, their primary business purpose, from inception, is lending to micro and small enterprises.
- *Commercial banks*: An increasing number of banks – national, regional and international banks – are attaching microfinance products to their normal banking business, as they have become aware that microfinance is bankable and profitable.

Deposit-taking MFIs: A number of MFIs have also emerged in some African countries as non-bank financial institutions (NBFIs) and are mobilizing deposits and offering microcredit. They are, therefore, normally regulated, although they are not registered as commercial banks. Some of these MFIs such as the Faulu Kenya Deposit Taking Microfinance (DTM) Ltd transformed from NGO MFIs, while others were set up from the start as NBFIs involved in MF activities. There are also some parastatals, consumer finance companies and building societies, which operate as NBFIs, mobilizing deposits and offering microcredit.

NGO MFIs are largely credit only MFIs. While they are normally affiliates of international NGO networks offering microfinance for some humanitarian or social reasons, few are set up locally as stand-alone NGOs.

Community-managed Loan Funds, which are also referred to as revolving funds, self-managed village funds, Village savings and Loans Associations (VSLAs) or community-based finance groups also offer microfinance to the poor, especially in rural areas.

Consumer lenders: These are a new breed of money lenders that offer consumer loans to the poor, especially salaried workers. They are found mainly in the urban areas and in the developed or higher income markets. .

Some information on MFI activities are gathered and reported in MIX (see MIX/CGAP, 2010). If the number of MFIs reporting could be used as a rough proxy, the information indicates that the dominant type of provider is the NGO MFI (102 out of 271 reporting MFIs) followed by the cooperatives (79 MFIs) and the NBFIs (76 MFIs) and banks (16 MFIs). However, the banks report the highest number and growth of depositors (increasing by about 2 million depositors to just below 7 million between 2007 and 2008) followed by the cooperatives or credit unions (increasing by about a million depositors to 3.3

million), while the NBFIs report the highest growth in borrower numbers followed by the NGOs and, with a sizeable distance, the banks and the cooperatives.

Microfinance Products

The MFIs offer a variety of products ranging from deposit services, loans of different types, money transfers, micro-insurance and micro-leasing.

- *Savings instruments*: The need for affordable savings instruments is high among the poor and microenterprises, and many MFIs are driven by the savings mandate. In fact, according to MIX reports, many MFIs in Africa indicate provision of savings instruments as their core business, and many have more savers than borrowers²⁰. The exceptions are those in North Africa as only commercial banks there are allowed to mobilize deposits. According to MIX, sub-Saharan Africa (SSA) maintained the highest growth in depositors of any region in 2008, at 40 percent, even though savings size across the region dropped by 22 percent between 2007 and 2008, as the poor struggled to cope with the external shocks (fuel and food crisis) and the uncertainties in the global economy.
- *Credit facilities*: African MFIs offer different types of credit facilities ranging from the traditional but fast growing consumption financing, including for education and other household emergencies to working capital loan products, especially for traders; and agricultural finance. In North Sudan, MFIs offer only Islamic finance, with no interests charged, while margins are factored into the repayment plans of goods or equipment purchased by the MFIs for the client. African MFIs do not typically offer long-term loans. However, some are venturing into housing finance, despite the challenges of land titling and collateral problems. These housing loans include construction loans, hire-purchase facilities and community-based housing schemes. MIX estimates that about 55 per cent of the loan portfolio in sub-Saharan Africa (according to 2009 data) is consumption lending (including for housing), while microenterprise lending takes just over 40 per cent.
- *Local transfers and remittances*: Some MFIs are also involved in money transfers, which have become not only significant in terms of volume but also profitability. Some MFIs are linking transfers to new technology, which is not only helping to reduce cost but also ensure security and finality of transaction, while others are developing savings and investment products related to remittance receipts. For international transfers, however, some MFIs are partnering with such international companies as the western Union or MoneyGram.

²⁰ These could include 'forced savings'.

- *Micro-insurance:* In some countries, MFIs provide micro-insurance to low-income people to help them better manage risks and cope with crisis. The most common insurable risks relate to loan, life and burials, but health (such as was offered by MicroCare in Uganda, along with its other insurance services), crop (as offered by Opportunity International in Malawi to enable farmers cope with the impact of drought), and property insurance schemes are also offered. There are also microinsurance initiatives led by the ILO with UNCDF and other partners. In North Africa, however, there is a glaring absence of micro-insurance.

Microfinance Methodology

Microfinance institutions (MFIs) offer a range of services including loans, savings facilities, insurance, transfer payments, and even micro-pensions. However, because they operate primarily in underdeveloped financial markets, they are faced with unique difficulties; namely, lack of infrastructure or mobility as well as dealing with clients with inadequate collateral, insufficient legal status, inability to cope with the complexities of dealing with traditional financial institutions and a high level of transaction costs of dealing with such clients who may also be scattered geographically. Consequently, MFIs have adopted several innovative practices to accommodate these difficulties, including the use of (any or a combination of) small sequential loans, agent banking, group lending, and now mobile banking (Liedholm and Meade, 1995; and Swope, 2005).

- Sequential loans: Many MFIs operate on a formula that gives out small loans, of short-term maturity, and with small weekly repayment schedules, which are easier for the poor to handle than bullet repayments at the end²¹. The amounts for future loans are increased gradually based on the repayment performance of the client, which also gives the borrower the financial flexibility needed to grow gradually, taking advantage of opportunities in a slower but safer way and allowing the development of a repayment discipline and a long-term relationship between lender and borrower;
- Agent banking (see Box 2, below): Agents are located within the community and normally develop good rapport with the clients. This rapport, a key feature in the agent banking system, is important for a number of reasons. First, personal relationships with clients provide staff with an awareness of issues that potential clients may be facing, and

²¹ These loans conform to the needs of poor microentrepreneurs, most of whom are looking for a working capital loan to expand an existing livelihood enterprise rather than set up a new one. Even when the intention is to start a new enterprise, it is often a simple processing or trading activity or service yielding a regular cash flow from which repayments can be made, and with little fixed capital requiring a larger, longer term investment loan.

by working *with* clients instead of *for* them, staff members are able to make changes in the microfinance system to accommodate for clients' needs, and, consequently, improve their own efficiency. Second, rapport helps to establish a relationship based on mutual trust and friendship, which offers clients extra incentive to repay a loan. Third, knowledge of the people in a community allows staff to recognize and avoid potential problem clients, or people who cannot be trusted to repay a loan; and

- Group lending: Group lending is designed to make up for the lack of collateral. In group lending, the loan is made sequentially to a self-selected group and their collective responsibility and the built-in incentive of further loans based on past performance cause them to pressure or even help each other to repay. According to Basu et al (2004), the efforts of MFIs to work through group-schemes have the potential of yielding a wide range of benefits. They suggest that:
 - At the level of the clients, group savings schemes are advantageous as individuals mobilize their savings jointly, and can use joint savings as security against loans. The aggregation of individual savings may allow group members to constitute larger collaterals and enhance their access to credit services.
 - At the level of the institutions, on the saving side, the use of groups and community-based organizations provides scope for generating substantial economies of scale for the collecting institution. These schemes can facilitate the development of institutions that can operate on a full-intermediation basis, rather than specializing either in collecting savings or lending. Since most credit-only institutions eventually reach a point where they are constrained on the resource side, deposit mobilization provides a sustainable basis for expanding lending operations. MFIs have the potential for eventually graduating to a less constrained market-based approach in the management of both sides of the balance sheet. They could promote more efficient intermediation.
 - At the macroeconomic level, deposit collecting institutions can help to increase domestic financial savings mobilization by tapping the resources of the poor who are otherwise isolated from the formal financial system.
 - Finally, by providing financial services on both the deposit and lending sides, MFIs that serve groups and communities could empower underprivileged social constituencies to contribute more effectively to economic development and poverty reduction. While MFIs have commonly focused on women, they may

also benefit other social groups²². One could argue that MFIs could serve as appropriate vehicles for targeting such groups.

- Information Communication Technology, especially the mobile phone platform, has facilitated the reach of microfinance to the rural and unbanked areas. The approach has caught on in several countries since the introduction of the M-pesa by safaricom, an affiliate of Vodaphone in Kenya. The future of branchless banking has several possibilities – the MNOs on their own (such as, for example, the M-Pesa in Kenya, Orange Money in Côte d’Ivoire, Senegal and Mali; MTN Mobile Money in Ghana, Côte d’Ivoire and Benin; Zain Zap in Burundi), partnership between the bank and the MNO, or acquisition of a bank by the MNO.

Box 2 : Agent model -- Making financial inclusion possible

Geographic exclusion, whether due to the extreme size of a country like South Africa, large numbers of rural migrants working in Kampala or the hilly regions of Kenya, is a huge challenge for the microfinance industry. In particular, reaching poor clients in rural areas is often prohibitively expensive for financial institutions since transaction numbers and volumes do not cover the cost of a branch. In such environments banking agents that piggy bag on existing retail infrastructure – and lower set up and running cost - can play a vital role in offering many low-income people their first-time access to a range of financial services. There are also many low-income clients who feel more comfortable banking at their local store than walking into a bank branch. To reach all such people, a number of African banks are adopting agent model banking.

A banking agent is a retail outlet contracted by a financial institution or a mobile network operator to process clients’ transactions. Rather than a branch teller, the agent can be the post office, pharmacy, supermarket, convenience store, lottery outlet, and many more. In some countries, however, the regulation of agent banking is selective on the kind of outlets that can be used. Under the model or partnership, credit functions, credit decisions and client relations are with the bank but the cash management is with the agent, who conducts the transaction and lets clients deposit, withdraw, and transfer funds, pay their bills, inquire about an account balance, or receive government benefits or a direct deposit from their employer.

The arrangement offers a win-win situation to the partners. The MFI is able to mobilize saving from and extend credit to the bottom of the pyramid people as well as offer insurance schemes or handle remittances. The benefits to the clients under such partnerships are in terms of the reduced travelling costs and the personal attention. The agent benefits in commissions provided by the MFI.

There are, however, challenges. At the partnership level, there is the issue of prompt payment of cash collected, the problem of ensuring discipline of remotely-located officers, and the risks of fraud. However, the benefit of technology and the use of management information systems and clear operational guidelines are helping to resolve some of the challenges. However, as in the case of branchless banking, regulation still poses a challenge, with many authorities either overregulating or under-regulating. There is need for experience sharing as countries reform regulatory frameworks to reflect such innovative changes in the financial inclusion methods.

Microfinance Interest Rates and Pricing

The interest rates of microfinance institutions are high, as MFIs grant many more small loans than traditional banks do, using a rigorous methodology that results in higher operating and processing costs. Moreover, a lack of information on past credit performance and, in many cases, an inadequate legal structure to enforce non-payment increases risk for lending

²² First Allied S&L in Ghana works with occupation-based groups such as butchers, kente weavers, carpenters, and other associations

institutions, which also causes MFIs to charge higher interest rates than in the traditional banking sector to cover their risks. However, when compared with informal moneylenders the MFI rate is often significantly lower. In the same way, micro-insurance premiums are higher than the regular insurance premiums, reflecting higher operating costs as well as high vulnerability of the poor and their lack of alternative means to protect themselves.

The high interest rates and premiums are, therefore, important for the sustainability of the MFIs and to ensure continued availability of the service, which is considered by development experts and supported by evidence to be more important to microentrepreneurs than lowly-priced services that may not be accessible or available on sustained basis²³. However, it is not always easy for MFIs to be fair and transparent regarding pricing. In this regard, MFIs may benefit from membership and support from Microfinance Transparency that not only certifies the transparency pricing of member MFIs but also provides training and support in calculating what could be fair interest rates, using a number of elements (including term, upfront fees, upfront savings, and savings interest rates²⁴).

III.2.2.Meso-Level: Industry Infrastructure and Systems

The meso or industry level provides the infrastructure and systems that facilitate the activities of the institutions and reduce transaction costs. The stakeholders (see Table 1) are providing the following services:

- Payments and clearing systems, which increase efficiency and reduce transaction costs;
- Information infrastructure, including legal and regulatory framework for information exchange, the rating agencies, private credit bureaus, public credit registries, public sector databases such as property, vehicle collateral and asset registries, voter registration and national ID databases, and auditors that enhance transparency on institutional performance and transactions as well as creditor information, thereby enhancing risk mitigation;
- Technical support, capacity building and education services (research companies,

²³ According to Planet Finance (2009), in 2006, globally, the average interest rates in sustainable MFIs were estimated to be about 26%, while a study conducted in the Dominican Republic, Colombia and Chile showed, for example, that even a monthly interest rate of 6% represented only 0.4– to 3.4 % of a microentrepreneur’s operating costs and research conducted in India, Kenya and the Philippines showed that the average annual rate of the return on investment in microenterprises ranges from 117 to 847 %.

²⁴ See information from Microfinance Transparency: <http://www.mftransparency.org/>

universities, training and technical assistance providers, consultants), which enhance innovation;

- Associations and networks of retail financial service providers and other institutions engaged in advocacy and information dissemination;
- Financing infrastructure (wholesale or second-tier mechanisms, such as apex lending facilities, commercial banks etc);
- Financial and capital markets (investment funds, bond issues and securitization).

The financial infrastructure and systems, therefore, enable risk mitigation, improve transparency, increase efficiency, and enhance innovation (UN, The Blue Book, p.115). A well developed meso-level is, therefore, important for the functioning and progress of the financial system generally and especially for supporting the activities of the institutions and access of the poor to financial services. While a review of the financial infrastructure in Africa shows that it needs substantial strengthening to match the vision of financial inclusion in the continent, a few services are improving.

Credit Registries and Credit Bureaus	Countries	
Public Credit Registries (26)	Angola Burundi Cape Verde CEMAC (6) DRC Ethiopia The Gambia	Guinea Liberia Madagascar Mauritania Mozambique Sao Tome WAEMU (8)
Private Credit Bureaus (13)	Botswana Ghana Kenya Malawi Namibia Nigeria Rwanda	South Africa Swaziland Tanzania Uganda Zambia Zimbabwe
MFIs participate in Credit Bureau or Credit Registry (6)	Burundi Mozambique Rwanda	South Africa Tanzania Uganda
Neither Credit Bureau nor Credit Registry (6)	Eritrea Lesotho	Sierra Leone Sudan
No Information (4)	Comoros Djibouti	Seychelles Somalia

Source: CGAP: SSA Microfinance Analysis and Benchmarking Report 2009

Many countries are in the process of introducing secure, speedy and effective wholesale payments systems, while the application of information technology (IT) platforms have also facilitated mobile banking in a few countries. Private credit bureaus and public credit registries that enable the MFIs to gather information about the credit history of clients of financial institutions and assess their credit risk have also sprung up in a number of countries (see Table 2 above)²⁵. However, only three countries allow MFIs to participate in existing private credit bureaus (Rwanda, South Africa for all lenders, and Uganda for microfinance deposit-taking institutions). MFIs participate in public credit registries in three countries (Burundi where MFIs must report to the registry, Mozambique where MFIs can access borrower information, and Tanzania, once in place). Kenya, Morocco, South Africa and Nigeria are also reported to have local rating agencies. A few technical service providers and capacity building facilities also exist in various countries, such as the “Confédération des Institutions Financières » (CIF) in West Africa and based in Burkina Faso, and the MicroSave project in Kenya, which have trained experts in various area of microfinance. Microfinance professional associations, which help to collect and disseminate information, provide capacity building, dialogue with government and, in some cases, participate in setting standards, and also help in market development. Their activities are particularly important in nascent and small markets, countries with a very challenging MF context as well as very large countries. In Africa, according to AMAF, these associations are strong in Benin, Ethiopia as well as Ghana, Uganda, Kenya and Malawi, and they play important roles for the sector in their countries (see Annex 8). Generally, however, the financing infrastructures are weak in Sub-Saharan Africa but are strong in South Africa and the North African countries.

III.2.3.Macro-Level

The government, through its various ministries, the central bank, financial supervisory agencies and other policymaking and regulatory agencies, provides the enabling environment for the growth of MFIs and the effectiveness of the financial infrastructure. In particular, the government is responsible for ensuring the existence of an appropriate policy framework, effective legal, regulatory and supervisory system, and a conducive investment climate.

²⁵ Purpose of public registries is banking supervision, while private bureaus seek to help lenders make better credit decisions.

Policy Framework

Until the 1990s, the approach adopted by policymakers (and donors) towards fostering inclusive finance consisted largely of Odirigist measures or direct interventions through a blend of targeted credit programs, interest subsidies, establishment of specialized development finance institutions and other donor and government instruments. The case for the direct interventions and the subsidized microfinance programs was based on the arguments that:

- the poor cannot save;
- the poor need cheap credit to empower them to participate in economic activities;
- cheap credit would encourage the poor and microenterprises to adopt modern technology in their activities; and
- private banks provide little or no credit, forcing small and poor borrowers to use moneylenders who charge usurious interest rates.

However, these programs generally had a limited outreach and resulted in huge costs, with little identifiable impact on financial inclusion for the poor. Furthermore, microfinance programs and institutions sponsored by government and donors from Tunisia to Malawi, Senegal to Tanzania collapsed under the weight of losses generated by the interventionist and directed credit strategies manifested by subsidy dependence, low recovery rates, inadequately diversified portfolios, inadequate credit targeting and rent-seeking by credit officials. Private, for-profit financial institutions were crowded out of the market by state and donor-supported microfinance institutions. Despite the enormous resources directed at subsidized credit interventions and frequent bail-outs of state-owned credit institutions, the approach failed to provide access to financial services for the poor and microenterprises.

With the financial sector reforms that were launched in the late 1980s, African countries adopted market-based economic management programs, including liberalized interest rates and exchange rates, and targeted the maintenance of stable macroeconomic conditions, especially low inflation and stable exchange rates, towards fostering sound financial systems. They have also rehabilitated ailing banks and privatized most of them, while also opening up the banking sector to foreign competition.

Box 3: Six key messages that frame the parameters of a favorable policy environment

1. Governments have key roles to play in giving priority to building a sound and responsive microfinance sector. Governments have major roles to play in building solid, responsive policies, regulations and legal structures that work for microfinance. Governments need to stay out of retail microfinance and encourage private institutions to build sustainable services.
2. Interest rates should be liberalized (*market-determined*), ideally for the financial sector as a whole. At a minimum, interest rate ceilings should be removed for microfinance, to allow institutions to charge what it costs to provide sustainable access, using competition—not controls—as a means to get interest rates down.
3. Microfinance networks, rating agencies, and wholesale finance institutions all have important roles to play in building performance standards and transparency among unregulated and regulated MFIs.
4. Governments need to recognize the important role that regulated and unregulated institutions can and do play in microlending, with regulations focused on those institutions that seek to mobilize savings from the public.
5. Regulatory and supervisory regimes should address the special features of microfinance, to encourage a range of regulated financial institutions to pursue microfinance. Often, the entity responsible for regulation and supervision needs to build capacities in this area.
6. New and modified legal structures are often needed to ensure that such dimensions as minimum capital and reporting requirements are tailored to the relatively small size of many institutions that specialize in microfinance.

Source: Women's World Banking: Policy Change – Experience in the WWB Network, WWB Network, Vol 1, No. 3, October 2003

However, financial sector reform by itself, although very important, is not generally accepted as a sufficient condition for fostering financial inclusion. In particular, some governments see a legitimate need to continue with interest ceilings on the grounds that 'high interest rates are not acceptable in the market segment that serves poor and low-income people and that they may reduce the profitable business opportunities for the poor, reduce their ability to accumulate assets, and may also lead inexperienced or financially unsophisticated poor or low-income borrowers into debt traps' (The Blue Book, p102). Consequently, while many countries decontrolled interest rates in the 1980s and 1990s, there were still countries left that had some form of interest ceilings up to the early 2000s (Helms and Reille, 2004)²⁶.

While some experts insist that interest ceilings are not necessary because increasing competition in the financial markets can bring down interest rates, others point to the limitations of competition in this regard (See The UN Blue Book, p103). In particular, the smallness of the financial markets as well as market imperfections and structural problems can

²⁶ Three types of interest rate ceilings were observed, namely: (i) banking interest rate controls are generally codified into banking and central bank laws which grant the central bank of a country the legal authority to fix the maximum lending rate (and sometimes the minimum interest rate for deposits) for regulated financial institutions; (ii) usury limits that are part of the civil code and authorize a government body, generally the central bank, to set a limit that private lenders may charge; and (iii) De facto interest rate ceilings that resulted from political pressure and/or the need to compete with large subsidized government lending programs that keep interest rates below a specific level (Helms and Reille, 2004, p. 8).

limit competition, especially in rural areas, preventing the lowering of interest rates in the short-term. At the same time, there are concerns that ‘interest rates charged in microcredit operations should neither prevent achieving sustainability nor promote hidden inefficiencies, emphasizing the importance of disclosure and performance benchmarking across the sector’ (UN, The Blue Book, p 103). Therefore, while most governments have shifted policy paradigm to market-based principles, they are also paying attention to issues of transparency and accountability as well as institutional efficiencies and improvements in the investment climate, all of which are important for sustainability of the MFIs (see Box 3 above and Annex 3).

On broader policy issues, some governments have incorporated financial inclusion in their overall development policies, the poverty reduction strategy and other sector strategies such as the financial sector development and rural development strategies. Others, like Nigeria and the WAEMU countries, have gone even further in developing national microfinance strategies. These activities have facilitated an increase in knowledge and understanding of the significance of inclusive finance, the sharing of a common vision, and clarification of the desired direction with desired timelines, which various ministries and public agencies are incorporating into sector strategies²⁷. However, many countries are yet to undertake this critical step, as currently, AMAF estimates that only 17 African countries have put in place microfinance strategies (see AMAF/WWB, 2008). Based on the experiences to date with the formulation and implementation of national microfinance strategies, UNCDF is currently working on an approach to develop national financial inclusion action plans which take less time to develop and are more action oriented.

Legal, Regulatory and Supervisory Frameworks

In the second generation financial sector development reforms that many countries launched in the mid-1990s, governments are focused on improving financial governance and financial infrastructure, including strengthening accounting, auditing and other information systems as well as the regulatory, supervisory and payments systems. However, there has also been a general acceptance of microfinance as an essential market segment of the financial sector, and a realization that strengthening the legal, regulatory and supervisory frameworks for microfinance is critical not only for the advancement of microfinance and the soundness of the institutions but also the health of the financial sector as a whole. In particular, while savings and credit cooperatives are assumed to be self-regulating, as deposit-taking increases, the need for prudential supervision becomes important to safeguard the health of the financial sector.

²⁷ See CGAP: Brief on Microfinance Strategies, June 2008.

Governments are, therefore, adopting several significant changes such as a push toward transparency and more rigorous standards, as well as the adoption of important reforms on the regulation front (see Table 3 below).²⁸ The integration of microfinance into formal financial systems also brings new compliance requirements, such as AML/CFT regulations, as well as new opportunities, for example to tap into payment systems and to get real time settlement.

Experts, however, agree that while a deep regulation would contribute to enforcing international financial standards and making microfinance safer (and depositors too), it could also make it too complex for small MFIs to operate; and the net effect could be a reduction in microfinance supply, which is the consequence that regulation want to avoid. Furthermore, a too strict regulation usually limits the capability to innovate, therefore policy makers deciding which regulation to implement must consider the overall soundness of the financial system, but also innovation.

The objectives of regulation should include: financial system stability; depositor protection; customer protection; effective and efficient use of investors' funds; the setting of minimum standards; promotion of industry encourage growth; and clarification of the legal position of MFIs (see Chiumya, 2010). In general, experts (see Vento, 2010) agree that the regulatory framework for microfinance should depend on a number of criteria, as follows:

- **Systemic risk deriving from MF, which depends on the development of the industry in the country, on the industry's age and on the volumes intermediated by MFIs in the financial system:** Regulation and supervision are expensive public goods²⁹, and should be used in those areas with the highest payoffs in terms of systemic risk mitigation. Therefore,
 - where MF is a marginal phenomenon, involving a few credit-only NGOs and a small number of beneficiaries, there would be no need to regulate,
 - where MF does not create systemic risk, given the small amount of loans and the very limited access to the payment system of MFIs, experts generally agree on soft regulation, essentially based on public registration (licensing), or suggest the implementation of self-regulation schemes and second-tier regulation (delegated

²⁸ More details of these legislations are reported in MIX, 2009.

²⁹ Moreover, in some developing countries, it is more likely that public goods are involved in a host of principal-agent failure such as corruption, which often make vain any attempt to supervise microfinance institutions. On cost and benefit analysis of supervising MFIs as well as on the danger of corruption see Meagher (2002).

regulation).

- The need to design a specific regulatory framework for MFIs is especially felt in the countries where MFIs are significant actors in the financial market; otherwise, the most common solution that is adopted is to regulate under Banking Law those entities which collect deposits and offer loans, whereas credit-only organizations are often in a shadow area, without any explicit regulation or supervision³⁰.
- **The typology of activity carried out by MFIs; particularly, the most sensitive distinction is between credit-only institutions, entities that collect savings, and intermediaries which provide other financial services not included in traditional intermediation:**
 - All the institutions that provide credits as a unique financial service are characterized by a very low contribution to the overall systemic risk. Therefore, they are often not regulated even if some countries require from them transparency standards and the control of unfair practices (so called “conduct of business” reporting).
 - Of course, whenever a MFI does not limit its activity to credit supply, but collects savings, and sometimes offers payment instruments, the institution is almost everywhere forced to be converted in a regulated entity (commonly a bank), or assumes the status of “microfinance bank” where a specific regulation exists. Such conversion, as obvious, implies the respect of all entry requirements, of minimum capital requirements and prudential ratios, as well as of periodical reporting.
 - For MFIs which offer other financial services, it seems appropriate to adopt a regulatory approach similar to credit-only institutions, if the only peculiarity is represented by the lending methodology; on the other hand, for those MFIs which intend to provide more complex financial service than the traditional financial intermediation, a specific regulation is strongly recommended.
- **The origin of funds utilized in order to provide microfinance services -- public’s sums, donor’s funds or member’s savings:** Whenever money is donated by third-party organizations, these usually have appropriate instruments for assessing the MFI they intend to finance; furthermore, in absence of specific regulations, donors can prevent unfair practices by monitoring the selected institutions and requiring from them specific reporting on the use of funds. However, when funds are provided by the public or from

³⁰ On the options regarding regulation of credit-only MFIs see Christen and Rosenberg (2000).

deposits, because of asymmetric information between depositors and MFIs and the fact that depositors are exposed to moral hazard in the event of MFIs' crises, regulation and supervision are required. Therefore, the ideal regulation to adopt must be diversified according to the source of funds.

- All MFIs, whatever is their source of funding, in order to improve their capability to attract money, should be required to be publicly registered and should produce periodic reporting (including at least credit methodologies, concentration, credit provisioning and write-offs) to be addressed to a specific regulatory body – where microfinance market is a significant portion of the financial system – or to the authority in charge of supervising the financial system in other cases;
- MFIs which collect public's funds should be compliant with a set of tailor-made rules concerning market entry, minimum capital ratios, organization and deposit insurance. These regulations on one hand should impose milder capital requirements than banks, on the other hand they should delimitate the potential activity, and therefore the risk, that these entities could run.
- **The nature of MFIs to somehow regulate, analyzing institutions that have different legal structures, governance, target clients and goals (distinguished, for descriptive reasons, in NGOs, credit unions, microfinance banks and downscaling commercial banks), which must be treated according to various approaches:** The most significant aspects to deepen about the nature of MFIs and their regulation are legal structures, the borders of their activities and their internal organization .
 - As mentioned before, as long as NGOs operate as credit-only institutions they need a very limited attention from regulators; however when NGOs begin to offer savings facilities they are required to assume a different legal status, with a well-defined capital in order to calculate prudential ratios and to implement internal control functions. These institutions, therefore, should then be regulated according to their new nature.
 - Credit unions and microfinance banks, considering their deposit-taking nature, but also their difficulties in raising capital and their goal of sustainability, have to be regulated by a specific set of rules which prescribe less stringent capital requirements and an easier organizational structure than banks.
 - Downgrading commercial banks, which by definition are fully regulated banks according to the national “Banking Law”, do not seem to need particular

requirements if compared to other banks, because they go on performing not only microfinance services; therefore, in most countries they continue to be supervised and regulated as usual banks.

The combination of all the above-mentioned criteria implies that it is not possible to imagine a single regulatory approach suitable for microfinance industries continent-wide

Box 2 above and Annexes 4 and 5 provide examples for how the policy, legal and regulatory frameworks, which focus on the promotion of private sector involvement and the adoption of market-oriented financial and credit policies, can be developed to accommodate some of the particular features of microfinance. Some of these elements are reflected in some of the microfinance frameworks already developed in African countries. These frameworks include the regional frameworks developed for both the WAEMU and COBAC areas but also some country-specific ones developed for a number of African countries (at least 39, as reported by AMAF)³¹.

Box 3: Responsible Finance: Mobilizing Stakeholders at the Micro, Meso and Macro Levels

Responsible finance is concerned with the delivery of retail financial services in a transparent and equitable fashion. Focus on products, processes, and policies that appropriately balance customers' interests with those of providers' and avoid harmful or unfair treatment. Responsible finance is promoted through measures that may include consumer protection regulation, industry or provider codes and standards, and improvements in consumer financial capability.

- **Regulation.** The first pillar focuses on the role of governments in setting legal and regulatory frameworks that protect consumers and establishing effective and efficient mechanisms to enforce these standards while supporting financial inclusion at the same time. The main challenge is the tradeoff between risks and potential over-regulation. There is a need to set priorities that are proportionate to actual risks on the one hand and safe, sound and sustainable access for low income clients on the other.
- **Self-regulation.** The second pillar focuses on industry self-regulation initiatives by actors in the financial industry—including investors, financial institutions, commercial banks, MFIs and umbrella bodies. Self-regulation initiatives may include voluntary codes of conduct on transparent or responsible practices by the financial industry. One of the main challenges seen is in the cost of adherence to standards and potential conflict of interest in associations supervising implementation of members.
- **Financial Capability.** The third pillar entails empowering stakeholders and facilitating behavioral change through various channels. Financial capability is the combination of knowledge, skills, attitudes and especially behaviors which consumers need to display in order to manage their money well and take the best decisions possible given their economic and social circumstances

Source: CGAP Sources

Client Protection

A related area that is gaining importance as microfinance increases is client protection. While microfinance was borne out of a social concern to empower the poor to be able to make investments in their income generating activities and microenterprises, and lift themselves out of poverty, its spread and attractiveness as an investment avenue have elicited the interest of

³¹ However, according to CGAP (SSA Microfinance Analysis and Benchmarking Report 2009) , 29 countries have adopted explicit legislations for MFIs, while another 5 are drafting special legislations. However, in 10 other countries, MFIs fall under other broader legislations (Annex Table --).

diverse players who may not all share the same aims and ethical standards. As access has increased so have abuses.

Even for those who shared similar aims, competition grew to such an extent that credit policies became lax and led to multiple borrowing by clients and erosion of credit discipline. In some countries, notably Morocco, Bosnia-Herzegovina, Nicaragua, and Pakistan, this led to repayment crises and rapid and severe deterioration of credit quality. In other countries, crises led to strong government intervention. In South Africa, for example, an exemption to the interest rate cap led to entry of many players—including consumer credit providers, and there was little concern for portfolio quality. Unorthodox credit collection policies and perceived abuses by lenders led to the government creating a Microfinance Regulatory Council in 2000 with powers to regulate lenders operating under the interest rate cap exemption. Also in 2006, in Rwanda the Central Bank announced the immediate closure of 8 MFIs citing gross mismanagement, poor credit management practices, failure to meet minimal conditions for licensing, and loss of customer confidence. However, such emergency interventions, which were also taken by authorities in other developing regions, made policymakers and regulators more aware of emerging risks and concerns in microfinance, including unethical financing practices, over-indebtedness of clients, lack of transparent pricing, inappropriate loan collections.

In Bolivia, opening of the market to non-bank institutions and subsequent rapid expansion of credit followed with the recession made it difficult for clients to repay their loans and a debtor association was created that led the most radical wing to take the Superintendency of Banks and Financial Entities and threaten to blow it up if their demands were not met. The Superintendency was able to create guidelines for conflict resolution and the crisis was ended. In 2006, the state government of Andhra Pradesh closed down tens of branches of several of the leading MFIs accusing them of usurious interest rates, taking illegal collateral, and employing questionable recovery practices. In April 2007, Compartamos, a MFI in Mexico that was originally funded by various grants, issued an initial public offering (IPO) that was hugely successful by financial market standards, but caused a crisis of conscience amongst many in the sector, particularly because high profits were achieved through charging very high interest rates.

These risks and concerns of very high profits of MFIs, which led governments to look more closely at appropriate regulation, as well as to be supportive of the self-regulatory approaches that were emerging amongst a number of players in the sector, led to the focus of responsible finance (see Box 3 above) and eventually to the development of Client Protection Principles and Codes of Conduct. The principles of client protection, whose development was led by the Smart

Campaign, and which MFIs should be encouraged to adopt include:

- ***Avoidance of over-indebtedness.*** Providers will take reasonable steps to ensure that credit will be extended only if borrowers have demonstrated an adequate ability to repay and loans will not put borrowers at significant risk of over-indebtedness. Similarly, providers will take adequate care that noncredit financial products, such as insurance, extended to low-income clients are appropriate.
- ***Transparent and responsible pricing.*** The pricing, terms, and conditions of financial products (including interest charges, insurance premiums, all fees, etc.) will be transparent and will be adequately disclosed in a form understandable to clients. Responsible pricing means that pricing, terms and conditions are set in a way that is both affordable to clients and sustainable for financial institutions.
- ***Appropriate collections practices.*** Debt collection practices of providers will not be abusive or coercive.
- ***Ethical staff behavior.*** Staff of financial service providers will comply with high ethical standards in their interaction with microfinance clients, and such providers will ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.
- ***Mechanisms for redress of grievances.*** Providers will have in place timely and responsive mechanisms for complaints and problem resolution for their clients.
- ***Privacy of client data.*** The privacy of individual client data will be respected in accordance with the laws and regulations of individual jurisdictions, and such data cannot be used for other purposes without the express permission of the client (while recognizing that providers of financial services can play an important role in helping clients achieve the benefits of establishing credit histories).

Investment Climate

Governments in African countries are already taking steps towards establishing the right investment climate, which has to do with creating a conducive environment (macroeconomic, social and legal) for investments and business activities of enterprises and individuals. It is about reducing direct and indirect costs of doing business and reducing risks of failure: improving labor laws, building and maintaining physical infrastructure, financial infrastructure and ensuring that appropriate institutions (independent judiciary and even commercial courts, effective and impartial police and prison service, law enforcement) are established and functioning. In the financial sector,

including microfinance, which is vulnerable to economic shocks and risks of default, and where property rights are weak, it is important to establish legal frameworks for collateral and enforcement of property and creditor rights. It is also important to ensure that labor laws and land tenure systems are not restrictive and deterring to business.

Impacts: The obvious critical issue is whether the new paradigm in microfinance, with the shifts in government policy, regulatory and enabling roles, has helped MFIs achieve financial sustainability and improve outreach. While there is little hard data available to answer this question fully in African situations, Basu et al. (2004), cite some evidence and cases that African MFIs were helped by the new paradigm to improve their financial performance, especially in cases where they had autonomy over their management decisions. They cite, for example, that

- In Benin, following the 1989-93 and 1999 financial rehabilitation programs, many savings and loan cooperatives (SLCs) were able to substantially expand their deposits and loan portfolios, recover their nonperforming loans, and achieve break-even or positive net profits in their current operations.
- In Ghana, the performance in the rural microfinance sector is reported to have improved in the late 1990s and early 2000s as a result of a combination of (i) a more commercial approach, (ii) a restructuring of the sector through re-capitalization and capacity-building, and (iii) strengthened regulation, which contributed to reduce drastically the proportion of distressed rural credit banks (RCBs). From 1996 to 2001, the proportion of “unsatisfactory” credit unions declined from 70 percent to 60 percent and that of those in the worst categories from 42 percent to 15 percent.
- In Guinea, the MFIs (four of them at the time) are reported to have strengthened their financial performance over the period 1997–2003. They achieved this by lowering the share of non-performing loans (NPLs) in their total credit and raising their lending rates, and improved their prospect of achieving a more sustainable financial position. The share of NPLs in the four MFIs was considerably lower than that of the commercial banks, and with the aim of achieving financial sustainability, the MFIs maintained a wider interest rate spread than that prevailing in the banking sector.

III.2.4. Regional Level

There has been limited attention to microfinance at the regional level outside of the two economic and monetary unions (WAEMU and CEMAC), where the central banks are

involved in designing regional programs³². The central banks of these two unions are involved in developing regional policies as well as legislative and supervisory frameworks and capacity building for their respective member countries.

However, an interesting recent trend in microfinance is that of established financial service providers (such as Ecobank, with its operations in 27 African countries; Bank of Africa in 12 countries; Equity Bank, spread in the East African countries; Standard Bank in 17 African countries; and Zain Africa, which has launched a remittance platform in several African countries) expanding operations into other countries. While the cross-border operations of these regional banks take place through local branches, their regional spreads enable them to transfer know-how, strong systems, and methodologies to establish footholds in new countries fairly quickly. Therefore, they play an important role in regionalizing financial services. However, by broadening the scope of their operations, they also benefit from economies of scale and other benefits of regionalization, for example, in costly technology investments that should facilitate progress in their microfinance activities.

Over the past two years, there has also been increasing attention from the African Union, which has formulated a roadmap for microfinance development in Africa, including the adoption of the Key Principles of Microfinance (see Annex 2) and a commitment to promote financial stability, increased access and client protection.

III.2.5. Funders

Donors have been providing significant amounts of grants to MFIs in Africa and still do for most NGO MFIs and younger MFIs, but many other MFIs are increasingly tapping the potential of savings mobilization as a core source of funding. In addition, there is the potential of local currency loans from banks, some of which also refinance MFIs and take equity positions directly in some of them. Some national and international private investors are also involved in financing or refinancing MFIs. Funds can also be mobilized from the capital markets through bond issues, securitization and local equity markets.

Bilateral and multilateral development agencies, foundations, and large NGOs have traditionally provided much of the cross-border funding for microfinance in SSA. At the end of 2008, according to MIX data, donors' commitments to SSA amounted to over \$2 billion,

³² The World Bank, supported by DFID and other development partners are in the process of designing an East African Community Financial Sector Regionalization Project which has strong emphasis on microfinance and SACCOs

and represented a 13 per cent increase over the previous year. The African Development Bank and the International Fund for Agricultural Development together account for over 25 per cent of total commitments. Much of the funding is concentrated geographically, with one third of all donor funding going to just five countries³³. Donors concentrate much of their funding (66 per cent) on retail institutions, and especially capacity building, which is a serious constraint to MFI growth in Africa. However, there is also considerable donor funding (23 per cent) at the meso level, either through wholesale financing or support to infrastructure. There is also considerable interest in macro-level funding, with funding received by Africa (at 5 per cent) being higher than for any other region.

Deposits mobilization, however, remain the largest source of funding (with a share of 66 per cent) for African MFIs, as generally their microfinance clients express a higher demand for savings than for loans³⁴. Savings mobilization is set to increase even further as many MFIs introduce market-driven savings instruments. In Kenya, Equity Bank's depositors increased from 556,000 to 1.8 million between 2006 and 2007³⁵, while the amount of deposits mobilized increased by US\$110 million to US\$168 million during the same period. The performance is set to improve even more with the partnership between the bank and Safaricom, the mobile telephone company, which will enhance deposit mobilization through the use of mobile telephone technology.

Borrowings from a variety of lender types are another key source of funding for MFIs, which, on the whole, receive an equal amount of funds coming from foreign and local lenders, although the foreign loans carry a slightly higher interest rate. Some MFIs also cite high indirect costs in lines of credit from multilateral development banks because of the periodic reporting requirements³⁶. Many African MFIs have successfully arranged overdraft facilities from local commercial banks. These moves have been facilitated by increasing profit margins in micro-lending³⁷.

The stock market, although nascent in many countries, is an important source of medium and long-term funds for some MFIs. The trends in corporate financing in countries such as Ghana and South Africa and the possibility for companies in some countries (such as Botswana, Ghana, Tanzania, and Namibia) to list their corporate bonds without listing their shares is an indication of the potential of the bond market for mobilizing funds. In Kenya, Faulu Kenya

³³ See MIX/CGAP, 2009. The five countries are Ethiopia, Ghana, Kenya, Mozambique and Uganda

³⁴ This feature is also reflected in the MIX observation that during the financial crises, institutions with a strong deposit base tended to fare better than those relying heavily on foreign investment.

³⁵ WWB/AMAF, 2010 p. 3

³⁶ This view was expressed, for example, by the Chief Executive of one institution in Senegal during field mission for this study.

³⁷ In Morocco, for example, the return on assets of MFIs were reported to range between 4.08% and 19.17% in 2006 (see AMAF 2008, opcit)

DTM Ltd successfully issued a five year bond for US\$7.5 million in 2005. Equity Bank also successfully floated its shares on the stock market as a strategy to raise capital, while also improving its strategic position and raising the profile of its brand³⁸. For many MFIs, however, direct access to the domestic stock markets is not possible. Nevertheless, the capital markets hold indirect benefits of providing a source of medium to long term funds for commercial banks, which they can on-lend to corporate clients, including the MFIs.

³⁸ See page 6 of R. Reddy: *Microfinance: Cracking the Capital Market II*, Insight No. 22, ACCON, Boston, USA.

IV. SWOT ANALYSIS OF THE AFRICAN MICROFINANCE SECTOR

Microfinance is significant in the efforts to promote inclusive finance in African countries. It also supports microenterprise development and, therefore, contributes to the promotion of the private sector in African countries. In this regard, significantly, microfinance is growing rapidly, seizing emerging opportunities but also dealing with a number of challenges. The sector therefore has its strengths and weaknesses that must be taken into account as many countries endeavor to integrate it fully into the formal financial sector and consider how to enhance the sector's support to private sector development. This section analyses, with a focus on private sector development, but also on household financing, the strengths, weaknesses, opportunities and threats or constraints (SWOT analysis) at the three levels (micro, meso and macro) of the sector. The SWOT analysis forms the basis of recommendations for interventions by governments, MFIs and development partners.

IV.1. Micro-Level

MFIs must be structurally strong to offer sustainable and high-quality services to the private sector, especially microenterprises and households. Despite their significant presence and growth, most MFIs in African countries are far from achieving financial and institutional sustainability and are, therefore, constrained in the support they could provide to the private sector.

IV.1.1. Micro-Level Strengths

Strong savings growth: Often called the “forgotten half of microfinance,” savings has emerged as the number one issue for microfinance clients³⁹. For many MFIs, savings provide a source of funds for financing enterprises. Savings growth is particularly strong in African countries. MIX estimates an average penetration rate of 5 percent for savings in African countries. At the end of 2008, MFIs in SSA reported reaching 16.5 million depositors, significantly higher than the 6.5 million borrowers. Moreover, while SSA witnessed a slowed

³⁹ At a recent forum of development partners and practitioners on microfinance and enterprise development (USAID, 2008), participants agreed that savings and insurance are more relevant financial services to the very poor than credit. This is partly because very poor people are unable to start a sustainable microenterprise, and most vulnerable households are not ready to take on the opportunities and risks of credit. That, in turn, doesn't make them attractive clients for credit-only providers, especially, those focused on sustainability.

growth in borrowers in 2008, there was a continued and strengthened uptake for depositors, as their growth rate increased by 10 percent to reach 40 percent, which is more than for any other developing region. Savings mobilization provided a source of growth through the financial crisis for deposit-taking MFIs. While the crisis caused a dramatic slowdown in borrower growth in 2008, from 25 percent in 2007 to just 12 percent in 2008, deposit-taking MFIs, which dominate the African market (reaching 86 percent of all SSA borrowers) grew faster than MFIs that do not mobilize deposits. In fact, the growth in borrowers at the median deposit-taking MFI approached 20 percent, much higher than SSA's 12 percent growth in borrowers across all types of MFIs.

Desire of some cooperative institutions and other MFIs to adapt their structure to the environment: Several cooperative institutions have modified their structures and innovated in order to adapt to local circumstances. They have found solutions for improving their profitability while meeting local demand, for example by placing teller windows linked with their branches in remote areas and by grouping certain branches. Other MFIs have located branches at walking distance from the markets. These moves have helped the MFIs concerned to reach high efficiency levels despite the high cost in the African context.

Increased ability to service the rural areas: Rural finance remains one of the major challenges facing microfinance, and several rural regions have sparse coverage by MFIs because of cost considerations. However, increasingly, with the application of technology and the development of innovative methodologies, rural areas are now being reached by MFIs in countries such as Kenya and Ghana.

Suitability for support to microenterprises and private sector development: As indicated earlier (see Section II above), MFIs provide suitable support to microenterprises and, therefore, private sector development in a number of ways:

- They provide access to financial services, including credit, insurance and pension, towards smoothing the income of the poor and ensuring that they do not use their working capital to support the enterprise in time of economic and financial shocks or during lean seasons. MFIs, therefore, help to enhance risk management, permit enterprise development and make for better money management, all factors that contribute to building sustainable microenterprises;
- The methodology of MFIs, especially the small, sequential loans (see Microfinance Methodology under Section IIB), conveniently meets the needs of poor micro-entrepreneurs in obtaining flexible financing to start or expand microenterprises;

- MFIs can also leverage their activities by creating linkages with the banks as a source of wholesale finance, creating efficiencies in the mobilization of resources from microenterprises and expanding their access to finance.

IV.1.2. Micro-Level Weaknesses

Structural fragility of most MFIs

One distinguishing feature of microfinance in most African countries is the relative fragility of several MFIs, which generate internal risks to the strength and sustainability of their operations, thereby constraining them from playing a fully effective role in financing the private sector, enterprises and households. In many cases, the fragility of the MFIs reflects the following:

Governance problems: There is a serious governance problem among cooperative institutions that make up the vast majority of MFIs in African countries. The market as a whole is thus made more fragile. Several difficulties are apparent:

- Volunteer work may make some elected heads not as motivated and lead to frequent departures before the end of terms. The need to engage in remunerated activity is not always compatible with their mission.
- Some managers lack the training and skills in management and finance to carry out their duties effectively.
- Some social behaviors are inconsistent with the cooperative principle: favoritism in extending credit, embezzlement, and setting poor examples regarding loan repayment.

The cooperative institutions often are poorly managed as a result. Relationships between salaried technicians and elected officers are sometimes tense, particularly regarding decision making and allocation of work within institutions.

Poor portfolio management: According to the 2009 MIX report, although portfolio quality among MFIs in Africa has improved in recent years due to increased due diligence, portfolio risk is still higher than in other regions. The portfolio at risk (PAR) for over 30 days and 90 days in 2008 were 5 percent and 2.7 percent respectively, with the corresponding averages for Central Africa reaching as high as 8.7 percent and 7.2 percent respectively. The average PAR ratio is higher than world averages and the CGAP recommended standard for PAR > 30 days not to exceed 3–5 percent. A sizable PAR poses a cost burden (decreased interest income, increased collection costs, larger reserves provisioning, etc.), which constrain the MFIs in financing enterprises

and households. Besides, it causes the sustainability of African MFIs to be achieved only slowly, and the additional costs are reflected in the high interest rate charged to clients.

Lack of internal systems and controls: In a period of growth, this weakness poses even greater risks, and many of the individuals interviewed confirmed a high incidence of misappropriation of funds, especially among the cooperatives and in the rural areas. Computerized management information systems (MIS) are still not in widespread use. Even where procedures are in place, it is difficult to monitor activity closely. This lack of technical resources is compounded by the problems of introducing efficient internal controls attributable to insufficient human and financial resources.

Scarcity of human resources: The recruitment and management of human resources are challenges for MFIs in African countries, particularly for those established in rural areas. The scarcity of skilled staff leads to sizable recruitment and training costs. It is particularly difficult to find qualified staff in rural areas or to attract such staff from the cities. In addition, there is considerable turnover among staff who are constantly attracted by new opportunities.

Supply of credit not fully meeting demand

Inadequate supply of credit: MFIs in Africa generally show a higher level and volume of deposits than of credits. According to MIX (MIX, 2009), the situation was exacerbated in 2008, reflecting a worldwide trend, and growth of borrowers slowed dramatically to 12 percent, from 25 percent in 2008. There are several reasons for the generally limited number of borrowers compared to depositors, and especially also for limited medium and long-term lending: (i) methodological shortcomings, such as requiring real guarantees that microenterprises and poor clients have difficulty providing; (ii) the attractiveness for MFIs in many countries of placing assets in Treasury bills (BTAs)⁴⁰ with high rates as compared to loan portfolios; and (iii) the fact that most deposits are short-term provides no incentive for MFIs to grant medium- and long-term loans to private entrepreneurs.

Limited ability to meet demand from enterprises

Demand for credit from enterprises has been normally much higher than the MFIs can support. Some studies indicate that less than 15% of SMEs in African countries have access to

⁴⁰ Treasury bills generally attract much lower interest than credit provided to borrowers. However, the attractiveness of Investment in treasury bills could be a reflection of conservativeness in providing credit and a risk mitigation strategy.

microcredit – 14% in Zambia, 13.6% in Mozambique and 10.8% in Kenya, with credit in Mozambique being relatively more frequent in urban than in rural areas (16.1% and 13.1) and quite similar between male and female headed MSEs⁴¹. The Mozambique survey also showed access to credit to be much more frequent among trading enterprises and restaurants (20.1%) and fishing and extraction activities (21.6%), compared to other sectors. The higher capital turnover in trading activities may be the major reason for this finding. However, across activities, the results indicate that the great majority of SMEs receiving credit operate in trade and manufacturing. This result is consistent with findings in other countries. Even so, the type of activity is just one of the many factors determining access to microcredit. Other factors include the level of education of the enterprise owner and the size of the enterprise. The source of credit, however, varied widely among countries. In Mozambique, the source of credit was family members and moneylenders but surprisingly low from the ROSCAS (0.2%) and formal institutions (2%). This structure of share of MSEs receiving credit by source is very similar to that found by Parker (1996) in Zambia, but very different from Kenya (Daniels, Mead and Musinga, 1995), where nearly half of all credit came from ROSCAS, followed by formal credit institutions, and relatives.

IV.1.3. Micro-Level Opportunities

Large number of points of service: Accessibility is an important factor for micro-entrepreneurs and other microfinance clients. Thanks to the large number of bank branches, savings banks, and post offices, the African microfinance infrastructure has immense opportunities for serving microenterprises and other clients. Moreover, for commercial banks in particular, a remarkable diversity of distribution channels has emerged over the past few years, including the traditional branches, ATMs, mobile phones and debit/credit cards, to enhance their retail capacity in lower income market segments. In Ghana and some other African countries, some banks have mobile units or branches located within walking distance from the markets to facilitate collection of deposits from traders. These developments could signify a future direction of the NBFIs that are also trying to augment their retail capacity.

Increasing linkages among the banking sector, private sector, and microfinance as MFIs increasingly place funds with the banks and banks also provide funding (or refinancing) for the MFIs. In addition, banks are beginning to invest in the capital of MFIs. At the same time, in some countries such as Kenya and Uganda, MFIs are connecting with small businesses as agents to connect to clients in hard-to-reach areas. These linkages are enhancing the ability of

⁴¹Mozambique Ministry of Agriculture and Fisheries: Micro and small Enterprises in Northern and Central Mozambique: Results of 1996 Survey, Working Paper No. 27, MOA, Mozambique, 1997.

the MFIs to serve micro-entrepreneurs and other clients.

Technological Advances: Technology offers a big opportunity to microfinance in terms of improving MIS but, increasingly, it is also impacting on products and delivery channels, and in particular enabling the offer of cost-effective money transfer products on a large scale. Automated payment technologies, including mobile phones, internet banking, ATMs, point of sale card readers and satellite communications have eliminated the need to carry large cash amounts while also increasing the convenience of banking. In addition, technology is facilitating the development of methodology to reach the rural areas, which have been difficult to serve because of cost considerations. Currently, mobile branches are surfacing in many African countries as a strategy to service clientele who live in areas in which it is not cost effective to open a branch. Such advancements are particularly important for rural enterprises, which can now be served by the MFIs.

Development of innovative financial products: With the benefits of years of experience, market research and client feedback, many successful financial products for microenterprises and poor households have been developed, including savings products, loans, micro-insurance, micro-leasing and housing finance. More significantly, the pace of innovation is quickening as, in addition to the wealth of new technologies, the finance sector benefits from the understanding of the needs of the private sector and reorientation of MFIs. These developments have also helped to control operational costs, which are very high in Africa and can erode profit margins and the ability of the MFIs to serve high risk, even if high profit, enterprises.

IV.1.4. Micro-Level Threats

MFIs face a number of challenges in financing the private sector in African countries. These include the following:

Unfavourable environment and situation of clients: The health of the MFIs depends ultimately on the conditions at client levels. The informal sector clients of the MFIs encounter various challenges, translating into high risks for the institutions:

- the business environment is costly and cumbersome for the MFI clients, reflecting high prevalence of corruption; lengthy and costly processes to establish a business; difficulties in securing business premises, irregular and costly transport, electricity and water; and limited access to support services;
- limited legal rights of women, who form the majority of clients of MFIs;

- as access to microfinance increases, vulnerable clients with limited knowledge of their rights and limited knowledge of financial management may overextend their repayment capacity, endangering the health of the MFIs;
- socio-economic indicators show that poor households and micro-entrepreneurs in Africa are more prone to diseases than in other regions, exposing them to high and unexpected health expenses; and
- the informal enterprises that predominate African economies may not have the right documents to access financial services.

Unfavorable environment and situation of MFIs themselves: The conditions of the environment of the MFIs mirror some of those faced by their clients, including microentrepreneurs, unreliable, and costly infrastructure services; weak property rights and enforcement policies; poor governance standards; weak human resource capacity, reflecting the level and type of education, health and high labor costs; low and uneven population densities; socio-political conflicts and frequent civil strife. These unfavorable conditions, in turn, translate into a number of risks for the MFIs in financing the microentrepreneurs:

- High costs constitute a very serious challenge to the operations of the MFIs. The situation reflects low and uneven inadequate and expensive infrastructure, high labor costs, and high portfolio at risk compared to other regions; and diseconomies of scale due to the smallness of financial markets;
- Poor and uneven quality of management at a time of rapid change constitute the greatest risk for the MFIs, as the institutions are being stretched by high rates of growth, the growing complexity of business and pressures to become more commercially-oriented. Also significantly, MFIs tend to be dominated by visionaries, who are strong on charisma but less so on management skills and strategic flexibility;
- Poor quality of corporate governance, which is closely related to the poor quality of management, and can lead to lack of information and transparency, low portfolio quality, reluctance among funding agencies, and lack of growth or collapse of the MFIs;
- Poor quality of staff is a perennial and worsening risk for the MFIs in Africa with the increase in competition, poaching of staff, lack of training and high and rising salaries. According to MIX (2009), there is a high staff turnover among MFIs in Sub-Saharan Africa (SSA), contributing to high operating costs. MFIs in the region allocate a higher percentage of their funds toward staff salaries compared to other regions.

IV.1.5. Micro-Level Recommendations for Government, MFIs and Development Partners

In the decade ahead, the challenge on advancing inclusive finance at the micro-level will center on expanding and sustaining retail capacity, providing financial services that respond to the needs of micro-entrepreneurs and poor households, especially helping them to generate income and build assets, and reducing transaction costs that can be passed on to clients at lower cost. While the primary responsibility is on the MFIs themselves to improve their performance and take advantage of emerging opportunities and technology to deal with challenges and improve their operational and management efficiency, governments and donors could provide support. In particular, **governments** should provide upstream support to MFIs by fostering an enabling policy and regulatory environment that balances increased access for poor people, financial stability, and consumer protection and, through enhanced competition, encouraging the MFIs to improve efficiency⁴². **Donors** would provide support to both governments and MFIs themselves, as appropriate, through enhanced dialogue and increasing awareness of best practices, supporting analytical work or research and the development or dissemination of guidelines (or know-how tools); building capacity towards improved methodologies and practices; and providing financial support. Support to the government could be provided through the regulatory or supervisory ministries, or authorities such as the central bank, while support to MFIs could be provided through collaboration with MFI associations or apex institutions, by grouping cooperative institutions or creating points of service, and, where possible, through collaboration with MFI regulatory and supervisory authorities.

Strengthen institutional capacity to deliver a range of financial services (at reasonable cost to those with limited access to financial services)

MFIs should clarify their vision, set goals and take action towards enhancing the sustainability of their institutions and expanding their retail capacity. Four lines of action are particularly important:

- improving operational management and portfolio quality by improving MIS and adopting international standards in portfolio management;
- Improving financial management and especially structure fees and interest rates appropriately;

⁴² Based on African Union-Recommended Best Practices for Adoption by Member Countries (see Annex 6)

- Improving internal governance, including clarifying the roles of board members and technical staff and improving transparency and accountability; and
- Strengthening human resources capacity – ensure adequate staff strength and appropriate skills mix.

Development Partners: Support MFIs in the four areas outlined above, namely improving operational and portfolio management, financial management, internal governance and human resource management.

- ***Support MFIs to improve operational management and portfolio quality.*** Development Partners could provide technical assistance to address the problems of lack of adequate MIS and lack of appropriate methodology for due diligence on borrowers, which are at the root of high PARs. Donors could also finance training in credit risk analysis and help to deploy credit scoring tools to more MFIs. In addition, donors could finance technical assistance targeting MFIs to resolve the problem of portfolio quality by disseminating quality standards for portfolio management (e.g., international standards for calculating PAR, provisioning rules) and helping to develop portfolio rehabilitation plans (including special procedures for recovering arrears).
- ***Build capacity of MFIs on financial management.*** Donors could help MFIs improve their financial management capability, including the analysis of their cost and revenue structures. This should enable them to gain better knowledge of and mastery over setting fees and interest rate structures with a view to achieving greater efficiency and financial viability. In addition, donors could support capacity building of local audit firms to audit MFIs.
- ***Encourage MFIs to professionalize their governance.*** Donors could provide training towards improving the definition of the allocation of responsibilities among elected officers and technical personnel and also support the technical training of elected officers and technical specialists through networks.
- ***Contribute to the strengthening of human resources capacity:*** Enhancing human resources is an issue that extends substantially beyond microfinance and has long-term implications. Nevertheless, development partners can help MFIs acquire and maintain staff they require. They can finance technical assistance relating to the development of human resources for MFIs such as improving recruitment methods, introducing career and training plans for employees, developing incentive systems, and

creating other mechanisms to increase staff motivation and loyalty.

Governments should set policies at macro level and support development at meso level that enable MFIs to strengthen institutional capacity, and set standards to ensure that they do. Governments should focus policy and regulatory actions on promoting a stable economic, financial, and legal environment for microfinance. In this regard, governments could promote the adoption of international standards as part of the regulations and encourage development partners to support and work with the MFIs in improving their operational efficiency. The BCEAO Regional Decentralised Finance Support Programme (PRAFIDE), supported by Lux Developpement, UNCDF, CGAP and other Development Partners (see Annex 7) provides a best practice example as to how the government could target its support. In this project,

- Government disseminates a new legal framework and strives to clarify its implications to supervisory units and professional associations
- Government ensures implementation of the new law to improve the health of the microfinance sector through effective supervision and oversight
- Government ensures improved quality and standardization of financial reporting (by introducing a new accounting framework and establishing a credit bureau)

Promote development of a range of services to meet the needs of the poor and those with little or no access

To improve the linkage between supply and demand, there would be need for:

- *undertaking market research on demand to better assess clients.* Although there are many research and evaluation tools already available, at the national levels there could be further need to undertake research on issues concerning (i) the client base and its needs; (ii) client satisfaction; and (iii) the organization of test groups to obtain more hands-on knowledge of the market and how it reacts;
- *the establishment of a database that includes local and international experiences;* and
- *the development of new services and/or distribution methods.* This would involve the development and pilot testing of new products and/or markets.

These are largely public goods activities that would benefit from collaboration among MFIs, donors and Governments. In addition:

MFIs should maintain a strong focus on cost reduction as well as an organizational culture conducive to continuous improvement and innovation. In particular, they should

be willing to invest in product innovation, product design around specific needs of clientele, and customer focused service delivery.

Development Partners could disseminate the knowledge and know-how already gained elsewhere to support the analytical work and the development of new products. In particular, there could be several financial tools and products tailored to the poor already available in other African countries or developing regions, and they could be disseminated more widely at country or regional levels. In addition, donors could set up a fund accessible by all MFIs based on the model of the capacity-building fund referred to below (see meso-level recommendations).

Government should develop policies and regulations that support product diversification and sustainable delivery. Policies and regulations should enable the development of sustainable microfinance services and institutions that grow with their clients—eliminating subsidized, short-lived programs. Governments should also encourage microfinance institutions to operate efficiently, to adapt traditional collateral requirements for lending to poor clients and should promote the use of new technologies to reduce the cost of delivering financial services to clients.

Facilitate participation of diverse institutional types to enhance competition, improve the range and quality of services, and reduce costs

Costs remain high despite productivity gains in the last decade. Operating costs need to be reduced through improved efficiency, scale, and application of technology to enable lower interest rates and to encourage entry by a wider range of retail actors. In most countries, there is still scope for new methodologies and institutions that would increase competition, especially regarding the supply of credit. To meet this challenge

MFIs could reduce costs and become more competitive by investing in innovations in technology; building inter-institutional linkages to enhance access to finance and introduction of new services; and forging ties with various types of commercial stakeholders, such as wholesalers of agricultural equipment and inputs, merchants, etc., that can provide supportive services (e.g., an MFI might use a merchant to open a teller window on market day).

Development Partners could help finance the organization of fora that would enable local bankers to meet other bankers involved in microfinance to enhance awareness. Donors might also support the direct activities of banks involved in the sector and disseminate good microfinance practice information to all banks. Moreover, through their work in many

different countries, donors have gained familiarity with various types of institutions that are capable of functioning on a large scale, and could support their replication or adaptation in other countries where they are not found. Donors could also subsidize the expansion of MFIs into hard-to-reach areas. The support of donors in this case could be provided according to some strict criteria such as (i) existence of a business plan that includes expansion-related projections; (ii) achievement of financial and institutional sustainability, as measured by critical international indicators; and (iii) financial contributions to the expansion by the MFI itself. This subsidy could be used to finance physical infrastructure (branches, teller windows, and commercial partnerships), new technologies, or a portion of operating costs for the short term.

Governments should remove policy barriers to the profitable provision of diverse microfinance services. In this regard, Governments could collaborate with local banking associations and donors to organize fora towards enhancing banks' awareness of microfinance.

IV.2. Meso Level

MFIs need support services, such as training, auditing, or private refinancing. There are weaknesses of this portion of the market, which constrains the effectiveness of macro-level actions as well as the efficiencies at the micro-level. The fragility at the meso level also risks broadening, or perpetuating, fragility at the micro level.

IV.2.1. Meso-Level Strengths

Start of microfinance refinancing by the banking sector in many African countries: The participation of local banks helps promote the sustainability of MFIs, their expansion, and their integration into the national financial systems. While donors have a role to play when it comes to priming the pump, it is the local financial markets themselves that must carry out the task.

Existence of professional associations: In the 14 WAEMU and CEMAC countries and in Ethiopia, MFIs are required to belong to professional associations, while in many other African countries MFIs are grouped within professional associations. These associations should normally be financed primarily by their members, although many receive assistance from donors for general budgetary support and specific projects⁴³. In some countries such as

⁴³ Although networks could be very useful in advancing the progress of microfinance, their sustainability remains an issue because of funding constraints. Project AFR/017 from Lux Development is trying to tackle also this issue with other donors. Networks need to stick to their priorities and members must recognize their added value or they would have no incentives for them to pay membership fees and meet other financial obligations.

Madagascar, the law on microfinance requires a microfinance association to have ties to the professional banking association, thus climbing a further step toward integrating microfinance into the formal financial sector. These associations have played an important role in enhancing professionalism and protecting their members' interests in the past and will be called on to continue to do so. They have solid ties with their counterpart organizations abroad through networks such as the Africa Microfinance Network (AFMIN).

Initial supply of specialized training: MFIs already have a training base in microfinance and related areas available abroad and, in many countries, locally. It includes various operational, financial and management training programs offered by or through CGAP as well as masters level and other technical or professional programs available at a number of overseas universities.

Interest shown in microfinance by audit firms and consultants: In many African countries, there are a number of well-established local and internationally-affiliated firms involved in MFI audits. Some of the firms have received CGAP training on the specifics of microfinance. The fact that MFIs have access to audits on a regular basis enables them to have audited financial statements. This benefits sound management and transparency and eases access to commercial refinancing or participation in their capital by national or international investors.

IV.2.2. Meso-Level Weaknesses

Fragility of services provided to MFIs

The industry infrastructure is generally underdeveloped and services provided to MFIs are still rather scant and depend on outsiders, thus jeopardizing their sustainability. Reflecting the underdeveloped industry infrastructure, almost all countries show some kind of weakness in one area or another, even if other areas are well developed. A few surveys have catalogued the industry level weaknesses in some countries (see, for example, WWB/AMAF, 2010). This section will, however, focus on the key weaknesses, which include:

Generally, limited number of skilled service providers: The small size of most African local financial markets and the lack of trained personnel explain the gap between the supply of and demand for national consultants and service providers. In some countries, the supply is inadequate for several different types of services, including internal control, management consulting (business plans, for example), MIS, and accounting.

Problems with accessing training: While training programs exist locally and internationally, in many countries access to training at local levels is difficult due to several factors: existing training may be poorly promoted and coordinated; no centralized information on training, making it difficult to determine who is offering what, with the possibility that some training programs may be offered at the same time and topics sometimes overlap; and often training is excessively centralized in the capital or other urban centers, while there is genuine demand for training that is more readily accessible by MFIs established in remote areas.

Risk of unfair competition in training and other technical support areas: Subsidies from donor projects sometimes compete with services offered by the private sector. Unfair competition jeopardizes the viability of a private services sector, which is fragile in many countries, thus boosting the fear of a rupture in unsubsidized support services.

Limited transfers of skills: There is a lack of skills transfers under the technical assistance from abroad. Training missions follow one after the other without the training really being incorporated into MFIs operations. References are sometimes made to the sustainability of service providers rather than that of the MFIs. Nonetheless, most MFIs do not consider training as an investment and, therefore, are not always keen to contribute financially to cover fully or partially the cost of training. It is, therefore, possible that the MFIs do not always do everything they can to view training as an ongoing and essential investment in their sustainability.

Local rating capacity and cost: Some MFIs and apex institutions interviewed complained about the cost of submitting to rating, especially, if firms also have to have audited accounts, which some banks find more useful than the rating when considering the financing of the MFI. Some MFIs are not, therefore, willing to pay for rating without donor subsidies. The cost might, indeed, be relatively high for smaller MFIs. Moreover, some MFIs pointed out the conflict of interest that could exist in the area of rating as some of the rating agencies are affiliated with some MFIs (such as Planet Rating and Planet Finance).

Uneven quality of audit and other service providers and perception of high costs: Despite the interest shown in micro-finance by audit firms and other service providers, a majority of them have little training in the special characteristics of microfinance, and service quality is considered uneven. For audits in particular, some auditors fail to adopt an adequate approach (for example, the loan portfolio audit may be insufficient) and do not probe deeply enough, either because of a lack of financial motivation to do so or because of a lack of knowledge. The findings do not always enable stakeholders (banks, donors, potential investors, and the MFIs

themselves) to gain a clear vision of the financial health of MFIs, especially without an in-depth portfolio analysis. Moreover, MFIs consider the service to be costly, while in turn the audit firms do not yet consider this activity to be profitable.

Low capacity of national microfinance associations

With the exception of a few countries, MF Associations remain weak in many African countries and are not able to perform effectively their core functions of information collection and dissemination and dialogue with government or coordination with donors to organize training programs for their member MFIs. The weakness at the association level is reflected in the poor development of other systems at the industry level. In this regard, references are made to the poor development of the microfinance sector in such countries as Angola, Guinea-Bissau and Sudan, where the microfinance sectors are still nascent and the country context is difficult.

Unavailability and unreliability of information in a few countries

Lack of comprehensive, standardized, and regular statistics: In some countries, statistics on MFIs and their activities available from various sources (central bank, ministry of finance, the professional associations, and some projects) are partial and not cross-comparable. AMAF attributes the lack of information to the absence, in many countries, of functioning microfinance associations, whose fundamental roles are those of an information broker and advocate for the industry. Often researchers and policymakers have to reconcile divergent data from various sources to make meaningful interpretations on the situation of microfinance. This is even more pertinent in informal sector microfinance. The dearth of information hinders strategic planning for the sector's development.

Lack of national identification systems and client information: In many countries, especially the English-speaking Sub-Saharan countries, there is no national identification card system, making it difficult to establish client identity and gather information about them. The lack of information on clients and their financial behavior engenders costs and risks for MFIs. Moreover, in some countries credit information bureaus have not been established or are not functioning efficiently and MFIs have to make decisions without complete information on the histories of their clients, thereby increasing the risk of default and the risk that clients are borrowing from several MFIs at the same time and are over-indebted.

IV.2.3. Meso-Level Opportunities

Growing interest of the Mobile phone industry: Led by the example of Kenya (see Box 5 below), in a number of countries, mobile phone networks are growing increasingly interested in providing platforms for money transfers and payments that should also help the microfinance industry. Clearing and Payment systems are being enhanced by the introduction of electronic systems such as the EZwich in Ghana. There is also a growing opportunity to expand financial access through ATMs, smart cards, as well as ease of cross border money transfer and business transactions. Such embracement of IT by microfinance is enhancing the ability to mobilize savings and transfer payments to remote areas as well as facilitate the work of agent bankers, and advance the agenda of inclusive finance (see discussion on Agent banking under Microfinance Methodology, in Section IIIB above).

Several ongoing and upcoming capacity building initiatives

Heightened donor interest and coordination has resulted in the availability of several training programs directed at various stakeholders, including for the MFIs (towards improvements in operations, internal governance and financial systems); audit and accounting firms (on MF standards); government (towards improved regulation and supervision) as well as microenterprises and individual MF clients (for entrepreneurship and financial literacy). These programs are helping to build capacity at the various levels (see Annex 10 on the Mapping of Donor-supported Capacity Building Programs).

IV.2.4. Meso-Level Threats

Unfavorable environment and situation of service providers

The conditions of the environment of the service providers mirror some of those faced by their MFI clients, including poor, unreliable, and costly infrastructure services; weak property rights and enforcement policies; poor governance standards; and weak human resource capacity. As in the case of the MFIs, these unfavorable conditions, in turn, translate into a number of risks for the service providers, including the high cost of operation, poor human resource capacity, and lack of standardization in audits and local ratings.

Box 5: Mobile Remittance Service in Kenya – An Example in Adaptation of Technology for Progress

The provision of mobile remittance services is a key growth area in payments systems. Remittances have grown rapidly in recent years, reflecting the growth in migration. Even at the height of the recent global crisis, remittances remained crucial. The global impact of the economic downturn meant that the support payments that migrant workers sent back home to their families became even more important.

While the provision of remittance services was once the sole preserve of money transfer operators such as Western Union and Moneygram, it has become competitive with the entry of financial institutions, which are identifying remittances as a way to reach unbanked, or 'under banked' consumers. Unsurprising, then, that mobile remittances is one of the key growth areas in remittances.

One of the earliest mobile remittance services was M-Pesa (M for mobile, pesa is Swahili for money), a mobile-phone based money transfer service set up in October 2005 by Vodafone affiliate Safaricom in Kenya. The service was aimed at mobile customers who do not have a bank account. The initial concept of M-PESA was to create a service which allowed microfinance borrowers to receive and repay loans conveniently using the network of Safaricom airtime resellers. This would enable microfinance institutions (MFIs) to offer more competitive loan rates to their users, with the reduced cost of dealing in cash. The users of the service would gain through being able to track their finances more easily. But when the service was trialed, customers adopted the service for a variety of alternative uses and M-PESA was re-focused and launched with a different value proposition: sending remittances home across the country and making payments. The continuing success of M-PESA has been due to the creation of a highly popular, affordable payment service with only limited involvement of a bank. It has opened up possibilities for service expansion to previously unbanked areas. The idea is fast spreading across Africa and even globally with different models, including an MNO alone (as in M-Pesa), partnership between an MNO and a bank, or an acquisition of a bank by an MNO.

However, there are a number of challenges. As the model catches on in several countries, questions and issues arise in regulation, and policymakers are somewhat divided. Some authorities see a conflict between financial regulation and financial inclusion, but many policymakers accept that "regulation should not be simply for the sake of regulating" and therefore should respond to innovations in the market. Finally, while some policymakers see non-bank based regulatory models as more advantageous for clients (in terms of ease of access and use), many were not comfortable with the model unless a bank had a stronger presence. There are also challenges in promoting cross-border mobile transfers. One key challenge is how to formulate appropriate regulations that will safeguard security of transfers without stifling the innovation. Moreover, the international remittance market is by no means homogenous - conditions vary from country to country and corridor to corridor. Nevertheless, most agree that the objectives of AML-CFT were compatible with branchless banking, but doubts remained in a few specific cases. There is need to develop a protocol that will enable money to be sent across different networks in a seamless way to make remittance services truly international, rather than just a series of "closed loop" services. Another challenge is to make mobile remittance services fully interoperable with other payments applications. It would tackle the problem of getting cash out of the mobile device and place less of a burden on the receiving side to deal with cash. The regulatory questions around branchless banking are often not black and white, but usually gray. What is quite clear, however, is that the private sector is raring to go in many African markets, and policymakers need to be informed now more than ever on the appropriate ways to respond.

Funding challenges

Funding remains a constraint in the African financial sector in which the MFIs operate. While it is difficult to ascertain the true extent of the financing constraints because of limited transparency and information disclosure of African MFIs, the challenge is widely accepted and attributed to a number of factors, including the traditional conservative nature of African banks and the high cost and short-term tenor of local bank financing; a wrong perception that MFI profitability is low compared to other investments; negative stereotypes of foreign investors on high risks and high costs of the African investment climate; and the high cost of accessing capital market funds for the small and medium MFIs.

IV.2.5. Meso-Level Recommendations for Government, MFIs and Development Partners

Governments, donors and the private sector should **collaborate to support building the financial capability of MFI clients; training of MFIs; advance MFI transparency⁴⁴, and support the development of industry infrastructure.**

Governments should

- ***support the improvement of financial capability of MFI clients.*** Clients need to evaluate the financial services options and be capable of deciding what is best for them and manage their use of those products and services. This can also include financial literacy programs. There is, however, the question of who should deliver and who should pay. Some governments and central banks are involved (Ghana, for example). However, some FIs see it in their interest to educate their clients and do it on their own at their own expense, while others do it with subsidy or in partnership with other organizations.
- ***encourage involvement of private sector and donors in building capacity of MFIs,*** and in this regard, also encourage the use of existing training facilities;
- ***advance MFI transparency*** by fostering the adoption of standards on good practice for financial disclosure as part of the regulatory framework and helping to build capacity to implement the standards;
- ***support the development of industry infrastructure*** as a collaborative effort among all stakeholders (government, banks and MFIs, as well as donors). In this regard, government will promote the following:
 - sustainable refinancing systems for MFIs: Government support could have a leverage effect to give MFIs access to the capital market by:
 - helping to establish guarantee funds, which have the benefits of leveraging and risk sharing in finance mobilization, but this controversial tool will have to be handled prudently and professionally to avoid its potential adverse effects (e.g., negligence in monitoring repayments), and
 - encouraging MFIs to submit to financial ratings. A rating report brings transparency and constitutes a critical tool for gaining access to private capital

⁴⁴ MFI transparency is essential for all aspects of institutions' lives; not only for the management and supervisory authority, but also for the protection of savers or the search for investors.

from investors and banks.

- *deposit insurance schemes*: Deposit insurance helps protect depositors, especially small depositors in case of a bank or MFI collapse, and therefore boosts the confidence of savers in the financial system
- *private credit bureaus*: While credit bureaus are a must for mature markets, extending data collection to the level of small borrowers has proven difficult. The absence of strong credit bureaus covering the lower end of the market has constrained the development of microfinance, especially advancing towards standardization and more developed business models such as credit scoring. Credit bureaus are also important from the client perspective: avoid over-indebtedness, benefit from client protection and ethical treatment, obtain services from financially and operationally sound institutions. Government can encourage and support the establishment or strengthening of such bureaus at national levels.
- *Payments systems*: Well functioning payments systems can be the backbone for product development and lower cost delivery systems, which are important from both the client and MFI perspectives. They also have potential implications for social protection and Government to Person (G2P) payments.

MFIs: MFIs should strengthen national and regional microfinance associations to enhance client protection, support retail providers, and interface with policymakers and regulators. Currently many are weak or too dependent on donors. While there is the issue of potential for financial sustainability via MFI members' willingness and ability to pay, the associations also need to build skills and capacity and demonstrate value to members. There are a number of important issues that are best taken up by these structures and have an important role to play. In particular, functioning associations are indispensable in nascent markets or in countries where developments at policy levels are not conducive to microfinance. These associations could optimize the collective ability of MFIs to improve transparency, enhance dialogue with government for policy and regulatory changes towards creating an enabling environment for microfinance and business development. They could also help identify gaps at the institutional, sector and national levels, and to formulate requests to government and donors for support in addressing challenges. The associations could also forge partnerships with government and donors to develop industry infrastructure.

Development Partners could support training of MFIs; advancement of MFI transparency, and the development of industry infrastructure.

- **Training:** Many donors are already involved in supporting capacity building in African countries (see Annex 10 on the Mapping of Donor-supported Capacity Building Programs), and it is important that donors continue to buttress MFIs with training activities for both the MFIs (in financial and business management as well as project operations, monitoring and evaluation) and potential clients (in financial literacy), but adopt, as a priority, the ‘transfer of skills’ as an essential prerequisite for sustainability, including:
 - *subsidizing or financing of training:* While it is generally preferable to subsidize training from the demand side, subsidizing training from the supply side should be made contingent on certain criteria, such as (a) requiring training to be open to all MFIs that meet a minimum set of criteria (size, transparency, etc.); (b) promoting co-financing, to ensure applicant MFIs are truly motivated, while building in financial sustainability by phasing donors’ subsidies over time so that eventually financing is assumed by the MFIs in its entirety; and (c) avoiding duplication of training programs, especially when they are available in the private sector; and
 - *making skills transfer sustainable* by facilitating “training of trainers” programs and preparing and disseminating instructional materials, with particular attention to internal training.
- **Promoting MFI transparency** by supporting government efforts to foster the adoption of standards on good practice for financial disclosure and helping to build capacity to implement the standards. Donors could also accept the possibility of co-financing MFI audits, especially in countries where only few MFIs are sustainable, but decreasing over time so that the institutions will assume full payments eventually.
- **Support development of industry infrastructure:** Donor financing could have a leverage effect in developing the industry infrastructure, including establishment of guarantee funds, rating agencies, deposit insurance schemes, private credit bureaus, payments systems and the strengthening of national and regional microfinance associations.

IV.3. Macro-Level

Several African governments are taking the appropriate steps to enhance progress in microfinance: in the area of establishing the right policy, regulatory and supervisory

frameworks as well as a conducive business environment. Despite the promising trends and opportunities, there are also challenges in various areas.

IV.3.1. Macro-Level Strengths

Positive change in the general environment: Improvements in the overall economic environment and, in particular, the paradigm shift to market-based economic management, attention to the importance of transparency and rigorous standards in African countries are helping to develop the financial sector. The policy and institutional arrangements include:

- ***Adoption of national microfinance policies/strategies consistent with good practices:*** Several countries (see Table 3 below) have adopted national policy or strategy statements that reflect the key principles of microfinance, which have been adopted at the highest levels of donor agencies.
- ***Proper assignment of microfinance within the realm of the overall financial system and clarification of the supervisory responsibilities:*** Despite the relevance of microfinance and its positive effects in several development areas (e.g., social welfare, education, health, agriculture and rural development), according to a recent survey (WWB/AMAF, 2010) many African countries (especially the West African and East African countries) have accepted that microfinance is part of the overall financial system and correctly placed responsibility for microfinance within the realm of the financial sector (ministry of finance and economy or the central bank). Many (such as Kenya, Ghana and the WAEMU countries) have also created special units within the central bank or the financial supervisory agency for the supervision of microfinance. In many cases, the central bank or main supervisory body supervises the banks and the deposit-taking MFIs, while the ministry of cooperatives or some other ministry is assigned responsibility of supervising the SACCOs and the NGOs.

Type of Legislation	Countries	
Specialized Microfinance Laws (29)	Burundi CEMAC countries (6) Comoros DRC Djibouti Ethiopia The Gambia Guinea	Kenya Madagascar Mauritania Mozambique Rwanda Sudan Uganda WAEMU countries (8) Zambia
Drafting Specialized Microfinance Laws (5)	Cape Verde Liberia Malawi	Sierra Leone Zimbabwe
MFIs implicitly or explicitly fall under the broader banking or non-banking financial institutions legislation (15)	Angola Botswana Ghana Lesotho Liberia Malawi Mauritius	Namibia Nigeria Sao Tome Sierra Leone Somalia South Africa Tanzania Zimbabwe
No Legislation/No Framework (3)	Eritrea Seychelles	Swaziland

Source: CGAP: SSA Microfinance Analysis and Benchmarking Report 2009

IV.3.2. Macro-Level Weaknesses

Fragilities of the general economic environment: Despite progress made in macroeconomic reforms and key infrastructure, the macroeconomic situation in many African countries remains vulnerable to economic and political shocks. Also, in a number of countries, interest rates are high and crowding out the private sector, with direct implications for microfinance, as some financial institutions (including MFIs) will sometimes rather invest in treasury bills than extend credit⁴⁵. Moreover, the productive base, especially agriculture, fisheries, and tourism as well as petty trading, which provide employment to a majority of MFI clients, is also fragile and vulnerable to external shocks. Sometimes, with the need to increase output rapidly or contain the adverse impact of external shocks, both authorities and clients exert pressure on MFIs to lend regardless of the risks and their lack of internal capacity. The need to act rapidly is often used to justify or tolerate recourse to sub-standard microfinance practices, ultimately jeopardizing the sustainability of MFIs. By making MFIs more vulnerable, these measures may slow access to financial services by the poor.

Supervision remains weak: Although many countries have clarified supervision of microfinance, in many cases the teams specialized in microfinance supervision are still relatively small and resources are scarce. One consequence of this situation is that the process for examining and

⁴⁵ See Honohan and Beck, 2007

issuing licenses is time consuming.

Questions about the involvement and role of other ministries: While many countries have accepted the proper placement of microfinance within the ministry of finance, in many cases, because of the other benefits of microfinance or the nature of the institutions involved, other ministries are still assigned some responsibilities, creating conflicts and confusion that still need to be clarified. Sometimes donors' involvement, governments' political objectives or some other vested interests make it difficult to streamline or clarify the responsibilities.

Ineffective legal system: In many African countries, there are no special (fast track or small claims) courts and judiciary services for commercial and finance matters. The same legal infrastructure would be strained when coping with the pressure of demands ranging from drafting new legislations to prosecuting cases, registering businesses, titles and deeds in addition to dealing with matters brought before the court. Consequently, the capacity of the courts to deal with civil, criminal and commercial cases is pushed to the limits with long delays in the resolution of issues. There are also allegations of corruption and many instances of criminal activities (embezzlement) in microfinance that are only lightly punished or not punished at all. Moreover, the slowness of court proceedings and their high costs (fees for mortgages), particularly regarding collateral collection, undermines the financial equilibrium of MFIs. More generally, the widespread absence of valid ownership deeds and other real guarantees in many countries poses a genuine obstacle to microfinance development.

Low levels of financial literacy

Financial literacy of MFI clients is important in educating potential clients about the rudiments of savings, credit application and financial management. It is a key ingredient to graduating people from almost bankable to bankable microfinance and, therefore, important in supporting industry growth. However, in many countries in Africa, the level of financial literacy is low and constitutes a constraint in the growth of the industry.

IV.3.3. Macro-Level Opportunities

An expanded range of institutions has evolved in many countries. Awareness of microfinance has grown dramatically, with new private sector actors joining the industry. In particular, strong regulated and unregulated MFIs, banks, and cooperatives have made major contributions to outreach, product development and buildup of the industry. A diverse set of

global, regional and country-level networks have emerged, playing distinct roles in capacity building, lateral learning, innovation, policy change and mobilization of new actors. Global and local loan and equity funds are now financing strong MFIs on commercial terms. Also, increasingly, retail institutions are responding to the demand by low income entrepreneurs and households to provide the savings, insurance, housing finance and flexible loans needed to build income and assets.

Agreement on key performance indicators and standards in microfinance: Internationally, there is agreement on key performance indicators that national policymakers can prescribe. The implementation of these standards by networks, rating agencies and MFIs would result in improved performance, and expanded financial markets for microfinance. Moreover, specialized rating agencies have helped build transparency and financing for microfinance. Mainstream rating agencies are also beginning to take the microfinance industry seriously.

Increased interest of donors: Donors have stepped up support for financial sector development and their collaboration with countries in line with the Paris Declaration on Aid Effectiveness and its principles of ownership, alignment and harmonization. In Africa, this collaboration and support are set to be enhanced in the context of the Partnership for Making Finance Work for Africa. African countries must seize the opportunity of these developments to leverage their financial sector development programs and, especially mobilize support for the development of financial inclusion.

Opportunity for establishing national identification through voter registration: Many countries are seizing the opportunity of regular voting to establish national identification for its citizens. Although the exercise is not directly linked to financial sector development programs, the use of voter IDs have also made it possible for many to establish required documentation for access to financial services. It could also help overcome a major hurdle in establishing credit bureaus in many countries.

Greater interest from standard setting bodies: Since the late 1990s, there has been an increased interest in the development of financial standards, and the microfinance sector has benefited from the trend⁴⁶. The formulation and implementation of standards have helped to

⁴⁶ The SEEP Network is leading the industry wide MFI Reporting Standards Initiative (www.mfireportingstandards.org) to establish a process and methodology for standards setting, along with core financial reporting standards, while MIX leads the effort to encode paper standards, like IFRS and the FRAMEWORK, in technology standards that support the electronic exchange of financial data. Microfinance Transparency leads standard setting in pricing. CGAP has also been at the forefront of issuing various guidelines.

increase transparency, foster greater investment, and better enable comparisons, benchmarking and analysis of financial information. Good standards are, therefore, making reporting easier and faster, saving operational time and improving the information available for managers (and other stakeholders) to make decisions. Standards also provide a mechanism to address new information requirements, such as IFRS – international financial reporting standards – an emerging requirement in the financial sector. Wider adoption of standards in microfinance is also improving the ability of technology vendors to create, implement, and maintain quality solutions for MFIs, and making it easier for MFIs to identify off-the-shelf software products which meet their business requirements. Other standards are enhancing transparency in pricing and facilitating comparisons across the globe. While some have pointed out that African MFIs and MF associations do not always have the capacity to participate in standard setting fora, the broad consultations during the formulation process ensure the reflection of conditions in all developing regions.

IV.3.4. Macro-Level Threats

Risk of politicization in policymaking: Even as the increased government interest in microfinance brings opportunities, it also carries the risk of politicization. Some governments, at the instigation of clients, are turning back the clocks and calling for an interventionist approach: interest rate ceilings, establishment of government microfinance banks, and political oversight in microfinance supervision. There is always the danger that some countries with weak political governance systems may go down this path to the detriment of the poor, as they allow political criteria and overemphasis on outreach rather than sound administration and consideration of sustainability drive decisions.

Risk of market distortions from subsidies: Closely related to the above is the risk that some governments and even donors, although with good intentions, inappropriately use or encourage the subsidization of interest rates—sometimes out of a sense of urgency to boost the production sector and because it appears convenient to do so⁴⁷. Subsidized rates pose many risks for the financial sector in African countries, because they increase the risks of inflation, while making both the demand for and supply of credit in microfinance more fragile for a number of reasons:

⁴⁷ This was the case in recent years even in some countries, where microfinance industry has registered impressive progress such as Benin (in the wake of the 2004 economic downturn) and Kenya (the threat of the unapproved so called 'Donde Bill' that sought to control interest rates) as well as in others such as Malawi, Sudan and Madagascar, where the industry is still at infant stage.

- Risk of confusion between credit and subsidy, which could eventually lead to increase in loan defaults;
- Resistance of beneficiaries and other vested interests when the subsidy is being phased out, with the possible political ramifications;
- Possibility of attracting a higher risk borrower base to the MFI customer pool; and
- Unbalanced competition for MFIs that opt to use market rates.

Risk of rigid legal and regulatory frameworks: While many African countries have embarked on legal and regulatory reforms in the financial sector, the reforms in microfinance are still evolving and there are issues regarding what and how to regulate and what not to regulate. Failure to regulate can have disastrous consequences, especially on the risks to clients eventually, but over-regulation also risks overburdening the supervisory agencies, while stifling innovation of MFIs and their ability to serve clients. While many countries have been able to strike an appropriate balance between what is and what is not regulated, in some countries, there are still areas that need to be addressed to enhance progress and impact of the industry, including issues of:

- ***Interest rate controls*** – The control of interest rates and the imposition of other business parameters may have their short-term appeal of protecting clients from exploitation, but, in the long term, they pose serious threats to progress in microfinance. The controls could force the MFIs to operate within very low margins, which may reduce their profitability and ability to bear the cost of innovation and expand services, especially into rural areas. In the WAEMU area, for example, some studies have established that the cap on interest rates within the PARMEC Law, a common approach to the regulatory framework for MFIs developed by BCEAO and adopted by all WAEMU member countries, except Guinea Bissau, between 1993 and 1998, adversely impacted on some MFIs⁴⁸.
- ***Overly restrictive regulations***: In many countries, the desire to protect clients could result in other overly restrictive microfinance regulations that limit the diversity of institutions or services. Some of the regulatory frameworks allow only very limited types of institutions to provide microfinance services, while in other countries the restriction may not be explicit, but through the regulation on minimum capital requirements or overly

⁴⁸ See Korotoumou Ouattara: 'Microfinance Regulation in Benin – Implications of the PARMEC Law for Development and Performance of the Industry', Africa Region Working Series, World Bank, June 2003. In the new law approved by the Council of Ministers in 2006 there is still a cap on interest of 27%

restrictive regulations for deposit taking. Some regulatory frameworks could also be so detailed in their prescriptions that they end up micromanaging the MFI operations – from limits on the size of loans to the building structure hosting the MFI activities. Whatever they may be, overly prescriptive regulations risk stifling innovation in the MFI products or limiting refinements in the MFI business models. Moreover, they put additional strain on the already stretched supervisory agencies.

IV.3.5. Macro-Level Recommendations for Governments and Development Partners

Microfinance is an evolving area and governments have an important role in helping to improve the investment climate and building policy, regulatory and supervisory capacity at the macro-level. Development Partners can also offer support either directly as related to the industry or within a broader support for financial sector development. The collaboration of government and donors to advance microfinance could cover the following areas:

Formulate national visions and action plans and clarify roles of various stakeholders

Many countries lack shared visions and strategies. These visions and strategies need to be home-grown, but should reflect best practice and lessons learned over the past years on the key elements needed in building inclusive finance. Beyond the building of a national vision and strategy, policies, regulations, standards, financing and capacity building mechanisms also need to be developed. Each actor has a different role to play, and the division of responsibilities among the stakeholders, especially between the public and private sector, and among the various ministries and other public agencies need to be clarified.

- **Governments** should take responsibility for clarifying national visions and strategies, and a working partnership with all stakeholders. Governments could use their convening power to bring together various stakeholders (in national workshops or conferences) to discuss and clarify the responsibilities. In particular, Governments could adopt the good practice that all micro-finance activity, even when its components are part of programs managed by other ministries, should be supervised by the ministry of finance (or central bank). This would help confirm microfinance as a financial sector activity.
- **Development Partners** could enhance dialogue among national stakeholders (policy makers, regulators, microfinance institutions, banks and low income people) and help to

gather and review experiences, both local and of other countries, to inform the formulation of a vision and strategies that are not politicized. In this regard, based on best practice, donors could encourage governments to confirm the leadership role of the ministry of finance (or central bank) in program design and management. Moreover, donors could ensure that projects they are helping to fund that include a financial component, whether in the urban, agricultural, or rural environment, incorporate the good practices of microfinance as well as have a market orientation.

Strengthen country systems for managing financial sector soundness

An important factor in microfinance development is the prevalence of financial sector soundness (that is, improving financial stability and reducing risks).

- **Governments** have the responsibility of promoting a stable economic, financial, and legal environment for microfinance. Governments should ensure financial sector soundness through sound macroeconomic management and greater alignment between the financial sector policy (including microfinance) and budget management (at the ministries of finance) to ensure consistency among monetary and fiscal policies and real sector priorities, including poverty reduction strategies. In this regard,
 - Governments should strengthen their systems for macroeconomic management, including building the capacities of the ministry of finance and the central bank. An essential first step to establishing good macroeconomic management is an assessment of the economic and financial situation.
 - Governments should, therefore, strengthen the capacity of their systems to lead all stakeholders in undertaking financial sector assessments and monitoring (surveillance of) macroeconomic developments towards identifying emerging challenges and stresses (including for microfinance).
 - The monitoring mechanisms could also help governments establish mechanisms for early warning and management of vulnerabilities.
- **Development Partners:** Donors are already involved in supporting financial sector reforms in African countries.
 - The Bretton Woods Institutions (BWIs) have traditionally taken the lead in advising countries and helping to design financial sector programs. Other donors can support this effort by focusing on capacity building and strategy development to complement

the programs led by the BWIs, and specifically to improve macroeconomic management as well as diagnostics and strategy development for the broader financial sector, but also specifically for microfinance.

- The BWIs also undertake financial sector assessments (the FSAPs), which also aim at identifying vulnerabilities. However country coverage may not be complete. Other donors can, therefore, support countries to undertake interim (targeted) macro or financial sector assessments to complement the FSAPs, and help countries to draw from them to formulate financial sector development plans.
- Many low-income African countries lack capacity for the necessary statistical analysis because of a lack of up-to-date data, equipment or skills⁴⁹. Donors can provide technical assistance to build institutional capacity to gather and analyze data strategically; and also support training programs to upgrade skills of staff of central banks, ministries of finance, and other relevant government agencies especially in identifying and addressing issues related to financial system soundness.

Reform and implement financial sector regulations that take into account a range of financial services and providers.

Microfinance is evolving continually with ongoing financial sector reforms, the adaptation to new policy frameworks and technology and the introduction of innovative products. Therefore, even seasoned central banks will need to continue to adapt their regulations. They will need to show flexibility that ensures security of the industry but does not stifle competition and innovation. In this regard, as recommended by the African Union Ministers of Finance (see Annex 6), “policies and regulations should enable the development of sustainable microfinance services and institutions that grow with their clients—eliminating subsidized, short-lived programs”.

- **Governments** should take the lead in formulating or reviewing microfinance regulation, ensuring that various stakeholders have the opportunity to provide inputs. However, regulation or their enforcement is of little consequence if the MFIs are not capable of implementing them. Governments should sensitize MFIs and their service providers (especially trainers, accounting and audit firms) of any new changes in the regulation and supervision.

⁴⁹ See ADB, 2010.

- **Development partners** should assist governments to review their regulations and address weaknesses in their form and implementation. In addition, donors can help build the capacity of the central bank and other regulatory agencies to ensure the enforcement of regulations. At the same time, donors can help build capacity of MFIs to implement new regulations. An example of such useful combination of support to the regulatory agency (or central bank) to reform the regulation and to the MFIs to build capacity for implementation is that of the BCEAO, which is supported by Lux Developpement, UNCDF, CGAP and SIDA (see Annex 7).

Build supervisory capacity

While progress is being achieved in microfinance regulation, in the near and medium term, the most pressing regulatory issue in countries where the industry is registering rapid progress is supervisory capacity. In these countries, regulatory authorities are struggling to cope with the emergence of various MFIs and within each category their growth and spread in the country, and supervisors must determine which MFIs are worth supervising.

- **Governments** should aim at establishing efficient supervisory systems that protect the savings of poor people, without stifling the development of microfinance, and should make a realistic separation between which MFIs should be supervised by the central bank and which should not⁵⁰. Even where realistic regulatory and supervisory frameworks have been formulated, many central banks face capacity problems. Governments should, therefore, also build the capacity of the central banks to ensure effective supervision.
- **Development partners** can help provide support to governments in the drafting of instructions on the new regulations or laws so they can be properly followed by the MFIs⁵¹. In addition, the supervisory agencies also need to build their capacity to guarantee efficient supervision of MFIs, which are fragile in many countries, especially regarding governance. Development partners can help the supervisory agencies build capacity and improve the organization of their services. This could involve supporting staff training to improve skills, but also providing equipment and other technical or specialized support.

⁵⁰ The risk-based approach adopted by BCEAO in an interesting one. Under the approach, big MFIs (with total portfolio or deposit of the equivalent of \$4 million and above) fall under the supervision of BCEAO and the Banking commission while the small ones are supervised by the Ministry of Finance.

⁵¹ A good example of such donor support is the BCEAO- Lux Developpement, UNCDF, CGAP and SIDA Project AFR/017 (see Annex 7).

Increase efforts towards client protection

While the macroeconomic conditions such as the economic vulnerabilities of the poor, weak supervision and low levels of literacy can expose the poor to exploitation by the MFIs, few countries have regulations that protect MF clients. This situation constitutes real risks to the progress of the industry and needs to be addressed at the micro, meso and macro levels.

- **MFIs** should adopt client protection principles and translate them into practices throughout their institution. Investors should consider client protection in their investment agreements with retail institutions and in their own practices.
- **Governments and Development Partners** should promote transparency and disclosure, promote redress mechanisms for complaints, and should consider facilitating building client capabilities. Governments should also ensure that they adequately supervise the industry. Governments and development partners could also support the development of industry infrastructure towards enhancing client protection⁵².

Reform of the business environment

The reform of the business environment calls for long term investments, but it is very important for financial sector development, including microfinance.

- **Governments**, as recommended by the African Union, should lead the establishment of the right investment climate - reducing direct and indirect costs of doing business and reducing risks of failure - which has to do with creating a conducive environment (macroeconomic, social and legal) for investments and business activities of enterprises and individuals, including the building and maintaining physical infrastructure, financial infrastructure and ensuring that appropriate institutions (independent judiciary and even commercial courts, effective and impartial police and prison service) are established and functioning, as well as establishing legal frameworks for collateral and enforcement of creditor rights and non-restrictive labor laws.
- **Development Partners** should, therefore, provide capacity building and financial support

⁵² For example, MF Network associations can help by establishing industry standards, holding members accountable to standards, perhaps providing redress mechanisms for clients, working with government to develop appropriate regulatory stance. Credit bureaus can facilitate the monitoring and minimization of client over-indebtedness; establishment of deposit insurance can help protect the savings of depositors, while rating agencies and audit firms that understand inclusive finance and the particularities of microfinance can help make institutional performance more transparent and institutions more accountable to their clients, the government and the public at large.

towards the required improvement in the business environment, including modification of business laws and regulations, especially in the areas of taxation, contract enforcement, land tenure reforms, collateral registration and enforcement, and enforcement of creditor rights. In addition, donors should help reform and build capacity of the judiciary, including the establishment of commercial courts and the training of judges.

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V. PARTNERSHIP FOR PROGRESS

The financial inclusion agenda is a fast-growing area and one on which, for now, many governments and the international development community see as important in contributing to private sector promotion and ultimately poverty reduction. Not surprising, therefore, both governments and the international community have become intensely engaged in supporting the private sector, where interests are also expanding.

In the coming years, the agenda (as reflected in the above recommendations at the micro, meso and macro levels) should include:

- **Reducing industry fragility and building retail capacity in microfinance.** MFIs need to be backed in mobilizing resources and expanding capacity; commercial banks need to be mobilized, and exposed to best practice in microfinance; and cooperatives and savings institutions should be encouraged to build efficient, dynamic services.
- **Building domestic financial markets for microfinance.** Domestic savings is the key. Savings matter as a service to microenterprises and the poor to keep deposits, as a source of loanable funds and self-reliance for (rural) financial institutions, and as the main source of domestic capital in the national economy. Wholesale funding in local currency is needed. Bond issues, securitization, and equity will be needed for specialized MFIs.
- **Utilizing technology to cut costs and expand outreach.** The key challenge is how to reduce the high costs of many small transactions. Efficiency measures and the smart application of technology will both be important if costs are to be reduced and if more remote networks are to be reached.
- **Building industry infrastructure to enhance depth and diversity of product offerings,** including the soft infrastructure that facilitate capital access or help to improve transparency and judicious use of mobilized resources; the mechanisms that help to mitigate risks and support the transformation of funds for longer-term use; as well as hard infrastructure that enable the use of IT to expand outreach. A related key point is also how to take into account a risk-based approach while dealing with branchless banking issues (use of agents, KYC requirements etc) as well as the challenge for regulators implicated by the new developments, including mobile network regulators (for mobile banking), financial intelligence units (for AML/CFT), and other regulators involved in data protection.
- **Adapting key financial standards to microfinance and fostering their**

implementation: The Finance Ministers and Central Bank Governors of the G20 have called on international standard-setting bodies to consider how they can further contribute to encouraging financial inclusion, consistent with their respective mandates. Standards are a way of doing things above board, and their adoption for the financial inclusion agenda are expected to help improve the transparency, accountability, and credibility of policy, and increase the robustness and effective functioning of microfinance. In this regard, the most relevant standards would be those related to (i) Corporate Governance Standards - for enterprise and market integrity; and (ii) Financial Regulation and Supervision - for financial system stability, and only to some extent, those on (iii) Macroeconomic Policy and Data Transparency – for Government policymaking and operations (see Annex 9). While the G20 recognized the complementarity between financial inclusion and financial integrity, many regulators are concerned that rigid application of the standards, which were developed for mainstream financial institutions, could be counterproductive to microfinance, as it would limit informality and innovation in the industry and exclude many MF clients. However, some of the standards permit “risk-based” approaches to their implementation, which could serve the dual goals of (i) improving financial integrity and (ii) promoting financial inclusion. This win-win scenario has been highlighted by the Netherlands Crown Princess Máxima, the UNSG’s special advocate for inclusive finance for development. Progress on realizing the G20 recommendations do not only depend on adapting the standards to MF, but also implementing them in the countries, which would require

- assessing the constraints and formulating measures to address them,
- formulating appropriate guidelines to reflect national characteristics and specificities of the African economies, most of which are in transition,
- promoting country ownership,
- providing a judicious blend of market and official incentives for the adoption and implementation of standards,
- adopting a peer review mechanism, and
- mobilising resources towards the implementation of standards⁵³.

⁵³ See M. I. Mah'moud: Framework for Implementing Banking and Financial Standards Under NEPAD, ADB, Abidjan, May 2002

- **Formulating country strategies and reforming country microfinance policies, regulatory and supervisory frameworks** to create an enabling environment for both the MFIs and their clients, especially the microenterprises. Country-level strategies and policies should reflect participation by all key stakeholders. They should incorporate objectives, key policies, support services and roles to remove constraints and smoothen the field for MFIs, while protecting clients. Admittedly, among experts, the role of the regulation in microfinance development is still an open issue. While some are in favour of a market-directed approach, with the regulator simply setting the framework for the industry, others advocate a more government-directed stance with an active promotional role for the regulator. Still, in some countries, the role of the regulator is to integrate microfinance into the overall financial infrastructure, but that would usually require a degree of promotional support in the early stages of the industry's development; the regulator's support to ensure the soundness of these institutions could involve lending assistance and gradually the introduction of prudential norms. Generally, given the diverse possibilities, it is safe to conclude that microfinance policy, regulatory and supervisory frameworks should be informed by research and better data on both demand side and supply side to understand local impacts. Up-to-date data would also inform decisions and investments during implementation.

Synergies will be created by stakeholder coordination at the national level, including cooperation in capacity building and project/program design and implementation. While governments and the private sector stakeholders should take the lead role at the appropriate national levels, external development partners have shown keen interest and can play an important role as partners. Several partner institutions, including CGAP, WWB and UNCDF, already focus on building knowledge and capacity in microfinance, while the World Bank, African Development Bank, IFAD, the bilaterals and, to some extent, UNCDF and UNDP also provide financial support in addition to knowledge and capacity building. In the process, experience has taught many lessons and, based on these, CGAP members, who are at the forefront of building knowledge and drawing lessons for microfinance development, have identified key principles and best practices to improve partnership and enhance the effectiveness of development partners. The CGAP-recommended principles and guidelines also reflect the overall framework of the Paris Declaration and the Accra Agenda for Action and are endorsed by all major development partners involved in microfinance.

Essentially, *the Accra Agenda for Action* addresses three major challenges to enhance progress on aid effectiveness, namely:

- ***Country ownership:*** Developing country governments will take stronger leadership of their own development policies, and will engage with their parliaments and citizens in shaping those policies. Donors will support them by respecting countries' priorities, investing in their human resources and institutions, making greater use of their systems to deliver aid, and increasing the predictability of aid flows.
- ***Building more effective and inclusive partnerships:*** The increasing involvement of various development actors—middle-income countries, global funds, the private sector, civil society organisations—brings valuable experience to the table, but it also creates management and co-ordination challenges. Therefore, all development actors will work in more inclusive partnerships so that efforts of development partners will have greater impact on reducing poverty.
- ***Achieving development results—and openly accounting for them:*** More than ever, citizens and taxpayers of all countries expect to see the tangible results of development efforts. Therefore, development partners will demonstrate that their actions translate into positive impacts on people's lives, and will hold themselves accountable to each other and to their respective parliaments and governing bodies for these outcomes.

Governments and external development partners should, therefore, commit to the guidelines drawn by CGAP that reflect the commitments in the Accra Agenda for Action.

The implications for governments and donor systems are summarized in Box 6 and Table 4 below.

Box 6: CGAP Recommendations on the Role of Governments

As recommended by CGAP and reflected in the AU recommendations, Governments should

- *maintain macroeconomic stability* through appropriate monetary and fiscal policies;
- *involve the private sector in formulating poverty reduction strategies*, and explicitly recognize its leading role in financial sector development, including microfinance. The active participation of the private sector should help to embed microfinance firmly within financial systems, with private and non-governmental actors taking the lead (as opposed to government bodies, such as ministries of agriculture and health, and local authorities).
- *adjust regulatory frameworks*, if and when needed, to permit all types of financial institutions to offer services to poor people. Premature or restrictive regulations can stifle innovation. The introduction of prudential regulation is generally only warranted when a critical mass exists of institutions that are strong enough to obtain licenses to mobilize deposits from the public.
- *invest in supervisory capacity*. In many developing countries, bank supervision capacity is limited. There is no point in licensing institutions that cannot be effectively supervised.

On the other hand, Governments should avoid the following:

- *Interest rate ceilings*, which undermine the ability of MFIs to cover their costs, while they also generally hurt the poor by making it hard for new MFIs to emerge and for existing ones to stay in business. Faced with interest rate ceilings, MFIs often withdraw from markets, grow more slowly, become less transparent about total loan costs, and/or reduce their work in rural and other costly markets.
- *Provision of credit at the retail level*. Governments (including local authorities, development funds, line ministries, and other public institutions) should not be directly involved in credit delivery or the management of microfinance initiatives. Experience shows that government ministries and project management units usually lack the technical skills and political independence needed to manage microcredit programs
- *Subsidized lending programs*. Subsidized lending is usually associated with high default levels. It absorbs scarce public resources that need constant replenishment. It distorts markets, hampering the development of sustainable lenders, and can encourage rent-seeking behavior.
- *Political interference*. Government interference in governance or management of private institutions can threaten their sustainable development. Such interference can force managers to lend to unfit clients or lower interest rates, ultimately decreasing the number of poor who access services.

Source: CGAP: *The Role of Governments in Microfinance*, Donor Brief No. 19, June 2004

Table 4: Ensuring Effectiveness of Donors' Support to Microfinance in African Countries

<p>African countries have the primary responsibility for leading microfinance development to accelerate the fight against poverty.</p>	<p>Where there is country ownership and commitment, improvements in microfinance can take place relatively quickly. Donors' support to microfinance should be guided by a country focus, working with governments, the relevant private sector institutions and other stakeholders to further microfinance development.</p>
<p>2. Donors should strengthen country systems, rather than bypass them.</p>	<p>To optimize <i>development objectives</i>, donors should endeavor to strengthen and use country systems, building capacity at the government, sector and institutional levels and consistent with their respective comparative advantage and strategy. Donor funds should complement private capital, not compete with it. Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop support infrastructure, and support experimental services and products</p>
<p>3. Donor support to microfinance development will be tailored to country circumstances.</p>	<p>Every African country has a unique combination of microfinance features, strengths and vulnerabilities. No one size fits all. Donors' approaches should, therefore, be tailored to meet the specific developmental needs and microfinance challenges of fragile, middle and low-income countries.</p>
<p>4. Donors consider weaknesses in microfinance development as symptoms of broader financial sector challenges</p>	<p>Donors' approach to supporting microfinance should aim at building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.</p>
<p>5. Donors should pursue strategies of constructive and systemic engagement, including in high-risk environments.</p>	<p>Donors' approaches should be predictable and consistent, so as to avoid punishing the poor twice and creating "aid orphans." Potential for progress, rather than initial conditions, should guide the engagement of each donor in microfinance, based on countries' and institutions' commitment to reform and direction of change.</p>
<p>6. Donors should strengthen transparency in their own operations and in the programs they support through enhanced information disclosure.</p>	<p>To address their <i>fiduciary concerns</i>, donors should enhance their safeguards and integrity mechanisms, including financial management and procurement systems, to ensure that the funds they provide are used for the purposes intended and are properly accounted for. They should also require proper information disclosure and reporting for the programs that they support. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance.</p>
<p>7. Each donor's activities in support of microfinance must be focused on delivering results, demonstrating impact and adding value compared to other donors.</p>	<p>Delivering results will require enhancing strategic alignment, upstream analytical work, improving quality-at-entry, and a results framework for measuring progress. Donors should also be committed to mainstreaming gender concerns, strengthening social cohesion and encouraging accountability to the stakeholders, including the poor.</p>
<p>8. Donors should build strategic partnerships with each other to achieve common objectives.</p>	<p>Donors' approach should be based on a division of labor, seeking to enhance synergies and complementarities, consistent with the Paris Declaration and Accra Agenda for Action commitments on aid effectiveness.</p>

Source: Based on the Accra Agenda for Action and the CGAP-approved guidelines (Annex 2).

ANNEXES

Annex 1: Clarification of terminologies ‘Microfinance’ and ‘Inclusive Finance’ by the Blue Book

Many development practitioners and financial institutions believe that we are in the midst of a paradigm shift from microfinance to inclusive finance — from supporting discrete microfinance institutions (MFIs) and initiatives to building inclusive financial sectors. Inclusive finance recognizes that a continuum of financial services providers work within their comparative advantages to serve poor and low-income people and micro and small enterprises. Building inclusive financial sectors includes but is not limited to strengthening microfinance and MFIs.

Existing terminology that developed over many years to describe microfinance initiatives no longer serves well when we shift to discussing inclusive financial sectors. Microfinance has been defined as the provision of diverse financial services (credit, savings, insurance, remittances, money transfers, leasing) to poor and low-income people. Retail financial service providers that serve this market segment are increasingly more difficult to define with one common term. They include NGOs, private commercial banks, state-owned and postal banks, non-bank financial institutions (such as finance companies and insurance companies) credit unions and credit and savings cooperatives. Many of these institutions are quite large; many are quite old; and many have large numbers of clients and highly diverse products and services. As a result, the term MFI is often not descriptive or adequate to refer to this diverse group of financial institutions. While each of them plays an important role in inclusive finance, many of them could not be considered MFIs in the technical sense.

As a general guide, the Blue Book refers to the range of institutions mentioned above as financial service providers and to those that serve poor and low-income people as financial service providers that serve the lower segment of the market. This book often makes the distinction between retail and wholesale financial institutions. It also specifically distinguishes financial institutions that provide payments, clearance and settlement services as important participants in inclusive financial sectors. When references are made to organizations that provide credit only, the term microcredit is used. When we discuss financial institutions that provide financial services to poor and low-income people through special windows or mechanisms, we refer to these as microfinance operations, or if they are credit only, microcredit operations.

Thus, MFIs represent only one type of financial sector organization. They receive a large amount of attention and in the consultations undertaken in preparing the Blue book because they have been studied and discussed extensively over 25 years. As a result, the reader (of the Blue Book) may note a tension between the effort to present a broader treatment of inclusive finance and a narrower treatment of microfinance, and particularly microcredit. As the paradigm shift mentioned above is only recent, it is expected that greater clarity and precision in terminology will evolve gradually.

Source: UNCDF/UNDESA: *Building Inclusive Financial Sectors for Development (The Blue Book)*, New York, United Nations, May 2006, Box 1.2

Annex 2: The Key Principles for Microfinance

A set of universal *Key Principles for Microfinance* has been developed through broad consultation with microfinance practitioners. They are widely recognized by the microfinance community globally and have been adopted by the G8. They are:

1. Poor people need a variety of financial services, not just loans. In addition to credit, they want savings, insurance, and money transfer services.
2. Microfinance is a powerful tool to fight poverty. Poor households use financial services to raise income, build their assets, and cushion themselves against external shocks.
3. Microfinance means building financial systems that serve the poor. Microfinance will reach its full potential only if it is integrated into a country's mainstream financial system.
4. Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people. Unless microfinance providers charge enough to cover their costs, they will always be limited by the scarce and uncertain supply of subsidies from donors and governments.
5. Microfinance is about building permanent local financial institutions that can attract domestic deposits, recycle them into loans, and provide other financial services.
6. Microcredit is not always the answer. Other kinds of support may work better for people who are so destitute that they are without income or means of repayment.
7. Interest rate ceilings hurt poor people by making it harder for them to get credit. Making many small loans costs more than making a few large ones. Interest rate ceilings prevent microfinance institutions from covering their costs, and thereby choke off the supply of credit for poor people.
8. The job of government is to enable financial services, not to provide them directly. Governments can almost never do a good job of lending, but they can set a supporting policy environment.
9. Donor funds should complement private capital, not compete with it. Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop support infrastructure, and support experimental services and products.
10. The key bottleneck is the shortage of strong institutions and managers. Donors should focus their support on building capacity.
11. Microfinance works best when it measures—and discloses—its performance. Reporting not only helps stakeholders judge costs and benefits, but it also improves performance. MFIs need to produce accurate and comparable reporting on financial performance (e.g., loan repayment and cost recovery) as well as social performance (e.g., number and poverty level of clients being served).

Source: CGAP. "Key Principles of Microfinance," available www.cgap.org.







Also in CGAP: *Good Practice Guidelines for Funders of Microfinance*, CGAP, 2006

Annex 3: Characteristics of Old and New Approaches to Microfinance

Old Paradigm	New Paradigm
Primary Goals	
<ul style="list-style-type: none"> • Growth and income expansion (pursued by introducing modern technologies with concessionary credit). • Poverty reduction. 	<ul style="list-style-type: none"> • Growth and income expansion (pursued by introducing modern technologies with concessionary credit). • Poverty reduction.
Working assumptions	
<ul style="list-style-type: none"> • Accelerated economic development requires controlled commodity and financial markets (such as control of food prices and interest rates). • Small farmers and rural entrepreneurs cannot pay commercial interest rates and cannot save. • Access to concessionary credit is essential to growth and poverty reduction. 	<ul style="list-style-type: none"> • Accelerated economic development requires enhanced competition in goods and financial markets (through applying flexible prices). • Small farmers and rural entrepreneurs can pay commercial, market rates of interest. They also can and want to save. • Access to non-subsidized financial services is essential to growth and poverty reduction.
Role of Government	
<ul style="list-style-type: none"> • To directly intervene in and control the production sector and credit. 	<ul style="list-style-type: none"> • To create a favorable policy, regulatory and general business environment, while minimizing direct intervention in and control of the production sector and credit.
Mechanisms of Government Intervention	
<ul style="list-style-type: none"> • Government interventions in product markets that favor cities and heavy industry. • Government control of interest rates, credit allocations, and institutions to provide low cost credit to particular groups that “cannot afford” market rates. • Emphasis on meeting lending targets, rather than sustainability of programs. • Provide special benefits and concessionary funds to state-owned FIs; subsidize on-lending interest rates to FI clientele to compensate for policy biases and distortions in the production sector. • Cover loan losses of FIs and frequently bailout loss-making institutions. • Support poorly administered production insurance and credit guarantee schemes. • Underdeveloped legal framework and accountability. 	<ul style="list-style-type: none"> • Reduce government intervention in markets (for example, agricultural prices and supplies), and reduce inflation, which is a heavy tax on the poor. • Maintain a level playing field among economic sub-sectors and enhance competition. • Raise or remove ceilings on on-lending interest rates (to cover costs) and small scale deposits (which provide income for depositors and increases stability of funding). • Utilize a wide range of financial intermediaries (commercial banks, NBFIs, MFI NGOs, cooperatives, credit unions etc), supported by second tier institutions that fund only well-performing intermediaries; Allow financial services to cover their costs, which will encourage new products. • Privatize FIs (or segments thereof) where appropriate and shut down inefficient and unsalvageable FIs. • Introduce insurance-type instruments to help households manage risk; review effectiveness of credit-guarantee schemes. • Improve the legal framework.
Policy variables and outcomes	
<ul style="list-style-type: none"> • Subsidized interest rates are used primarily as compensatory mechanisms and not for resource allocation. • Subsidies mostly benefit mainly well-to-do, influential entrepreneurs. • Insufficient provision of savings facilities and artificially low deposit interest rates result in limited savings mobilization; RFIs depend on rediscounting facilities and donor and budget funds to back their (subsidized) loan portfolios. • MFIs do not enjoy autonomy; most operational decisions (such as on-lending interest rates, cost of borrowed funds and staff policies) are dictated. • Special privileges are often extended to MFIs, resulting in dependence on concessionary funds, lack of competition, and no incentives to improve performance. • No commercial imperatives exist for (state-owned) FIs; management is not accountable for FI performance; financial indiscipline and poor loan collection prevail. 	<ul style="list-style-type: none"> • Positive real interest rates serve as a resource allocation mechanism. • All entrepreneurs have access to financial services. • RFIs' dependence on borrowed funds from donors and governments is reduced as domestic savings mobilization becomes the main source of finance, improving financial self-sustainability. • MFIs enjoy autonomy in introducing efficient operating methods. • No special privileges are extended to state-owned MFIs; a level playing field is maintained and competition among MFIs is encouraged; access to subsidies (when warranted) is not contingent on an MFI's ownership. • Institution building and financial discipline is encouraged through management's accountability for RFI performance; poor loan collection is not tolerated.

Source: Adapted from J.Yaron, M. Benjamin and G. Piprek, *Rural Finance: Issues, Designs, and Best Practice*. Washington, DC: World Bank. 1997

Annex 4: Some key areas in which policy, regulatory and legal frameworks may be needed to enhance microfinance operations

Key Features of Microfinance		Responsive framework
Transaction costs are too high		MFIs need to be able to charge relatively high interest rates
Clients lack conventional collateral		Portfolio quality is used as a basis for assessing risks
Simple loan tracking and accounting		Simple yet rigorous reporting requirements -- with microfinance standards and benchmarks
Savings important to MFIs and clients		Ability of high performing MFIs to mobilize savings from borrowers and from the public
Many small branches		Ability to establish branches and agencies rapidly
Loan officers are not traditional bankers		Flexibility in hiring, and performance-based incentives

Source: Women's World Banking: *Policy Change – Experience in the Women's World Banking Network, WWB Network, Vol 1, No. 3, October 2003*

Annex 5: When should savings mobilization be regulated?

The case for regulation is clear when...	There is a grey area when...	There is no need to introduce prudential regulation when...
...savings are mobilized from the general public that are then intermediated (on-lent)	...savings are deposited in regulated financial institutions ("frozen")compulsory savings are mobilized as loan collateral and clients remain net borrowers
...membership boundaries are so "open" in the case of cooperatives that a "member" is not different from a public "depositor"	Clients "top-up" their compulsory savings, i.e., deposit more than is required by the loan contractinstitutions are small and community based, where the cost of supervision outweighs the benefit
	...member-based organizations are very large and not able to supervise themselves	
<p>"The broader the deposit base, the more flexible the use of deposits, the more the need to regulate is compelling" (<i>Independent consultant</i>).</p> <p>In other words, the further away the client is from his or her savings, the greater the need to protect the client through prudential regulation .</p>		

Source: UNCDF/UNDESA: *Building Inclusive Financial Sectors for Development (The Blue Book)*, New York, United Nations, May 2006, Table IV.1

Annex 6: African Union-Recommended Best Practices for Adoption by Member Countries

a. Adopt the Key Principles for Microfinance.

(see Annex 2)

- a. Focus on three priority roles.** Member states are responsible for fostering an enabling policy and regulatory environment for microfinance that balances increased access for poor people, financial stability, and consumer protection. Specifically, policy and regulatory actions should focus on:
 - **Financial Stability.** Governments should promote a stable economic, financial, and legal environment for microfinance. This environment should enable the development of sustainable microfinance services and institutions that grow with their clients—eliminating subsidized, short-lived programs.
 - **Improved Access.** Governments should encourage microfinance institutions to operate efficiently, to adapt traditional collateral requirements for lending to poor clients, and to remove policy barriers to the profitable provision of diverse microfinance services. In addition, governments can facilitate the use of information and communication technologies (ICT) and non-bank retail channels to reduce the cost of delivering financial services to clients.
 - **Client Protection.** Governments can ensure proportionate prudential regulation that protects the savings of poor people, and promote consumer protection and market conduct regulation.
- b. Create the momentum for continental, regional, and sub-regional financial capability programs.** Clients are at the center of inclusive financial systems, and they require the financial literacy and skills to make choices and optimize their use of financial services. Financial capability campaigns can be viewed as public goods that benefit clients, financial institutions and, ultimately, the financial system at large.
- c. Support new technologies to promote access.** The opportunity of new technologies engenders new business models. The implications of local grocery shops or mobile phones *de facto* offering financial services can challenge traditional banking regulation models.
- d. Promote the development of national identification systems.** Many microfinance clients operate in the informal economy and do not benefit from any official status, especially in countries that do not have a universal identification system. The lack of a national ID systems increases costs for institutions, and makes it difficult to develop key market infrastructure services, such as for example credit bureaus. Though not directly linked to microfinance, improvements in this area would have significant positive consequences for many actors involved in financial service provision to poor people.
- e. Promote standards and benchmarks:** This should be done with a view to improving professionalism, performance and quality of services. International rating agencies can be engaged to work with national/regional microfinance networks in developing industry standards specific to Africa.
- f. Research, training and capacity building:** The possibility of establishing regional training centres at REC level with a view to building capacity for industry leadership and management should be considered. Wherever possible, existing reputable training institutes such as IDEP (Dakar, Senegal), should be approached for possible collaboration in this field.

Source: African Union: 'Advancing the African Microfinance Sector', Extraordinary Conference of African Ministers of Economy and Finance (CAMEF), Addis Ababa, Ethiopia, 14-17 December 2009

Annex 7: Promotion of Inclusive Finance in the WAEMU: Microfinance Support Program

The BCEAO Regional Decentralised Finance Support Programme (**PRAFIDE**) has a number of **components**. The component supported by the consortium's (CGAP/SIDA/UNCDF) project has three main areas of focus:

- **Improve the regulatory framework:** BCEAO will finalize and roll-out an MFI-specific accounting framework; work with the regional OHADA Commission to finalize new legislation on cooperatives; and amend the so-called PARMEC law that serves as the framework for all microfinance operations in the region.
- **Strengthen supervision of MFIs:** BCEAO will consolidate responsibility for supervision of the largest MFIs in the region; conduct an increasing number of inspection missions; provide training and coaching for staff from the BCEAO and national Ministries of Finance; and establish national Microfinance Committees that will review licensing, supervision, and sanctions.
- **Improve information on the sector:** BCEAO will continue to publish annual monographs on each country, a regional summary, monthly updates of its activities, and an annual study on a relevant topic.

The PRAFIDE component supported by Lux Developpement has two pillars, as in the table below:

Overall Objective	Consolidate the sector and enhance risk management towards promotion of microfinance activities in the WAEMU Zone	
Components	Pillar 1 Adapt and strengthen microfinance supervision in the WAEMU zone to comply with the new regulatory framework	Pillar 2 Build capacity of MFIs in the generation and management of financial information
Expected Outputs	<ul style="list-style-type: none"> ✓ The new legal framework is disseminated and its implications made clear to Ministry supervisory units and professional associations ✓ The law is put into effect and improves the health of the microfinance sector through effective supervision and oversight ✓ Improved quality and standardization of financial reporting (new accounting framework and credit bureau) ✓ Statistics on the microfinance sector is available and made public 	<ul style="list-style-type: none"> ✓ Identification and testing of Management Information Systems that comply with the new accounting framework and BCEAO rules ✓ Improved MFI internal controls through dissemination of appropriate methodologies ✓ Appropriate external controls that follow supervisory unit standards ✓ Microfinance is formalized and self regulated within the networks

Sources: BCEAO and the Luxembourg Cooperation Agency, Dakar, Senegal. Also CGAP, Washington, DC.

Annex 8: Association of Ethiopian Microfinance Institutions —An Example of What a High Impact Association Can Do

- Create an environment of constant dialogue and face-to-face meetings between the MFI community and the regulators and policymakers to enhance understanding, advocate and lobby. Ethiopia has been extremely successful in dialoguing with the government to a point where the government could play its role as key supporter, instead of distorter, as in some other countries.
- Promote transparency and performance indicator reporting and benchmarking, which has proven to be a key driver of sectors. It is working well also in Benin, Ghana, Madagascar and Uganda.
- Analyze performance indicator trends to discern issues early that affect sectors at large. The networks in Benin, Cote d'Ivoire and Burundi have also begun doing this.
- Become a main source of information and contribute to building research capacity in microfinance
- Create a spirit of cooperation wherever possible; MFIs that operate in Addis Ababa, have formed a sub-network to exchange experiences and share client lists.
- Give direction, provide the long-term perspective, quantify the gaps, undertake projections, and set clear quantifiable goals. Most recently, AEMFI embarked on an extremely useful exercise, namely to come up with a vision for where the sector should be in ten years' time, laying out the various steps and issues to be tackled to achieve this.

Source: Women's World Banking/AMAF, *Diagnostic to Action: Microfinance in Africa*, New York: Women's World Banking, NY, 2008

Annex 9: Key Standards for Sound Financial Systems⁵⁴

Subject Area	Key Standard
Financial Policy	
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency
Financial Market Integrity	
Payment and Settlement	Core Principles for Systemically Important Payment Systems
Corporate governance	Principles of Corporate Governance
Insolvency	Principles and Guidelines on Effective Insolvency and Creditor Rights Systems
Accounting	International Accounting Standards (IAS)
Auditing	International Standards on Auditing (ISA)
Anti-Money laundering	The Forty Recommendations of the Financial Action Task Force on Money Laundering
Financial Regulations	
Banking Supervision	Core Principles for Effective Banking Supervision
Securities regulation	Objectives and Principles of Securities Regulation
Insurance supervision	Insurance Core Principles
Data Transparency	
Data dissemination	General Data Dissemination System (GDDS)/Special Data Dissemination Standard (SDDS)

⁵⁴ These exclude the best practices in micro-finance that will be recommended for implementation and assessment because of the tool's importance in poverty reduction in African countries.

Annex 10: Overview of Regional Facilities for Capacity Building of Microfinance sector in Sub Saharan Africa

Regional Capacity Building Facility operating in Sub-Saharan Africa ¹	Funders	Strategy/ Objective	Main capacity building interventions financed (by level of financial system)	Geographic focus	Amount/ Instruments used	Term	Fund manager
Microfinance Capacity Building Facility for Africa [NB working name "MICFAC Africa"]	DFID and WB Contact: DFID: Angus Kirk A-Kirk@dfid.gov.uk WB: Koro Ouattara Kouattara @worldbank.org	To build capacity amongst microfinance operators and to increase the supply of quality financial services for poorer populations throughout Sub-Saharan Africa by focusing on a regional approach to capacity building.	RETAIL/MICRO (i) Performance linked grants to address key internal/institutional impediments to the development of MFIs (eg weaknesses in governance, management and staffing) to enable MFIs to reach poorer clients sustainably, (ii) increase in the supply of microfinance operations to serve new clients and new markets (e.g. supporting capacity building during institutional start-up phase). Focus mostly on demand side (i.e. MFI users of capacity building services). The design phase will consider support on the supply side (i.e. through providers of capacity building services).	39 low income IDA countries (the Facility will be rolled out on a phased basis in order to ensure that country and regional contexts as well as existing initiatives are properly considered	The target size of the Facility will be determined during the course of the current design phase. GRANTS	5 years from the launch (expected late 2010).	Options for the management of the Facility are being considered during the current design phase.
SSA Capacity building facility	AFDB with funds from AECID and UNCDF	Build capacity of MFIs to enable them to attract funding from commercial investors	RETAIL/MESO/MACRO Developing the local training capacity for loan officers and middle management, improving	Liberia, West Africa to start with	5m Euro AECID 250,000 UNCDF	2010-2015	

¹ The focus is on regional facilities whilst we recognize that there are numerous capacity development projects/efforts at a national level across the financial sector (e.g. by GTZ, DFID funded FSDs). Most funds have a priority list of countries in which they intervene, sometimes linked to investments. For global facilities also active in SSA, see bottom.

	Contact: AFDB: Rafael Jabba R.Jabba@ AFDB.org		transparency and reporting, support innovation in delivery mechanisms, product development, expansion to rural / remote areas, consumer protection, build capacity of regulatory and supervision bodies, projects strengthening the market infrastructure		GRANTS		
EU/ACP Microfinance Programme	EC Contact: Stefania Zaninello stefania.zan inello@ec. europa.eu	To build the capacity of key microfinance actors and enhance equity and in ACP microfinance for microenterprises and low income household.	RETAIL/MESO/MACRO 1) Support access to finance for the most vulnerable and focus on innovative delivery models; (2) Activities that enhance consumer empowerment and capacity building; and (3) Improvement of equitable and efficient local market: work with ACP microfinance actors (service providers, MFIs, policy makers)	Sub-Saharan Africa (excl South Africa) (Funds from this project also go to Caribbean and Pacific islands)	15 m Euros GRANTS	2010- 2014	Tender launched for technical assistance team
Africa Enterprise Challenge Fund	DFID, CGAP, IFAD, Dutch Ministry Contact: Hugh Scott AECF Director hugh.scott @aecfafric a.org	Support innovative that are adjudged to have greatest impact on largest number of rural poor people	RETAIL Grant funding for private sector companies (agribusiness, rural financial services)	Kenya, Uganda, Tanzania, Rwanda, Burundi, Ghana, Nigeria, Mali, Burkina Faso, South Africa, Mozambique, Malawi, Zambia	50-100m \$	2008- 2014 (2 competitions a year for 6 years)	KPMG Development Services Ltd with Imani development and Triple Line Consulting

LINKED TO INVESTMENT							
TANDEM (Transfer and national accompaniment for the development of an expertise in microfinance)	CIDA Contact: DID Paule Droin pdrouin@did.qc.ca	Improve financial service offer for poor people, especially in rural areas	RETAIL/ MESO Develop expertise, improve performance on critical management functions and offer a platform for knowledge sharing and exchange.	19 countries in francophone Africa	2,2 million CAD GRANTS	2007-2010 (second phase in development)	DID
Regional project in UEMOA	LuxDev Contact: Kotsoni A kemakou kotsoni.ake makou@luxdev.lu xdev.lu Anne Bastin anne.bastin@luxdev.lu	Support consolidation of the decentralized financial sector and control risk	MICRO/MACRO Adapt and reinforce the supervision of MF in the UEMOA Strengthening of decentralized financial system in the production and control of financial information	8 member states of UEMOA	18.825 million Euro GRANTS	2008-2013	BCEAO
Capacity building in francophone Africa	A FD CGAP Contact: Corinne Riquet corinne.riquet@gmail.com	Support the structuring of a private market to build a sustainable supply of training for MFIs in francophone Africa using CGAP's courses.	MESO Coordinate supervision of Training of Trainers and training on CGAP courses organised by training partners Develop new courses to meet the needs of MFIs (e.g. financial education) Coordinate organization of seminars for external auditors Contribute to the animation of a training partners network	16 countries in francophone Africa	500 000 Euros GRANT	2010-2012	CGAP
Microfinance capacity building facility	A FD Contact: Philippe Serres serresp@afd.fr	Strengthen capacity of microfinance institutions and improve the enabling environment	RETAIL/MESO Initial TA for Greenfields, MIS, Support meso and macro level with training and market infrastructure	Global with aim to have 80% for Africa	20 million Euros GRANTS	2009-2012	AFD

<p>Regional Micro Small and Medium Enterprises (MSME) Investment Fund for Sub-Saharan Africa (REGMI FA)</p>	<p>Current Funders: BIO, OeEB, EIB, AFD, Proparco, IFC, KfW, B MZ, NMI, AECID</p> <p>Future Funders: AfDB, FMO, EC/Europe Aid</p> <p>Contact: Sonja Breitner Sonja.Breitner@kfw.de</p>	<p>Structured as public-private partnership, REGMI FA aims to remove obstacles to the growth of MSMEs by providing flexible and innovative funding solutions in response to the particular requirements and market constraints of the African continent.</p>	<p>RETAIL.</p> <p>(i) Medium to long term debt financing of commercially viable and preferably smaller MSME lending intermediaries in all Sub-Saharan Africa with a particular emphasis on local currency funding;</p> <p>(ii) Provision of Technical Assistance to support the growth process of the institutions, including training on governance, risk management, product development, social performance management, transformation, Performance Management, Marketing, MIS (focus on selection support and training)</p>	<p>Sub-Saharan Africa no focus countries. The fund will start building up a portfolio in the first year in Ghana, Nigeria, Kenya, Tanzania, Uganda and DRC. 2-3 new countries will be added each year to the portfolio.)</p>	<p>201-2015: 200 M USD plus a separate TA Facility of min. 7 Mio EUR to accompany INVESTMENT</p>	<p>Unlimited Maturity</p> <p>(Launched on May 5, 2010)</p>	<p>Investment Manager: Symbiotics Investment Management S.A. ; TA-Advisor : Microfinanza Srl</p>
<p>FINTECH (non profit organisation that manages Africa's Technical Services Facility)</p>	<p>EIB, BMGF, FMO</p> <p>Contact: Wagane Diouf wagane@meceneinvest.com</p>	<p>Build capacity in portfolio companies and support industry development</p>	<p>Institutional: MIS and upgrade technology, improve governance structures, development of new products. Industry: Research, feasibility studies, pilot testing, knowledge platforms.</p>	<p>Countries within portfolio Senegal, Sierra Leone, Cote d'Ivoire, Ghana, Burkina Faso, Niger, Nigeria, Cameroun, Madagascar, Uganda, Tanzania, Kenya, Malawi, Mozambique, SA, Botswana</p>	<p>8.35m\$ GRANTS</p>		<p>Mecene Investment</p>

Source: CGAP --Prepared by CGAP for Africa Afternoon, CG Nairobi, May 19, 2010

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