

# **AFRICAN DEVELOPMENT BANK**



## **CONCEPT NOTE ON MICROFINANCE SCALING UP IN AFRICA: CHALLENGES AHEAD AND WAY FORWARD**

**Leila Mokaddem, Manager  
Private Sector and Microfinance Department**

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## Microfinance Scaling-Up in Africa: Challenges Ahead and Way Forward

### I. Background

Efficient financial markets are essential for economic development. They allow economic growth through resource mobilization and investment, trade facilitation, risk diversification. Even poor people can benefit from efficient financial markets: with access to savings, credit, insurance, and other financial services, they become more resilient and better able to cope with the everyday crises they face; access to financial services also translates into better nutrition, improved health, increased gender equity, and higher children schooling rate.

The importance of financial services to the poor, or “Microfinance”, has been internationally recognized as a mean not only to fight poverty but also to bring peace, in October 2006, when the Nobel Prize was granted to Mohammed Yunus, funder of the Grameen Bank in Bangladesh. “Lasting peace can not be achieved unless large population groups find ways in which to break out of poverty. [Microfinance] is one such means. Development from below also serves to advance democracy and human rights”, were the words to announce the Prize.

However, financial services available to the poor remain very limited, above all in Africa. Best practices and solutions are known, but the challenge is to bring them into widespread use. The challenge is to develop inclusive financial markets whereby the poor have access to the whole set of financial services. Microfinance will reach the maximum number of poor clients only when it is integrated into the financial sector.

To reach this objective, the following key principles have to be applied<sup>1</sup>:

- A. **Poor people need a variety of financial services, not just loans.** Like everyone else, the poor need a range of financial services that are convenient, flexible, and affordable. Depending on circumstances, they want not only loans, but also savings, insurance, and cash transfer services. Microfinance is not limited to Microcredit.
- B. **Microfinance is about building permanent local financial institutions.** These institutions need to attract domestic savings, recycle those savings into loans, and provide other services. Microfinance should not be limited to NGOs or credit unions, let alone projects. Institutions should aim at commercial sustainability, offering products based on sound market research, rather than relying upon subsidies and government support. Banking for the poor does not mean poor banking.
- C. **Microfinance institutions should be able to charge interest rates that cover their costs.** It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they

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<sup>1</sup> From CGAP, Key Principles in Microfinance

cannot cover their costs. Their growth will be limited by the scarce and uncertain supply of soft money from donors or governments. At the same time, a microlender should not use high interest rates to make borrowers cover the cost of its own inefficiency.

- D. **Microcredit is not always the answer.** Microcredit is not the best tool for everyone or every situation. Destitute and hungry people with no income or means of repayment need other kinds of support before they can make good use of loans. In many cases, other tools will alleviate poverty better—for instance, small grants, employment and training programs, or infrastructure improvements. Where possible, such services should be coupled with building savings.
- E. **The role of government is to enable financial services, not to provide them directly.** National governments should set policies that stimulate financial services for poor people at the same time as protecting deposits. Governments need to maintain macroeconomic stability, avoid interest rate caps, and refrain from distorting markets with subsidized, high-default loan programs that cannot be sustained. They should also clamp down on corruption and improve the environment for micro-businesses, including access to markets and infrastructure. In special cases where other funds are unavailable, government funding may be warranted for sound and independent microfinance institutions.

*How to apply these principles? How to help microfinance meet the expectations it raised in terms of economic development? African governments, central banks, donors and development finance institutions such as the African Development Bank have a key role to play.*

## II. The State of Microfinance in Africa<sup>2</sup>

Microfinance always existed in Africa, albeit informally. Revolving credit associations, “tontines” were the first form of microfinance; credit unions rapidly expanded; and today the panorama is quite diverse, with individual lenders, self-managed groups, cooperatives, NGOs, regulated MFIs, and even banks, providing a wide range of financial services. However, an overwhelming majority of the economically active population, above all in rural areas, so far remains excluded from the formal financial system; and even those who have access to the financial system can still not get all the services they need.

Historically, microfinance in Africa has developed in different stages across the region. Financial intermediaries such as cooperatives, rural and postal savings banks pioneered the industry in the 1970s, especially in West and East Africa. In the 1980s and 90s, the sector saw a number of donor-supported credit-only non governmental organizations (NGOs) develop and sometimes transform into new types of non-bank financial institutions by the end of the 90s. Today West Africa is dominated by credit cooperatives, while regulated non-bank financial institutions stand out in East Africa, and Southern Africa is mainly served by a large

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<sup>2</sup> Based on MIX figures and analysis, in “Benchmarking African Microfinance 2006” - Sample of 119 institutions from 24 countries

number of NGOs, some downscaled banks and newly established special-purpose MSME banks. Although the majority of reporting MFIs are regulated, the largest number of unregulated MFIs is located in East Africa. However, this number is likely to decrease as many Ugandan unregulated MFIs continue to take advantage of an evolving regulatory environment, beginning in 2004, which allowed them to transform into regulated deposit-taking institutions.

Table 1: Number of African MFIs, by Type & Region

| MFI Type     | Central Africa | East Africa | Indian Ocean | Southern Africa | West Africa | Total      |
|--------------|----------------|-------------|--------------|-----------------|-------------|------------|
| Cooperative  | 10             | 4           | 8            | 2               | 32          | 56         |
| Regulated    | 3              | 23          | 1            | 18              | 26          | 71         |
| Unregulated  | 5              | 15          | 0            | 8               | 8           | 36         |
| <b>Total</b> | <b>18</b>      | <b>42</b>   | <b>9</b>     | <b>28</b>       | <b>66</b>   | <b>163</b> |

Source: Mix, "Overview of Outreach & Financial Performance of Microfinance Institutions in Africa". April 2005

CGAP counted 467 active microfinance programs in Sub-Saharan Africa (SSA) in 2006. On the whole, the microfinance sector in Africa was represented by a handful of large institutions — including 16 MFIs with over 50,000 loan clients each — and by scores of small, young MFIs appearing in new and established markets alike. Strengthened by reforms of recent years, African microfinance attracted international attention, resulting in young start-up banks, NBFIs and NGOs setting up activities in Central, East and Southern Africa.

For the same year, 190 African MFIs reported to the MIX: they all together reached **4.8 million borrowers** with **1.6 billion USD in loans**, while serving **7.2 million savers** and managing **1.5 billion USD in deposits** (Table 2).

Table 2 : Microfinance Outreach

|                                    | SSA   | MENA | All Regions |
|------------------------------------|-------|------|-------------|
| # MFIs reporting to the MIX        | 190   | 41   | 1,038       |
| <b>Outreach</b>                    |       |      |             |
| # Borrowers (millions)             | 4.8   | 1.7  | 57.9        |
| # Voluntary Savers (millions)      | 7.2   | 0.0  | 67.7        |
| <b>Balance Sheet</b>               |       |      |             |
| Gross Loan Portfolio (million USD) | 1,553 | 641  | 24,429      |
| Voluntary Savings (million USD)    | 1,477 | 0    | 16,062      |
| Assets (million USD)               | 2,944 | 734  | 34,632      |
| Equity (million USD)               | 686   | 317  | 5,736       |

Source: MIX, "Selected Microfinance Indicators 2006" Feb 2008

Growth in 2006 was spectacular in certain markets and among specific MFIs. On average, credit activities among the institutions that reported to the MIX grew by 47%, while savings services doubled in just 12 months. The highest growth in clientele was recorded in Kenya, particularly among the two leading Kenyan microfinance banks that showed a combined 170,000 additional active borrowers in one year.

In terms of depth, the weighted average outstanding loan per borrower for African MFIs is US\$617. In relative terms, compared to GNI per capita (153%), these loans are larger than those offered in all other regions but Eastern Europe and Central Asia (EECA) – Table 3.

MFIs in Africa often serve a mix of poor and more middle class clients in order to achieve better cost coverage. Financial intermediaries (i.e. institutions accepting savings), specifically cooperatives, reach a higher-end loan clientele on the lending side (usually salaried workers), while handling savings balances that are typically three to five times smaller than the credit balances they offer.

Table 3: Depth of Outreach

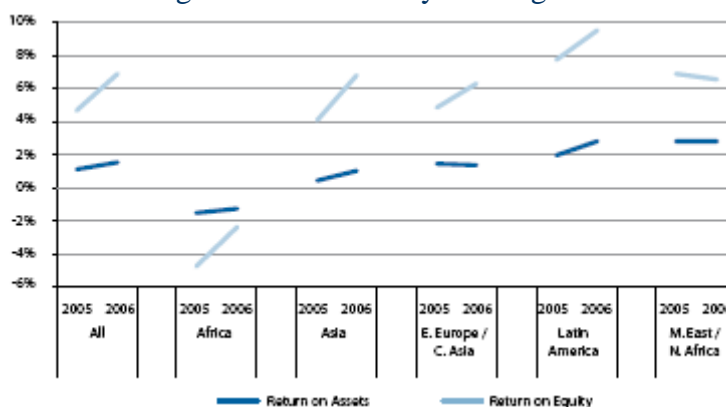
|  | EAP | EECA  | LAC   | MENA | S. Asia | SSA        | All   |
|--|-----|-------|-------|------|---------|------------|-------|
| Sample Size (# of MFIs)                              | 131 | 202   | 272   | 41   | 202     | <b>190</b> | 1,038 |
| Average Loan Balance per Borrower (USD)              | 534 | 2,581 | 1,126 | 520  | 137     | <b>617</b> | 1,031 |
| Average Loan Balance per Borrower (% GNI per Capita) | 44  | 162   | 51    | 30   | 27      | <b>153</b> | 85    |

Source: MIX, "Selected Microfinance Indicators 2006" Feb 2008

A distinctive nature of microfinance in Africa is the large deposit mobilization. Unlike in most regions around the globe, more than 70 percent of African MFIs offer savings as a core financial service for clients and use it as an important source of finance for their lending activities. African MFIs rarely resort to outside borrowing. Research conducted by CGAP in 2004 shows that African MFIs account for only 21% of recipients of foreign investment, and only 6% of total dollars invested by international financial institutions and privately managed funds. In contrast, MFIs in the Latin American and Caribbean, Eastern Europe and Central Asia regions received 7 and 10 times more foreign investment, respectively.

In terms of profitability, African MFIs do not fare well compared to their counterparts in the rest of the world. African MFIs return on assets averages (-2%), compared to 2.5% for the Latin America and Caribbean region, 3% for MENA, 1% for Asia and 1.5% Eastern Europe (figure 2). African institutions faced tremendous hurdles in reaching sustainability: low population density with a predominantly rural population, weak communication infrastructure and high labor costs ("compensation to employ and retain skilled personnel averaged 12 times GNI per capita, over twice as much as any other region in the world", MIX).

Figure 2 : Profitability Per Region



Source: MIX 2006 Peer Group Medians

In terms of **women empowerment** and gender equity, African microfinance plays an important role. Women account for around 70% of the world's microfinance clients. The vast majority of them have excellent repayment records, in spite of the daily hardships they face. Although microfinance does not address all the barriers to women's empowerment, when properly designed, they can make an important contribution to women's empowerment. Some of the most valued benefits include expanded business and social networks, improved self-esteem, increased household decision-making power, and increased respect and prestige from both male and female relatives and community members. Because women contribute decisively to the well-being of their families, investing in women brings about a multiplier effect. There are many testimonies from African women on the positive impacts generated by their access to finance<sup>3</sup>.

Overall, MFIs in Africa are growing and are dynamic. Clearly, there are some positives on the performance of African MFIs to date. The sector is expanding. African MFIs are among the most productive globally, as measured by the number of borrowers and savers per staff member. MFIs in Africa also demonstrate high levels of portfolio quality.

However, African MFIs face many challenges. Expenses are high, and on average, revenues remain lower than in other global regions. Efficiency in terms of cost per borrower is low. More importantly, available data suggests that Africa has a long way to go before it bridges the gap between demand by poor households for financial services and supply thereof. It is estimated that the coverage rate for financial services to the poor in Africa is only 6.9%, the lowest for the developing world. There are an average 2.5 branches for 100,000 persons in Sub Saharan Africa (SSA), compared to 15 in the rest of the world; and an average 6 branches per 1,000 square kilometres compared to 34 (IMF). In 2004, savings in banks represented only 19% of the GNP in SSA, against 38% on average in other regions; and private sector loans represented only 13%. On average, only 11% of households had access to savings accounts, compared to 25% in other low- and middle income countries and 90% in industrial countries. Chad and the Central African Republic have the lowest access levels, with savings accounts held by less than 1% of the adult population. By contrast, the figure is close to half in Botswana and South Africa.

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<sup>3</sup> **Nana Addai, client of Sinapi Aba Trust, Ghana, in "Empowering Women through Microfinance – Cheston & Kuhn 2002.** "Before joining SAT, I did not have much money, so I had to collect the goods from somebody, sell them, and give her the profit before she would give me some. . . . Every week I would have to render accounts to the supplier—what had been bought, what is left, etc., before she would give me other goods to sell. . . . Because I now have my own money, I am able to negotiate well for good prices and . . . if what my suppliers are selling is not nice, I can go to a different store to purchase what I think people will buy. . . .The time that I spend with my business has reduced because I now have my own money, unlike the past where I was working for somebody so I had to be able to sell all day long before she would give me my share. So always I was tired and in a rush to make sure that I spend more time at the business to ensure that people buy it. But now I have my own business and money, and I can organize myself better to get time to rest."

### III. Microfinance: Priorities for Africa

The challenge in the region is to **achieve scale and reach remote areas without losing control of costs**. The good news is that it is possible. As they grow in size, larger institutions in Africa can be profitable: the top quartile of African MFIs reporting to the MIX not only were profitable, but boosted their ROA by one percentage point (from 0.9 in 2005 to 1.9 in 2006). Once MFIs reach profitability, MFIs were able to expand their operations and achieve economies of scale. These positive returns allowed them to reach twice as many borrowers as their unprofitable peers.

To achieve scale, stakeholders have to focus on the following priorities.

#### A. Bringing Financial Services to Rural Areas

Despite the disproportionate concentration of poverty in rural areas, microfinance tended to gravitate away from rural borrowers. Some 70 percent of the population in Sub-Saharan Africa lives in rural areas, where financial services are scarce, at best. Delivering small loans and savings mechanisms can be particularly challenging in areas of low population density, where the distance between clients is great, transportation networks are often poor, and low income levels tend to translate into impracticably small financial transactions. African rural finance history can also scare brave MFIs away, as past failures line the way. As CGAP stresses it, “the overwhelming failure of state development banks that provided billions of dollars in subsidized agricultural finance to farmers in the 1970s and 1980s, combined with scant rural penetration by risk-averse commercial financial institutions, has led to a widespread dearth of agricultural credit”<sup>4</sup>.

However, there is hope. CGAP in 2002 identified promising rural lending operations and two of the five selected case studies were in Africa: the Cooperative League of the USA (CLUSA) in Mozambique, for organizing farmer associations and linking them to financial service providers<sup>5</sup>, and Equity Bank Limited in Kenya, for taking banking services to people via high-tech mobile banking units<sup>6</sup>.

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<sup>4</sup> CGAP Case Studies in Agricultural Microfinance – August 2005

<sup>5</sup> “The Cooperative League of the USA (CLUSA) launched a program in Mozambique in the mid-90’s, when the country was still overcoming a long period of armed conflict. As a supporter of market-oriented business associations, CLUSA focused its efforts on organizing impoverished, isolated farmers in the northern provinces, where the commercialization of cash crops (e.g., maize, cotton, and cashews) was gaining momentum. CLUSA worked with local producers to form and strengthen farmer associations, then trained the associations to pool and market their crops to commodity traders, leading to higher farm gate prices and an 85 percent (inflation-adjusted) increase in average annual farm revenues. CLUSA also assisted the associations to establish better relationships with local agri-businesses that provide input credit and short-term crop advances to smallholder farms prior to purchasing their harvests. In addition, CLUSA brokered a partnership with a financial services provider, Gapi, to offer loans to farmer associations for agricultural purposes. In 2003, 10,000 farmers in CLUSA-supported farmer associations accessed more than US \$300,000 in agribusiness company credits and nearly \$100,000 in loans from Gapi, with average repayment rates of close to 100 percent.” In “CGAP Case Studies in Agricultural Microfinance – August 2005”

<sup>6</sup> “Equity Bank, Limited, [...] provides microfinance services to more than 250,000 low- and moderate-income citizens in Nairobi and Kenya’s Central Province via a network of branch office offices and mobile banking units. [...] In 1994, [Equity] began tailoring its loan and savings products to a microfinance market, eventually adding two loan products for tea and dairy farmers that are secured by agribusiness contracts. By the end of 2003, the deposit base of Equity had grown to US \$44

The challenge is therefore to identify these innovations and replicate them. Donors can play a key role. For instance, the German government, through GTZ, significantly contributed to the success of the Bank for Agriculture and Agricultural Cooperatives in Thailand in promoting rural savings. This program helped develop a new financial product called “Save and Get a Chance”, which attracted more than 2.3 million rural Thais, with average savings deposits of 83 euros, within only 6 years. “Save and Get a Chance” had such phenomenal success because it was designed specifically for low-income clients. It also yielded an impressive return on investment for GTZ and provided the local bank with a sustainable source of refinance<sup>7</sup>.

## **B. Implementing Efficient Microfinance Regulation and Supervision Framework**

Many African policymakers have recognized the importance of an enabling macro-economic and legal framework, and in this regard are promulgating policies to support the development of microfinance institutions and inclusive financial systems that serve all. Prudential regulation is needed to protect the financial system, protect depositors, and manage the money supply. As credit-only MFIs usually have little impact on any of these, and given the serious challenges confronting supervisors in developing countries, financial authorities usually focus on deposit-taking MFIs. They might implement non-prudential regulation for credit-only MFIs, requiring for instance such MFIs to register and identify the parties that control them, to give clients transparent interest rate information, to produce financial statements in a meaningful format, and may be to participate in a credit bureau.

Difficulties in drafting microfinance legal framework lie at two levels:

(i) Regulation: finding the right balance between too much and not enough regulation is a difficult task. “A very inflexible and conservative approach may unduly restrict the supply and expansion of microfinance by not allowing financial institutions to adopt appropriate lending technologies. On the other hand, and much more common, well-intended efforts to promote microfinance may result in an overly lenient framework that enables and permits weak institutions to operate, which in turn may lead to bankruptcies, shake confidence in a budding industry and cause poor people to lose their savings.”<sup>8</sup>

(ii) Supervision: drafters of new legislation typically fail to give enough attention to the practical feasibility of supervising compliance with the new regulations. In Indonesia, Ghana, and the Philippines, for example, dozens of new institutions took advantage of a newly created licensing window, but supervision proved grossly inadequate and a high proportion of them failed. As CGAP underlines it “citizens should be able to assume, and usually do

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million and its outstanding loan portfolio topped \$22 million. Equity initiated a mobile banking program in 2000 with the goal of efficiently reaching more clients in remote rural areas. Mobile banking operations have been introduced successfully and by the end of 2003 accounted for more than US \$1.3 million in deposits, serving over 12,000 clients in 30 rural communities”. In “CGAP Case Studies in Agricultural Microfinance – August 2005”

<sup>7</sup> CGAP Direct, Case Study No. 1 “Success in Rural Savings: How One Donor Led the Way”, by Ruth Goodwin-Groen

<sup>8</sup> “Principles and Practices for Regulation and Supervision of Microfinance”, IADB 2004

assume, that the issuance of a prudential license to a financial intermediary means that the government will effectively supervise the intermediary to protect their deposits. Thus, licenses are promises. Before deciding to issue them, a government needs to be clear about the nature of the promises and about its ability to fulfil them”.

Even though there have been many initiatives to improve regulatory frameworks in the region in the past years<sup>9</sup>, there is still a large room for improvement so that regulation and supervision not only enable microfinance but also foster it. The legal environment in Sub-Saharan Africa is complex and defies a broad regional summary. As Dr. Joachim Bald states it<sup>10</sup>, “microfinance regulation [in Africa] is a challenge to supervisors, because of the prevalence of the cooperative model and decentralized community-based institutions, which makes inspection activity very onerous. While a growing number of countries have microfinance regulations, implementation is still being phased in and actual supervision and inspection capacity is lagging behind”.

The challenge ahead is to finalize the setting up of legal framework that enables a diverse and sustainable microfinance, and the implementation of viable supervision systems. A side challenge is to reinforce the legal and judicial system, in order to promote creditor’s rights. Banks in developed countries can count on the judicial system to help recover collaterals or call upon guarantee. It is often not the case in Africa and this is a serious impediment to develop credit.

### **C. Training Human Resources**

One of the key bottlenecks in Africa is the shortage of strong institutions and managers. Skills and systems need to be built at all levels: (i) microfinance institutions (managers for “greenfielding” new institutions, credit professionals who can drive growth and institutional strengthening of existing MFIs, project managers with know-how in appropriate product design and marketing for downscaling projects), (ii) external services (information technology, accounting, audit, and consulting capacities), (iii) central banks and other government agencies (supervision units).

Capacity building and knowledge management are the essential remedies for this fundamental constraint. Donors can support these areas through different initiatives: financing local training centres, granting allocation for studies abroad, organizing local knowledge sharing events, and strengthening local intermediaries. Sidas’s experience in Nicaragua has been very relevant in this field. In 1998, the microfinance sector in Nicaragua was threatened by strict financial regulation that had been adopted after the failure of several commercial banks. The

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<sup>9</sup> Many initiatives are underway to improve microfinance regulation and supervision across Africa: the BCEAO is currently revising the PARMEC law; in CEMAC, a prudential framework was introduced in 2002 and implementation is now being phased in; in Madagascar, a new law governing microfinance was introduced in 2005 that is now being fleshed out in terms of guidelines and regulations; Kenya recently published a microfinance draft bill; etc.

<sup>10</sup> “Feasibility Study, REGMIFA Fund” March 2007

local Sida staff also recognized that the microfinance sector had no advocate at the national level in Nicaragua. They invited key microfinance players to meet and gauge the idea of creating a national network of MFIs. Local institutions seized on the idea and within a few months, the Asociación Nicaraguense de Instituciones de Microfinanzas (ASOMIF) was up and running with limited Sida involvement and funding. Six years later, ASOMIF had doubled its membership, established an effective members' credit bureau and become an active national organization to which Sida no longer provided financial support.<sup>11</sup>

#### **D. Encouraging Enterprises to Go Formal**

A key concern for MFIs is to know their clients. It is all the more difficult as these clients are most of the time informal businesses: personal and business expenses are mixed and therefore difficult to track; assets property is unclear and cannot support collateral lending. As they access microfinance service and grow their business, these clients could choose to formalize – but it is rarely the case. Some entrepreneurs choose to stay small; they started their activity only to generate cash and are satisfied once they can cover their family expenses. But others have more ambitious growth objectives – and still remain informal. Administrative bottlenecks and slowness largely explain this aversion, along with taxation. Government's role is to provide adequate legal framework for small businesses. Out of the 46 SSA countries displayed in the Doing Business survey, only 4 were rated as “easy” places to do business<sup>12</sup>, 8 as “moderate” and the rest of them received the “difficult” mention. In 2006, the report concludes that 9 of the world's 10 most difficult business environments are located in Sub-Saharan Africa.

Encouraging enterprises to go formal would certainly impact the provision of financial services to the poor. Banks and other financial service providers would gain confidence and would be ready to take more risks.

#### **E. Developing the Financial Infrastructure**

Financial infrastructure is the entire set of legal, regulatory, accounting, credit reporting, and payments systems that supports the effective functioning of financial markets and financial intermediation. Smart use of technology could play a major role in strengthening this infrastructure and help MFIs in many areas such as credit risk management (stronger MIS, credit bureau), distribution channels (mobile service stations, cell-phone and internet banking, agency service points in rural retail stores, ATMs), and even funding (transparent information, rating agencies). In several countries around the world, financial service providers are piloting and mainstreaming the use of new technological approaches to bring financial services to people who have been difficult to reach up to now. Brazil's banks use 90,000

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<sup>11</sup> CGAP Direct Case Study# 16 “Decentralization Empowers Local Technical Staff: Sida's Catalytic Role in Forming a Stakeholder-Led Microfinance Network in Nicaragua” by Ivana Damjanov

<sup>12</sup> South Africa, Mauritius, Namibia, Bostwana

electronic terminals in retail outlets as a low-cost channel for hard-to-reach areas. Millions of people in the Philippines, Kenya and South Africa receive remittances and make purchases using their mobile phones. Banks in India are sharing their technology platforms with microfinance institutions (MFIs) to expand their product range and reduce costs.

These technologies exist in Africa and are used, but in numbers too small to have real impact on the costs and efficiency of financial services for poor Africans. In order to reach this kind of scale, much greater numbers of financial service providers need to begin using technology to adapt their operations, products and services. Why do so few financial service providers in Africa use technology? The primary reason is lack of knowledge -- about the different technologies available, the service providers, the costs and implementation strategies. In addition, African financial service providers also need proven systems that are priced to fit their financial capacity.

Countries governments and donors can support these initiatives by promoting knowledge sharing on these new technologies, and by improving the overall banking infrastructure in order to provide systems rightly priced. The three main areas are the following:

- **Payment infrastructure:** inefficient payment systems drive up costs and create an energy-draining drag on the sector. Africa's payments systems are the least developed globally. Cash dominates, and inter-bank domestic transactions can take up to 45 days in Ethiopia, for example. 33 countries in SSA have started modernization of their payments systems, typically beginning with the interbank clearing of large value payments.
- **Credit bureaus:** Credit bureaus are an essential element in the credit infrastructure as it helps replace create history and therefore trust among lender and borrower. It provides clients a chance to build up reputational collateral over time as their payment experience is recorded and becomes available to lenders. A recent CGAP survey confirms that Africa has the least developed credit bureaus globally, and that significant hurdles remain that delay introduction of large scale industry-wide bureaus: weak national identification systems; exact residential addresses may be impossible to establish; privacy laws often restrict information sharing by publicly-owned credit bureaus. South Africa is the noted exception here.
- **Management Information System:** Much could be gained by backing common software solutions with wide distribution in the industry that would come with professional support and release management that avoids dead-end investment in IT.

Donors could also play a role in promoting transparency and accountability, by reinforcing a major actor of the financial infrastructure, the rating agencies. Improved transparency of MFI financial performance is a basis for improved performance and increased flow of commercial funding to MFIs. However, rating agencies often charge higher prices in Africa than in other regions, because of additional work to assess the quality of the information provided and visit remote branches. This cost discourages MFIs and turn rating agencies away from Africa.

## **F. Solving Funding Issues**

Funds keep flowing to microfinance. The current community of microfinance funders comprises roughly 40 public agencies, 20 foundations, and 80 funds and other microfinance investment vehicles. International banks (such as Citigroup, Deutsche Bank, TIAA-CREF, Morgan Stanley, ABN AMRO and Société Générale), private investors, international nongovernmental organizations, and individual donors raise the numbers even higher. CGAP roughly estimated international public fundings for microfinance at \$1.5 billion in annual commitments, an outstanding portfolio from International Development Institutions of \$2.3 billion; and \$1.5 billion for microfinance investment vehicles. These numbers do not include private foundations, banks, investors, or Individuals, for which reliable information is not available.

Nevertheless, African MFIs face a lack of adequate funding to finance their growth. Funds are still small and highly concentrated in the leading institutions; they are mostly short to medium term loans in hard currency; MFIs have a hard time accessing equity or long term and local currency loans. The problem is exacerbated by the fact that in many African countries, currency derivatives markets are insufficiently developed. The danger is that in order to attract long term financing, MFIs may be tempted to improve their risk profile by concentrating on larger, less poor borrowers. More certainty on the funding side and foreign exchange risk should be welcome stimulants to microfinance supply throughout Africa. It is critical for the Bank to offer financing, both mezzanine and senior, in local currency.

Growth calls for new financing models. The endgame is for microfinance to principally fund itself through local deposits, as most retail banks do (local deposits can be a more stable, plentiful, cost-effective and less risky source of financing than cross-border funding); but MFIs will still need external refinancing. Challenges, particularly in Africa, include enabling equity investment and promoting local currency funding. They can be solved by creating/strengthening legal status for private entities doing microfinance, supporting NGO transformation processes, creating incentives for local banks to refinance MFIs, developing saving and remittances products, and promoting securitisation.

What is the role of governments, of donors? For development partners, that have a market-maker role, it is important that to enable microfinance institutions to start-up effectively, expand efficiently and be in a position to access local and international capital markets, in lieu of donor funding. In particular, MDBs such as the AfDB aim to go deeper into the market with the objective of grooming emerging institutions, for them to access local and international sources on commercial terms.

Development partners, like AfDB, have therefore an important catalytic role in mobilizing development finance, creating strong demonstration effects through innovative mechanisms

and innovative structured finance. Their role is not to cover all funding needs. Too much subsidized money from international socially motivated investors and donors can even serve as a major disincentive for deposit mobilization, crowd out local and international commercial sources, and mask operational inefficiencies of microfinance providers.

#### IV. The Bank's Role

The Bank's objective is to support the development of sustainable and dynamic financial service providers that collectively provide increasing access by the poor, including women entrepreneurs and heads of households, to a range of financial services and products. In particular, the Bank's strategy for the financial sector development in Africa aims at addressing three gaps: *the financial intermediation gap* as represented by the fragility of the financial system, *the development gap* as reflected in the shortage of long-term finance for investment, and *the under capitalization situation* that results in a vast unmet demands for financial services by the SMEs, the economically active poor and the disadvantaged groups, including women. Hence the Guidelines are anchored to microfinance "Best Practices" that have developed over the years, throughout the world, promoted and endorsed by the Consultative Group to Assist the Poor (CGAP) and leading practitioners.

The Bank benefits from a unique positioning compared to other public donors and development finance institutions. Thanks to (i) its Board of Directors and (ii) its ability to work with both the public sector and private entities, the Bank has access to microfinance main stakeholders: the Bank can work directly with governments but also with private companies to make the most out of its programs.

The Bank wishes to support the development of inclusive financial systems on three levels: the ***micro*** level (promoting strong retail financial service providers); the ***meso*** level (supporting market industry infrastructure, e.g., rating agencies, training providers, information technology, etc.); and on the ***macro*** level (fostering a conducive policy environment and ensuring the appropriate role of RMCs). At the three levels, and depending on circumstances in each RMC, the Bank can provide a range of financial instruments/products and services to support the growth and expansion of the microfinance sector throughout Africa.

At the micro level, the Bank adopted a market-oriented approach to create sustainable linkages between MSMEs and domestic financial services. With this overarching objective, the Bank would interact with financial service providers for MSMEs as follows:

- Support high-growth microfinance institutions with senior and subordinated debt for the purpose of building up their MSME book and to address their funding gap with regard to medium and long-term maturities, particularly in local currency. Such high potential, emerging MFIs would typically have portfolio sizes between \$1 Mio and \$5 Mio and

would be characterized by above-average cost coverage for the peer group, a solid governance structure and a substantiated growth strategy.

- Support start-up MFIs with equity participation, where depositor funding is not yet available; cash generation is non-existent and Bank presence catalyses participation by other investors and prepares it for future listing. The Bank may seek to make common and preferred equity investments in MFIs to the extent it identifies attractively priced MFI equity investment opportunities with viable exit strategies. With this instrument, Bank participation can be either at the holding company level or, directly in the MFIs.
- In a view to strengthening MFI balance sheets and improving their commercial borrowing ability, Mezzanine finance represents an important product innovation and should be promoted in the form of subordinated debt, non-voting preference shares and convertible debt.
- The majority of microfinance exposures, both mezzanine and senior, should be delivered to MFIs in local currency.
- The Bank offers credit enhancement instruments, such as partial guarantees to MSME retail lenders in order to mobilize funds in local currency with domestic banks. Guarantees can be an effective means to gradually bridge the gap between overly liquid domestic financial institutions and an MSME sector starved for investment. The design of the guarantee window will incorporate the lessons learned from existing MFI guarantee programs, and insist on the cost benefits of the guarantee fully flowing to the guaranteed borrower instead of being absorbed by the intermediary banks.
- The Bank can also provide grants for technical assistance and capacity building purposes.

At the meso level, the Bank will support actors that provide technical services to retail institutions. Such qualifying actors include, but are not limited to, associations, training centers, consulting firms, rating agencies, accounting and auditing firms, management and information systems providers. The Bank also aims at taking part in financial infrastructure strengthening through the development of payment systems, credit bureaus and rating agencies.

At the macro level, the Bank aims at supporting RMCs to create enabling environments that promote the growth of financial intermediaries such as MFIs. Depending on the RMC, areas of focus will include enacting legislation, laws, and regulations that support microfinance; cultivating respect for the rule of law, particularly laws concerning the enforcement of loan contracts and collateral; eliminating interest rate ceilings; allowing MFIs to mobilize savings while protecting the fiduciary interests of depositors; and helping institutions to manage and invest savings with due diligence and to control fraud. A conducive environment will also help the informal-sector clientele of financial intermediaries to expand their entrepreneurial activities into more profitable ventures, such as formal SMEs. The primary targets of this macro level element of the Bank's strategy are RMC governments, through their ministries and central banking authorities, as well as legislative bodies such as national assemblies and parliaments. Enabling environment initiatives to regulate microfinance and promote

integration at regional levels, such as those of multi-country central banks, will also be supported.

## V. Key Issues for Discussion

The Bank intends to take advantage of this event to reflect on how microfinance can help improve their countries economic situation and how to put microfinance forward on their political agenda, rural finance in particular. The goal is also to offer the opportunity for development partners, government agencies, local financial partners such as microfinance institutions and networks, to review their role and agree on the best approaches to promote and build the microfinance industry.

The proposed meeting will address the following questions:

1. How can RMCs promote a fostering legal environment for microfinance operations? How can donors/development partners and RMCs collaborate to quickly and efficiently transform these environments, and most importantly to create the necessary supervision capacity? How does Africa compare to the rest of the world? Are the initiatives underway sufficient to fully fill in the gaps?
2. What are the priorities in developing the financial infrastructure? What are the legal obstacles to develop the necessary infrastructure (such as confidentiality in the banking law for credit bureaus, etc.)? Can regional initiatives be launched to reap benefits from cost sharing?
3. How development partners can fill the financing gap through coordinated structured finance mechanisms? What are the challenges to effectively support building a sound and commercially oriented microfinance intermediation sector?
4. What is the role of the donors, in a world where private investors are increasingly active? What is the limit between market facilitation and market distortion? These questions are all the more important as donors subsidies directed to Africa are significant. CGAP survey of 16 development agencies in 2006 highlighted that more than \$2.5 billion—one-third of worldwide project support committed to deepening financial access—is dedicated to Sub-Saharan Africa<sup>13</sup>. Are these funds directed to the

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<sup>13</sup> “Fundors are active in all 47 Sub-Saharan countries; but among the funded countries there is a notable inconsistency in the distribution of funds. The six most heavily funded countries—Ghana, Kenya, Madagascar, Tanzania, Mali, and Uganda—account for over 40 percent of total funds for the entire region. The 20 least-funded countries, on the other hand, account for less than two percent of total regional funding. Results vary considerably by country, and funding is most heavily concentrated in East Africa, where reported funding consistently exceeds \$75 million per country. In contrast, funding in Central Africa averages \$16.5 million per country. Funding levels in Sub-Saharan Africa are increasing, as is the level of coordination among funders. In several countries such as Uganda, Tanzania, Kenya, Senegal, Mali, Democratic Republic of

appropriate programs? How can donors make sure they aren't they distorting the market and pushing away private investors? As CGAP Chief Executive Officer Elizabeth Littlefield stresses, "much of the public money spent on microfinance is ineffective or duplicative. With so many new investors in microfinance, we urgently need to focus on spending every dollar more effectively. The quality of aid programs is at least as important as the amount of money they spend".

1. How can RMCs promote and design legal and taxation frameworks that motivate firms into formalizing? How can they make doing business easier?