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Promoting Access to Low Cost Finance for Investment in Sub-Saharan Africa

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1. INTRODUCTION

Sub-Saharan African economies typically have structures that are dominated by sectors that add little value in the course of production and distribution of products. The limited value addition and low productivity associated with most undertakings ensure that incomes are generally low and provide little opportunity for further investment. While governments crave for diversification of their economies, the investment that is required to achieve this has not been forthcoming. Investments are generally small and undertaken in areas that offer little risk. Thus, for example, while agriculture is generally perceived to be an important sector for economic growth, and requires considerable value-added in order to enhance its contribution to total output, the risks associated with the sector are generally high, thus forcing potential investors to stay away from the sector. Those who stay in the sector hardly undertake any investment and the little investment is in the low-risk sub-sectors and activities. The same rationalization can be applied to other sectors, thus generating a strong rationale for the proliferation of small and microenterprises (SMEs), with very little prospect for growth in a dynamic way. In sum, the problem that Sub-Saharan Africa faces is that the activities that occupy many people see very little investment.

While this may be so, a number of studies of enterprises in Sub-Saharan Africa show that whatever investments that take place in firms are dominated by owners' capital. There are clear limits to how much investment can be financed in this manner. And that is why firms remain small without growing. It is generally expected that as enterprises grow through different stages i.e. micro-, small-, medium- and large-scale, they would also shift financing sources (Steel and Webster 1992). Their capital needs and how these are satisfied should evolve in relation to their sizes. Thus, while many microenterprises may find informal sources of credit and personal or family savings adequate to launch their operations, and profits sufficient to provide day-to-day working capital, their financing needs can no longer be met this way as they grow larger. Medium- and large-scale enterprises are more likely to be interested in actual debt finance (against equity finance) than smaller firms. It is, however, also likely that poor access to formal loans and the non-suitability of informal loans for some firms limit the use of credit by firms wanting to expand. Within this context, therefore, the use of other financing mechanisms, including supplier's credit, may be important.

Why has the access to loans been poor? Until recently, this question was often answered within the context of repressed financial markets. When the financial system was repressed by policies that shifted the allocation of investible funds from the market to the government, non-price rationing worsened the segmentation that was often observed between formal and informal financial institutions. Credit rationing at low interest rates led to practices that effectively discriminated against small enterprise borrowers. The assumption that some entrepreneurs might use informal credit for investment in their businesses in the absence of formal credit was prompted by the consideration of the two as substitutes. There is clear evidence that the two are not nearly substitutes (Aryeetey 1992).

In the recent liberal environment, it had been expected that by relaxing interest rates, to achieve positive real rates, financial systems could mobilize more deposits and increase the availability of funds for lending. Liberalized lending rates were also expected to facilitate lending to efficient private sector clients who previously lacked access because generally high information and transaction costs discouraged banks from lending to high-risk sectors under fixed interest rates. Banks were expected to do price rationing which is more efficient. But there is hardly any evidence that this has happened in Sub-Saharan African countries.

Nissanke and Aryeetey (1998) identified three main features of the formal financial system in sub-Saharan Africa after liberalization. They observed that, first, banks and other formal sector institutions continued to hold their assets and liabilities in very short-term financial instruments. Also, banks held liquid assets in excess of prudential and statutory requirements. Finally, there was a high proportion of non-performing loans on bank balance sheets. The absence of developed equity or bond markets to perform maturity transformations restricted banks to the holding of short-term assets that matched their short-term liabilities. Nissanke and Aryeetey (1998) suggested that a vicious circle had emerged which inhibited the development of longer-term capital markets. Typically, minimum reserve requirements in many countries were set as high as 40-80 per cent of total bank deposits in the last two decades. This compared with levels of around 10-15 per cent in industrialised countries (Kitchen, 1986). In addition, the macroeconomic environment in most countries was still considered to be too risky to justify longer term lending by banks when compared with the returns from holding government instruments.

For most sub-Saharan African countries, a high-level of government borrowing resulted in high interest rates after financial liberalisation. This encouraged banks and other financial institutions to concentrate on holding short-term government securities. In Ghana for example, this resulted in an inverted yield curve with short-term interest rates (of over 45%) above long-term interest rates in recent years. The concentration in holding short-term liquid assets as well as ‘excess liquidity’ also restricted the development of money markets in sub-Saharan Africa. There is very little secondary market activity on the money markets.

Compared to the advanced economies, a variety of financial markets have evolved in those economies which are not available in most of Sub-Saharan Africa[1]: government securities markets, equities, spot and forward foreign exchange markets, markets for corporate securities, mortgages, insurance, and derivative instruments such as futures and options exist. While Banks in the industrial economies have to compete with these institutions and markets as both borrowers and lenders, banks in Sub-Saharan Africa have to compete with informal and semi-formal institutions. Given the fragmented nature of financial markets in the informal sector, the nature of the competition faced by banks in Sub-Saharan Africa is different from that faced by banks in the advanced industrialised countries. This dichotomy has enormous implications for efficient lending to small firms and households and continues to shape the institutional developments around lending for investment.

Given the nature of the dichotomy in institutional development and the fact that a large number of those with difficulty in obtaining finance for investment are those that have been described as small or marginal borrowers, it is not surprising that recent efforts at providing low cost funds for investment have focused attention on this category of borrowers. The strengths and weaknesses of both formal and less formal financial arrangements have featured in the efforts to provide low cost finance for investment. The new tendency has been to aim at achieving an integrated financial system that involves the use of principles allowing each sector to employ the strengths of the other with a view to mitigating their own weaknesses as they push towards greater lending for small or marginal borrowers (Aryeetey 2005).

In this Issues Paper, the objective is to shed light on recent developments in the campaign to develop low cost finance instruments in sub-Saharan Africa, and how greater linkage formal and less formal arrangements may lead to low cost investment finance. While paying attention to what efforts banks are making to develop such low cost finance for private investment, we discuss also new trends in microfinance and their significance for investment. The emphasis is on explaining what works and why it works.

In section 2 we discuss the constraints to enterprise growth in the region. This situates the financial constraints within the broader constraints to growth among small firms. We try top explain the difficult access to finance for small businesses in section 3, looking at how difficult it is for financial institutions to mobilize deposits under both policy and structural constraints, and these same factors the amount and type of lending that they can do. In section 4 we turn our attention to alternative forms of financing with emphasis on the low cost aspects of microfinance. This section shows the objectives, strategies and methodology of microfinance institutions (MFIs) and their experiences in sub-Saharan Africa. Section 5 introduces some recent developments in bank support for low cost finance and section 6 discusses some possible principles and approaches for creating

[1] The most significant observation to be made about SSA financial markets is their fragmented nature. The financial system in many countries is made up of formal and informal segments, as well as some more recent semi-formal segments (Nissanke and Aryeetey 1998). Each segment has smaller fragments that see little interaction and hence hardly any influence over market conditions in them. This structure has basically not changed even after financial sector reforms in many countries.

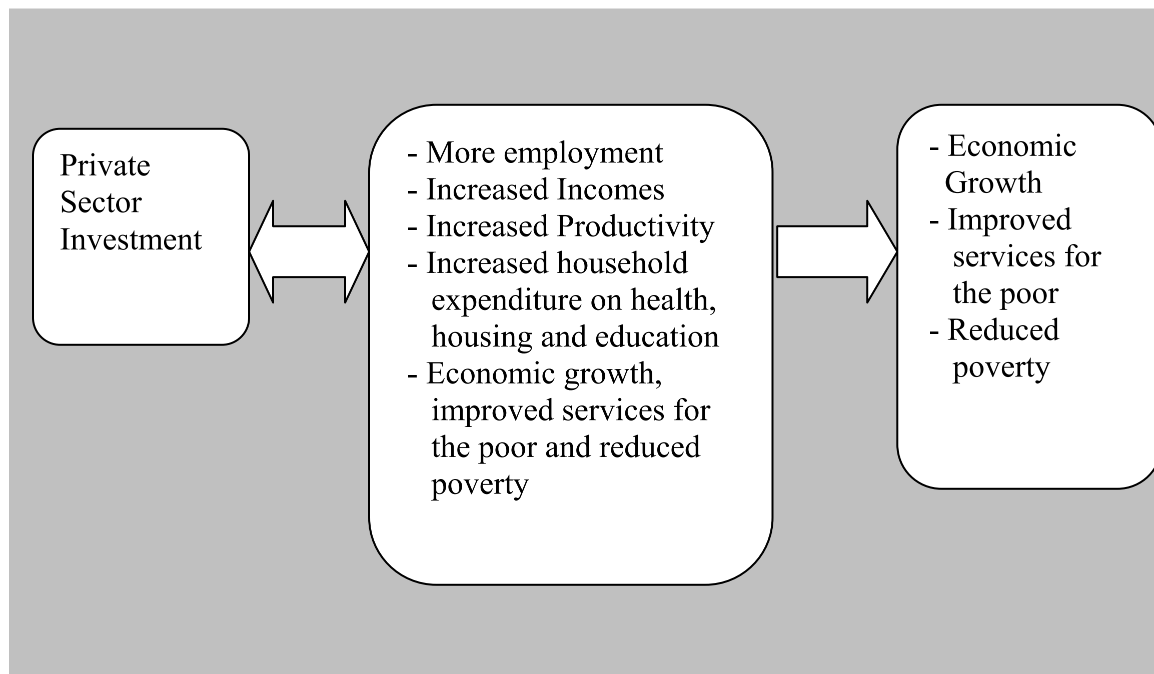
linkages between formal and less formal institutions for effective low cost investment finance.

2. CONSTRAINTS TO ENTERPRISE GROWTH IN SUB-SAHARAN AFRICA

In order to promote growth in Sub-Saharan Africa, it is generally accepted that there must be a conducive macroeconomic environment within which the private sector, especially the smaller firms, can flourish. The significant role played by small enterprises in this regard clearly shows that they have a potential to accelerate development through their labour-intensive production methods, potential use of local resources and less reliance on imports. Elsewhere, they account for 98 percent of employment in Indonesia, 78 percent in Thailand, 81 percent in Japan and 87 percent in Bangladesh (Fadahunsi and Daodu, 1997).

Figure 1 below captures the potential gain an economy derives from appropriate private sector investment, particularly in relation to poverty reduction.

Figure 1: Private Sector Investment Reduces Poverty



Source: DFID and the Private Sector, 2005

Some of the key challenges to SME growth and development are the high start-up costs for many projects, understanding the target market, and finding the appropriate business models that can deliver effective results through studies on past experiences of success and failure. These challenges are both internal and external. In general, most firms in the sub-Saharan African private sector perceive various constraints to their expansion as

being beyond their immediate control and relating to access, thus making them external (Steel and Webster 1992). Most surveys suggest that problems related to finance dominate all other constraints to expansion (Aryeetey 1995, RPED 2003). The problems that are often cited among all size categories are (1) the absence or inadequacy of credit for working capital; and (2) the lack of credit for the purchase of capital equipment.

Have the financial systems been prepared to deal with the finance problem? After reforms in many countries in the 1990s, one of the fastest growing sectors became the financial sector. In Ghana for example, its contribution to GDP moved from a little over 2% in the mid-1980s to almost 10% by the end of the 1990s. In the same period that this remarkable growth was taking place, however, there was probably the largest public outcry against the activities and performance of the sector in relation to the real sectors of Sub-Saharan African economies. A consequence of the initial growth that resulted from economic reforms was a significant increase in the demand for finance by businesses, which formal financial units failed to satisfy. Industries, particularly small business and other home-based activities, complained of inadequate financial support for their operations. When credit was available from the financial sector, the terms under which it was provided, was considered to be difficult for small businesses.

Obviously, simple liberalization has not been effective in improving credit delivery. A number of interesting and important observations with regard to the financing constraints of enterprises and their relationships with banks after the reforms have been made (Nissanke and Aryeetey 1998). One major observation has been that internal sources of finance continue to dominate the finance of fixed investments. Only a half of Ghanaian SME applications for bank loans had any chance of being favourably considered in the 1990s. About two-thirds of microenterprise loan applications were likely to be turned down. There is every indication that smaller enterprises have a greater problem with credit than larger firms. In the Aryeetey et. al. (1994) study of Ghana, as many as 42% of microenterprises listed credit for working capital among their major constraints compared to 38% of small-scale enterprises and 25% of the medium-sized firms. These figures do not appear to have changed as the RPED studies (RPED 2003) had similar observations after five years. A similar trend occurs with credit for equipment purchase, even though larger firms have greater problems with credit for equipment than they do with working capital. These results were not too different from observations made by Soyibo (1995) in Nigeria and by Chipeta and Mkandawire (1995) in Malawi.

The difficult access situation reflects an inverse relationship between size and demand for credit, as well as access. A number of other studies have observed that the success ratio for large firms applying for bank loans tends to be much higher than for small-scale enterprises and microenterprises. The prevailing evidence then is that the smaller the firm, the more important is lack of access to finance as a constraint. Other problems related to domestic finance are to do with the difficulty involved in dealing with banks and difficulties in meeting finance requirements from own profits (World Bank 2004).

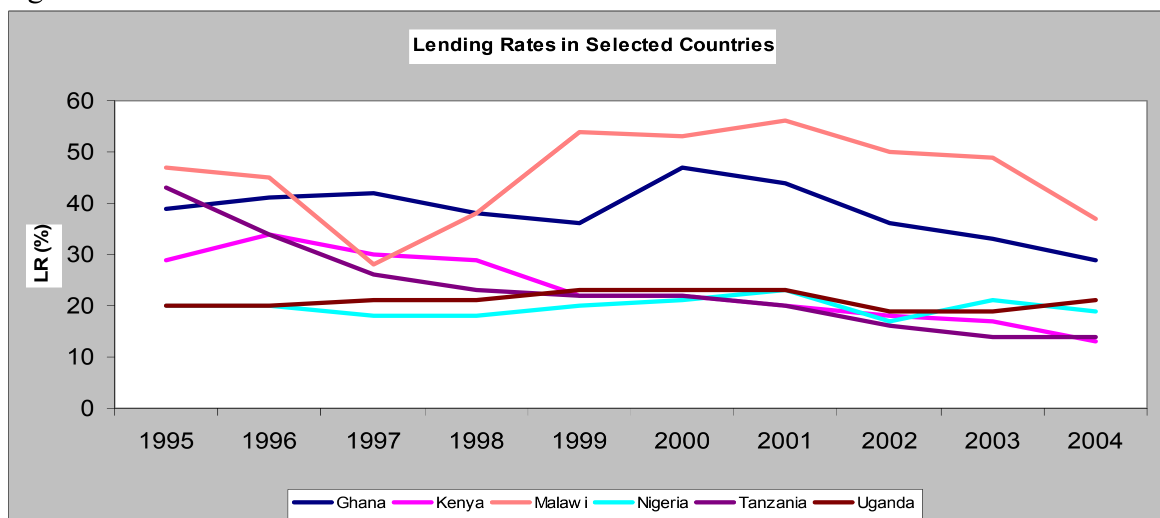
While bankers attribute high rejection rates among SMEs to the absence of viable or bankable projects, entrepreneurs suggest that it was because they were not seen to have good collateral (Aryeetey et. al. 1994). As a consequence, it is now widely accepted that the obstacles to financial market development were not simply policy-induced, but have some structural and institutional origins that cannot simply be addressed with macroeconomic policy reform.

In Uganda credit to the private sector in 2001 was only 6% of GDP. The more financialized Kenya had private sector credit amounting to 25% of GDP. This goes to show the enormous variation across countries. But more than 85% of the private sector credit in most countries is channelled to a small group of large borrowers. The fact that in most countries there is not much lending to the private sector is reflected by the low domestic investment rates.

Interest Rates

But beyond access, the problem of high interest rates is one that is generally associated with Sub-Saharan African financial markets. This is seen as reflecting the absence of competition in the markets. The clearest indicator of the absence of competition in sub-Saharan African financial markets is the continuing wide spread in interest rates. In general, between 1990 and 2004, the difference between lending and deposit rates for many Sub-Saharan African countries was in excess of 12 percentage points and appeared to be widening (Aryeetey 2005). Interest rates have remained high in most countries despite the reforms intended to make the markets more efficient (See Figure 2 below). Even though interest rates have come down in the last couple of years, they remain high. While the high rates remain, commercial lending by banks has shrunk in favour of bank holdings of government securities. The prevalence of exorbitantly high *real* lending rates and the continuing increase in the lending-deposit rate margins is particularly worrying. In 2004, hardly any sub-Saharan African economy had a lending interest rate of less than 10%.

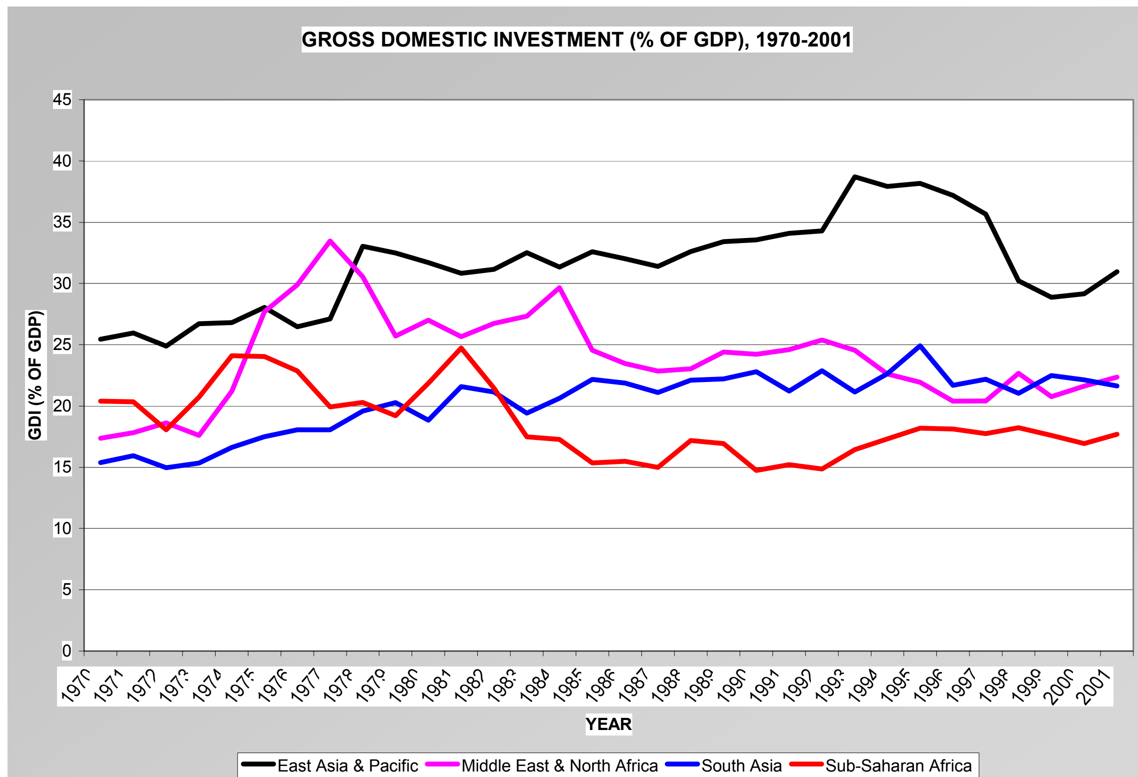
Figure 2



Investment Profile

The poor situation with credit is reflected in low domestic investment. Indeed most sub-Saharan African countries have not seen much improvement in domestic investment rates. After the mid-1980s the resource composition changed significantly for the region, as did the structure of demand with economic reforms. By 1990, Gross Domestic Investment had fallen to 14.6% of GDP, as the average annual growth was –3.8% for 1985-90. For the rest of the 1990s, however, investments grew by an average of 3.7% annually, reaching 17% in 1998. The gradual rise in investments as savings continued the slow growth was largely made possible by external resources in many countries. Growth in investment has been slowest in sub-Saharan Africa compared to other developing areas and this is related to the limited availability of domestic resources.

Figure 3



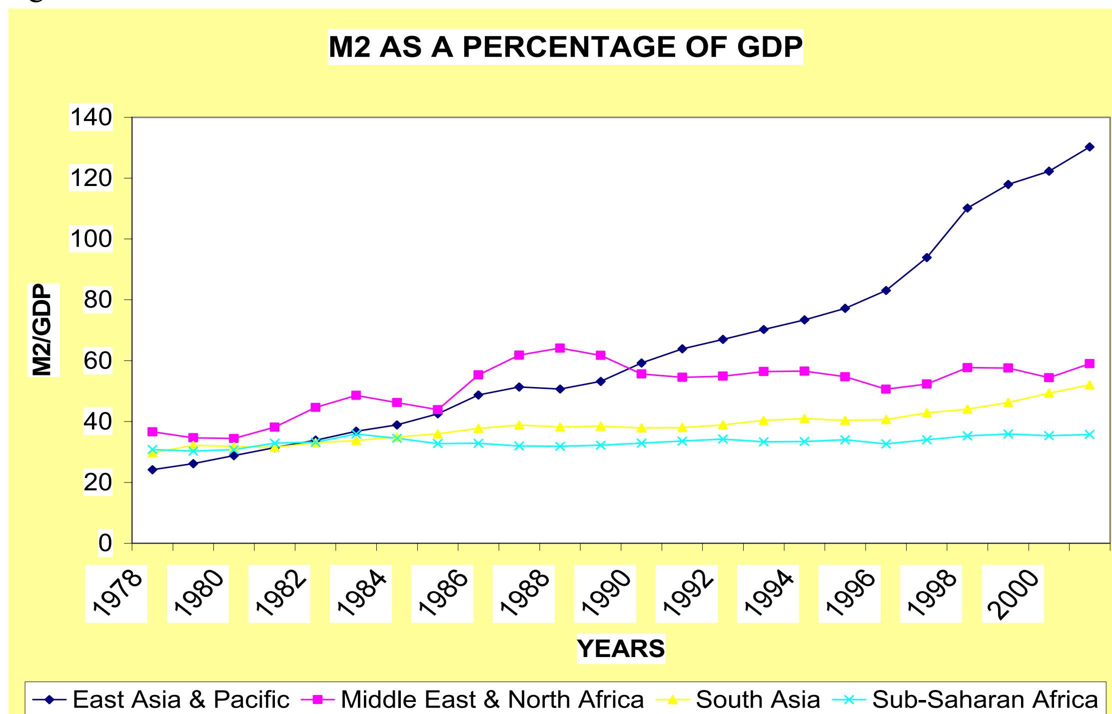
3. EXPLAINING THE BARRIERS TO ACCESSING LOW COST FINANCE

The problem of difficult access to low cost finance from formal institutions can be looked at from the angle of both deposit mobilization and credit allocation. The general explanation may be drawn from the fact that financial institutions do not mobilize enough deposits to facilitate lending for investment. And they have difficulty using other sources of funds if these are not guaranteed by third parties, such as governments.

Savings Mobilization with 'Traditional' Banking Structures

It is usual to gauge the performance of formal savings with a measure of financial deepening, the M_2/GDP ratio. While this may not provide an accurate picture of how people wish to save, it is indicative of how well a financial system is performing in terms of its ability to attract surplus funds[2]. This indicator has shown considerable strengthening in Asian economies for almost three decades, but this has not been so in sub-Saharan Africa. The financial deepening indicator for most Sub-Saharan African economies provides very few indications of sustained improvements in the financial systems, with ratios that averaged 24 percent in the early 1990s declining in many countries. In other words, the capacity of formal financial institutions to attract deposits did not see much improvement in the last decade, particularly compared to other developing regions (Figure 4). It is not surprising that many would seek new ways of mobilizing deposits.

Figure 4



Indeed suggestions that private saving in Sub-Saharan Africa is not growing rapidly enough are supported by trends in bank liabilities and data on deposit mobilization. Nissanke and Aryeetey (1998) indicate from reviews of central bank annual reports and flow of funds analysis that private deposits did not grow much in the last decade. From their survey the numbers of depositors and the amounts being deposited did not vary

[2] M_2 clearly reflects the use of deposits for transactions rather than the demand for long-term savings. The argument that it is not a good reflection of how people wish to save is supported by fact the monetary base in many Sub-Saharan African countries with growing M_2/GDP ratios has remained high, and has been not much less than the ratio.

significantly over a four year period when reform was taking place. In the cases where some increase in the deposit sizes were observed, as in Ghana, this was attributed to an income effect following economy-wide reforms.

In terms of the liquidity of formal savings, Nissanke and Aryeetey (1998) note that a feature of commercial bank deposits is that they are overwhelmingly short-term, and attract little or no return to the depositors. Very few depositors used the few long-term deposit instruments that were available. Using survey data on the numbers of depositors and average deposit sizes from sample branches, Nissanke and Aryeetey (1998) show inconsistent growth in the numbers of depositors and deposit sizes in the reform years. They observed that where deposit mobilization grew fastest, it was usually the outcome of some exogenous intervention in the process. For instance, in Tanzania, where both rural and urban deposits grew fastest, the rapid growth was largely the result of a government decision to pay salaries and farmers' payments through rural bank outlets.

In finding reasons for the difficulty in mobilizing deposits despite reforms, there have been a number of suggestions. The most common has been that reform did not necessarily create an incentive for banks to alter their structures in pursuit of efficiency. This was largely because in many countries banks began, soon after reforms were initiated, to concentrate their efforts on lending to governments anxious to finance growing deficits. Since they could afford to enlarge their profits with the high-return risk-free assets of governments, there was little enthusiasm to develop their liabilities appropriately. This would explain why in many countries, the interest on deposits has been negligible and interest rate spreads have continued to widen. Aryeetey et al (1998) identify two major lessons from the various empirical studies of financial sector reform. First, abrupt and full-scale financial liberalisation in the midst of pronounced macroeconomic instability and imperfect financial structures destabilises the financial system.

In many sub-Saharan African countries, the problem continues to be one of over-centralized banking structures that provide little initiative for branch level personnel to show initiative in deposit mobilization. Studies of bank branches in Nigeria, Malawi, Tanzania and Ghana showed clearly that the more centralized banks were in decision making, the higher their transaction costs in dealing with smaller customers (Aryeetey and Nissanke 1998). The studies have portrayed institutions in which depositors have had to travel long distances to make deposits and where actual time spent at branches while making deposits often exceeded an hour, depending on time of year. In other words, when bank branches are not present in many rural areas, financial sector reform has little implication for mobilizing deposits.

In effect, despite one decade, or more, of reforms most Sub-Saharan African financial systems are unable to mobilize adequate deposits. They have, however, lately come under growing pressure to find alternative sources of funds as governments have also come under increasing pressure to reduce their borrowing from domestic banking systems in order to achieve macroeconomic stability. It is this later trend that is obliging banks to

search for the marginal depositor and also change or adapt structures in order to accommodate that.

Ineffective Lending Arrangements

The failure of formal finance to reach small borrowers has meant that the majority of the small borrowers continue to fall back on various non-commercial sources such as friends, relatives and neighbours, professional money lenders, traders, store-owners, output processors and landlords. Flexibility, speed, transparency of procedures, personal relationships and low transaction costs constitute the main strengths of informal private finance. There are, however, many limitations and disadvantages of informal credit, particularly from money-lenders who charge very high interest rates on loans, sometimes as high as 5-10 per cent per week or up to 20-30 per cent per month. High interest rates invariably mean that small borrowers tend to borrow only when it is critical to do so, and borrowing is often restricted to small amounts obtained for brief periods. In general, loans from informal sources are inadequate for development or investment purposes, being often only for short-term purposes and rarely for capital assets; they are usually for traditional rather than new or innovative activities, and mostly for survival needs rather than for developmental needs.

Why don't banks or formal financial institutions usually provide low cost finance? While it is generally possible for small borrowers to have access to low cost finance, there are a number of reasons for banks often not being unable to meet this demand. These include a difficult macroeconomic environment and other structural constraints. We dwell here on the structural constraints since these have proven more difficult to tackle in the last decade. They include the following:

Perceived High Risks: The rationale behind special credit schemes for small or marginal clients arises fundamentally from the failure of the mainstream financial institutions to serve them on account of high risk. In general, formal financial institutions are overwhelmingly urban-oriented from the point of view of both the distribution of branch network over the national territory and the concentration of their deposit-lending activities. Formal finance considers lending to small borrowers as riskier than to others (high default rates). Requests for credit are hard to evaluate. Monitoring loan performance is difficult: debtors simply disappear. Quite commonly, lenders prefer to deal in large sums creating a preference for large and medium-size enterprises (as against small and micro enterprises), higher income households (as against poorer households) and bigger farmers (as against small and marginal farmers and landless workers).

Lack of Collateral: Lack of collateral limits access to rural credit and is related to poorly defined property and land-use rights and weak land and property markets (WDR, 2001). Stringent collateral requirements of formal lending institutions often rule out a large segment of the population from access to credit.

High Operating Costs: High operating costs are due to the small size of most rural people's accounts in relation to the cost of service delivery. A low level of economic

activity, low rural population density and poor infrastructure also increase operating costs.

Enforcement Problems: Enforcement problems are common in many developing economies. That is, even when borrowers have assets that can be used as collateral, they are often not acceptable to banks because of the high cost and long delays in using judicial enforcement mechanisms (Fafchamps, 1996).

Formal Banking Procedures and Physical Access Difficulties: Difficult formal procedures constitute major barriers to the rural population. Procedures instituted by formal financial institutions to reduce lending risks often constitute 'social' access barriers to the rural population because of the predominance of illiteracy and the need for formal documentation (Goodland et al., 1999). To ensure sustainability in the face of high operating costs, banks often concentrate their branch network in urban communities, thus increasing physical access costs to rural clients.

Clearly, the objectives, organizational structure and lending procedures severely restrict the ability of formal institutions to service the credit needs of small clients. Such a situation obviously cannot stimulate significant business growth. There is reason to believe that the shortage of investible funds at acceptable rates has been a barrier to the expansion of the small business sector, which has also been a barrier to the sector taking advantage of available opportunities.

In response to the growing dissatisfaction with financial services, the last decade has witnessed the emergence of a number of bank and non-bank financial institutions, attempting to provide what they perceive to be the required services. Indeed the most significant institutional growth has been in the Non-Bank Financial Institutions sub-sector interested in small and medium-size enterprises. These have included Savings and Loan Companies, Leasing Companies, Venture Capital Funds, Finance Companies, etc. Also active in the area have been a growing number of NGOs, a myriad of informal operations, credit unions and other financial cooperatives. Despite this recent institutional growth, there is evidence that demand from the small and micro-businesses is still largely unmet.

In searching for further alternatives to formal sector finance, the attention being paid to microfinance for meeting the small private sector credit demand overshadows all the other developments.

4. MICROFINANCE AND INVESTMENT FINANCE IN SUB-SAHARAN AFRICA

"Microfinance" refers to the "small but growing number of specialized financial institutions that use innovative delivery methods to extend the financial services market" (Berenbach et.al. 1998). "Microfinance institutions consist of organizations and agents that engage in relatively small financial transactions using specialized, character-based methodologies to

serve low-income households, small farmers and others who lack access to the banking system. They may be informal, semi-formal (that is, legally registered but not under the central bank regulation), or formal financial intermediaries" (Steel 1998, p.7).

Microfinance needs to be seen as an effort to counter the effects of credit market failures that result in fragmentation and the exclusion of many potential borrowers from markets. These efforts have led to a variety of credit schemes that have been introduced into many countries. But microfinance activities are far better known in Asia and Latin America than they are in Sub-Saharan Africa. Apart from there being fewer programmes in Sub-Saharan Africa, their occurrence among countries varies considerably also. When Webster and Fidler (1995) studied microfinance institutions in eight West African nations, they found that there were countries with a good number of programmes, (including Mali, Guinea, Burkina Faso, The Gambia and Guinea Bissau), and others with very few, including Sao Tome, Chad, Mauritania and Sierra Leone.

Objectives and Strategies of Microfinance Schemes in Sub-Saharan Africa

Microfinance schemes are generally derived from other innovative credit arrangements that began as community-managed credit and savings schemes. These innovative community schemes were "established to improve members' access to financial services, build a community self-help group, and help members accumulate savings" (Holt 1991). But the subsequent microfinance programmes are more likely to be the outcome of donor projects[3], and are not necessarily community-based. For many innovative schemes, credit provision may not be the only operational objective. Even for those that perceive credit provision as the ultimate assignment, the extent to which direct supply of credit is present in their programmes, depends on whether they adopt the 'minimalist' or 'integrated' approach.[4]

Most of the acclaimed innovative schemes have been based on the 'minimalist' procedures. The last decade has been the emphasis on market principles (Jackelen and Rhyne 1991; Steel 1998). Webster and Fidler (1995) observed that many Sub-Saharan African microfinance arrangements have benefited from best-practices developed in other developing regions. They have drawn some ideas from more successful projects elsewhere, including the following:

- the issuing of short-term loans;
- starting with small initial loans;
- concentration on small working capital to firms with proven track record;
- specialized services without targeting;
- simplified services;
- localized services;

[3] Eighty-two percent of 62 microenterprise development programmes studied by Webster and Fidler (1995) have a microfinance component. As much as 52% offer exclusively microfinance.

[4] By the "minimalist approach", the organization concentrates only on lending. All activities that it engages in are designed to facilitate lending. These include the training of staff and also beneficiaries to the extent that they can comprehend how the loan programme works. Under the "integrated approach", training and other forms of technical assistance are regarded as integral components of a whole scheme for assistance.

- shortened turn-around time for loan applications;
- motivation of repayment through group solidarity or joint liability;
- savings mobilization from the poor; and
- charging of full-cost interest rates.

Microfinance services are provided by three types of institutions, namely

- formal institutions, such as rural banks and cooperatives;
- semiformal institutions, such as nongovernmental organizations; and
- informal sources such as money lenders and shopkeepers.

But the different institutions generally apply models that are drawn from a known pool and relying on the principles indicated above. Zeller (2001) has suggested five models for microfinance institutions that we discuss below.

1. The Cooperative Model

The cooperative model was first applied in developing countries, inspired by the successes in Europe and North America at the end of the nineteenth century. The main principles of the cooperative approach include:

- Participation: The cooperative members are the owners, contributing to the equity capital through shares. Loans are only granted to the members.
- Minimalist approach: The MFI solely focuses on the provision of financial services.
- Responsibilities: Members participate in major decisions and democratically elect officers from among themselves to orient and monitor the administration of the cooperative.
- Profit sharing: Surplus earnings remain in the cooperative in the form of equity capital or are distributed to the members.
- Structure: Each cooperative is geographically limited. However, a cooperative can join a second financial level of organization (e.g., a regional union or federation), which can ensure supervision, refinancing and technical support among the federated cooperatives. A third financial level, the central union, may exist at the national level.

In some developing countries, government funds as well as bank credit were channelled to the rural populations through cooperative societies as part of governmental interventions to supply credit to people living in the rural areas. In general, however, the success of government-promoted formal cooperatives in serving the poor has been rather limited and fallen far short of expectations. The contributing reasons were: the lack of a popular base, the marginalisation of the very poor as leadership position often fell on the local elite, corruption and other malpractices.

2. Solidarity Groups

The second type of MFI is derived from solidarity credit groups, and these have the following characteristics:

- Participation: Three to ten clients join a group to receive access to financial services (primarily credit). They may have to save before receiving a loan.
- Complementary services: In addition to financial services, the support agency may offer non-financial services, such as training or market information, to the group members.
- Responsibilities: Group members collectively guarantee loan repayment, and access to subsequent loans is given only if previous loans are paid in full.
- Profit sharing: The profits are not shared among the members, but used to build up group funds and emergency reserves. The ownership of these funds is often unclear. Intragroup savings accounts may be opened; they can be used according to the members' wishes.
- Structure: The group (three to ten members on average) can join a centre (around five groups). The centre allows for economy of scale in disbursement of loans, collection of savings or repayment, and training. The upper level (regional, or national) is in charge of decision making (top-down approach).

The most common responses of the rural poor to their marginalization (from the mainstream credit) has been to 'turn inwards', that is to take initiatives to mobilize their own resources as a method of meeting their credit needs and of reducing their dependence on the outside. These include rotating saving and credit groups, informal savings clubs and mutual aid groups, all of which are informal arrangements of one kind or another, hence may be termed `informal group finance'. In many rural communities in developing countries, informal group finance plays an important role in meeting the credit needs of the poor such as survival needs, working capital needs of micro businesses, and unforeseen family expenditures. In some communities, these may be the only sources of credit available to the poor.

The most important informal credit source, after individuals and relatives, is the ROSCA (Buckley 1997). Although informal group finance may be important in many communities, it has not attained a scale and coverage to make a significant impact on the credit problem of small investors. Quite often the resources mobilized by the poor through their own savings have not been of a sufficient magnitude to meet their development needs, particularly to expand the scale of their on-going microenterprises, adopt new technologies or start new enterprises. They are generally of marginal importance in the rural finance of many countries.

3. Village Banks

The village bank can be seen as a mix between the cooperative and solidarity group models, seeking to capitalize on the advantages of each. The village bank usually has fewer members than a cooperative, and is less formalised and complex in structure. Other characteristics are:

- Participation: The members of a village bank organise themselves to provide community-based savings and credit services. Membership fees may contribute to the equity capital of the bank.

- Responsibilities: The village bank is a community credit and saving association managed by a committee elected by, and among, members.
- Profit sharing: Profits are either distributed to members or used to increase the equity capital.
- Structure: Highly decentralised institutional structure. Ideally, the village bank is independent of any upper level organization for provision of financial products. The decentralized structure allows serving villages in more remote areas.

Specialized credit institutions such as unit Rural Banks have been set up as alternative institutions to commercial banks, which have failed to reach the poor. They engage in both saving mobilization as well as lending operations, and could replenish their resources by borrowing from other banks, refinance from central bank and grants from government and donors. In Ghana for example, Rural and Community Banks (RCBs), which are unit banks owned by members of the community (through purchases of shares), account for the largest share of microfinance services.

4. The Linkage Model

The fourth model builds on existing informal self-help groups (SHGs), such as rotating credit and savings associations (ROSCAs). The linkage model seeks to combine the strengths of existing informal systems (client proximity, flexibility, social capital, reaching poorer clients) with the strengths of the formal system (e.g. risk pooling, term transformation, provision of long-term investment loans, financial intermediation across regions and sectors). The main principles are:

- Participation: Members of a SHG enter into a group contract with a bank that provides savings and credit services to the group. An intermediary NGO may provide complementary services, such as training or certification of creditworthiness of groups.
- Responsibilities/profit sharing: The bank, sometimes assisted by an NGO, provides the services. Internally, the SHG may organize member-managed savings accounts.
- Structure: The SHG is linked to the bank through a group contract. Individual members of the SHG do not have any links with the bank.

Notable examples of this model are Mutual Guarantee Associations (MGAs). An MGA may be an association comprised of artisans who together create an organization, which establishes a dialogue with banks. The associations play the role of an intermediary between the artisans and banks and negotiate with them to secure loans for its members. This can be a viable solution to the problem of access to credit from banks for small entrepreneurs who cannot offer sufficient collateral.

5. Microbanks with Individual Financial Contracts

The above four MFIs are member-based. Members contribute to a varying degree in the management, ownership and control of the MFI. On the other hand, microbanks, such as BancoSol in Bolivia, mainly rely on individual contracts between the institution and its

client. This type of MFI is closest to the classical banks. However, the loan collateral may not be conventional, using for example savings of the client, knowledge on his/her creditworthiness, or other persons as guarantees of the loan. It is obvious that clients prefer to have an individual loan if they could get it on the same terms as those provided by member-based institutions, such as the first four types described. This is so because participation in any of the above MFI-types carries additional transaction costs on behalf of the client (for example for meetings). However, microbanks have seen their greatest success so far in urban areas of better-off developing or transformation countries. Because of the relatively high loan sizes of microbanks it is unlikely that many are reached. However, the somewhat better-off clients may not have any access to traditional banks, and loans to small enterprises certainly will make an indirect contribution to poverty reduction. Some of the main principles of microbanks are:

- Participation: Clients are selected by the microbank based on creditworthiness.
- Responsibilities/profit-sharing: The client is individually responsible for loan repayment, and is not involved in management, ownership or profit-sharing.
- Structure: Emphasis is given to a decentralised structure that gives decision flexibility and strong performance incentives to managers of the microbanks.

The five institutional models above clearly differ in their outreach to small borrowers. But there have been studies to show that MFIs which offer additional complementary services in the form of business training or agricultural extension may achieve greater welfare impact than MFIs that focus on savings and credit alone

Savings Mobilization by Microfinance Institutions

In the past, while the notion prevailed that small borrowers were too poor save, there is now significant evidence that even the rural poor are capable of (and could be depended upon) to save regularly (Morduch 1994). In particular, the poor have demonstrated their willingness to build up substantial funds when they are organized into groups and stimulated to mobilize their own resources as a first step towards their development. In fact, their savings represent a higher portion of their net assets than those of their counterparts in society's upper income segments.

Some observers argue that compulsory savings requirements enhance clients' financial discipline, facilitate peer monitoring, and encourage loan repayment (Besley 1995). Others, like Robinson (1993), however, argue that programs should mobilize deposits, should be voluntary and not compulsory, since the poor do not need to be taught how to save. Moreover, the poor are often concerned about the liquidity of their deposits, and may find such forced savings inconvenient and sometimes counterproductive (Hulme and Mosley, 1996). However, with access to well-designed savings products, low-income people can accumulate wealth. When aggregated and invested properly, these small, sometimes seemingly insignificant amounts can add fuel to country economic growth. An important conclusion is that savings mobilization should be a vital component of a credit scheme for rural poor.

There are three main barriers to the use of the deposit facilities commonly offered by banks (as identified by the World Bank 1997): (i) high opening and minimum account balances, (ii) high travel time and transport costs involved in making deposits and withdrawals at the bank branch, and (iii) lack of familiarity with bank branch operations and procedures. Given that institutions that are highly successful in mobilizing deposits tend to cater to better-off clients than the smaller clients there is the need for microfinance institutions to adopt savings mobilization strategies that help the poor overcome these barriers. The efforts of MFIs to work through group-schemes have the potential of yielding a wide range of benefits, leveraging the importance of local communities in sub-Saharan Africa into schemes that have proven successful in other regions, the most notable of which have been developed by the Grameen Bank.

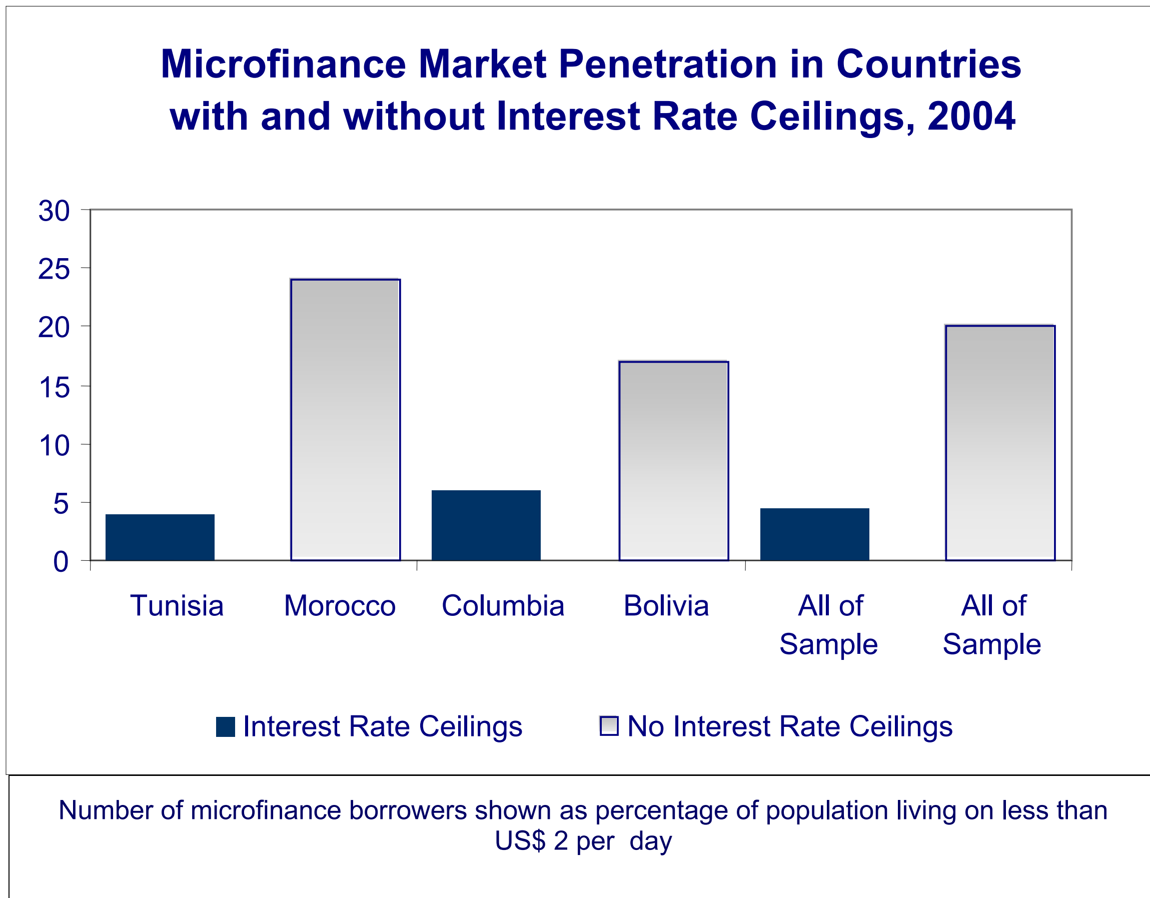
Experiences of Microfinance Lending under Liberalized Interest Rate Regimes

The average fixed costs of making a small loan are higher than the costs of making a larger loan. The cost of making micro-loans is even higher because clients generally make several, frequent, and tiny repayment transactions for each loan. Informal credit markets already exist in most poor communities. One typically finds lower-income borrowers taking and repaying repeated informal loans at interest rates much higher than any formal MFI would charge (Acción International 1991). There is overwhelming empirical evidence that huge numbers of small borrowers do indeed pay interest rates at a level high enough to support MFI sustainability (CGAP 2004). MFIs charging very high interest rates usually find that demand far outstrips their ability to supply it. Most of their customers repay their loans and return repeatedly for new loans.

In view of the above experience, there are often arguments against the introduction of interest rate ceilings on the grounds that the poor can pay. Even though many developing countries liberalized interest rates during the 1980s in the context of financial sector reform, a number of countries retained some sort of interest rate ceiling, and others have since introduced ceilings in an attempt to protect consumers from “unscrupulous” lending practices. In some countries, the emergence of non-governmental MFIs charging interest rates higher than commercial and state banks has spurred governments on to impose or consider imposing interest rate ceilings.

Figure 5 below shows the market penetration figures for two types of countries with similar characteristics. This comparison sheds some light on the possible effects of interest rate ceilings. Morocco and Bolivia clearly have significantly higher market penetration rates than their respective peers. One factor (among many) that differentiates the two pairs is the restrictive interest rate ceiling, whether legal or de facto, that exists in countries with low penetration rates. The analysis uses a proxy indicator for market penetration among poor populations: the ratio of the number of microfinance loans to the number of persons estimated to be living on less than US $2 per day.

Figure 5



Source: CGAP Occasional Paper 9, "Interest Rate Ceilings and Microfinance: The Story So Far." CGAP. September 2004.

The question often posed is why are poor clients made to pay the full cost of their loans? Why not charge them subsidized rates? In view of the earlier argumentation, the general view among advocates tends to be that although it may be justifiable to provide subsidies to microfinance programs that conduct business in harsh socioeconomic environments, the traditional welfare approach to subsidizing interest rates is generally not recommended. Programs that target specific populations with subsidized interest rates have generally suffered low repayment rates, institutional dependency, and limited growth unless they continue to receive new subsidies from donors or governments. There is a very long history of subsidized interest rate programs that have failed, decapitalized, and died after the donor project ends.

It is often argued that instead, subsidies ought to be extended to institutions that focus on social intermediation; that is, helping the poor organize themselves, building their skills and management capacity, and helping them to develop self-governance structures that will enable them to take ownership of the project over the long term (Bennett, Goldbery and Hunte, 1996; Hoff and Stiglitz, 1993). Experiences from around the world reveal that

where such microfinance institutions have focused on a participatory approach to poverty alleviation and microenterprise development, over the long run, they have also been able to achieve high levels of financial sustainability, and in some cases become independent of subsidies (Bennett et al., 1996; Bhatt, 1997; Chao-Beroff, 1997).

Success cases have also demonstrated that small borrowers have often been willing to pay market rates for their loans as well as to repay the loans on time provided they derive clear benefits from the financial services provided to them. For example, Castello, Stearns, and Christen (2000) report such an analysis on a sample of MFI borrowers in Chile, Colombia, and the Dominican Republic. These borrowers were paying relatively high effective interest rates, averaging 6.3% per month. But these interest payments made up a tiny fraction of their overall costs, ranging from 0.4% to 3.4%. (Acción International, 1991). In any project with innovative features, there is no difficulty in charging interest rates on loans to cover not only operational costs but also to protect the real value of loanable funds in the face of inflation. Unless MFIs charge interest rates that cover the costs they incur in lending, they cannot mobilize relatively large amounts of commercial finance at market rates to provided credit for the poor. Interest rate ceilings that are set too low for sustainable microfinance constrain poor people's access to financial services. Interest rate caps often drive clients back to the expensive informal market where they have no or little protection.

It is interesting that while some MFIs start off with high interest rates, with greater efficiency, scale and competition they invariably lower their interest rates. In Bolivia, BancoSol's effective interest rate (interest + fees) was 65% per year when it began operations in 1992 with 4,500 clients. Today, in a highly competitive market and with 55,000 clients, its annual percentage rate is 22% (CGAP, 2004)

Microfinance and Loan Default

The linking of savings and credit programs is often used as a way to overcome the problems caused by asymmetry of information between lenders and borrowers, and by the borrowers' lack of collateral, although this limits the flexibility in allocating loanable funds. In particular, the weakest performers could drag down the performance of the entire group. However, by making the group responsible for loan recovery and repayment, peer pressure acts as a substitute for collateral. MFIs can then save on transaction costs and increase the repayment rate. Hence, group-based microfinance techniques may also be viewed as a response to portfolio performance problems experienced with individual loans. At the same time individual lending technologies have also been successfully adapted to the microfinance context. In Ghana for example, the RCBs had initially focused on standard commercial loans to individuals and experienced a high volume of non-performing loans, but they later improved performance by adjusting the terms of the loans, generally to short-term (4-6 months), and by requiring weekly repayments, and retaining a compulsory up-front savings of 20 percent as a security (Coulter and Onumah 2001).

Secondly, for microfinance to be appropriate, a pre-existing level of on-going economic activity, entrepreneurial capacity and managerial talent is needed. If not, then clients may not be able to benefit from credit, and will simply be pushed into debt. In many settings where credit is extended to small borrowers without regard for their debt capacity, it ends up being a cash transfer, as these populations cannot make investments that would allow them to improve their productive capacity and repay their debt at the same time. Indeed, it is not surprising that the poor often "self-select" themselves out of credit programs in recognition of their inability to "use" the loan profitably. They are reluctant to incur debt that they cannot repay (Hashemi 1997). In cases where "top-down'' enterprise development approaches "hand out" credit without due consideration of the entrepreneurial capacity of the client base, experience suggests that some microfinance institutions have increased rather than reduced poverty (Hulme and Mosley, 1996). Thus, if initial needs assessments reveal a destitute or an ultra- poor population that really needs assistance for survival purposes, microfinance might not be a suitable input, and other development interventions are recommended (Lipton, 1988).

There are instances where loan recovery could be adversely affected by unforeseen circumstances such as harvest failures and factors arising out of the fragility of the economic base of the poor. In cases such as these however, successful projects like the Grameen Bank have attempted to deal with the problem by setting up contributory group funds, the resources of which are used to repay loans in such eventualities as well as to provide consumption loans to the members thereby obviating the need to divert loans for non-productive purposes (Hashemi 1997). Group funds therefore, play the role of a social insurance to ensure loan repayment and a buffer to absorb the `shocks' of external events in order to provide some resilience in the face of crises that adversely affects poor households. In this instance as well, we see the important role that ROSCAs and other form of informal group finance play in ensuring that the poor have access to low cost finance.

Some Weaknesses of Microfinance

Weak institutional capacity of rural and small finance providers is related to the limited availability of educated and well-trained people in smaller rural communities. This is a particular issue for community-based institutions. Barriers in lending are compounded in rural areas where banks have no offices and borrowers are few (Besley, 1994; Olamola & Mabawanku 1993). Also, institutions remain modest-sized since they face limited expansion because of their limited funds. They are only able to provide mainly short-term finance, as they cannot easily turn the savings they collect into medium or long-term loans.

Microfinance institutions are also up against the cost of refinancing through the formal banking sector and have no access to refinancing either by the central bank or by venture capital. Microfinance institutions could be put on a firmer financial footing by developing and adapting long-term savings products that exist elsewhere, such as life insurance and home-saving plans, and encouraging the setting up of specialized refinance banks such as Mali's "solidarity bank" (Banque Malienne de Solidarité), or working more closely with

the formal banking sector (Benin's SME support organization PAPME and the local Bank of Sub-Saharan Africa).

Other Innovations in Low Cost Finance for Investment: The Collateralization of Agriculture Commodities (Warehouse Receipts)

Given that rural transactions are often predominantly informal and cash-based, with little or no documentation (Onumah 1998), the rural poor often lack assets, which can be collateralised. This problem is further compounded by the fact that valuation and liquidation of rural assets, especially land, can be frustrated by lack of effective legal/registration systems and missing markets for such assets (WDR 2001). Hence, to ensure their chances of accessing finance, a new concept known as the collateralisation of agricultural commodities has been adopted in many Sub-Saharan African and South Asian countries to provide them with opportunities to manage and reduce the risks to which they are exposed. The use of the warehouse receipt (WR) system follows this concept. Coulter and Onumah (2002) define warehouse receipts (WR) as documents issued by warehouse operators as evidence that specified commodities (of stated quantity and quality) have been deposited at particular locations by named depositors. The depositor may be a producer, farmer group, trader, exporter, processor or indeed any individual or corporate body. The commodity remains the property of the depositor until sold at market, while the warehouse operator can extend credit in the form of cash to people who deposit commodities in his warehouse. The use of WRs is often associated with structured financing transactions, which ensure that if a transaction proceeds normally then the lender is automatically reimbursed (i.e. the loan is self-liquidating), and if it goes wrong the lender has recourse to collateral that can be liquidated with minimum difficulty.

Even though, this has proven to be a sound intervention, a major limitation has been that it tends to exclude smallholders and small-scale traders. It is accessible mainly to large borrowers who own or can lease substantial warehouse space and can afford the substantial collateral management fees. In addition, lack of regulatory oversight of the collateral managers has sometimes led to cases of fraud, which have discouraged inventory-backed financing by banks (Coulter and Onumah 2002). Even though subsistence producers may not be in a position to take advantage of the system, their capacity to cope with household food insecurity will be improved with decline in seasonal price variability.

In Ghana, despite this limitation, some NGOs have tried to establish inventory credit systems for smallholder groups, with TechnoServe pioneering it. Although it brought immediate benefits to participating farmers, the system has not proved economically sustainable because of the small volumes of grain involved usually much less than 1,000 tonnes of maize in a single year (Kwadjo 2000). In addition, the scheme needs intensive supervision to make the banks feel secure. This case and other experiences suggest that, to be sustainable, warehousing schemes must appeal to a wide clientele, not just smallholders, and build large volumes, reduce unit costs and improve overall system

efficiency. Despite growing interest in developing WR systems in Sub-Saharan Africa and other developing countries, there is still a need to overcome these challenges.

5. RECENT DEVELOPMENTS IN BANK SUPPORT FOR LOW COST FINANCE

A widening of financial services provision by commercial banks is generally seen as essential to tackling the finance problem of small investors on an adequate scale. This is largely because they have far more resources than other lenders. Considering that there are structural difficulties in carrying out this function, there is increasingly the tendency to view collaboration between formal and less formal operators as the way to go. The challenge is how to achieve an *inter-linkage* between the formal and less formal sectors, so that the strengths of the two sectors could be combined to ensure an improved flow of credit to the small investors. As already noted, while the strength of the less formal sector lies in its flexibility, speed and low transaction costs in meeting the credit needs of small depositors and borrowers, the formal sector has the capacity to lend considerably more resources. An important issue therefore is how to devise methods to provide better and increased financial services to the marginal borrower by learning from the experiences of both formal and less formal (individual and group) finance.

In this regard, the biggest change in the developing world, which is yet to gain root in sub-Saharan Africa has been the involvement of more formalised financial structures like banks in the delivery of microfinance services. Financial systems are being reorganised to make them more efficient as formal institutions pursue marginal clients. A number of them continually search for possibilities to extend services to small depositors and borrowers without affecting costs adversely. The main principle operating here has been decentralization. The decentralisation of financial services is an approach being taken by formal financial institutions to mobilise deposits from small depositors. This allows more direct decision making to be done away from the centre of the institution. Invariably, this has its advantages and disadvantages. The obvious disadvantages are problems that arise from reduced accountability and the low calibre of staff usually found in branches away from the centre. The more independent branch offices become the harder it is to ensure that the standards and accepted practises are implemented across board. However, decentralisation as a way of reaching marginal clients cost effectively has many advantages and therefore the need for some of the best practises that have yielded good outcomes to be adapted. Some of these best practises include the keeping of lean structures, accountability and incentives for increasing operational efficiency, streamlining of operations, and outsourcing and networking (Wisniwski and Hannig, 1998).

The Use of Lean Structures

Keeping structures lean particularly in rural areas, has led to substantial reductions in administrative costs in a number of places. But this cannot be pursued at the risk of neglecting essential aspects of the business of providing financial services. For lean

structures, it is essential to have bank staff members that have above-average information to be used for making appropriate decisions, regardless of how far away they are from the centre.

The Hatton National bank (HNB) in Sri Lanka illustrates how this may be achieved. In order to build a sustainable microfinance program it established a clear career-development path for the staff selected to carry out the program. In addition, in integrating the general rural credit program with regular branch operations, HNB takes advantage of the external economies from the existing infrastructure in its branch offices. A cross-subsidy from other bank operations may exist in this case. However, the virtual lack of differentiation in the pricing of regular rural loans and deposits raises the issue of whether transactions costs are being adequately covered. This is not an easy issue to address since the rural loans are not isolated from the rest of regular banking operations. In theory, recovery of transaction costs should be managed with a transaction fee, lower interest rate or adjusting minimum deposit balance to qualify for interest payment**.** The success of such a program ultimately requires institutional commitment, operating autonomy and a management environment conducive to responsive business decision.

Accountability and Incentives for Increasing Operational Efficiency

The idea behind the creation of profit-centres within existing banks is that those centres will not be over-burdened with the 'excess baggage' of the main organization. By having such centres, it is expected that there will be a transparency of costs and that those involved at the centres will have a higher responsibility to perform. Minimization of the transaction costs of lending and borrowing emerges as a critical factor in the success of rural credit programmes. Transaction costs to borrowers consist of the expenses of documentation, travel costs and other incidentals, and the earnings foregone during the waiting period (opportunity costs of waiting for a loan) and losses because of delayed receipt of a loan. The time-intensive nature of borrowing (the time-lag between application and disbursement) and delayed loans are often critical transaction costs confronting small borrowers when borrowing from formal institutions. Such transaction costs to borrowers could sometimes be much more than the interest cost of a loan (Adams, 1988).

There are several examples in the microfinance literature about attempts to improve upon operational efficiency, and while the best known are found in Asia, it is worth noting that recent innovations in Ghanaian rural banking offer some useful insights into how these are organized. The biggest lesson to be drawn from the experience of the Atwima-Kwanwoma Rural Bank in the effort to introduce *susu*[5] operations to its clients is the fact that the institution was willing to learn from the informal sector, adopting from informal savings collectors the practice of making daily collections. The daily contact with clients and potential clients through the *Susu collector* facilitates easy marketing of the bank's products to several thousand people on a regular basis. The personal contact between the collector and the client is known to have influenced significantly deposit flows and sizes (Aryeetey 1994).

[5] This refers to the operations of individual mobile savings collectors, quite popular in West Africa.

Susu collectors have generally been known to have lower transaction costs per each dollar collected from depositors than regular commercial banks (Aryeetey 1994), and when banks have adopted the practice, their client base has expanded considerably. At the Nsoatreman Rural Bank, which also introduced *Susu* services to clients using contracted independent collectors, each *Susu collector* was able to expand the client base from 150 to 200 in a year. The expansion in total deposits was comparable to what has been achieved at the Atwima-Kwanwoma Rural Bank, and helped to improve its lending portfolio.

Streamlining of Operations

It has been considerably difficult for many banks to introduce new technology into the delivery of financial services to the poor in many developing countries. Aside from the known hardware problems, the difficulties arise from the dearth of critical information to be used in feeding the new technologies about financial transactions. It is interesting, however, that there are a number of initiatives that appear to have substantially overcome some of these known difficulties. Standard Bank in South Sub-Saharan Africa provides a good example of the use of modern technology to reach small depositors. The development of the facility was assisted by the fact that the high costs of the ATM infrastructure ensure that the product's fees are prohibitive for the poor. Trying to contain the cost enabled Standard Bank to develop a new electronic product to reach a lower income group than any other banks had previously. Having first set up a "downgraded" service, the bank later brought its E-Bank back into the main organization. The issue of whether or not to integrate services for the poor into regular operations is probably an important one to consider.

Outsourcing and Networking

There is ample evidence that outsourcing and the development of networks has become one of the commonest ways to decentralize the microfinance functions of banks. It often involves handing over key functions to other agents with greater experience and structures that have access to better information. In many countries, the use of self-help groups is a common way of achieving this arrangement. The experience of NABARD in India is insightful for discussions of the use of decentralized and effective institutions. There are a number of lessons to be drawn from the NABARD experience.

On the issue of why a bank should downgrade its facilities, it may be noted that formal financial institutions can be motivated to provide financial services to small borrowers, if they can achieve a cost-effective volume. The formal banking system has the technical expertise in financial services and management of financial resources, branches in rural and remote areas, regulation and supervision to ensure the safety of deposits, and funds to finance an expanding portfolio. What they lack is an orientation towards working with marginal depositors and borrowers. Using a lean structure that generates access to others is sensible and cost-effective.

The NABARD experience shows that advocacy alone may not be sufficient to widen the financial services to the poor. Convincing bankers to serve the poor also required a sustainable financial technology that could generate a large volume of deposits at low cost. In many environments, even a banker committed to serving the rural poor would find it difficult to cost-effectively manage large numbers of small deposits. Suitable product design, stream-lined procedures and appropriate delivery technology can drastically reduce transaction costs and default rates.

The strength of both ROSCAs and microfinance programs as seen in the above examples is in their ability to reduce transaction costs through proximity, personal knowledge about the credit worthiness of other members, and well-understood rules (Saito et al. 1994). Village credit unions, because local members govern them, are able to reduce transaction costs as a result of their proximity to borrowers (Almeyda de Stemper 1987). Since commercial banks lack incentives to offer microfinance, they could be linked to other organizations able to reduce transaction costs. For example, Barclays Bank in both Kenya and Zimbabwe plays a supportive role in microfinance programs sponsored by NGOs and donor agencies. ROSCAs have also been linked, with some success, to commercial banks in both Cameroon and South Sub-Saharan Africa (Ardener, 1995; Burman and Lembete, 1995).

Establishing Mutual Guarantee Associations (MGAs)

Mutual Guarantee Associations (MGAs) can also be a viable solution to the problem of access to credit from banks for small entrepreneurs who cannot offer sufficient collateral, in particular for artisans. In several European countries, MGAs have proven to be a helpful and successful scheme to help artisans gain access to credit lines that would otherwise be unavailable to them (De Gobbi 2003). Traditional financial institutions such as commercial banks also benefit from MGAs, which can help them reduce administrative cost and level of risk as the risk is shared both by the MGA and the bank. Although some Sub-Saharan African countries have initiated mutual guarantee schemes notably in Senegal, Cote d'Ivoire and Burkina Faso they have not been very successful as compared with those in Europe. It is reported that this has mainly been because of loan applications being selected according to questionable criteria instead of by merit differences and disagreements between MGAs committee members and the microfinance institutions as well as a neglect of collateral commitment (Pole Microfinancement 2002). This model could work in many countries if there was solidarity among members and a sound legal and regulatory framework.

Linkages do not always work smoothly. Traditional institutions can be very strong (Bell 1990). Commercial banks are not always stable, a factor that has deterred bank efforts at linkages in Cameroon (Niger-Thomas 1995). Decisions are not always sound. The failure of a ROSCA-commercial bank linkage in Lagos is attributed to the extension of credit greater than the savings mobilized by the ROSCA (Nwankwo 1994). A village agent may know the credit worthiness of other villagers but lack any other skills, including literacy, needed to act on behalf of a bank or microfinance program (Eboh 1995). Care must be taken to make sure linkages are in tune with local cultures (Ardener 1995; Kinutha-

Njenga 1996; Moodley 1995). Leadership of a ROSCA occurs through social status in the community, for example, not through managerial abilities.

5. TOWARDS EFFECTIVE LOW COST FINANCE FOR INVESTMENT

The central problem for financial market development in SSA remains how to ensure that institutional development and innovation lead to a filling of the "credit gap" facing growing small borrowers. As we saw earlier, while they lack access to bank credit, their requirements often exceed the limits of informal agents as well as many microfinance programmes. There is currently limited scope for enhancing the allocation of credit equitably and efficiently outside of a closer relationship among formal, semi-formal and informal sector operators. We mentioned earlier that fragmentation of the financial system can be very wasteful. Closer linkages among different segments can improve the efficiency of the system by enabling different agents to specialize for different market niches and by facilitating the flow of savings and credit up and down the system. Filling the credit gap may require incentives to the formal financial sector to establish conditions and support for less formal institutions to move up to this market following a closer integration of the financial markets.

Our approach to increased and effective low cost finance for investment dwells on increased linkages between banks and other financial institutions. In addition to discussing here how such linkage development might come about, we also discuss possible operational approaches for bringing microfinance closer to small entrepreneurs. This has been called the financial systems development approach (Aryeetey and Nissanke 1998).

There is the obvious need for national policy frameworks that have appropriate levels of incentive and regulatory policies as a context for achieving the desired linkages. In addition to using such a framework to provide a developmental platform for financial institutions by helping them to reduce and share risk with an acceptable incentive structure, the framework should draw in broader economic relationships by ensuring that the approach is truly driven by demand from the real sector. Hence, while avoiding a crowding-out of the private sector, the maintenance of steady growth of the real economy is very essential.

Forging Links in Deposit Mobilization

Banks should by all means be encouraged (and given incentives) to enter into closer relationships with such less formal agents as savings collectors and savings and credit associations, as well as non-governmental organizations (NGOs). They have the potential of becoming effective mechanisms to mobilize deposits from and deliver credit to the household and micro business sector. These agents can bulk up small savings at relatively low cost and could retail more credit to small borrowers if backed by access to bank credit.

While the direct contact between banks and informal deposit mobilizers will be very useful, the use of semi-formal institutions, such as Savings and Loan Companies, well-functioning Finance Houses and credit unions also holds considerable potential as shown by the discussion of the role of such semi-formal institutions. It is often suggested that when markets are fragmented, it is best to develop new institutions that will integrate markets, and only then to regulate. In a satisfactorily operating market-based economy, the development of such new institutions is likely to take place if the demand for additional financial services exists. The government only needs to be supportive.

Forging Links in Credit Allocation

One way for banks and less formal lenders to link up for the purpose of credit allocation is for the development of an agency relationship in which banks rely on less formal institutions for various aspects of the lending chain, e.g., loan screening, loan monitoring and contract enforcement. Similarly, the realization of the full potential of informal finance units lies in the identification of any similar strong links between formal and informal units. This relationship should ideally be oriented towards a two-way flow of deposits and credit in order to enhance financial intermediation in the region. While the potential is much stronger in some countries than in others, they must be developed wherever possible to ensure that the benefits arising are for mutual growth. In eastern and southern African countries as well as francophone countries, where cooperatives are relatively well-developed, they could be the less formal institutions for developing such linkages.

Special incentives could be particularly useful in encouraging banks to develop twinning arrangements with semi-formal or non-bank financial institutions, to provide them with management support as well as funds. For example, funds on-lent to microfinance intermediaries could be rediscounted at a concessional rate to increase the profitability to banks, or tax incentives provided to compensate for the costs and risks of developing small borrower portfolios. This would lead to the layering of credit supply through different intermediary steps that involve a number of 'shock absorbers'. This is a principle quite well-known in informal finance in those arrangements that involve interlinkage with traders.

While the principle of channelling credit through less formal sources may be acceptable to a number of formal operators, there is the need for caution with regard to which of the several less formal agents can serve as good partners for such lending. It is important to rely more on well-established agents that operate from within recognizable bodies, such as associations, cooperatives, companies, unions, etc. These have greater credibility than individuals. In addition to this, individual moneylenders with good long-standing relationships with banks could be useful for the purpose. The policy of channelling formal credit to less formal lenders can be defended on the grounds of efficiency and increased financial integration, especially among small farmers. Informal lenders can build a personal relationship with their borrowers that can ensure an extremely low loan default rate. Encouragement of more subcontracting in the real sector would also generate more financial linkages in parallel. For example, if leasing companies could pass on tax

benefits to banks to obtain better credit terms, they could in turn pass on more finance to their clients. There are good illustrations of how this works in Taiwan.

Government Policies for Enhancing Linkage Development

If banks have not linked up with informal finance and microfinance already, it is because of considerable distrust, inadequate knowledge about the latter, prejudice in some cases, all of which create a risky environment for banks. Policy may be designed to overcome this. There should be an approach that focuses on building institutions that serve the identified segments. A possible ways for policy to be used to enhance the development of linkages between the various segments, including the informal sector and such semi-formal lenders as NGOs is the use of the regulatory and supervisory systems to provide incentives for formal institutions to want to cooperate with less formal agents.

Indeed the regulatory and supervisory systems could be of considerable importance in providing incentives to banks. If banks perceived that risk was considerably reduced by dealing with credible semi-formal and informal agents, they would be encouraged to use them. Effective regulation and supervision of semi-formal and informal institutions would tend to be problematic, in some cases, however. Government would require a proactive approach. This would embrace a legal, regulatory and prudential framework that fosters, and when possible, accelerates financial market development. This framework supports the setting up of mechanisms, institutions and instruments that promote and facilitate this development as the economy grows and market functions expand. Regulation should steer away from restrictive laws and focus on removing the obstacles to financial market development. Restrictions on what assets banks may hold could be modified to encourage them to invest in semi-formal financial institutions. This requires the diversification of formal sector instruments. Commercial bills and bankers' acceptances based on cooperative or 'mutualistic' guarantees could be developed to establish a link between semi-formal and formal financial institutions.

Innovation in Microfinance: Strategies for Reducing Lender Risk

The principles for reducing lender risk in integrated financial systems will necessarily have to involve internal management restructuring that will lead to improved appraisal of risk, the development of other tools for containing risk and some risk-sharing procedures. Formal and informal lenders and deposit-takers will have to learn to share risks with each other while developing better techniques for dealing with borrowers at the margin for whichever market niche they have adopted. It is essential that techniques for lending to small borrowers minimize risk and these have seen significant improvement in the last decade throughout the world. It is possible to reach small borrowers cost-effectively, taking into account existing risk profiles of such borrowers.

At the margin, financial institutions want to know whether it is cost-effective to take deposits from and lend to small businesses. Internally, they will have to adjust the credit-delivery methodology, focusing on the way in which borrowers are identified, approved and supervised. Financial institutions that have been more successful in extending and

recovering credit to small enterprises have often based their lending operations on an in-depth market assessment at the design stage, allowing them to determine actual patterns of demand and to identify and address relative levels of risk involved.

Financial institutions lending to small borrowers must be profitable. They must earn enough to cover the cost of funds and recurrent operational and administrative costs. This requires the use of interest rates freely to assure profits, considering the negative impact too high rates will have by way of incentive effects and the effects of adverse selection. They must therefore strike a proper balance between risk management and low transaction costs as a percentage of average earning assets.

There are a number of innovative financial institutions that have been successful in maintaining this balance. They have employed a variety of measures to effectively reduce small borrower lending risk, basing their risk reduction strategies on the fundamental principles of minimizing poor judgments on character and capability, through careful credit analysis, using intensified follow-up to track projects and loan repayments; and applying "get tough" policies on repayment.

It is interesting that many institutions are increasingly emphasizing non-tangible aspects of creditworthiness (character, repayment history, motivation to succeed) to reduce the likelihood of poor credit judgment and the resulting need for intensive collection efforts. One of the more successful microfinance institutions in Sub-Saharan Africa has been the Senegalese Private Enterprise Credit Agency (PECA). It addresses the intangibles by carrying out rigorous risk analysis of the potential borrower and business operation, including on-site observation of the business operation and interviews with employees and key informants in the community. These are on operator's character and debt repayment records. Personal knowledge of the borrower or the person introducing borrower is generally accepted to be a crucial first step.

In view of the high dependence of a large number of economic activities in Sub-Saharan Africa on the agricultural sector, which is itself highly dependent on uncertain weather conditions, it is always advisable for entrepreneurs to seek ways of reducing this dependence. As entrepreneurs seek to move from this strong dependence on one sector, it becomes important for the financial system to complement that move with its own diversification. It is certainly essential that where feasible, financial institutions diversify their loan portfolios to reduce their dependence on high-risk activities. While this could be done through loan pricing arrangements, there is often no guarantee that the desired results will be achieved in poorly functioning market systems. PECA has taken direct actions to diversify their portfolios as a risk reduction measure, to avoid sectoral concentration or over-emphasis on lending in areas vulnerable to natural calamities or external shocks.

An approach that seems to be catching on with some successful financial institutions and which has been used quite effectively by a few informal lenders when necessary has been the adoption of a tough stance on contract enforcement. It has been shown that while collateral confiscation in the informal sector does not happen everyday, the knowledge

that the lender could actually do it has often put some fear into borrowers and encouraged them to make repayments on time. It is interesting that some non-bank financial intermediaries have adopted a 'get-tough' policy on repayment. PECA ensures that any client not paying within 10 days of loan maturing is visited by a legal officer. If loans are non-performing for more than 60 days, action is initiated to seize security.

Interest Rates and Microfinance

Despite the virtues in striving for competitive interest rates, the difficulty of working this in poor Sub-Saharan African countries is becoming more and more apparent. Sub-Saharan African governments are generally being drawn out to induce a more positive response from the financial sector to real sector needs. There has been some suggestion for the state to play a more active role than the financial liberalization doctrine would imply. Hellman et.al. (1996) have put forward what they see as a new paradigm of "financial restraint". The ideas behind financial restraint are largely influenced by the experiences of high-performing East Asian economies, including the Japanese post-war experience.

Financial restraint policies aim at creating rents within the private sector. Rents are defined to mean the "returns in excess of those generated by a competitive market" (Hellman et.al. 1996). They differ from financial repression in the sense that the rents that are obtained from holding deposit rates and lending rates below the competitive equilibrium level go to private sector agents instead of the government. This is achieved by putting in place financial policies that regulate entry and direct competition. The imposition of different lending rates for different sectors serves to distribute the rents to the financial and real sectors. The rents are intended to reduce information-related problems that hamper perfectly competitive markets.

In order to differentiate between financial restraint and financial repression, a number of conditions must be satisfied. These include the existence of a stable macroeconomic environment with low and predictable inflation rates as well as positive real interest rates. It is important that the policies of financial restraint do not lead to rent extraction by the government from the private sector.

In the basic analysis of financial restraint, it is argued that selective intervention through financial restraint creates "franchise value for banks that induces them to become more stable institutions with better incentives to monitor the firms they finance and manage the risk of the loan portfolio". Banks are expected to expand their deposit base following the creation of rents and then increase the extent of intermediation. Directed credit is expected to compensate for market deficiencies including the lack of long-term lending. Lower lending rates should induce a reduction in the agency problems of banks as adverse selection is reduced. It is suggested that in some East Asian economies, directed credit led to "contest" effects among firms, which if well structured can provide even stronger incentives than competitive markets.

The proponents of financial restraint indicate that it is not a static policy instrument. It is suggested that the various sets of financial policies must be adjusted with time, depending on the performance of the financial markets and the economy in general. "As financial depth increases, and, in particular, as the capital base of the financial sector strengthens, these interventions may be progressively relaxed and the economy may make the transition to a more classic "free markets" paradigm" (Hellman, et.al. 1996, pp.166).

In attempting to reach poor households and other enterprises, we tend to be of the view that financial restraint provides an appropriate policy framework. But this is not enough. There is the need to develop a more comprehensive approach that goes beyond financial policy reforms. The institutional arrangements for applying a policy of financial restraint are an important complement to the policy reform process as we argued earlier. Hence, there is the need to consider answers to such questions as the following: which credit and insurance delivery mechanisms might allow financial institutions to achieve a second best solution? Also, what financial institutions are most accessible to the poor and how do these impact on SSA production? Alternatively, what type of credit conditions are most agreeable with borrowers and what institutions are most suited for providing it? This is what we seek to achieve with a microfinance sector amply integrated in the rest of the financial system.

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