MicroSave
Market-led solutions for financial services

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and Latin America

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Informal Sector Finance Systems: What The Microfinance Industry Can Learn From Them

Norfolk Hotel, Nairobi

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MicroSave: Rationale and Project Description

Background:
After nearly 20 years, the microfinance industry has enjoyed a great deal of success in terms of outreach and sustainability, particularly in certain parts of Latin America and Asia. However, microfinance remains primarily a supply-driven endeavour, with a limited number of methodologies applied to provide mainly working capital loans to poor microentrepreneurs. Over the past few years, industry practitioners and experts have increasingly recognised that the poor require a wider range of financial services to manage risk and improve their welfare. Savings services in particular have garnered much interest, especially in Africa where the traditional supply-led credit models have not resulted in the hoped-for massive outreach and sustainability.

***MicroSave*:**
MicroSave is a unique project that promotes the development of a market-led and more client-responsive approach to delivering financial services among microfinance institutions (MFIs). To achieve this goal, the project has successfully combined:

1. Primary field-level research regarding the financial service needs and preferences of the poor,
2. Action research working intensively on the ground with a selected group of microfinance institutions (MFIs),
3. Toolkit and curriculum development, and
4. Extensive information dissemination.

The field-level research entailed extensive interviews with poor people (including microfinance clients) to better understand their financial behaviour and risk profile; while the action research involved helping MFIs to better listen to clients and design appropriate financial products based on better market information. Both research activities complemented each other and directly fed into the toolkit/curriculum development and dissemination efforts.

MicroSave has emerged as an industry leader in the area of market-led microfinance, contributing significantly to the global debate on the importance of broadening the boundaries of financial service provision to the poor. ***MicroSave*** is a founding member of the Product Development Taskforce, which is co-ordinated by CGAP to promote a coherent and high-quality approach to the development of toolkits and training around this growth area in microfinance[1]. In addition, ***MicroSave*** is essentially the operational wing of the CGAP Savings Mobilisation Working Group and the current Programme Director is the Chair of the working group.

The project has received a great deal of international attention and accolades for its work in the areas of market research and product development for microfinance. Many would argue that ***MicroSave*** put the issue of "listening to clients" on the microfinance map in a relatively short period of time and with very limited resources.

The overall strategy for ***MicroSave*** entails a four-pronged approach:

1. Research Activities
MicroSave has already completed over 25 action-oriented, operations research studies and 10 case studies on a wide variety of topics including clients' needs and behaviour, reasons for clients leaving MFI programmes, strategic marketing for financial institutions, staff incentive schemes, product costing and pricing, the product development process, institution and product risk analysis etc.. (See the programmes' website for details).

There are two main components of the study programme:

1. Need and Demand for Financial Services (Demand Side Issues)
2. Meeting the Need and Demand (Supply Side Issues)

On the website, the results of this study programme are divided into the following sections:

[1] Members include representatives from CGAP, USAID's MBP and AIMS projects, and GTZ.

1. Impact Assessment and Market Research Methods
2. Product Development Process
3. Product Innovations - Credit
4. Product Innovations - MicroInsurance and Leasing
5. Product Innovations - Savings
6. Reaching Remote Areas
7. Retaining Customers
8. Risks and Vulnerability of the Poor
9. Studies of Informal Sector Financial Services
10. Strategic Marketing

2. Action Research Programme Activities
MicroSave works with around 10 carefully selected Action Research Partner financial institutions to assist them to deliver market-led financial services to the low-income market. This includes all aspects of strategic marketing including:
1. Corporate Brand and Identity,
2. Product, and
3. Product Delivery/Customer Service strategies.

This approach encompasses analysis of clients' demand and views; corporate brand and identity development and communication; product development, testing and rollout; product costing, pricing and marketing; staff incentives; customer service and delivery systems.
Currently ***MicroSave***'s Action Research Partners are:
1. Equity Building Society (Kenya)
2. Kenya Post Office Savings Bank
3. Centenary Rural Development Bank (Uganda)
4. FINCA-Uganda
5. Uganda MicroFinance Union
6. FINCA-Tanzania
7. Tanzania Postal Bank
8. Credit Indemnity (South Africa)
9. Teba Bank (South Africa)

***MicroSave's* Toolkits for Training and Technical Assistance to the Action Research Partners**
Using the acclaimed toolkits it has developed, ***MicroSave*** provides training and technical assistance to the Action Research Partners on:
1. Market Research for MicroFinance
2. Costing and Pricing of Financial Services
3. Planning, Conducting and Monitoring Pilot-Tests
4. Product Roll-out
5. Strategic Marketing for MicroFinance Institutions
6. Product Marketing Strategy

MicroSave provides training and technical assistance on an as needed basis on:
1. Institutional and Product Risk Analysis
2. Staff Incentive Schemes Development
3. Customer Service
4. Corporate Brand and Identity
5. Process Mapping

MicroSave's role is to ensure that its Action Research Partners have an adequate understanding of the issues involved in moving from product design to full scale implementation, including operations and other supply side issues. In addition, ***MicroSave*** serves as a sounding board and provides documentation of at least some of the partners' experiences.

In late 2002, ***MicroSave***'s Mid Term Review team assessed the Action Research Partner programme and concluded, "Feedback from Action Research Partners indicates that the ***MicroSave*** project has made significant efforts in implementing its work under the action research program, and the partnerships with

MicroSave have been exceptionally well received by the partner institutions. In terms of the market research training, toolkit and client need analysis, the review team considers the ***MicroSave*** project to be the most advanced project of its kind in the world[2]."

3. Training Activities

MicroSave *has conducted or assisted with over 25 "Market Research for MicroFinance" courses all over the world. The course is recognised as "world class" and was described by Beth Rhyne and Marguerite Robinson as "the best course on microfinance client demand available to MFIs in the world today, by a large margin".*

*"**MicroSave*** has an excellent staff of professionals who conduct the training and mentor MFIs in how to use the tools as part of the product development process. Their experience, hard work, enthusiasm, and ability to work effectively with MFI practitioners on the ground have been key to ***MicroSave*** accomplishments to date.

The outreach of the ***MicroSave*** Market Research for MicroFinance toolkit has been impressive. The training has involved international, regional, and national MFIs, networks and support organizations working both within and outside of Africa. Aggressive marketing and promotion and the relevance of the training to current interests in the MF industry, have been key its successful outreach.

> "… The tools offer MFIs a structured way to listen to and learn from clients."
>
> "…The market research process creates a bond between the clients and staff of an organization. Clients realize you are concerned about them and listening."
>
> "…The biggest change resulting from the use of the tools is in attitudes towards microfinance clients. They are seen as having rights as consumers."
>
> (Email respondents, 1/02)

The assessment found the tools training to be solid in both content and process. The practical field experience is invaluable and has had a direct influence on the way many institutions now carry out their activities. The training is highly rated by participants and the fact that they pay up to $2,500 to attend the course indicates the value it is afforded by participants and their institutions.

The tools are well designed and easy to adapt to different settings and purposes. With training, users can generate information that is credible and useful for improving products and services. Given the growing interest in the microfinance industry for meeting a broader range of client financial needs, the ***MicroSave*** Market Research for MicroFinance toolkit is timely and in high demand[3]".

***MicroSave** is currently completing the development of similar training curricula for its suite of toolkits (see Training and Technical Assistance to the Action Research Partners section above) and will initiate training on these in 2004 using two approaches:*

1. *The Young Executive Development Programme, which provides internship opportunities within* **MicroSave**; *and*
2. The Senior Service Providers Capacity Development Programme, which provides focused, practice-based training on the ***MicroSave*** toolkits.

4. Dissemination Activities

MicroSave puts a great deal of emphasis on optimising the dissemination of the lessons it learns and the knowledge it generates. This is done through a wide variety of media including:

- The ***MicroSave*** website and E-Briefs
- Dissemination workshops
- The acclaimed Briefing Notes series
- Presentations and training programmes at Boulder, New Hampshire etc.
- Booklets

[2] "Assessment Report of ***MicroSave**'s* Work with its Action Research Partners" - Ezra Anyango, Marguerite Robinson, and Guy Winship

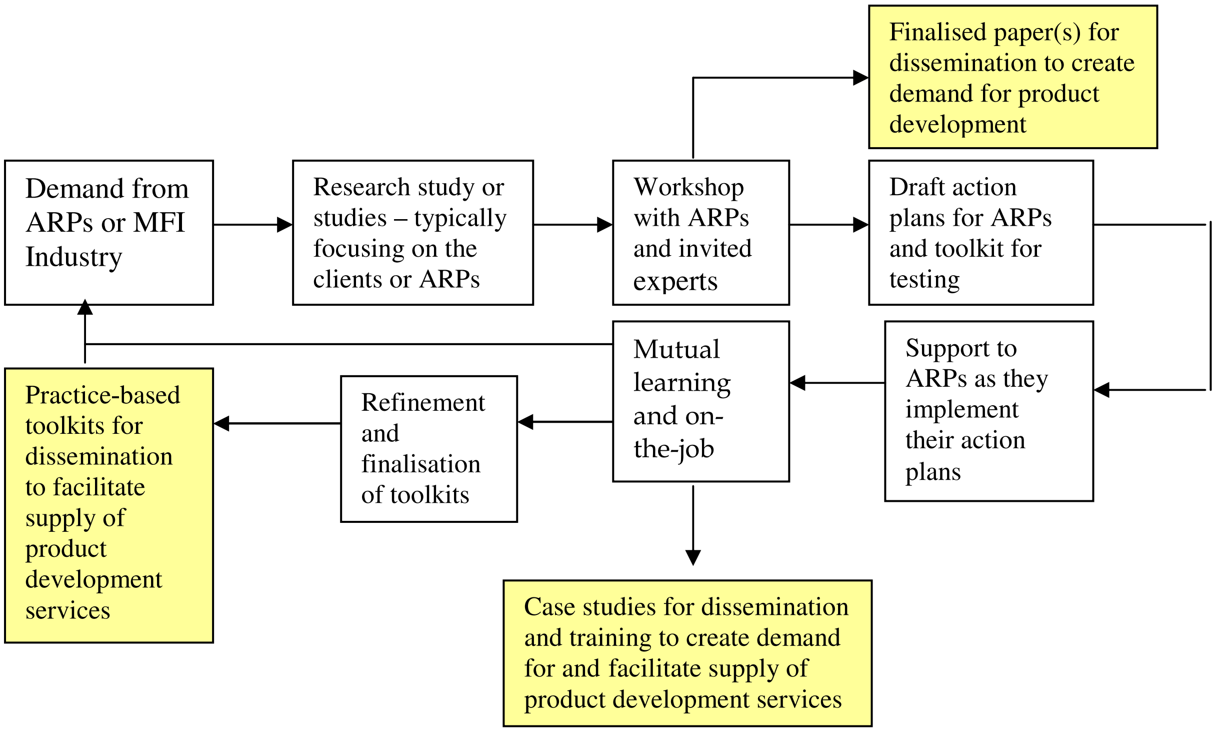
[3] "Assessment of the Use and Impact of ***MicroSave**'s* Market Research for Microfinance Toolkit - Ezra Anyango, Jennefer Sebstad and Monique Cohen"

- Formal books published by international publishing houses.

Conclusion
MicroSave's primary strength continues to be the interplay between its study, Action Research and toolkit development programmes, which create remarkable synergies and provide unique opportunities to:

1. Identify practice-based issues;
2. Conduct market and ARP practice-based studies on these issues;
3. Develop draft toolkits;
4. Test and refine these toolkits with the ARPs; and thus
5. Disseminate credible, practice-based, practical toolkits and information.

The ***MicroSave*** practice-based learning system can be described as follows:



The Recent Mid Term Review of MicroSave concluded:
"*MicroSave* II has continued to enhance its high reputation in the region, and generally across the global microfinance industry, most notably in demonstrating the importance of a client-responsive approach to the provision of financial services to poor people. All those who have had direct contact with *MicroSave* have commented on the professionalism, commitment, if not passion, which staff bring to their work. The project has performed impressively against its logframe targets, indeed with 15 months of the project still to run has already exceeded almost every one. The Director and his hard working team deserve high praise.[4]"

[4] "Mid Term Review Final Report ***MicroSave*** *II* and Recommendations For ***MicroSave*** *III*" - David Wright, Guy Winship, Ezra Anyango and Jo Woodfin

MicroSave

Informal Sector Finance Systems: What The Microfinance Industry Can Learn From Them

Objectives of the Workshop*:* Lessons from the informal sector may help the MF industry respond better to clients' needs and to reduce costs. The workshop seeks to explore these and to provide insights for ***MicroSave's*** future agenda.

Introductions
8.00: Registration
8.15: David Cracknell: "Welcome and Introduction"

Presentations (15 minutes max presentation plus 15 minutes for question/answer)
8.30: Catherine Masinde: "Challenges Facing the MicroFinance Industry in East Africa"
9.00 Leonard Mutesasira: "Lessons from the Informal Sector Financial Systems in East Africa: What Are the Implications for MFIs?"
9.30: Makarimi Adechoubou: "The Informal Sector Financial Systems in West Africa: What Are the Implications for MFIs?"
10.00: Roland Pearson: "The Informal Sector Financial Systems in Southern Africa: What Are the Implications for MFIs?"
10.30: Tea/Coffee
11.00: Sukhwinder Arora: "The Informal Sector in India: Towards A Strategy"

Plenary Discussion
11.30 Plenary Discussion: "Challenges for the MicroFinance Sector in East and Southern Africa" (moderated by David Ferrand)

12.45: Lunch

Presentations (15 minutes max presentation plus 15 minutes for question/answer)
1.45: Harry Mugwanga: "Harnessing Informal Sector Financial Systems: The Experience of Saga Thrift and Enterprise Promotion"
2.15: Rose Mwaniki: "Harnessing Informal Sector Financial Systems: The Experience of K-Rep"
2.45: Robert Hickson: "Managed ASCAs in Kenya"

3.15: Tea/Coffee

Working Groups
3.30: Working Groups to discuss the implications for MicroFinance in Africa and recommendations for ***MicroSave*** on how it might support the constructive inclusion of lessons from the informal sector into MFIs' activities
4.15: Report-back from Working Groups and Discussion

Closing Comments
5.15: Graham Wright: Closing Comments
5.30: Cocktails and informal discussions

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MicroSave offers its special thanks and appreciation to all the presenters who prepared such excellent papers at short notice (and under not a little duress) and to Nthenya Mule who drafted the proceedings of the workshop**.**

Challenges Facing the Microfinance Industry in East Africa

Catherine Masinde

Background

About 80% of the East African population lives in rural areas, with about 90% of this population segment depending on agriculture. A high proportion of women, at least 70%, characterises the rural populations. Despite their numeric dominance in rural areas, women find themselves disadvantaged: 50% of them have little or no education, or non-farm skills; most have no power to make decisions about family and community resources; most have no rights to land use; and few can access markets beyond farm gate.

Most populations in East Africa are predominantly poor, with at least 50% living on less than a dollar a day. While they do borrow, the poor would rather save, a need that is not immediately met by the financial products available from the microfinance institutions (MFIs) in the region. Low-income households' need for credit is not just to run their businesses, but also to smooth family incomes and address exogenous shocks. MFIs typically provide credit-for-enterprise and yet the majority of low-income households do not have enterprises; they have limited entrepreneurial, business and management skills and limited access to markets, capital and technology. There is a clear mismatch between the programmes advanced by MFIs and the environment within which they are operating.

The East African economies are weak and fragmented, with weak and fragmented financial sectors. Commercial banks have attained little depth, and because the central banks have not addressed the sector holistically, MFIs and other informal financial institutions have been left out of the financial structure. The linkages between rural and urban economies are rarely understood and addressed. Although rural financial service providers exist, outreach remains wanting, and the efficiency and sustainability of many is questionable. It is therefore critical to address issues of discontinuity as a whole.

The Financial Sector Landscape

The typical financial sector in East Africa is comprised of about four layers.

1. The central bank sets macro monetary framework.
2. Commercial banks and non-bank financial institutions operate within the formal financial sector, dominating in capital outlay, but have very limited outreach. Many have begun withdrawing from rural areas because they find it unprofitable to operate in these areas.
3. Lower down we encounter NGOs and MFIs, which are growing in number. There are now upwards of 30,000 of these operating in the region.
4. The bottom layer of financial service providers comprises the informal financial institutions, including RoSCAs, ASCAs, merry-go-rounds, and community based organisations in local communities.

However, because there is still no appropriate and adequate definition of microfinance, it cannot be situated in the sector, leading to unresolved discontinuities between service provision and demand.

The financial markets do not function as they should. Because there is severe lack of understanding their markets, financial institutions have not performed their role fully. There are no wholesale funds, and direct lending to mid-level businesses is non-existent. Client level impact assessment is rare and many times poorly conceptualised, failing to draw out the linked needs of the sector. While the individual financial institutions struggle to improve performance in the sector, no one is taking the responsibility to develop the financial sector.

What are the Challenges of Microfinance in East Africa?

Microfinance needs to be contextualized within the broader financial sector. Linkages will have to be created within the financial sector in the long term. The following challenges will have to be addressed critically if the industry is to be a key player in the financial sector.

Institutional Problems

- *Too few financial service providers with limited capacity for outreach.* Outreach is limited to the capacity of the individual institution.

- *Internal governance problems*. MFIs still have to address issues of accountability, transparency, succession, transformation, etc., to ensure competitive provision of financial services to their target markets. Most institutions have come from an NGO perspective and the overarching objective of the institution may not be efficient and effective customer-oriented service. In most instances, the institutions have evolved from social-welfare roots.
- *Limited management capacity within most MFIs*. When middle or upper management staff leave the industry and seek employment in other sectors a management gap is created because there is a limited pool of people with the experience and understanding of the industry to effectively take over leadership of these institutions.
- *MIS problems*. The MIS used are often wrong, expensive, use obsolete technology, and have poor data capture because of financial limitations.
- *Human resource weaknesses*. High staff turnover implies added costs to the institution as new staff is hired and investments must be made in training them. It is critical to also keep re-skilling staff to deal with the changing environment, however appropriate programmes have not been developed to do this, and the institutions themselves do not have very adequate budgets for staff training. In addition, the incentive structures in the industry are not always attractive to high calibre staff.
- *Vision and Direction*. Many MFIs in the industry have been initiated by a charismatic leader, "the guru of the organisation", who introduces an institutional model when the organisation first starts off, but cannot transfer her/his vision to the rest of the organisation.

Profitability/Sustainability

- *Down-market profits?* The industry will have to evaluate whether there are indeed profits to be made by serving the down-market niche.
- *Many MFIs have been recipients of subsidies*. While subsidies may have a role to play in helping institutions get on their feet, the challenge remains, determining how long subsidies should remain in place, and whether these subsidies foster institutional growth.
- *High-cost structures*. The industry is characterized by a very high cost structure, arguably one of the highest in the world. How can this cost structure be justified? Institutions in the industry will have to establish whether they can rationalize their cost structures, and still have staff packages that can adequately motivate good people.
- *Delivering volume*. Institutions will have to more critically address their capacity to deliver volume. A lot of emphasis has been placed on credit officer capacity, but this has not been complemented by depth and breadth in outreach.
- *Drop-outs*. If MFIs are to achieve sustainability they will have to address high drop out rates as a result of poor product offering, poor service delivery and limited innovation.

Limited Market Knowledge

The microfinance industry has been characterized by supply-led service delivery, without investment in understanding the market that it is serving and the particular needs of that service. Client needs and wants have been largely ignored as MFIs opt for the easy way out. The industry will therefore have to re-evaluate the following shortcomings:

- Provision of a mono-product – credit programmes.
- Focus on "imported", "adapted" or "borrowed" products that do not address the needs of local markets.
- Limited innovation and new product development, justified as too difficult, because the institution lacks sufficient time to carry this out. In addition, most MFIs feel more at ease adopting what other practitioners have "successfully" done.
- Institutional inertia has led to practitioners no longer learning and applying the lessons of their experiences to their operating environment.

Problems of Capitalisation

- MFIs, community based organisations (CBOs), and the informal financial sector have limited linkages to capital markets from which they may be able to access the financing needed to help them expand their operations, by responding to the needs of their market niches.
- Even in the face of shrinking donor funding, the industry is increasingly donor dependent.

- Most MFIs have credit-led programmes which have limited capacity to mobilise commercial capital.
- Most MFIs are registered as NGOs, whose ownership structures do not lend themselves to equity investment as there are no clear owners of the institution. Transforming NGOs to companies limited by guarantee still does not resolve the ownership problem.

Inertia
The industry has a potential market of 12 billion people that it can reach by 2015. This is a rather daunting goal, given the dismal performance to date. The failure of industry practitioners to continue learning about their market and developing strategies that are responsive to the financial needs of these markets has compromised the performance of MFIs. Industry turnaround will be dependent on institutions being more proactive and seeking the gaps in financial service delivery down-market and responding by providing the needed financial services.

What Next?
What should happen in the microfinance industry to ensure dynamism and growth? Several propositions could be considered, which involve a new stance in industry thinking, and introduce changes that would have to be carefully managed.

- *Shock Therapy*: Should non-performers be allowed to die as resources are shifted to performers? If this were the new approach to institutional support, what would be the criteria for identifying the performers. If the non-performers are allowed to die, what will this mean to the un-banked populations deep in the rural areas? Will they now be able to access services from the new breed of financial service providers?
- *Mergers and Strategic Alliances*: It is critical for financial service providers in the industry to achieve scale and scope, product differentiation and "niching," where people do what they do best and rely on others to do the rest.
- *Creative Banking*: It will be important to think outside the box. Currently, the microfinance industry has not been working with commercial banks as a matter of course. Why has this not been happening and are there conditions under which such an arrangement could be achieved? The microfinance industry will have to work with central banks and other financial sector players to situate microfinance firmly within the financial sector. It will be critical to deepen the financial sector, and therefore the key will be to work in a broader environment that addresses discontinuities in financial markets rather than having supply-led financial interventions e.g. agricultural finance, finance for enterprise, financial services for the poor. Institutions will have to understand the role of microfinance in the life of the client, because we currently do not know in what form clients need money.
- *Grow "Learning" Organisations*: The industry will need to be defined by institutions that are able to innovate, watch and change. By doing this, these institutions will be able to get rid of the inertia that is currently plaguing the industry.
- *Lose Organisational Weight*: Institutions will have to set realistic goals to become lean and mean. The focus will have to shift to efficient delivery of market driven services to clients.

Key Plenary Discussion Points

- In response to some of the challenges facing the microfinance industry, Uganda is taking a tiered approach to addressing some of the key issues driving the sector. The Microfinance Bill currently under formulation will try to address the mechanisms through which NGOs that have traditionally been offering micro credit services can transform themselves into micro deposit institutions (MDIs). The Bill is being formulated in consultation with the microfinance industry through a forum that brings together donors, practitioners and government agencies.

  In Kenya the Microfinance Bill is still being drafted and should be tabled in parliament soon. This process has been rather protracted, but has tried to bring together practitioners in the industry to give guidance to the Central Bank on how the Bill should be formulated. Tanzania is also in the process of formulating a microfinance bill.

- Presently, the microfinance industry has limited knowledge of its clients and their needs. ***MicroSave***'s initiative in developing the toolkit - market research for microfinance is a starting point for the industry to begin focusing its attention on the need to identify clients' financial needs, and develop products and services that address those needs. MFIs are still a long way from being entirely client driven, where they would routinely seek signals from their market niches on the financial services they ought to be providing. At the moment, it is very difficult to go into an institution that is doing well in its business and convince it that it does not know its clients, and that the products it is offering are not addressing the needs of its clients fully. More buy-in is necessary in order for the microfinance industry in East Africa to shift and become more demand driven.

- A serious situation has emerged within the commercial banking sector. In response to the alarming situation where non-performing loans comprise 40% of the total portfolio of this sector, the Central Bank of Kenya put in place additional prudential guidelines two years ago. Commercial banks are already facing a big challenge trying to serve their core clients. For them to take a step towards service provision for the microfinance sector remains a daunting challenge. In order for the commercial banking sector to bring financial services down market, an appropriate regulatory framework will have to be put in place, together with a training and development strategy for the sector. In addition, it will be critical for the commercial banking sector to change its attitude and begin viewing the microfinance sector as a sector within which it can deliver services profitably. Once the banking sector is persuaded that profits can be made in microfinance, strategies for delivering these services efficiently and effectively will have to be developed.

- The financial service sector needs to engage in creative banking. Most medium enterprises are beyond the reach of MFIs and cannot access financial services from the commercial banking sector because they do not fulfil the criteria for accessing credit from this sector. Linkages have to be created between microfinance institutions and commercial banks to ensure that these middle tier enterprises are adequately served.

- Currently, the Kenya Post Office Savings Bank has 2.2 million savers. However, the money it mobilises goes out through channels that do not serve the majority of these savers. Strategic partnerships will have to be developed but within a commercial context. This could be through NGO-MFIs or commercial banks with special credit lines for the microfinance sector. On the savings side, we need to develop deposit facilities that ensure protection of savers' money. It will be instructive to investigate why NGOs have not, to date, opted to go to the commercial banking sector to create strategic linkages. In order to take advantage of their respective competitive advantages, commercial banks and the key players in the microfinance industry will have to collaborate in broadening the financial services menu to the microfinance sector.

Lessons from the Informal Sector Financial Systems in East Africa: What are the Implications for MFIs?

Leonard K. Mutesasira

Why do the Poor Need and Manage Money

The poor often devise financial management strategies in order to respond and manage lifecycle events[5], emergencies[6], investment opportunities[7] and consumption smoothing[8] (Rutherford, 1998). Rahman and Hossain (1995) explain that the poor manage money for many reasons, most of which have underlying risk protection and risk management dimensions. These risks give rise to *precautionary strategies* intended to reduce the household's risk exposure while *loss management strategies* reduce the impact of the loss. The risk management strategies employed by the poor include investments in human, physical, financial, spiritual and social assets.

The informal sector is often a response to needs not appropriately met by the formal sector. Most poor people do not have *access*[9] to formal sector financial services because of:

- the geographic distance from the financial institution;
- the terms and conditions governing the available financial services it offers;
- the working hours of the institution;
- the long time it takes to make a transaction at the institution;
- the disrespectful manner in which the staff often treat poor clients;
- the intimidating appearance of the financial institution; and
- the complexity of the paperwork and the difficult process necessary to make a transaction (Bagachwa, 1995; Wright, 1999, Robinson, 2000; Mutesasira, 1999; Rutherford, 1999).

Informal Sector Financial Strategies Employed by the Poor

The poor manage money mainly through the informal sector by holding savings, loans, leasing, insurance, investments and often engage in domestic and cross-border money transfers. This paper seeks to draw lessons from these informal financial systems and the implications for microfinance institutions.

Saving is the most common collective money management strategy among the poor with RoSCAs[10] being one of the most popular and fastest growing organized form of financial device among the poor, especially in urban and peri-urban areas. The members take a periodic collection that is pooled and given to one member in rotation until everyone has got a chance to get the lump sum. Although this is not very common, the organizer or "chairperson" is sometimes paid a fee.

ASCAs[11] are not as popular as RoSCAs because they include a treasury management function with the attendant accounting challenges. They also demand loan recovery skills in case borrowers default. Other popular mechanisms include savings clubs, deposits with suppliers, deposit collectors[12] and money guards (Mutesasira, 1999).

Loans are a common money management mechanism with interest rates ranging from 0% to 25% with terms ranging from one day to one month. Reciprocal lending is by the far the most common source of credit although its popularity is waning because of the general decline in mutual trust. ASCAs, for net

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[5]Life cycle events include marriage and birth, education, home making, widowhood, old age and death, and an inheritance for one's offspring.

[6] This includes impersonal emergencies such as theft and fires and personal emergencies such as illness, accident, bereavement, desertion and divorce; again, large sums of money are required**.**

[7] This includes starting or running a business, acquiring productive assets or buying life-enhancing consumer durables such as TVs and refrigerators.

[8] Savings during high-income periods are used to finance consumption expenditures during low-income periods.

[9] *Access* is defined as the ability/ease of undertaking transactions with financial institutions.

[10] RoSCAs go by many names, which include merry-go-rounds, cash-round, *kibati*, *biika oyeguze*.

[11] ASCAs (Accumulating Savings and Credit Associations) are different from RoSCAs because not all members borrow and those who borrow pay interest, which translates into earnings for the savings only members.

[12] *Deposit Collectors* are private for-profit arrangements that take regular deposits (usually on a daily basis) of an amount determined by each client and return the accumulated sum (typically at the end of each month), less one day's deposit or a fixed amount as a commission or service fee

borrowers, are another popular source of lending and these are increasingly found embedded in MFI client groups. They often provide emergency loans (at 10%+ per month) to cover arrears or late payments among group members, and the income is periodically shared as dividends. They are not as popular because they require record keeping and numeracy skills, both of which are scarce among most poor people.

Evidence, both in rural and urban areas, indicates that there are few *moneylenders* serving the poor in East Africa. They tend to concentrate on the salaried middle class and richer traders because the poor rarely have the different types of acceptable collateral, which in Uganda for example, often includes physical assets and post-dated checks[13]. Credit terms typically range from one day to four-month loans, with interest rates of 10% to 30% per month. There is an active pawn broking market in Kenya, and in Uganda these pawnbrokers lend to poorer people.

Leasing - Operating leases involving the rental and use of equipment and tools in urban areas, and land in some rural areas, especially Kilimanjaro, are common (Mule et al., 2001). The equipment ranges from refrigerators for fishmongers, cars for taxi operators, to trucks and excavation machines for small miners in Tanzania. The terms vary, ranging from daily, weekly, monthly and duration of farming seasons[14]. The rental fees range from 5% to 20% of the value of the asset and are also dependent on the sector. Electrical tools tend to command relatively higher fees because of the high risks of breakage due to abuse and regular power surges.

Insurance – The poor in East Africa hedge against risks by organizing and participating in informal insurance schemes to cover costs of commercial, funeral and festive events (Wright et al, 1999). Small periodic payments[15] are contributed to a common pool maintained by a treasurer from which settlements are made in the event of an occurrence. In Uganda the *munno mukabi* - a type of burial society/funeral insurance fund - is a growing phenomenon. Informal business insurance schemes, although less prevalent, are being developed especially among taxi drivers who insure themselves in case of being jailed for traffic offences.

Investments – Apart from savings in kind, for instance in livestock whose value might appreciate, ASCAs[16] are at present the only organized financial investment option for the poor. They have very high returns for net savers because the interest on loans averages 5% to 15% per month. The high interest is a reflection of the very short-term nature of the loan ranging from one day to one month. In addition, the high interest rates are a reflection of the high level of risk due to default that has been observed in several ASCAs (Wright and Mutesasira, 2001).

Money Transfers - The informal sector has devised mechanisms for money transfers within and outside countries of residence, to respond to the need for moving money for commercial purposes, paying school fees, responding to distant emergencies etc. Although there are formal money transfer options, the poor typically use bus operators, friends and relatives because they are rarely aware of the formal services. Relatives and friends are the most common way of transferring money. They do it at no direct cost except for the high risk of loss of money and the expected gifts in exchange for the favour. In Tanzania's informal sector the use of long distance bus and transport operators is rapidly growing. The service fee ranges from 3.5% to 35% of the transferred value decreasing with increasing amounts[17] of money being transferred (Sander et al, 2001).

What Lessons Can We Learn from the Informal Sector?

The informal sector is perhaps the *biggest competitor* for the micro-finance market segment. MFIs should pay close attention to its strengths and weaknesses as they seek to refine their products and promotional strategies (see Appendix 1 for ***MicroSave's*** Product Competition Analysis Matrices for an example of one approach to this).

[13] In Uganda bouncing a check is a criminal offence and comes with an automatic jail sentence.
[14] In the case of land for farming.
[15] Typically every month.
[16] Savings in kind are an important investment option but will not be discussed in this paper.
[17] The amounts vary significantly but typically range between $10 to $100.

In a number of cases the poor prize *access* above security. East Africa is awash with failed informal sector financial systems but despite this, access to a regular opportunity to save in a disciplined manner makes RoSCAs popular and deposit collectors sustainable. Deposit collectors charge an average of 3% of deposits per month for doorstep services. Related to access is the *speed* with which services are delivered, which greatly reduces the *non-financial transaction costs*. Sometimes it takes less than a minute, where the same transaction at a bank would have taken 30 minutes. In addition to access, informal financial systems are popular because of *proximity* to the clients, which drastically reduces the non-financial transaction costs.

While many authors have stressed that "*liquidity* is the key to local savings mobilization," it is important to note that in many instances in East Africa, the poor have demonstrated a strong "illiquidity preference". This "illiquidity preference" is in response to the poor's self-imposed need for structured and committed savings mechanisms that prohibit them from withdrawing funds and allow them to fend off incessant demand.

With the exception of successful ASCAs and auction RoSCAs, the return on savings in the informal sector is rarely above zero. In other reported cases, the poor often pay as much as 3% of deposits per month to save through a conveniently accessible system such as a deposit collector who visits daily to collect savings.

The informal sector is more dynamic than the formal or semi-formal financial sectors because of some of the following reasons (Adams and Fitchett, 1992):

- The range of services provided especially small daily deposits, short-term loans, and small loans.
- The speed with which services are provided.
- Reciprocity, which is often a strong basis for financial transactions.
- Financial innovations that engender flexibility, speed and suppleness.
- Unwavering discipline because non-performance is quickly punished and borrowers have to earn their loans.
- Low transaction costs especially on the part of the borrower.
- Proximity of the service provider to the clients.
- Savings as the basis of transactions and not subsidised outside cash.

RoSCAs, most of which tend to be short term, are very popular because of the savings *discipline* they impose. However, their rigid, cyclical and self-liquidating nature is also their disadvantage, for they are often incapable of responding to emergencies: the need to build-up larger lump sums over time, in many cases fluctuations in the members' cash flow and the need to store money in the short term. For example, if the pay out or prize comes a month before school fees are due, the member is then forced to safeguard the money on his/her own.

Informal insurance schemes[18], in spite of their social advantages, remain insufficient especially in rural areas where the risks tend to be co-variant. Given the risks, the potential demand is huge. One critical area of innovation is linking informal systems to formal ones. This is likely to reduce the transaction for both the clients and institutions (Wright, 1999).

Save for a few cases[19], the informal sector has not demonstrated much progress in money transfer because a good money transfer product must ensure accessibility, efficiency and timeliness, reliability, a sizeable service network – including outside major urban centres, and affordability.

Implications for Microfinance Institutions

The foregoing discussion on the variety of informal savings mechanisms recommends that MFIs wishing to deliver demand-driven, poor-friendly savings products should pay close attention to the following (Wright, 2000. Rutherford, 1999; Robinson, 200; Mutesasira, 1999):

- MFIs should find ways of responding to the poor's wide range of financial service needs which include loans, savings, insurance, money transfers and investment options. This range of needs can be offered in partnership with specialized institutions. For example, some MFIs have

[18] Burial societies (*munno mukabi)*, business insurance, *ngozi* (a traditional healthcare scheme in western Uganda) etc.
[19] These include the Somali community in East Africa which is reported to have a strong and well established informal money transfer system especially in Kenya

demonstrated that health insurance services can be offered in partnership with formal insurance companies that have the required skill set to deliver insurance products.

- MFIs should always conduct systematic market research, paying attention to the informal sector because it is a big competitor for micro clients. Market research should not exclude a focus on understanding the strengths and weaknesses of each mechanism in order to draw lessons that can be incorporated in product development, refinement, positioning, and promotional strategies.

- MFIs should design products and services around the customers' cash flow capacity and patterns. In the case of savings, insurance and loans these should be amounts clients can save, pay or repay in small sums, of varied value, as frequently as possible.

- MFIs should make every effort to design micro-financial delivery systems that are convenient to allow for local, frequent and quick transactions. They should have as little paper work and other non-financial transaction costs as possible. In the case of savings, this may demand innovations around mobile deposit collection services. These services can be offered at a cost recovery fee because poor people have demonstrated a willingness to pay for good quality convenience service.

Key Plenary Discussion Points

- Microfinance providers have neither the capacity, nor the ability to engage in the provision of insurance services. MFIs should work in tandem with specialised institutions that are already providing insurance services to up-market clients to develop products and services more appropriately tailored to meet the needs of low-income clients. For example, in Uganda, AIG is working with some MFIs to take advantage of their client base and money collection mechanisms through groups. AIG in its turn is designing insurance products that are affordable and suit the needs of these low-income groups.

- The microfinance industry is not reaching the very poor with its current range of products and services. In the example of persons living with HIV or who have full-blown AIDS, the cost of health care is extremely high, yet there is no appropriate health insurance product that caters for the needs of this group. Some MFIs are working on a pilot basis with poor people to try and develop health insurance packages targeted at the health care financing needs of the poor. Most of these programmes do not screen for HIV and the premium costs are taken up by the clients.

- Investments in unit trusts are currently available in some of the African financial markets. In East Africa, nothing is being done to develop investment instruments for the poor. However in Zimbabwe, Kingdom Bank is going down market and trying to offer investment instruments to the poor. To date their efforts have proved fruitful.

- When operating in the context of macroeconomic decline, the microfinance industry needs to recognise that informal systems have a huge ability to provide safety nets, which MFIs currently do not provide. Rather, MFIs increase the vulnerability of their clients. Informal systems place a high premium on social networks, so individuals who have not defaulted on previous loans can get more money out of the system when they need it. MFIs therefore need to devise ways of working more effectively with these informal sectors, particularly in the area of developing safety nets through which clients can access lump sums of money to smooth household income flows or meet emergency situations.

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Examples of Product Competition Analysis Matrices

1. Emergency Loan Product

Product: *Emergency Loan*	**Our MFI**	**Competitor 1 MicroBank Ltd.**	**Competitor 2 Freedom from Debt NGO**	**Competitor 3 Community Co-operative**	**Competitor 4 Money-Lender**	**Competitor 5 Itinerant Deposit Collectors**
Product (Design)						
Application to Disbursement Time	1 week	Immediate	2 weeks	4-5 weeks	Immediate	Immediate
Collateral/Guarantees	Group	100% Savings account	Group/25% Compulsory Savings	50% Share Capital	None – reputation	100% Savings
Duration of loan	< 10 weeks	< 6 weeks	10 weeks	4 months	Variable according to need	Variable according to need
Repayment Periodicity	Weekly	Weekly	Weekly	Monthly	Variable according to need	Variable according to need
Grace Period	2 weeks	None	4 weeks	1 month	Variable according to need	Variable according to need
Loan Size	KShs. 1,000-5,000 (depending on credit history)	KShs. 3,000-15,000 (depending on balance in savings account)	KShs. 500-2,500 (depending on level of compulsory savings)	KShs. 500-5,000 (depending on share capital)	KShs. 50-10,000 (depending on credit history)	KShs. 250-2,500 (depending on balance with deposit collector)
Access Requirements	Group membership, weekly meetings	A savings account at MicroBank	Group membership, weekly meetings	Share Capital, > 6 months membership	None except personal relations/references	Regular savings deposits with the deposit collector
Price						
Interest Rate	1% per week on balance = 52% APR[20]	Nominal 24% pa = 48% APR	Nominal 7.5% = 55.7% APR	2% per month on balance = 19.2% APR	3% per week = 156% APR	2% per week = 104% APR
Other Fees		KShs. 500		KShs. 100		
Late Payment Penalties	1.5% per week on balance	None – balance deducted from savings	None	5% per month on balance	Interest = 3% per week	Interest = 2% per week

[20] Annualised Percentage Rate

Product: *Emergency Loan*	**Our MFI**	**Competitor 1 MicroBank Ltd.**	**Competitor 2 Freedom from Debt NGO**	**Competitor 3 Community Co-operative**	**Competitor 4 Money-Lender**	**Competitor 5 Itinerant Deposit Collectors**
Pre Payment Incentives	Built into interest calculation	None	None – prepayments not accepted	Built into interest calculation	Built into interest calculation	Built into interest calculation
Promotion						
Marketing/Information Dissemination	At group meetings	Staff incentives liked to timely recovery	Limited	At AGM	Word of mouth	Word of mouth
Advertising	None	Radio/newspapers	None	Notices in branch	None	None
Place	In weekly groups in Nairobi (City Market, Kawangware, Kibera), Thika and Nakuru	ATM at branch in Nairobi only (City Market)	In weekly groups in Nairobi (City Market, Gymkhana Market, Eastlands) and Eldoret	In branch in Thika	In community throughout the country	At home or market stall throughout the country
Positioning						
Slogan/vision	"Flexible financial services for you"	"The solid bank"	"Compassionate and caring community service"	"Co-operation for progress"	None	None
Corporate Image	The newcomer – fast, customer-responsive services.	Professional bank – but the poor are not welcome	Nice words but hard actions … confusing for clients-this used to be an NGO that gave grants	Slow but very cheap service – get it when you can!	Important, quick if expensive service – but don't cross these guys!	Valued at-the-doorstep service
Product Image	Fast responsive loans that require disciplined repayment	Large (expensive) loans for rich people	Gentle loans – nice grace period and anyway FFD do not collect until the client can pay.	Cheap and slow loans – usually taken by friends of the Board	Rapid response loans that must be repaid on time	To be used in desperation when you want to keep saving
Physical Evidence	Clean new branch, clear, professional-looking passbooks	Smart cards, ATM, large, impressive branch	A little run-down, and covered with family planning/ nutrition posters!	Increasingly shabby and run down	None – no paper work	Very simple deposit collection sheets

Product: *Emergency Loan*	**Our MFI**	**Competitor 1 MicroBank Ltd.**	**Competitor 2 Freedom from Debt NGO**	**Competitor 3 Community Co-operative**	**Competitor 4 Money-Lender**	**Competitor 5 Itinerant Deposit Collectors**
People	Welcoming, professional "tough love"	Disdainful of poor people – not friendly at all	Friendly and caring – always offering advice: sometimes too much advice!	Most members are welcome	Hard businessmen making money	The friendly mobile banker offering good service
Process	Quick and efficient but the waiting period causes problems	High-tech and efficient	Too long and too much counselling en route!	Very long, time-consuming and not predictable	Fast and efficient	Fast and efficient

Examples of Product Competition Analysis Matrices

2. Current Account Savings Product

Product: *Current Account*	**Our MFI**	**Competitor 1 MicroBank Ltd.**	**Competitor 2 Community Co-operative**	**Competitor 3 RoSCAs**[21]	**Competitor 4 Itinerant Deposit Collectors**
Product (Design)					
Opening Balance	KShs. 500	KShs. 5,000	KShs. 250	KShs. 100 – KShs. 1,000	KShs. 50 – KShs.500
Minimum Balance	KShs. 500	KShs. 5,000	KShs. 250	N/A	N/A
Other Requirements	National ID	National ID Referral by 2 existing clients	National ID Share Capital of KShs. 500	None	None
Deposit Policy	Any number at weekly meetings	Any number at all times (through safe deposit)	Any number in office hours	Daily/weekly/monthly	Daily
Withdrawal Policy	Maximum 3 per month at weekly meetings	Any number at all times (through ATM)	Maximum 2 per month	By rotation daily/weekly/monthly	End of the month
Price					
Interest Rate Paid	2.5% on balances >KShs. 5,000	5% on balances >KShs. 25,000 6.5% on balances > KShs. 100,000	None	None	- 36% (approx) see withdrawal fees below
Overdraft Interest Rate Charged	No overdraft facilities	Nominal 24% pa = 48% APR	No overdraft facilities	No overdraft facilities	2% per week = 104% APR
Account Opening Fees	KShs. 150	KShs. 500	KShs. 50	None	None
Ledger/Statement Fees	None	KShs. 150 per month	KShs.100 per quarter	None	None
Deposit Fees	None	None	None	None	None
Withdrawal Fees	KShs. 25	None	None	None	1/30th of the amount deposited
Account Closing Fees	KShs. 150	KShs. 500	KShs. 150	None	None
Promotion					
Marketing/Information Dissemination	At group meetings	None	At AGM	Word of mouth	Word of mouth

[21] Rotating Savings and Credit Associations

Product: *Current Account*	**Our MFI**	**Competitor 1 MicroBank Ltd.**	**Competitor 2 Community Co-operative**	**Competitor 3 RoSCAs[21]**	**Competitor 4 Itinerant Deposit Collectors**
Advertising	Annual "Savings Week" campaign	Radio/newspapers	Notices in branch	None	None
Place	In weekly groups in Nairobi (City Market, Kawangware, Kibera), Thika and Nakuru	ATM at branch in Nairobi only (City Market)	In weekly groups in Nairobi (City Market, Gymkhana Market, Eastlands) and Eldoret	In branch in Thika	In community throughout the country
Positioning					
Slogan/vision	"Flexible financial services for you"	"The solid bank"	"Co-operation for progress"	None	None
Corporate Image	The newcomer – fast, customer-responsive services.	Professional bank – but the poor are not welcome	Slow but very cheap (loan) service – get it when you can! Savings are made just to get loans	N/A	Valued at-the-doorstep service
Product Image	The businessperson's current account: earns interest and charges depend on how much you use the account	The rich person's savings account – high interest, high charges, fast service	Save to buy share capital to get loans – no interest paid and regular ledger fees "eat your money"	The communities' own little savings systems – but make sure you trust your partners	The most convenient and efficient service in town … if you can find the right (trustworthy) collector
Physical Evidence	Clean new branch, clear, professional-looking passbooks	Smart cards, ATM, large, impressive branch	Increasingly shabby and run down	None – no paper work	Very simple deposit collection sheets
People	Welcoming, professional	Disdainful of poor people – not friendly at all	Most members are welcome	Our trusted friends and neighbours	The friendly mobile banker offering good service
Process	Quick and efficient but collections/ withdrawals only through weekly groups causes many problems	High-tech and efficient	Lengthy queues on market days but friendly service	Fast and efficient but inflexible in times of need or when you have more than the regular contribution to save	Fast and efficient – doorstep/market stall collection

Informal Financial Systems in West Africa: Developments and Insights for MFIs

Makarimi Adechoubou

Introduction

The financial landscape in West Africa, and particularly in member countries of the West African Economic and Monetary Union (WAEMO)[22], has evolved significantly in recent years. Since the banking crisis of the late 1980s we have witnessed the emergence of new financial institutions, which provide financial services for those excluded from the banking sector.

Today, West African financial markets have taken on a variety of forms with a number of sub-sectors with different constituencies, practices, legal status and modus operandi. These sub-sectors can be characterized as follows:

- The formal financial sector comprising central, commercial, development and specialized banks
- The informal sector comprising tontines, "mobile bankers" (*banquiers ambulants*), solidarity groups, moneylenders, etc.
- The so-called "intermediate" or semi formal sector represented by microfinance institutions (MFIs), which adopt a cooperative (mutualist), village banking or solidarity group lending approach.

The appearance of MFIs on the scene and the consolidation of their activities has not led to the disappearance of informal financial systems. On the contrary, these systems have multiplied and developed during the last 10 years or so.

What are the strengths of such informal systems and how can MFIs draw inspiration from their approach in order to improve the quality of the financial services they offer?

This article will attempt to respond to this question by reviewing the following attributes of the informal sector:

- Principal characteristics and approach
- Activities and the scope of their outreach
- Strengths and weaknesses
- Developments, lessons and implications for MFIs.

Principal Characteristics and Approach

Informal financial markets involve the complete range of financial transactions, which are neither legally recognized nor subjected to classic banking regulations, and are independent of other such external forces. Informal financial transactions can also be characterized by the fact that they are not subject to any formal oversight and control by the state.

The informal sector enjoys a number of economic advantages over the formal financial sector for a number of reasons:

- It is composed almost exclusively of individuals
- It relies on the existence of social cohesion
- It is flexible and responsive
- It adopts a simple approach
- It is not subject to regulation.

Studies in urban as well as rural areas of West Africa have demonstrated that more than 80% of the population participates actively in the informal financial sector. This sector has adopted a number of guises and is characterized by the diversity of the actors involved.

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22 The WAEMO comprises Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.

While conscious of the dynamic nature of the informal sector, it is nonetheless possible to establish a typology of the different types of informal financing available, namely:[23]

- Community-based institutions which are organized according to customary and hierarchical rights and obligations and do not allow for voluntary membership
- Tontines or revolving credit associations organized on an individual and voluntary basis
- Moneylenders and unofficial private banks, which respond to market demands or activities while avoiding regulation and official control. Mobile bankers belong to this category of informal finance.

Traditional Savings: In rural areas, a significant proportion of savings is in kind: livestock, jewellery, food-stocks, material, etc. While risk prevention or mitigation is an important driving force behind this approach to savings, it could also be considered ostentatious.

Money Guards are individuals of recognized moral standing – village chiefs, former civil servants, merchants etc. Their primary role is to provide a secure place to deposit savings, without interest accrual on the money. Studies have shown that this practice exists in a number of countries including Benin, Niger, Senegal, and Togo.

Individual Loan Sharks (Moneylenders or Friends) operate primarily in rural areas. While they may grant non interest-bearing loans to friends or relatives, it is more usual for them to grant interest-bearing loans using usurious rates of interest. These loans are granted to farmers during the planting season or harvest periods. The normal monthly rate is 10% but can be as high as 20-30%.

Mutualist Associations can be divided into two main groups: those that handle savings only and those that handle both savings and loans. The most well known members of this latter group are revolving savings and credit associations (RoSCAs), also known as *tontines*. As a popular method for providing informal financial services, *tontines* are diverse and have different names depending on the country or even different regions within the same country: *Esu* or *Adjo* in Benin and Niger, for example. There are three types of *tontines* in West Africa:

- *The mutual tontine* is organized according to the principle of solidarity between members who know each other well. This is a financial association created between people who decide to pool their savings and take turns in accessing the said pool. Each of the members gets the pooled money or "prize" according to a pre-established order, which can be subject to change. Every member can also lend money or take out a loan. In theory, debts are not subject to interest.
- *The financial tontine* allows the distribution of pooled money by mutual agreement or sometimes even auction. Here members can influence the order of rotation according to their needs. Those that take out a loan before their turn pay interest, and those that save earn interest on their savings.
- A manager, who visits his clients, takes deposits or savings and grants advances and loans, administers *the commercial tontine*. Administrators of this type of *tontine* are also known as mobile bankers.

Mobile Bankers: As we have seen, it is possible to categorise mobile bankers as members of the larger family of tontines, but there is a clear difference between these two. Mobile bankers are not members of a social group, are not subject to reciprocity or solidarity, or assisting others on festive occasions. Rather, they are independent and dynamic individuals that apply a personal touch to the relationship between banker and client.

Their work consists of visiting their clients regularly to offer them financial services. The approach most frequently adopted involves handing over a card with 31 boxes or cells as well as the name, address, and sometimes even a photograph of the banker. The client and the banker agree on the amount to be put aside each day and, when the card is completed, the banker returns the total amount to the client minus a single payment, which is considered as commission for services rendered. Variations on this theme also exist: rather than make a deposit every day, the client can do so every two or four days or

[23] Hugo, Philippe (1996): "Uncertainty, Risk and Local Finance: The Case of African Economies", *Third World Review*, Volume XXXVII, N° 145, January – March 1996.

every market day. The period of time during which the deposits are made can extend to cover several months.

Tontine Banks adopt an innovative approach by combining elements of the mutual and commercial tontines. These banks made their first appearance in 1995 in the larger towns of countries like Benin, Mali and Togo, and are distinguished by their sedentary nature. They are agencies or establishments that collect savings and disburse loans.

Activities and Scope of Operations

Studies and research carried out in recent years in Benin, Mali and Togo[24] have made it possible to measure the degree of dynamism in the informal financial sector, as well as identify its main characteristics and activities.

The work of the mobile bankers, for example, has developed and diversified as it progresses from the initial function of money guard (*Ndanayamoko* in Mali) to that of someone who grants advances and loans. The volume of their financial activity is far from negligible. Estimates suggest that in Benin 9 billion FCFA[25] ($12.5 million) and in Togo 3.2 billion FCFA ($4.4 million) are collected annually.

While the clientele of mobile bankers is composed mainly of women, many of whom are involved in small-scale businesses, it also includes craftspeople, small and micro-enterpreneurs, service providers, apprentices, civil servants etc.

The management system applied by mobile bankers is simple and flexible with the cost of financial intermediation varying from one product to another. Collecting savings and granting advances during a cycle is subject to a monthly fee of 3.34%, while a 5% interest rate is applied to loans in Benin and a rate of between 10% and 30% is applied in Togo.

Mobile bankers maintain relationships with the intermediate sector and with banks in order to be able to deposit excess liquidity. Moreover, they make an effort to create representational structures at the national level in order, among other things, to normalise their profession.

As the *tontine* system has developed towards a more sedentary form, the experience of Convergence 2000 in Benin is worth mentioning. Created in the early 1990s, this organization distinguishes itself from the traditional *tontine* by the way in which its clients gain access to savings and credit services. Convergence 2000 offers its clients a service characterized by its proximity. Its loan officers visit the clients to collect savings on a daily, weekly or monthly basis. The management tools applied are the same as those used by mobile bankers. The loan products developed – advances and credit – are linked to savings.

Strengths and Limitations of Informal Financial Systems

The success of the informal systems stems principally from the way they adapt to the socio-cultural environment in which they operate. Their strengths are well known and can be summarized as follows:

- A constant search for physical and social proximity for operational purposes
- An approach to collecting adapted to the needs and customs of the populations concerned
- The flexibility of their methodologies and procedures
- Low transaction costs
- Good recovery rates on the loan products.

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[24] See for example ***MicroSave***'s studies: Kalala, Jean-Pierre and Alpha Ouedraogo, (2000) "Savings Products and Services in the Informal Sector and Microfinance Institutions in West Africa", and Goldstein, Gilles, Issa Barro and Dominique Gentil (1999), "The Role and Impact of Savings Mobilization in West Africa: A Study of the Informal and Intermediary Financial Sectors"

[25] According to the UN exchange rate for September 2001, 1 US dollar is equal to 722 FCFA.

This gives informal finance an important role among social groups that do not have access to the formal financial sector. That said, despite their significant economic impact, informal financial systems present the following inconveniences:

- Some of these systems operate within a limited group based solely on individual savings and are not able to satisfy the financing demands for economic activities which exceed available savings
- The savings are not always very secure, and some mobile bankers have been know to "do a runner" with the savings collected
- The proportion of savings invested is limited and is only invested on a short-term basis because of its very nature.

Developments, Lessons and Implications for MFIs

Although reliable figures are not available to allow for a realistic appraisal of the dynamics and recent developments in the informal financial sector, the experience of several countries in the WAEMU points to a strong move towards the "informalisation" of the economy since the 1980s. In most of these countries, we have witnessed the revival of the *tontine* and the development of the mobile bank. At the same time we are seeing that groups operate within the informal sectors in order to resolve issues of security, moral hazard, and access to capital. Thus, we are in a situation where the informal financial sector is sure to continue developing, particularly in light of the growth of urban areas and the increasing pauperisation of those who live there. What should we do? What are the lessons for MFIs, and what kind of linkages should be developed between the two sectors?

There is really no concrete answer to these questions at this point in time. However, studies in Benin and Togo have shown us the following:

- MFIs have been inspired by the informal sector approach to increase the proximity between loan officers and clients, simplify their procedures and make them more flexible, and adapt their products and services to their clients' needs.
- The potential for promoting a business relationship between mobile bankers and the local branches of savings and credit cooperatives should be explored.

Also, one of the most controversial questions has to do with knowing whether to intervene in the informal sector and, if so, what approach to adopt.

Above all, it would be worthwhile to continue to improve our understanding of the informal financial sector and to work with the key players to reflect on strategies that support and complement these activities, such as:

- Developing a framework for exchanging information and training
- Creating the conditions to increase the range of financial services offered
- Developing linkages between MFIs and the formal banking sector.

In actual fact, it is unthinkable that the informal sector will disappear or be absorbed into the formal sector in the medium term. The informal circuits are dynamic, as can be seen by the multiplicity of mobile bankers and the more recent appearance of *tontine* banks.

Finally, there should be no systematic opposition between the formal and informal financial circuits. Linkages exist with respect to their respective modus operandi, and these should be rendered more dynamic by tapping the networks of guarantees and proximity offered by informal finance.

Key Plenary Discussion Points

- The West African Economic and Monetary Union (WAEMU) has had some positive impact on the microfinance industry of the member states. The same law regulates all MFIs in WAEMU, and all MFIs are expected to adhere to this law. The Ministry of Finance in the respective countries supervises all the MFIs. However, it must be noted that the regulation does not address certain idiosyncrasies pertaining to particular MFIs, some of which are very developed, including cooperatives and *caisses villageois*. Discussions are currently underway to address the needs of particular institutions in this market.

- West African NGOs have not developed very good market research techniques; their focus still remains on rolling out products that they have developed without input from clients on their financial needs and priorities. Clients feel that the MFIs should be coming to them, and because the institutions have not responded to this gap, the clients do not feel obligated to repay loans. On a positive note however, some market research initiatives are taking place. ***MicroSave*** is collaborating with some MFIs in the region to this end. Similarly, CIEF, based in Burkina Faso has initiated market research activities to try and address client needs in the microfinance industry.

- The regulation of the microfinance industry that has been adopted in West Africa has its origins from outside the region, and does not accommodate the socio-cultural situation in the region. The recognition of this situation is coming to light, and work is commencing to try and correct this situation.

Informal Financial Systems and their Implications for Formal Financial Systems in Southern Africa

Roland V. Pearson, Jr.

Introduction

Informal financial systems in the southern African region share many of the same characteristics of informal financial systems anywhere in the developing world. However, there are two attributes that distinguish it and give it some special dynamics – its regional scope, and the linkage to the formal financial system.

As recent studies by ***MicroSave*** and others have shown, the informal financial system in southern Africa includes the fairly typical array of rotating savings and loan schemes and their various permutations among the poor. Like in many other places, poor people in southern Africa seem to value safety of and access to their savings over the return that they can receive on their funds. (Although this might change with certain factors discussed below, and be a product of the paucity of savings choices for poor people, rather than a real preference to just hold money safely, over getting a real return). In southern Africa, like elsewhere, entrepreneurs and poor consumers alike need access to lump sums of money either to take advantage of short-term business opportunities or for significant life events, such as marriages and funerals.

It is perhaps here at this latter shared trait that the relative uniqueness of the southern African market begins to take shape. Southern Africa (herein defined broadly as South Africa, Zimbabwe, Zambia, Swaziland, Lesotho, Botswana, and Namibia, with the purposeful, if not geographically correct, exclusion of Mozambique) has some of the highest HIV/AIDS infection rates in the world. This is partially a result of a key dynamic in the region, namely the prevalence of migrant labour, which in turn financially, leads to heavy remittance and transfer activity. It also has substantially raised the social importance and financial burden of death, including the increased proportion of family finances going towards funeral expenses, and the financial strain on remaining businesses and family members. This profoundly sad phenomenon also has opened the opportunity for and put pressure on the formal financial system, mainly insurance companies, but also banks and others, to offer largely non-credit financial products to the poor and low-income sectors of the southern African economies.

Status and Dynamics of the Informal Financial Sector and Poor Communities in Southern Africa

The informal financial sector used by poor people in southern Africa includes RoSCAs and ASCAs, savings clubs, savings at home, savings in kind, and reciprocal lending. All of these mechanisms or their likenesses exist in most developing countries, and the ones in southern Africa seem to reflect the usual array of characteristics and dynamics as those in other regions of Africa and elsewhere. Most of them include relatively heavy participation from women. Common bonds tend to be personal and/or geographic. They tend to include fewer than 30 members. The ability for these schemes to grow financially is limited by the meagre or negative (at least in real terms) financial returns achieved. Many participants in these schemes rate flexibility, proximity, reciprocity, and friendliness as important attributes for financial services, and these informal mechanisms tend to meet these desires very well.

Where things begin to become interesting in the region is among the savings with employers and suppliers, credit and lay-by relationships with supermarkets and furniture stores, and perhaps most importantly, burial societies. These mechanisms are technically informal in that the transactions and sometimes the institutions are not formally recognised or regulated by any official authority. Contracts and agreements tend to be undocumented or only loosely documented, and/or there is no industry organisational framework.[26] However, all of these mechanisms include an explicit and strengthening link to the formal sector.

[26] The dynamics change quickly. In South Africa, furniture companies that sell furniture on credit and lay-by arrangements are regulated by the Micro Finance Regulatory Council, since the terms and conditions of sale meet the criteria for a microfinance transaction, even though it just looks like selling furniture. Because of a usury law in the country, it was determined that the effective interest rates charged through credit and lay-by arrangements, as opposed to the cost of furniture that was purchased on a cash basis, needed to be controlled. Many poor and 'not so poor' individuals acquire household goods through such schemes.

Recent surveys by Escom in South Africa of financial and socio-economic attributes of poor people reveal a pattern found elsewhere in the region, as well. Burial societies, with about 6.5 million members, comprise the single most used financial service. Yet, that is closely followed by four services offered by banks and retail stores, namely savings accounts (card and passbook based), ATM cards, store credit card, and current accounts. *Stokvels*, which are semi-formal savings and sometimes credit associations, fall way down the list, with fewer than 1 million members (see chart below).

Table 1 – Types of Financial Services Used

Instrument	**People (m)**
Burial society	6.5
Savings account - card	5.28
ATM card	5.01
Savings account - book	4.32
Store card	4.24
Current account	2.65
Stokvel	0.9

MicroSave*'s* recent work in Zimbabwe revealed a similar prevalence of burial societies, and went on to explain the close relationship to the banking sector too. In short, burial societies and other informal and semi-formal schemes in southern Africa use the formal banking system to deposit their money. However, as will be shown later, they receive very little other service from those banks.

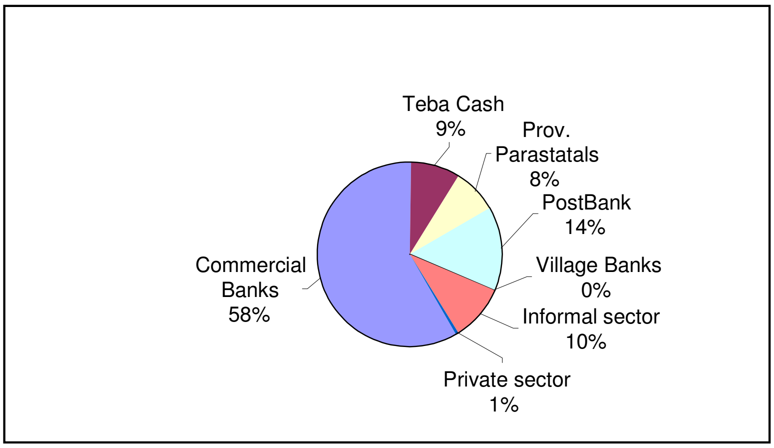
Percentage of people by area with specific financial services				
Financial service	**Total**	**Metropolitan**	**Other urban**	**Rural**
Account with bank	35	54	50	18
Insurance or assurance policy	20	34	32	6
Unit trusts	4	9	6	1
Postbank account	3	3	5	3
Shares	2	3	2	0
Other investments (formal)	5	8	8	1
Burial society	27	29	26	25
Medical aid	15	29	27	3
Stokvel	4	5	3	3

Other studies in South Africa show an even more pronounced use of banks. Nationally, 35% of poor and low-income people, the greatest proportion, have a bank account. The second most used service, at 27%, was burial societies. Consistent with the comments raised above, insurance, mainly life and burial insurance, comes in third at 20%. Even in rural areas, with relatively higher proportions of poor households and less access to banks, bank accounts still come in second at 18%, with burial societies at 27%. Insurance comes in a distant, but important, 6% in third place in rural areas (see chart above).

Another key attribute in the southern African landscape is the mobility of the population across national and international boundaries. The Escom studies in South Africa estimate that only 30% of the population has never moved. Lesotho has been historically described as a labour reserve for South African mines. About one half of those who are formally employed work in the mines of South Africa. Around one third of the gross national product (GNP) comes from migrant miners' remittances. Even though the employment of migrant mineworkers has been declining in recent years, following a peak of 126,733 in 1989, it was still estimated to be around 77,000 in 1998. Teba Cash has historically existed only to transfer miners' salaries to their families throughout the region. Some say that there might be as many Swazis in South Africa, especially Mpumalanga Province, as there are in Swaziland, and Swaziland's dependence upon South Africa as an 'export' market is undisputed, and draws many Swazis across the border to trade. ***MicroSave****'s* researchers in Zimbabwe found consistent cases of Malawian farm workers, often third or fourth generation in Zimbabwe, dependent upon the Zimbabwean economy and the informal and other financial networks of Zimbabwe.

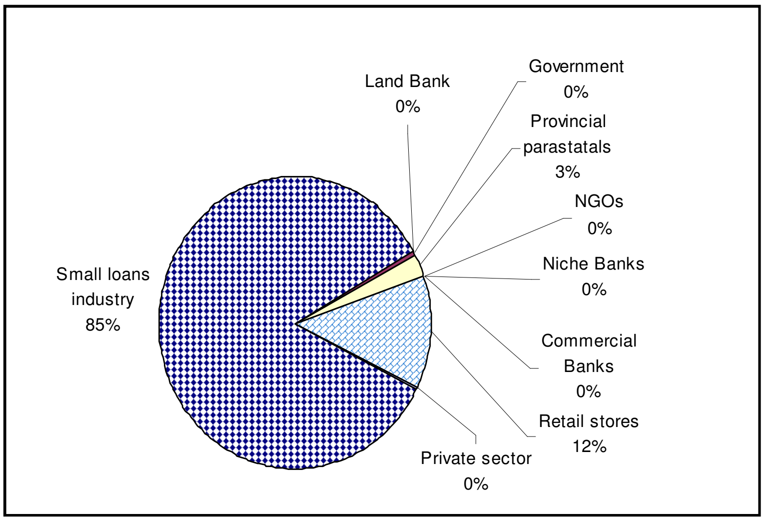
Status and Dynamics of the Formal Financial Sector in Southern Africa

Relative to the rest of the continent, and particularly in South Africa, the formal financial sector in southern Africa is complex, dynamic, and quite advanced. From banks, to building societies, to unit trusts, to stock exchanges, to internet-based banking, to off-shore structured finance, the formal financial sector in the region offers just about any institutional type and financial product known anywhere else in the world. Yet for the poor in the region, it largely dis-intermediates funds.



As shown in the chart to the left, banks in South Africa hold the vast plurality of savings deposits. The recent ***MicroSave*** research in Zimbabwe showed a similar trend there, with building societies and banks amassing 70% and 15%, respectively of the deposits of savings clubs. People like the safety perceived through the permanence of these institutions. They also clearly put their money where it is cheaper (i.e. lower minimum deposits, closer proximity of the branch, fewer or lower account charges, fewer restrictions on withdrawals, etc.).

On the other hand, it is patently clear that across the region, these same banks and building societies do not lend to those same individuals. In Zimbabwe, only nine housing cooperatives, out of an estimated number of more than 300, have accessed any loans from building societies, despite holding the bulk of their savings in these same institutions. Close to US$1 million in deposits has generated less than US$100,000 in loans to the housing cooperatives. Banks in South Africa that hold almost 60% of the total deposit base, lend less than 0.5% of the total amount of credit disbursed to the poor and low income sector there. Rather, it is the largely privately owned consumer/cash/payroll lenders, most of whom do not have bank licenses, who lend predominantly to poor and low income groups in South Africa, mostly in urban areas.



Small, isolated rays of hope have begun to shine. Homage Funeral Assurance in Zimbabwe is specifically targeting the poor and providing comprehensive funeral and related services. Kingdom and Century Banks, as well as Commercial Bank of Zimbabwe have dipped their toes into the market, beyond simple deposit taking. In South Africa, there is anecdotal evidence that some of the 'alternative lenders' – some of which are banks, and some of which are just finance companies – might be willing to collectively risk as much as US$6 million of their own capital (just over 1% of the total small loans industry loan disbursement in a year) on micro, small, and medium enterprise credit, and other markets that typically have no real security or collateral to offer.

Implications for Formal Players

This very quick and rough sketch of the informal and formal financial systems in southern Africa would seem to point serious actors to five major issues:

Lower the transaction costs – One way or another, poor people put priority on lowering the cost of financial services. Given the region's relative technological advancement and seeming willingness among most clients to use electronic transactions, formal financial institutions need to seriously explore ATMs, debit and credit cards, smart cards, EFT, Internet based solutions, and all other manner of modern innovations, to the extent that they provide the most cost-effective solutions.

Look on the 'other side' of the balance sheet – Credit for the poor is a tough business, and most formal institutions do not have the institutional knowledge or stomach for it. However, there is clear demand and need for liability based and fee based services. Insurance, particularly life and funeral insurance, is perhaps the biggest and most important area where the formal sector can add value and make money. The current HIV/AIDS pandemic and related malaise will overwhelm the rudimentary and largely de-capitalising informal structures of burial societies. These informal groupings and their members need the actuarial expertise and investment muscle of the formal insurance industry. Similarly large opportunities and keenly demanded services exist in various forms of funds transfer.

Encourage institutional and product diversity – Within prudent, but not restrictive, regulatory frameworks, formal financial institutions must be allowed to diversify their structures, and in turn, their product lines, to meet the multifarious needs of poor clients and to diversify their risks. Outmoded barriers between banking and insurance not only limit the options available to the poor, but also actually raise the costs and risks to the institutions of serving poor clients.

Don't worry too much about 'warm and fuzzy' – Perhaps many have put too much emphasis on encouraging community-based models of finance. As the Zimbabwe research and other observations reveal, the common bond informal mechanisms are really social constructs with financial attributes. When it comes to the nitty-gritty of the financial transactions, the same members who love the chumminess of the burial society, *stokvel*, RoSCA, savings club, etc. meetings, appreciate (even prefer) the security, efficiency, transparency, and independence of properly delivered financial services from formal institutions. All of the semi-formal mechanisms that try to take advantage of the community bond that is common among informal schemes (e.g. SACCOs, village banks, FSAs, etc.) inherently and consistently fall down in areas of governance, management, etc. Maybe the answer is to let fundamentally social constructs stay as such, skip the semi-formal mimics, and concentrate on improved formal financial service delivery.

Proxies, agencies, and linkages – Bridges must be built between poor communities and formal financial institutions. In part, the use of proxies and agents like supermarkets hardware stores, or petrol stations can help to lower transaction costs by placing services closer to clients than they otherwise would be if delivered by the actual financial institution. This strategy also helps to realise economies of scale, by using existing infrastructure and other resources, and, in turn, lowering transaction costs. Yet this strategy needs to go deeper to include employment of burial society representatives, for example, in service design and delivery. Such tactics should improve lines of communication and act as a conduit for both poor communities and formal financial institutions to learn about and understand each other.

Key Plenary Discussion Points

- Formal players should try to lower the transaction costs of doing business. The East African microfinance industry should watch and learn from what is going on in South Africa; significant innovation is taking place that may be instructive to institutions seeking to lower their institutional costs.

- In South Africa, regulations may be in place to govern the microfinance industry, but sometimes they are not followed. Due to a gap in adequate and appropriate range of products and services for low-income groups, some practices have been exploitative of the poor. For instance, some institutions take the ATM cards and PIN numbers of individuals wishing to access loans from them. The trend however is towards introducing more client-friendly approaches in financial services. Otherwise financial service providers will be restricted to competing on price alone. Even though client friendliness was not always the top priority for them, South African institutions were still being responsive enough to client needs to grow quite rapidly.

- Supervisory regimes need not be dependent on central bank oversight. Each country needs to decide on the type regulation it wants for its industry. Developing a regulatory framework for the microfinance industry in West Africa was a highly participatory exercise, at the end of which all the parties involved were happy with the outcome. South Africa's regulatory regime is separate from the Central Bank. The South African model has worked better than others tried elsewhere, which have been driven by central bankers. Central bankers typically have a rigid approach to risk. In most countries, central banks have not fully resolved issues of regulating the commercial banking sector, their bread and butter business, why should this same institution go into a whole new arena in which it has no experience?

- It is dangerous to talk about central banks making sure that all parts of the financial system exist because some of these parts exist elsewhere – in the informal sector, or should exist in a particular form. If industry players understand the role of microfinance in the lives of the people we are trying to help, then we will have the opportunity to transform the industry and the institutions within it into appropriate forms, to oversee delivery of services to clients.

- Microfinance institutions have taken the informal financial systems and subverted them to their advantage; the socio-cultural ties in informal financial system are crucial in the operations of informal financial system. Microfinance institutions take advantage of the group mechanisms as a means of guaranteeing loans they disburse to their clients, but they do not enforce the peer pressure needed to manage delinquency and ensure that the onus of collecting outstanding loans falls on the peer group members.

The Informal Sector in India: The Twain Shall Meet

Sukhwinder Arora

Introduction

Financial Services in the formal and informal sectors can be separate segments of the market with a limited number of customers having effective access to both the markets. The evolving scenario in India, however, indicates that the *Twain Shall Meet* or indeed are already meeting, and the formal financial sector is now actively linking up with informal self help groups.

Financial Services for the Poor

Financial services for the poor have often been misunderstood as micro credit for small business. In fact, one of the most important financial services is the opportunity to save small amounts, in order to generate larger sums for consumption or investment purposes. There is an increasing recognition that poor households, like everyone else, have a variety of needs for meeting expenses connected with life cycle – marriage, birth, old age etc. – or emergencies. Financial services, whether through access to credit or insurance, can provide important elements of a safety net. In active local economies, many poor households are also able to identify and invest in emerging opportunities such as buying land or starting/expanding micro enterprises. The financial services needed are determined by the specific context of the family and market opportunities, and a variety of financial products are needed. Services are also needed on an ongoing basis and one-off services are rarely enough. However, as limited financial services are available to poor households, they are often forced to match (or even fudge) needs and availability.

Formal Sector: Impressive Infrastructure but Waning Interest

The formal financial sector has substantially expanded outreach in the last 30 years. There is a bank branch for every 15,000 persons and even isolated rural areas can boast of a bank branch. However as the National Task Force on Supportive Policy and Regulatory Framework for Microfinance (NABARD 1999) noted "…[despite] having a wide network of bank branches in the country and implementation of many credit linked poverty alleviation programmes, a large number of the very poor continue to remain outside the fold of the formal banking system. Various studies have suggested that the existing policies, systems and procedures and the savings and loan products often do not meet the needs of hardcore and asset-less poor".

With ongoing reforms since 1991, the financial sector is also experiencing de-regulation. There is an emergence of private sector and specialist micro finance institutions, but the public sector dominates the financial landscape. Policy does not reflect the fact that it costs more to deliver good quality micro-savings and loan products to poor households. Interest rates on individual loans below Rs. 200,000 (approximately $4,000) are still controlled and unviable for commercial banks. Is it any surprise that the commercial banks are losing interest in small borrowers' bank accounts with balances below Rs. 25,000 (approximately $500), whose clients have declined from 63 million to 50 million between 1992 and 1997? These accounts represent 13% of the overall outstanding loans in 1997 as compared to 22% in 1992.

Informal Sector: Down but Not Out

Policy plans for a long time have focused on reducing the dependence of the poor on the informal sector. The Government of India suggested in 1954 the need to "…provide a positive institutional alternative to the moneylender, compete with him, remove him from the forefront and put him in his place". Rapid expansion of the banking sector took place and rural households' indebtedness to informal sources[27] dropped from 84% to 36% between 1961 and 1991. However, the poorer the household, the greater their dependence on the informal sector - poorest households (assets <$100) dependence on informal finance was as high as 58% in 1991. Many studies supported by DFID and others document the dependence on moneylenders, relatives, friends and user-owned devices such as Rotating Savings and Credit Associations (RoSCAs) and Accumulating Savings and Credit Associations (ASCAs).

[27] Government of India Debt & Investment Survey, 1992

Exploding Self Help Groups (SHGs), But What Are These?
SHGs (many of which operate as ASCAs) are becoming quite common in India. There are variations, but most SHGs are informal, with less than 20 members from a neighbourhood. Although men form SHGs, most groups consist of women members. These groups are self-managed, self-governed and initially self-financed. These groups are not to be confused with solidarity groups[28], as SHGs exercise considerable control over setting, modifying and enforcing rules for group functioning.

Initially promoted by NGOs, the SHGs received significant policy attention and support in the 1990s. Although NGOs continue to promote these groups, some state governments, banks, and Zilla Panchyats[29] have also undertaken significant SHG promotional activity. Over 260,000 SHGs, with 5 million members, already have access to bank resources, compared to 30,000 SHGs in early 1999. Between 2000-2001, banks disbursed $60 million to SHGs. Plans have been drawn up to link one million SHGs, with 20 million members, by 2007/2008.

SWOT Analysis of SHG-Bank Linkage Programme

Strengths	Weaknesses
• Starts with members savings • Flexible (member-determined) services starting with small loans for consumption/emergency (respond to needs and evolving capacity) • Voluntary/low operating costs – SHGs sustainable even with low volumes • High repayment rates • Enhances confidence/capacity of members • Provides training/space for community leadership • Lowers transaction costs for members and banks • Empowers women and communities	• Not all poor households have mutual trust, clear leadership or capacity to maintain accounts • SHGs often need a higher level structure to motivate, balance funds flow (across groups/time), learn and share lessons, supervise/audit • Quality of bank linkage is still an issue in terms of adequacy of funds, on-time availability and dependence on the attitude of the concerned banker • Not suitable for large (say >$300) or long term loans (say >2 years) to individual members • Transaction costs for banks still an issue • Dependence on subsidised bank funds • Time consuming for members • Men are largely ignored • Largely ignores the urban poor
Opportunities	**Threats**
• Quick scale up with de-centralised actions by a number of actors (>1000 Self Help Promoting Institutions) • Significant leverage of/for existing banking infrastructure • SHG graduates can access individual loans from banks (in theory) • Improve repayment ethics (current repayment rates for direct bank lending <60%)	• Quick scale up with government support: not enough attention on quality assessment and enhancement • Government grants to groups will distort incentives for members to form groups • Limited ability or simply time with bankers to assess group quality • Issues for higher level structures (cluster/federation/NGOs) remain -- incorporation; cost efficiency and recovery; centralisation/ governance

[28] Which through peer pressure and joint liability help to ensure loan repayment to a micro finance institution
[29] Third tier local government bodies

Towards a Strategy

Banks lending to informal Self Help Groups on such a large scale have provided a new momentum to the microfinance movement in the country. However the model has weaknesses that need to be recognised and addressed. It is also clear that many poor households will switch from one type of service to another or indeed access multiple services as and when options become available and their needs change and expand. Moreover, in a large pluralistic society of over 75 million poor households, no single approach can address the scale and diversity of services needed. This is especially so, as the microfinance sector is just emerging. This only reconfirms the need for significant innovation and experimentation.

DFID India finalized a microfinance strategy in January 1998, which focuses on a three-track approach:

- Develop sustainable financial service providers within a financial system (elements included upgrading informal institutions; linking non-formal with formal systems; establishing new institutions and adapting formal banks to the needs of the poor)
- Promote sound practices (elements include flexible savings as a key service; poor-friendly loan products; sound accounting practices; market research)
- Regulatory reform and enabling policy environment (elements include interest rate de-regulation; regulation of deposit taking; and prudential banking regulations and supervision).

DFID currently supports three microfinance projects:

- *Credit and Savings for Household Enterprise* (£9.85M 1999-2006), implemented by CARE India. The project will support 24 NGO partners to work with SHGs covering 200,000 women members in three states. Based on this experience, the project will also provide capacity building and policy advocacy support to other stakeholders.

- *National Micro Finance Support Project* (£16.5M 2000-2007), implemented by Small Industries Development Bank of India. The project will support 90 microfinance institutions and 10 formal financial institutions in rural and urban India to sustainably reach 1.3 million clients. The project will support capacity building by a range of providers, action research and policy advocacy for a more enabling regulatory environment.

- *Financial Deepening Challenge Fund,* Recently launched in two states to support formal financial institutions on a competitive basis to innovate and reach low-income customers normally not serviced by the formal sector.

Key Plenary Discussion Points

- The transaction costs of borrowing from banks are still high. However, with the SHGs, the groups themselves fix the interest rates on loans. Once a borrower has repaid a loan in the SHG system, then s/he can automatically get a follow-on loan, something which is not a given within the banking sector.

- In some areas, SHGs do not have a high demand for credit, and therefore have net savings. If banks operating in such areas took advantage of this pool of money, by giving the SHGs a good return on their savings, they could begin to draw these groups into the formal system and encourage them to mobilise savings. However, the government has not given banks the incentives to perform efficiently to take advantage of new markets. So banks continue to perform inefficiently, because they are used to operating under the protected public sector behaviour, and they do not venture into new markets, where they could begin to forge linkages with the informal sector.

- The microfinance sector in India is providing short and medium term financing for housing related loans. Sewa Bank has mobilised its clients' resources and about 50% of the lending it does is housing finance.

- SHGs have to be self-selecting because if external supporters promote them, they probably will not have longevity. Twenty people on the street may share poverty but they may not share mutual trust. The big advantage of SHGs over solidarity groups is that they save small amounts at a rate decided by them, a rate which is affordable to them. Members are not under pressure to take loans, they borrow when they are ready and in the amounts they would like to have. In India, there still exist issues of caste and class, landless and landed, giving a great diversity of issues to be addressed from a socio-economic perspective. Many SHGs generally want to be inclusive and support those who may be left behind; their willingness to help their neighbours may be higher than we may expect.

- SHGs, in the form of informal neighbourhood groups have existed for a long time in India, either as Chits, RoSCAs, or ASCAs. Families would contribute about Rs.2 per week into a fund, and on the death of a family member, the family is paid out their savings within 2 hours of confirmation of the death. Practices such as these have been going on for over 30 years. More recently, SHGs are being linked to MFIs. The women members sit on the board of the MFI and provide guidance to the institution wishing to provide services to the SHGs. This trend is emerging where people have been exposed to new ideas, however, it is important to understand that initial promotion is necessary before groups such as these begin taking root. They need support as they move towards integration with the microfinance industry.

- There are people who are trying to promote managed RoSCAs. RoSCAs themselves come in different varieties. Typically, members will decide on a contribution amount, and then the pay out will be carried out by lottery. In this auction system, the members will contribute a given amount, and then they bid for that pool. The highest bidder gets the pooled funds. The next round of bidding involves one less person, and the pool of money for which members are bidding becomes progressively lower. A manager oversees the entire process and gets a payment of about 5% of the total amount of money in the pool.

Plenary Discussion: Challenges for the Microfinance Sector in East and Southern Africa

Moderated by David Ferrand

- There is currently a ***large gap between the supply of and demand for financial services*** for poor markets. These markets exhibit a diversity of needs, and yet those of us who work in them talk of microfinance as though it were a homogeneous sector, which it is not. There has been an overwhelming and grossly misplaced focus on a single need – credit for enterprise. It is imperative that we begin differentiating market segments among poor groups.

- ***Informal financial systems have demonstrated themselves to be very positive in many ways***. Within these informal financial systems, we encounter financial service providers who are quintessentially market focused and sustainable; these service providers go about their business without any expectation or reliance of external subsidies. The microfinance system could learn a key lesson by tuning in to the financial needs of poor markets and developing and delivering services that answer those needs. However, on a cautionary note, we cannot neglect the truth that from an economic perspective, informal financial systems are not ideal financial intermediaries, because they are fraught with high risks and mismanagement. The microfinance industry therefore should not look to replicating the mechanisms in the informal system, but rather, take some of the positive attributes of the operations of these systems and apply them to its operations.

- ***Financial service provision is not concentrated in the microfinance sector***, but rather through the commercial banking sector, or in highly informal systems. One might argue that the microfinance sector exists to provide low-income populations access to financial services. If the objective is to reach large numbers of poor people, the informal sector has been more effective in doing this. In central Kenya formal microfinance institutions mobilise roughly 5% of savings among poor groups and disburse roughly the same proportion of credit to the same population category. In contrast, managed ASCAs are intermediating three times the amount of money handled by MFIs in this same geographical region. The formal banking sector is mobilising 60-70% of savings from the poor, but does not extend credit to this group; money is moving from one set of people, the poor, to another, the rich. The poor, who have a right to accessing financial services, are therefore opting into mutual arrangements because these are the only channels that allow them that access.

- ***Informal financial systems cannot reap the advantages of economies of scale*** because they have an extremely limited product range. However, they are responding to the needs of the poor on an individual level by diversifying access for the poor. The poor are keenly aware that informal systems are responsive to their circumstances; if a poor person deposits their money in a bank that bank will not "know" the poor person when s/he encounters a crisis situation. However, once that poor person has accepted the risk of losing her/his funds in the informal system, s/he knows that should a crisis situation emerge the situation will accommodate her/his circumstances. For instance, should s/he not be able to meet loan repayment obligations, the informal system would look upon her/him with some leniency.

- ***Is there profit to be made by lending to the downmarket niches?*** Commercial banks still remain reluctant to deliver financial services to low-income groups, even as MFIs continue to tap into this market segment, primarily through their micro credit programmes. However, MFIs still have a long way to go in meeting the demand that exists in the down market niches. It will be critical for financial service providers to develop appropriate products and services, because it is only through these innovative strategies that they will be able to reap even higher profits than they have been doing in the past. Perhaps the loan products that are currently on the market do not appeal to the needs of the target market. Unless this information is sought and action taken to improve on product design and delivery, sustainability will remain a seemingly insurmountable challenge, and MFIs will continue to find it impossible to reach the break even point because client retention is compromised by offering inappropriate products and services.

- ***The microfinance sector has raised profile of women's ability to save and access money***. However, this money disappears into the formal sector thereafter. The informal sector exhibits a strong gender divide. Women have a higher commitment to saving small amounts, can adapt better to operating within group situations where high trust levels are required to enable the group to work. Men generally need access to larger amounts of money and are less inclined to trust each other in a group setting. Young unmarried men are the most excluded group, because older men tend to exploit them when they are in a group setting, and their socio-cultural standing gives them a high-risk profile.

- ***Exogenous factors also influence the performance of the microfinance industry***. Political influence is a major challenge to implementing the policies of MFIs on the ground. The industry has seen many government sponsored credit schemes that are implemented by political cadres of the existing regime, who are not professionals in microfinance. In many cases the implementation of these programmes has not been up to par, which then gives the industry bad press. Additionally, politicians sometimes compromise the position of the MFI and use rhetoric that suggests that it is in fact the politician who has brought the institution's programme to that geographical region, and that the programme is there for welfare reasons. In such situations, clients become reluctant to finance their loans because politicians have misrepresented the features of the product. In other cases, MFIs, particularly those wishing to commercialise their activities, are exposed to unfair competition, for example through subsidised public sector programmes. In Uganda the experience of having public sector agents implement and manage microfinance programmes has been largely unsuccessful, and the president is willing to transfer the management of the public sector microfinance programme to the established MFIs that have more experience in the industry.

- ***The industry needs standards of operations to which all members adhere***, and it will be necessary to have a watchdog body to ensure that indeed those active in the industry comply with the basic rules of operation. Presently, there are organisations, usually small outfits or one-man affairs that enter the market under the guise of being MFIs, but have really been established for fraudulent purposes. These entities come into the market purporting to offer credit facilities for low-income people through savings that they mobilise for them. Due to general ignorance on how organisations in the industry work, coupled with an absence of a watchdog organisation to protect the interests of the public and ensure that financial service providers are indeed legitimate operators, these fraudulent entities are then able to disappear with the public's savings, particularly from low-income groups. Again, these incidences frustrate the work of MFIs and generally give the industry a bad name.

- **It is *critical to understand the socio-economic and even the socio-cultural dynamics*** within different regions and among different population groups. Understanding markets on these levels ensures that operations are tailored to suit the unique circumstances of a particular region or population group. For example it is anathema to use the word "interest" in loan programmes rolled out to Islamic communities, because this contravenes their religious teachings on the terms under which credit is extended to individuals. In such instances, the MFI may have to develop terminology that is more acceptable to the community, e.g. "service charge". Flexibility and adaptability of MFIs to different environments is key to their survival.

- ***Demonstration of impact needs to be recognizable in the microfinance industry***. MFIs have a role to play but this role will be finite. As needs, preferences and tastes continue to change there will be need for a wide range of products, services and delivery mechanisms, which may not be met solely by MFIs. Presently and from a service delivery perspective, self-help groups (SHGs) seemingly have no clear distinction from MFIs. If the industry does not try to understand the role of SHGs in poor people's lives then it will not situate SHGs in the financial sector, and will fail to benefit from lessons of how effectively these SHGs have served their constituencies. This learning and openness to synergies between the informal and formal sectors will allow the industry to define the role of MFIs, how and when they can be restructured to ensure that they continue to deliver appropriate services for their markets. All institutions in the formal and informal sector have a role to play in the provision of financial services.

- There may be ***merit in combining disciplines in the microfinance industry***, particularly to establish behavioural patterns that may lead to adjustment in financial service delivery mechanisms and in the types of products that MFIs can bring to the poor, particularly in rural areas. Some work carried out by the University of Nairobi's Anthropology Department demonstrated that in a certain rural location in Kenya, poor women would visit their local market centre primarily for social reasons, but that on a certain level they had developed their own mode of interaction with traders and other vendors in that market centre. This information could be invaluable to MFIs in helping them reassess how they are delivering their services, where the poor would be able to easily access them, who they are and how they interact with the monetised economy. Armed with this information the MFIs could appropriately refine or develop their products, how they deliver them, their pricing and so forth to meet the needs of these captive markets.

- ***ASCAs are beginning to provide a good link between the informal and formal sectors***. Some ASCAs are able to link their members to MFIs, where they can access larger loans. ASCA members already have an instilled discipline because they have been saving over time and therefore tend to be more receptive to the discipline conditions within MFI programmes.

- ***Some MFIs are brilliant at what they do***. They understand their markets and are serving an important function. MFIs are responding marvellously to donors, their current clients. MFI clients are not poor people, but rather donors who are answerable to governments overseas. There is a market for lucrative jobs through the international development world and as long as this market is driving the agenda for MFIs, they will not focus on the poor. Unless MFIs are forced to seek their livelihood from the poor households, they will not be able to respond appropriately to the needs of these households.

- ***Informal structures are working perfectly well, but the concern remains how significant they can be***. An MFI can make a difference in such a situation. Informal structures have limitations of scale and outreach. Formal financial systems have the capacity to penetrate farther into peripheral communities. However, the microfinance industry is struggling to become more market driven. The industry needs to re-engineer its approach to lending. It has not understood its clients, adopting structures and delivery mechanisms wholesale without any modification. Sustainability is necessary, but in the struggle to achieve this objective, the industry has imposed procedures, systems and products that have ignored the underlying structures that have been working in the informal systems for years.

- ***Is there something wrong with the microfinance industry in Kenya?*** Is it possible to lend to people who have been sidelined by banks and get this money back? There has been a failure to go beyond credit in the industry, and the donor community has played a key role in focusing attention so strongly on credit, rather than a diverse range of products and services.

- Until financial service providers in the microfinance industry have the institutional ability to bring in resources from outside the poor communities they are serving, they will forever be helping local communities cope, but will never succeed in drawing them out of the poverty cycle.

- ***The microfinance industry in East Africa has been driven by one product borrowed from elsewhere***, and implanted into a context that may not be same as the one from which it was imported. This action was driven by and gained wide donor support and has been one of the biggest problems facing MFIs. The focus of the MFIs then becomes the money that they can continue to access from these donors, and in this quest to secure external financial support, the MFIs neglect their missions of supporting the poor. There is thus a moral and ethical disconnect in how MFIs operate. On the one hand, the salaries of many staff employed by MFI-NGOs are subsidised by donors, and yet these institutions will be the first to recover the domestic assets of their clients who fall delinquent. These clients have worked very hard to acquire these assets, which are not in any way subsidised. The industry needs to adjust its focus to support income generation at client level, rather than promote the proliferation of institutions that are driven by money and not by their missions.

- ***Money, in the form of financial support to MFIs, was meant to be a means rather than an end***. This initial financial support to MFIs was valid, but now the industry is at a point where all the stakeholders need to refocus their objectives, and define what the industry is doing. Initially the microfinance industry provided a mechanism through which poor people could access financial services. Over time this intervention has developed into a business in its own right. The industry now needs to re-engineer itself, look at the strategies that will enable it to evolve into a sound business sector. The informal financial sector has a client/market focus, and the one key lesson that the microfinance industry can learn from it is to change its traditionally supply driven products and to products that answer its clients' needs.

- ***Several developments are leading the industry to reorient its focus***. There is now a squeeze on donor funding, which is driving MFIs to new directions that recognise the role of the market and the MFIs' clients in that market. For example, DFID – India is no longer giving grants to MFIs for their loan capital funds. Rather DFID is providing technical assistance and making capacity building contributions so that institutions can take equity positions in MFIs. With changes such as these, MFIs are now pushing for market driven research to start understanding their clients, because they realise they will have to cater to these clients more effectively in order to survive.

- In the East African region there is ***tension between an integrated financial sector approach to regulation***, i.e. having the microfinance industry regulated under the Banking Act, ***or having self or separate regulation for the industry***. There are diversified mechanisms for regulation. Having central banks as the regulatory authority for all activities in the financial sector is not the way to go. It is possible to develop a more appropriate regulatory regime. A tiered regime, where institutions in the lower tiers do not come under the regulation and oversight of the central bank may be an option. The industry would be structured in such a way that an MFI wishing to move from the lower tiers up would be able to do so. However this would not imply that all institutions would be obliged to move through all the tiers. Alternatively, networks may be a means through which the industry can establish a body that would be responsible for regulating MFIs. In dealing with regulation, the industry will also have to define who will bear the costs of regulation.

- ***Having altruistic objectives – sometimes seen as "warm and fuzzy" – should not be an excuse for sloppiness***. Many NGO-MFIs with social development missions have failed to execute their microfinance programmes professionally, and under no circumstances should this lack of professionalism be excused on the basis that these types of institutions are "warm and fuzzy".

Harnessing Informal Financial Systems: The Experience of SAGA

Harry Mugwanga

The Organisation

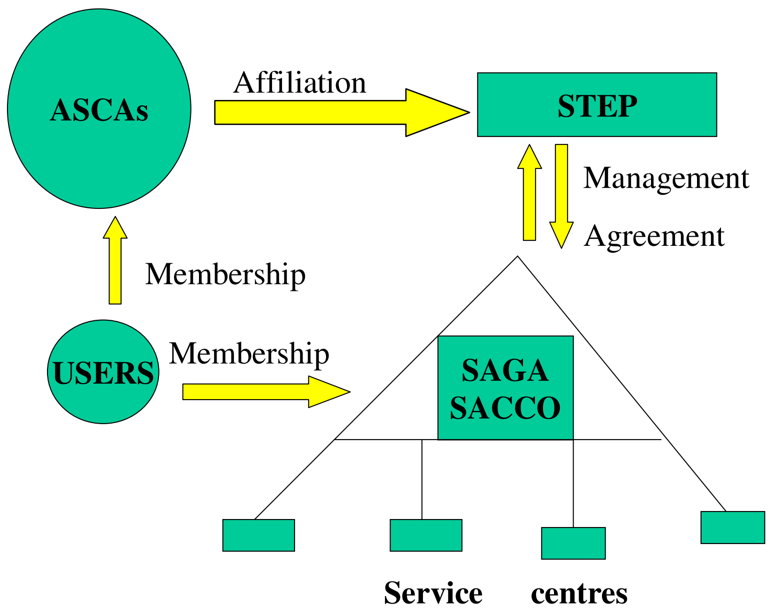
SAGA Thrift and Enterprise Promotion Limited is a company limited by shares and was incorporated in 1995. Lutatco, an enterprise development corporation founded in 1947 by people from the Kenyan districts bordering Lake Victoria, sponsored it. The current shareholders include the sponsor, K-Rep Development Agency Limited, Harry Mugwanga, Michael Ndeda and Edward Osawa, all socially motivated investors.

SAGA was conceived and set up in the context of exclusion of the Kenyan districts bordering Lake Victoria by Nairobi-based micro credit institutions that preferred to operate mainly in Nairobi and neighbouring districts. Moreover, it was clear back in 1995 that even if K-Rep, Faulu, KWFT, PRIDE eventually reached these districts, they would be largely irrelevant in a predominantly rural economy where over 90% of the population derives its livelihood from agricultural undertakings and where poverty reduction must start with measures which enable people to view land as a source of wealth. SAGA exists to facilitate services, which will enable the largest possible proportion of the population to invest in agricultural enterprises. Savings enable people to have flexible investment options, whether through the use of their own savings or borrowing against their ability to repay, indicated by their savings record.

Institutional Structure

Saga is a cocktail of three institutions assembled together to address outreach, legal and management issues in the provision of financial services to rural communities. SAGA uses grassroots organizations as its bridge to the rural economy. The preferred organizations are the accumulating savings and credit associations (ASCAs) that exist primarily to assist members to accumulate useful lump sums of money. These associations are identified through local administration offices, churches, village leaders and other social networks. Having decided to work with them, a market validation survey established the existence of 92 ASCAs in Kombewa Divison of Kisumu District with a total membership of 4,878, of which 3,080 members were women, and 108 ASCAs in what was formerly Bondo Division of Siaya District with a total membership of 3,069 members, of which 2,262 were women. From these figures we estimated that there were probably 3,000 such associations in the region of focus with 60,000 members. That, we thought, was a market with which we could do business.

How SAGA Works With ASCAs



The associations are affiliated to SAGA Thrift and Enterprise Promotion Limited for capacity building designed to enhance their ability to deliver their services to their members. SAGA assists them to articulate a simple vision focused on financial services delivery, develop and adopt bylaws, put together a simple plan and elect new officials. The association also elects a teller, usually the youngest or most energetic and literate member to assist with collecting and recording transactions at the association level. SAGA is responsible for training the teller in proper record keeping.

Associations thus affiliated to SAGA have a common bond as its affiliates. This qualifies their members to join SAGA SACCO Limited, which gives their savings and credit activities legality. SAGA SACCOs are registered on a District basis and so far there are two registered SAGA SACCOs. Registration is planned for another six SACCOs within the next three years.

As soon as a SACCO is registered, it enters a management agreement with SAGA. This agreement remains in force for as long as the SACCO uses the Service Centres or Front Offices developed and owned by the Company and as long as the SACCO requires access to external capital to enable it to meet its members' demand for credit. It is an open-ended long-term agreement. The management agreement assigns the management of the Service Centres to persons appointed and trained by SAGA. In addition, each Service Centre has a Centre Supervision Committee elected by the ASCAs served by that particular Centre.

The ASCAs, SACCOs and SAGA constitute the organization. They bring together abilities, which ensure that the organization has effective outreach, operates legally and is professionally managed.

Why We Work With ASCAs

In the famous words of one of the greatest generals of all times, Hannibal of Carthage (247-143BC), "… we will find a way, or make one." If a community has demand for a particular service they will find a way to satisfy that demand or create a mechanism for fulfilling it. If the rural economy or poor people around Lake Victoria need financial services, there must be ways that they have devised to meet this demand. We decided to look for those ways with the conviction that understanding those devices was an essential step towards understanding the market for financial services in the target region. We further argued that if we found and understood those ways, we would first make the users understand that we respect them and have come to make those devices work better for them. Once we have created trust and made the users of these devices accept our good intentions, we assist them to introduce other services that they did not have the capacity to manage on their own. The organisation's name was already identified with the local spirit of solving individual problems collectively. SAGA identified accumulating savings and credit associations as the commonly used financial service device that was most adaptable and could accommodate a broad spectrum of services.

How We Work With ASCAs

The first objective in our relationship with ASCAs is to improve the way in which they work. ASCAs exist to assist members accumulate savings that are distributed at some stage. They operate like a bank. Members join primarily to save, and save according to their means and purpose for saving. Members who face emergencies recognized by the association can borrow from the fund. However, most members do not save.

The ASCAs faced many challenges. Savings were kept by treasurers who sometimes borrowed from the fund without the knowledge of other members. Records were poorly kept. Insecurity in villages made it increasingly risky to keep money collected publicly at home. None of the associations had any proper bylaws or plans against which to assess the performance of their leaders. The system was too casual for managing people's savings and enjoyed only limited confidence of members. Each savings round therefore had a terminal life, rarely more than 12 months. We saw an opportunity to improve the system in several ways, hence our first objective. The second objective was to use the associations to introduce other savings products and eventually flexible credit.

Some Lessons

- Working with people who are already organized for financial services cuts costs of client mobilization. Working with ASCAs has made it possible to mobilize over 2,000 rural savers in just over one year of full operation and over KShs. 2 million in cumulative assets and liquid savings.
- Rural folk can and want to save through different mechanisms, including through ways that create long-term assets. The introduction of long term asset creation and other savings products met no resistance.
- Savings activities inform the Company about the users' debt capacity. Working with organizations that put savings ahead of credit has made it possible to provide agricultural credit without assuming agricultural risks.
- SAGA has been able to preserve some of the informality of the associations as long as it is engaged only in savings facilitation.
- Delivering credit through these associations will demand at the minimum more frequent meetings and some reduction in their informality.

Key Plenary Discussion Points

- Agricultural lending has dual risk: the risk the lender takes in disbursing a loan – they may not recover that money from the borrower if the borrower is not willing to repay that money; agricultural risk that may come about as a result of failure of agricultural production. Rather than lend specifically for agricultural purposes, the ASCA members are able to access loans based on their level of savings, which they can then invest in their agricultural activities or for any other financial needs.

- The Service Centres have SAGA Thrift and Enterprise Promotions (STEP) managers working in them, but members belonging to a particular centre nominate a centre monitoring committee to also play an oversight role in how monies are being managed in any one centre. The responsibility of managing individual groups, in terms of the dynamics within the group, largely rests on the group officials, together with ordinary members in that group. Each centre has its own bank account from which it transacts business with the members of each ASCA, whether in terms of savings or disbursing loans.

- STEP placed a strong emphasis on savings to ensure that the ASCAs understood that STEP was not there to lend money. STEP was keen to ensure that any borrowing carried out by ASCA members was because those members needed to borrow, not because the institution wanted them to borrow. STEP has placed a very heavy emphasis on capacity building, and has used its financial resources on capacity building at the ASCA level.

- STEP recognises that savings in an ASCA does not make sense unless there is a reasonable degree of credit in order to get some return on savings. The introduction of credit activities within the ASCAs has introduced a degree of formality in how these organisations carry out their activities. This formality ensures that the procedures developed protect the members' monies and allow them to expand the range of the financial services that they can access. Not only are members able to obtain credit, they are able to make an investment through their savings and get a return on that money they put aside. In addition, STEP has also the added advantage of being a conduit for external funds to the ASCAs through the STEP SACCOs.

- The centres publish trial balances, which give an indication of the financial performance of the ASCAs that have membership in these centres. The service centres have not yet reached a point where they are able to cover their costs, but it is anticipated that as the numbers of member ASCAs continue to grow and the monies they mobilise increase, then the centres will be able to cover the costs of the services they give to their members.

Harnessing Informal Systems: The Experience of K-Rep

Rose Mwaniki

Introduction and Background on K-Rep

K-Rep has grown to become a group of specialized microfinance development organizations, but was initially established in 1984 as a project of World Education Incorporated, sponsored by USAID.

In 1987, K-Rep was institutionalised and registered as a Kenyan Non-Governmental Organization under the Non-Governmental Organizations Coordination Act and also as a company limited by guarantee and having no share capital.

Initially, the main activities of K-Rep were confined to supporting other local NGOs involved in the development of the micro and small-scale businesses, by providing them with grants and technical assistance.

In 1989, K-Rep broadened its program of activities to include direct delivery of loans to micro and small entrepreneurs, research and training. The array of activities was later expanded to include consulting services.

Today, the K-Rep Group of companies has three subsidiaries:

- *K-Rep Bank Limited*, a specialized commercial bank providing financial services mainly to low-income people.
- *K-Rep Advisory Services Limited* providing business development and technical assistance services to stakeholders in the microfinance sector across Africa.
- *K-Rep Development Agency Limited,* a research and development organisation developing and testing new financial services for low income people that would be eventually rolled out on a large scale in the Kenyan microfinance industry.

Vision

The vision of the K-Rep Group of companies is *to have a world where everybody has access to financial services.*

Mission

The mission of the K-Rep Group is *to empower low-income people, serve as a catalyst for them to participate in the development process and enhance their quality of life.*

K-Rep's Experience in Direct Lending Through Informal Systems

Over the last 14 years, K-Rep has experimented with different micro finance methodologies with diverse results.

- ***Community Based Enterprise Loan Product:*** In 1986 under the USAID funded Rural Enterprise Project, K-Rep was given the authority to directly provide loans to Community Based Enterprises (CBEs).

  By August 1991, a total of 18 groups had been funded. During the four years of the project's implementation, the CBEs exhibited a consistently low repayment rate, brought about by:
  - Poor leadership and overall group management that generally affected all the CBEs
  - Lack of commitment and foresight on the part of the members in the majority of the CBEs
  - Deteriorating economic conditions in some of the districts which in return resulted in insecurity and poor crop production, for example the Tana River experience
  - Non-existent entrepreneur spirit to drive the community enterprises in the majority of CBEs
  - Local level political and administrative interferences among some of the CBEs.

  Consequently, an assessment was undertaken at the end of 1991 whose results showed that the community-based strategy was not an effective credit delivery strategy to low-income groups.

- ***The Birth of a New Lending Strategy – the Chikola Methodology:*** The Chikola lending methodology evolved as a result of the failures and ineffectiveness of the group-based loan product. While working with the CBEs, the existence of other types of self-help associations (RoSCAs) was discovered. These grass root informal savings and on-lending institutions were mainly created for the purpose of promoting business enterprises owned by their respective members.

Realizing the potential of these associations, particularly those that had a savings mobilization component, K-Rep now placed less emphasis on promoting group-owned enterprises in favour of these grassroots self help associations. In June 1991, K-Rep shifted its lending strategy towards the promotion of the Chikola loan product, *chikola* being the Miji-kenda word for RoSCAs.

A snap survey was undertaken in the Eastern and Central districts of Kenya where there is a strong tradition of group associations for economic reasons. The survey indicated that in each district, there were between 3,000 to 4,000 *chikolas*, which facilitate savings and credit services among members, whether for economic or social reasons. The survey further indicated that among the business-oriented *chikolas* much more financial resources were required than the savings mobilized to meet their members' financial requirements.

K-Rep then developed criteria of accessing institutional credit to such *chikolas* to enable them in turn to extend adequate credit to their members according to each individual's needs as follows:

- K-Rep would provide a single loan to a *chikola*, which it would then retail and distribute to the individual members at a cost.
- The group must have been in existence for at least 3 years and must have operated an on-lending activity for at least one year.
- The group would have to have proven experience in managing loans for its members and would have to be registered with the relevant Government department.
- The membership, preferably consisting of women, must not comprise close family relations.
- Each of the group members would be jointly and severally liable for the performance and repayment of the single loan received by the group.
- The group would have to open a "pool" bank account and raise at least 10% of the loan required.
- At least 90% of the members would have to be operating micro and small businesses.

Results of Chikola Operations: By 30th May 1995 documented performance of the loan product was as follows:

Parameter	1993	1994	May 1995
No. of loans		314	496
Individual Borrowers		4,434	4,674
Amount Disbursed		$2.6m	$3.6m
Repayment Rate	100%	92%	94%

The drop in the quality of the loan portfolio prompted K-Rep to evaluate the turn of events and establish the cause of declining portfolio performance. The following were the key findings:

- Most *chikolas* were having problems as a result of poor leadership.
- The lack of linkage between K-Rep and the individual borrowers, which is critical with character loans, presented problems in loan follow-up.
- Designer groups were creating themselves and the culture of proxy borrowing had set in.
- The cost of bank operations and maintaining group accounts was very high.
- Multiple borrowing and reluctance on the part of the groups to follow-up defaulters had a negative impact on the guarantee mechanism and consequently on loan performance.

Reorganization of the Loan Scheme: The Chikola loan product remains one of the key lending methodologies in K-Rep but it has had to go through a reorganization to enhance both its effectiveness and efficiency.

- Loans are appraised and disbursed at the individual borrower level. The loan guarantee however remains a responsibility of the entire membership. The group therefore does not earn an income from on-lending, as was the case previously but at the same time it does not incur any bank costs.
- The frequency of meetings was changed to weekly and fortnightly meetings, as opposed to monthly group meetings. This allowed for closer monitoring of loans and prompt initiation of the loan recovery process.
- Thorough and intensive pre-loan training was initiated, in the same format as the K-Rep Juhudi loan scheme. Groups had to undergo pre-loan training for at least 8 weeks prior to the first rounds of disbursement.
- The group management and leadership of Chikolas were enhanced.

Although these alterations to the original concept affect the framework of this informal financial system, K-Rep had used this adaptation of an informal savings and credit system to reach micro and small entrepreneurs.

Key Plenary Discussion Points

- A number of changes have been introduced into the Chikola loan programme to enhance its performance. Staggered disbursement was introduced to guard against default. Groups no longer have loans disbursed to all the members at once, because there was a high risk of members colluding and not repaying their loans.

- The costs to operations increased significantly when individual appraisal was introduced in the Chikola loan programme. The cost per shilling lent went up to KShs. 0.27. Over time however, K-Rep has managed to bring down this cost to about KShs. 0.10 per shilling lent, for its Chikola programme.

- Despite K-Rep's transformation into a commercial bank, a strong focus still remains on serving low-income people through its microfinance department. The loan sizes that these groups can access remain low (not more than KShs. 15,000 for a first loan) and the bank is making efforts to develop new financial products that address the needs of low-income people.

- K-Rep Development Agency (KDA) Limited is working on developing and pilot testing financial products aimed at promoting lending to the agricultural sector. Pilot testing of loans for the agricultural sector is taking place in Rongo and Kibwezi. These loans take into account that the gestation period for the crops being grown in this area is six months. Contact payments are made in the period between planting and harvest and then a balloon payment is made at harvest time, presumably when the farmers have sold off their crops. KDA is also pilot testing another loan product designed for dairy farmers.

Innovations in Microfinance:
The Managed ASCA Model of Microfinance in Kenya

Robert Hickson and Nthenya Mule

Introduction

With considerable donor support, a number of Kenyan MFIs have been able to develop significant outreach during the 1980s and 1990s. However, high operating costs, slow intake and high dropout rates have constrained their efforts to achieve financial and organisational sustainability.

In contrast there exist a number of local agencies using a microfinance model that, in the same environment, serving similar clients, and without any donor funding are operating profitably and expanding rapidly. We have coined the term ASCA Management Agencies to describe these newcomers to the Kenyan microfinance scene. These agencies provide management services to group-based loan funds in the Mt Kenya region.

The model was originally conceived by Partnership for Productivity (PFP), a local NGO that started out providing a range of donor funded developmental interventions, including traditional MFI lending to individuals and groups. In 1994 donors withdrew funding and, lacking capital, PFP decided just to work with the groups that had their own funds in a revolving loan fund (RLF) and to charge a fee for this service. Then in 1995 the training officer of PFP decided to start his own company, Enterprise Development Institute (WEDI), opening an office immediately next door and taking some of the groups from PFP with him. This organisation was also able to recruit a large number of groups. In January 1999 one of the WEDI staff then also broke away and started another organisation called Small Enterprise Development Institute (SEDI) and, as with the earlier split from PFP, took some groups with him from WEDI. This process has continued to this day and now some eight such entities operate the managed ASCA model in the region.

The Setting

Over the last three years, microfinance programmes have been operating in a difficult economic climate. Cash crop farming (primarily tea and coffee) in the rural areas, and microenterprise activities (especially retail trading) in the urban centres dominate the Mt. Kenya region. The overall contraction of the Kenyan economy has had a significant impact on all the sectors of the economy. The decline in coffee and tea prices on the world market has had a big negative impact on the income of the population in the Mt. Kenya region. This situation has been exacerbated by the poor performance of the coffee co-operatives in the region through which farmers were obtaining credit and selling their crop. The year 2000 was also characterised by a severe drought. Consequent, electricity rationing resulted in manufacturing and industrial sectors working below capacity levels, leading to reduced production. The retail sector, which relies on significant inputs from the manufacturing and industrial sectors, was in turn adversely affected.

The country’s economic decline has resulted in reduced wealth at the household level and the ability to repay loans has been affected. As a result, quite a number of households with outstanding loans are falling in arrears where they are unable to negotiate a change in their loan terms. Borrowers are also requesting smaller more affordable loan amounts. This has the effect of slowing the local economy and reducing the profitability of financial institutions.

The Market

During the last 2 years traditional MFIs in Kenya have been struggling with their client outreach. They have experienced problems of high dropout and low intake and one often hears the complaint that the microfinance market is exhausted, especially in the heavily served Mt Kenya region.

Yet despite this the outreach of those agencies providing ASCA management services is growing substantially. Over the last 18 months the three largest organizations using this model have increased their outreach by about 180%. They now manage between them approximately 27,000 clients with a total portfolio of over US$ 2 million. These clients are almost entirely women, and the geographical area extends well beyond the peri-urban domains of most Kenyan MFIs; ranging from Kirinyaga to Laikipia and Nyandarua, with Nyeri as a core, a radius of about 200 kilometres. This outreach is impressive in the Kenyan context.

However this growth has not been achieved solely through geographical expansion but also through the incorporation of a broader range of socio-economic groups. While traditional MFIs in Kenya tend to focus their attention on micro and small entrepreneurs in the belief that these are lower-risk clients or those through which microfinance can stimulate economic development, Managed ASCA agencies have no such prejudices or lofty goals of a higher purpose. Their mandate is to respond to client needs - profitably. Their clients, therefore, include salaried workers (e.g. nurses, teachers, civil servants), subsistence and semi-commercial agriculturalists, and women who borrow purely for consumption needs but who can rely upon financial support from either their husbands or children. Even within the more traditional market of microentrepreneurs the managed ASCA model is attracting many clients in both urban and rural areas who are not prepared to accept the rigid terms and conditions (such as weekly meetings and repayment schedules, and loan collateral requirements) or simply like the idea of owning and profiting from the fund from which they borrow.

The Service

ASCA Management Agencies (AMAs) recruit clients by canvassing areas that they consider can be serviced profitably. They promote the financial products they are able to offer and offer a limited free trial period to any new groups. Clients include both the members of existing merry-go-rounds (RoSCAs) and individuals interested in forming new groups for the purpose of participating in this managed financial intermediation.

Groups using ASCA management services must be registered as self-help groups with the Ministry of Culture and Social Services, through the Community Development Agency. The ASCAs then open a bank account with a bank of their choice. The signatories to this account are the chair, treasurer and secretary. The MFI with which the ASCAs collaborate is not a signatory to this account. The bank account is for the safekeeping of any money collected during a group meeting that is not lent out in *ngumbaco* (1 month credit advances) or loans (10 to 24 month loans).[30]

Broadly the model offered by the AMAs is similar, however, there are some differences, which often come about when a new operator sets up. We will describe here the main features of the model. Field Officers from the ASCA Management Agencies supervise monthly meetings of their clients. In these meetings savings are deposited, outstanding loans are repaid and new loans requested, discussed and disbursed from the available loan fund. Group members must apply in writing for new loans and these are considered on a first come first served basis to avoid any chance of favouritism. The Field Officers are expected to chase delinquent members as an important part of the service. Contrary to traditional microfinance programmes that consider that their clients are best positioned to chase their delinquent peers the managed ASCA model considers this function to be best performed by an external agent. Interestingly, in both systems the party owning the funds prefers to engage another to chase delinquencies.

Within this group, members contribute savings that are loaned to other members of that group. In addition to savings services, the model promoted by the organisations has two basic <u>credit</u> products. One is a short-term advance (called *ngumbaco*), which is usually for a month and on which a flat 10% interest is paid (annual effective rate 120%). An access fee of between KShs. 10-20 (US$0.13-0.26) is paid in order to get the advance. Advances may be renewed for up to 3 months, if the interest is paid monthly before they have to be repaid fully. Members are entitled to advances of up to three times their savings. The other credit product is a longer-term loan for 10 to 24 months at 17% flat, repaid in equal monthly instalments (annual effective rate approximately 81%[31]). A grace period of one to three months is permitted on the loan and a 1% application fee levied. Household assets may have to be pledged or another family member acts as a guarantor. Loans can be taken at up to three times savings.

[30] In remote areas, many groups do not have easy access to banks. This increases the banking costs to these groups, and the risk of theft while the treasurer travels to bank the group's money.

[31] The annual effective interest rate on these loans depends upon exact duration. It also depends upon the dividend being paid on savings. Using a cash flow model for a 12 month loan and assuming no return on savings gives an annual effective rate of 81%. If dividends of 20% are imputed on savings, then this rate falls to 61%.

The interest paid by members on loans is paid into the Revolving Loan Fund and, therefore, belongs to the members. The minimum monthly savings contribution (hereafter referred to as shares) is KShs. 100 (about US$1.30) with no upper limit. At the end of the year the dividend is calculated. This is based on the interest accumulated in the fund. The high rates of interest on loans yield very high dividends to those buying shares in the fund. On a random sample of 28 groups drawn from PFP, the dividend paid at the end of 1998 ranged between 16% and 60%, with an average of 34% for the 16 groups for which data were available. Earnings per share are calculated by the ASCA Management Agency after a 30% loan loss provision allowance has been made. An individual's dividend also comprises 10% of the total amount that she has paid in interest on her advance. The logic for this is that those who have taken advances have paid more into the group fund and should also benefit. Also in December there is a bonus or "celebration" which is a flat payout of around KShs. 500 (about US$6.40). This is deducted from the members' dividends and paid out as cash, whereas the rest of the dividend is added to the members' savings.

Savings withdrawals can be made down to a minimum balance of KShs. 1,000 (about US$12.80), if the member has no loans outstanding. Otherwise, she cannot withdraw to below half of an outstanding advance and cannot withdraw at all if she has a long-term loan.

PFP and SEDI have also introduced an Education Booster Fund. Members can save any amount over and above the minimum KShs. 100 per month. The savings receive a massive 10% per month interest, but withdrawals can only be made in December.

The Catch

The ASCA Management Agencies all charge a 1% commission each month on the total loan fund (loan portfolio plus cash in hand) up to a maximum of KShs. 2,500 (US$ 32). In addition, a fee is charged for the provision of savings books. Before loan losses are taken into account, this represents an annual cost of a little over 12% to the group fund, which compares very favourably to the effective rates charged by traditional MFIs in Kenya, which are commonly between 50 and 300% above prime lending rates.

However, despite what would appear a relatively modest fee structure these ASCA Management Agencies are proving very profitable. For example, SEDI's net profit for financial year 00/01 was KShs. 1,253,000 (US$ 16,064) giving an adjusted return on assets (AROA) of over 2,000%. This high return can be largely explained by the low cost structure of the ASCA Management Agencies. SEDI operates out of a tiny rented office costing US$ 50 per month; Loan Officers earn about US$ 50 per month and travel by public transport. SEDI's administrative and operational efficiency ratios[32] are 2.5% and 4.1% (low is good) respectively which is extraordinarily compared to efficiency ratios commonly found in traditional MFIs. This is private enterprise!

Ngumbaco loan funds have a theoretical yield of 120% per annum. Arrears in most these portfolios prevent the achievement of this, however, the *Ngumbaco* loan funds do provide average yields of between 40 and 70% to the fund owners even before fines and other charges are taken into account. This compares favourably to bank deposits, which yield about 2% per annum.

The Organisations

Apart from PFP, which is an NGO, WEDI and SEDI essentially operate as sole proprietorships. The three MFIs all have a very flat institutional structure headed by Programme Managers. The Programme Managers in WEDI and SEDI are both owner-operators. They drive the programmes single-handedly, recruiting and supervising all staff, networking with existing groups to draw in new clients and making all strategic decisions. WEDI and SEDI do not have a board of directors. The Programme Managers are not answerable to any higher authorities and their foresight, ingenuity and hard work alone determines the growth in outreach and income of the institution. PFP alone is required to produce monthly performance reports and submit them to its Head Office in Nairobi.

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[32] Administrative Efficiency = administrative costs excluding financial costs as % of avg. net portfolio
Operational Efficiency = total operational costs as % of avg. net portfolio

In all three institutions, the Programme Managers also perform the function of Loan Officers, attending to groups, helping them keep their records and, especially in delinquency management. The flat institutional structure in both SEDI and WEDI allows the institutions to respond quickly to situations on the ground.

However, it is in the administrative and financial management systems that important weaknesses appear in all the ASCA Management Agencies. Record keeping is poor and serious inaccuracies can be commonly found among financial records. Financial record keeping formats are inadequate and confusing. Often Loan Officers must enter critical details on blank pieces of paper for want of a format on which to enter them. Needless to say none of the ASCA Management Agencies perform any sort of financial analysis upon their portfolios of their own operations.

Systematic internal controls do not exist and fraud prevention depends upon the Programme Manager's capacity to occasionally check individual Loan Officers groups and their records. Of equal concern is the general inability of group members to provide any check on the records kept by Loan Officers. Group treasurers generally copy on there own pieces of paper what the Loan Officer has written without verifying its accuracy.

The Challenges

Delinquency Management: From the group member's perspective this is one of the key roles of the AMAs yet none of the institutions have developed effective systems for delinquency management. As the AMAs do not own the money in the RLF, and are paid on the size (including arrears), of the portfolio, rather than its performance, they have no direct incentive to ensure good portfolio quality. In fact it is directly against their short-term interest to expose arrears problems, as this will either increase pressure from the members for them to resolve these problems or cause the groups to stop paying the management fee.

The AMA can also be lax on following up delinquent loans because these do not immediately impact on the group's ability to repay loans. This is particularly so because clients are poorly informed about the level of delinquency and the adverse impact this has upon their fund's financial performance. Even if there are loan repayments in arrears, as long as most of the members are still able to get some advances and long-term loans on request, they are unlikely to feel that there is anything amiss. It is only when bonus payments start declining or members are repeatedly given significantly less in loans than they would like, that members are likely to realise the severity of the delinquency problem. As members are not generally able to keep independent portfolio records there is potential scope for AMAs to fraudulently overstate the size of the loan fund in their management records in order to further increase their earnings.

Financial Management and Analysis: This is closely related to the above challenge. The current lack of financial analysis prevents the AMAs from understanding and responding to loan portfolio problems within the ASCAs. While this may not be perceived as an immediate need by the AMAs themselves , there is a serious danger that if a number of groups discover the extent of their loan losses and express an appropriate outrage, this may start a major backlash that could destroy the ASCA Management Agency. For the model to carry happily into the future it is essential that the AMAs be able to demonstrate that they are managing with the process with accountability and transparency and in the best interest of the groups themselves.

Institutional Management Vs. Management by Charisma: The three largest AMAs face the ceiling that is faced by many small businesses. They are reaching the limit of operations that the owner-manager can personally supervise. In WEDI many group members associate the RLF programme with Mr Mugo and not with the institution itself, calling themselves – "*ikundi cia Mugo*" (Mugo's groups).

Programme Splintering: A unique feature of the managed ASCA model is its low entry cost. This has resulted in many Field Officers splitting away from their employer in order to start their own ASCA management service. The most recent case of splintering involved a loan officer taking 13 or so groups with him. For this reason, among others, Programme Managers try to maintain their own personal relationship with all clients and often rotate Field Officers frequently to prevent the development of strong client-loan officer relationships. Furthermore, because of the depth of outreach achieved by these programmes new clients tend to be found in more distant areas, these breakaway Field Officers must either be able to lure groups away from their competitors or travel far a field.

Conclusions

The strength of the ASCA Management Agency approach is twofold. First the service providers are driven by an entrepreneurial spirit and profit motive that ensures client - rather than donor - satisfaction, is a key objective. Secondly, they have struck upon a product and service delivery system that is cost effective, builds upon the popularity and familiarity of ROSCAs and, because it does not require large amounts capital funding allows the entry of entrepreneurs who don't necessarily have the contacts, language skills and powers of persuasion necessary to obtain donor funds.

These ASCA Management Agencies are opening up the microfinance market in Kenya. Providing that they are able to manage their impressive growth they stand to provide serious competition to the traditional MFIs. The table below provides a summary of the strengths, weaknesses, opportunities and threats faced by both these models of microfinance delivery.

	ASCA Management Agencies	**Traditional MFIs**
Strengths	▪ Low operating expenses and minimal capital costs ▪ Strongly client focussed products and services ▪ Flexible management able to respond rapidly to opportunities	▪ Well known product with strong donor support ▪ Relatively strong information and administrative systems ▪ Strong control over products and services
Weaknesses	▪ Weak portfolio management ▪ Weak institutional management ▪ High rate of staff breakaway ▪ Dependency upon single leaders (lack of middle management)	▪ Weak client focus in products & services ▪ Poor outreach (low client intake and high dropout rates) ▪ High operating expenses ▪ Doubtful sustainability
Opportunities	▪ Development of simple but effective systems for portfolio management and analysis ▪ Development of simple but effective administrative and internal control systems ▪ Inter-group financial intermediation (possibly in collaboration with a formal financial institution)	▪ Increase commercial orientation (e.g. inclusion of less poor and non-entrepreneurs) ▪ Reduction of high overhead administration costs ▪ Development of low cost and efficient service delivery systems ▪ Development of client focussed products and services that attract a broad cross section of clients
Threats	▪ Deteriorating portfolio quality may cause a wave of service rejection by clients	▪ Withdrawal of Donor support

Key Lessons for More Traditional MFIs

MFIs in Kenya have made major advances in introducing microfinance to East Africa. However, they have not yet been able to crack the holy grail of financial sustainability. The AMAs may provide some valuable lessons in the following areas:

Reducing Operating Expenses: Most Kenyan MFIs have evolved from NGOs concerned with relief and development. They have traditionally been dependent upon donor funding and, unlike commercial investors, the donor community has been tolerant of high cost structures. Over the last 5 years there has been a decided shift in donor thinking and MFIs are now generally expected to become commercially viable. Traditional MFIs in Kenya will need to follow the AMA example and radically cut their operational expenses and expand their client outreach if they are to achieve financial sustainability.

Improving Outreach: Kenyan MFIs must look seriously at the underlying causes of their poor outreach (which is resulting from both low client intake and high dropout rates). A number of African dropout studies suggest this phenomenon to be a rejection by clients of the traditional MFI products and appears to be mainly related to the inappropriateness of this product to financial needs of clients and the serious inconveniences associated with participation. If outreach is to be significantly improved it is likely that traditional MFIs will have to invest much more time and resources into market research to better understand their clients' financial needs and capacities. Unfortunately the incentive to do this may not arise until donors either exit or become more commercially oriented in their investments in their MFI partners.

These MFIs may also need to look beyond their traditional clientele and seek out additional clients who, while outside their service mandate, are able to sure up the profitability and, therefore, sustainability of the MFI. If MFIs are serious about serving poor households they should be able to cater to the needs of a broader clientele without losing their poverty focus i.e. their ability to serve these poor households as a distinct market segment within a much larger (and therefore sustainable) client base.

Key Recommendations for Donors

Necessity is the mother of invention. The innovation of the managed ASCA model arose as a direct response to lack of donor funds. While donors continue to prop-up inefficient mechanisms for microfinance delivery it is unlikely that these are going to dramatically change. At present it is far easier for an MFI that is experienced in *donor management* to secure income from donor grants and subsidised loans than from their actual loan portfolio.

If traditional MFIs are to become more efficient service providers: donors, as investors interested in the long-term viability of their investment, must demand a higher levels of performance from their investment instruments. Continued support should be strictly conditional upon the achievement of performance targets. This may mean withdrawal of support to MFIs with which a donor has had a long association. While this may appear harsh, it will help to create an environment in competition spurs innovation and in the long-term will benefit the donor's target beneficiaries.

Similarly, inappropriate donor intervention could destroy the essential qualities that are found among ASCA Management Agencies if it was to distract their attention away from client service. Critical to their current client focus is their very dependence upon these clients for their survival.

ASCA Management Agencies probably do need technical assistance to improve their institutional and portfolio management capacity. If individual AMAs are to expand further they will need to create a layer of competent middle management and institutionalise administrative systems and financial control systems that will assist the owner-manager to manage a larger entity. Such organisational development is necessary in order to assure the quality of the service being provided. Particular attention needs to be paid to ensuring that clients have the means to hold service providers accountable through improvements in transparency of ASCA management operations. Making this next step is often difficult for such small business operators who tend to manage by 'feel' - rather than by 'fact'.

The cost of making this step can be substantial and continue for a considerable period of time while the changes are being institutionalised. The bureaucracy that results can also reduce the institution's capacity to respond quickly to the market, which may dull its competitive edge in the managed ASCA market; a market that currently relies heavily upon the ability of Programme Managers to respond quickly to client concerns. Not until significant increases in economies of scale are achieved can the investment be said to have paid off. Many expanding small businesses are unable to survive through this "no man's land".

Donors interested in supporting ASCA Management Agencies should be prepared to provide small investments in technical assistance aimed at establishing simple but effective systems for portfolio management and analysis, management and internal control. The systems developed should be made available to all interested parties to prevent unfair competition in the managed ASCAs marketplace.

Finally, the operators of existing AMAs are, by necessity, very shrewd, and donors should beware of being beguiled into funding extraneous projects to benefit their clients. These may, in effect, strengthen the patronage relationships involved, for reasons other than the quality of the financial management service provided.

Key Plenary Discussion Points

- Despite the *ngumbaco* loans having a high effective interest rate (about 120% p.a.) the members have the option of taking out loans when they need them and also deciding on the type of loan they would like to take out; a member may opt to take a long term loan whose annual effective interest is much lower (17% p.a.) than that of the *ngumbaco*. The ASCA methodology does not pressure members to borrow loans in order to remain active members of the group, as is the case with many microfinance programmes. Because members of the ASCA get a dividend payout at the end of the year, they do not find the interest rate punitive, because they know that they will get a return on the money that they have put into the ASCA as shares; members also get a partial interest rebate on the interest payments they have made throughout the year as part of their bonus earnings.

- Both the AMA model and STEP have identified innovative means through which they can support ASCAs by providing non-financial services that are clearly needed by the ASCAs. In both models, if the institution (read Programme Manager, in the case of the AMA model) starts providing credit to the group members, there arises a conflict of interest between the institution and the groups. One of the key roles of the ASCA is to provide financial services, primarily savings and credit. The ASCAs do not lend outside their membership.

- The incentive structure for delinquency management is somewhat skewed in the AMA model. Delinquency management is out-sourced to another institution, which poses a potential with the AMA. The AMA's incentive is to maximize the total size of the portfolio; whatever is in arrears does not affect its total income, because the service fee is based on total portfolio size, not total performing portfolio. The ASCA members on the other hand would like to have a strong portfolio, which leads to a strong disjunct between the interests of the two parties. However, if the delinquency management role is relinquished to an external agent, therefore introducing an external authority, this may make it easier for that external party to get a response from delinquent person, rather than if the ASCA members themselves, who are invariably friends or relatives of the delinquent member, have to chase their delinquent member. The AMAs are currently quite lenient with many of the delinquent ASCA members. This option is good for the delinquent member because s/he feels s/he is dealing with an institution with a better understanding of her/his needs and problems. However, this leniency results in the poor performance of the ASCAs portfolio, which is not in the interest of the group as a whole.

- The ASCAs are very focused on what they want: to maximize their income. They cannot achieve this objective unless they satisfy the needs of their clients. These needs include having a mechanism through which members can save, and also allowing the members to access credit or their savings for whatever purposes they identify. Instrumental in the smooth running of this arrangement is the willingness and ability of members to repay their loans. With the ASCAs, member exits are not as big an issue as is the case with MFIs. Members who are exiting ASCAs are doing so because of the adverse conditions in the macro economy, which have resulted in a lack of funds.

- A key lesson is that the informal financial sector has certain features, efficiencies and strengths, from which the microfinance industry could learn. Rather than interfere by completely changing the basic operations of the models emerging in the informal financial sector, the microfinance industry can introduce mechanisms to strengthen this sector. However the mode stakeholders use to engage the informal financial sector is critical, and we can learn some lessons from past mistakes. Donors, for instance have engaged MFIs in a way that did not send the right signals, in terms of supporting the evolution of innovative market-focused organisations.

Implications for Microfinance in Africa and Recommendations for *MicroSave*

Group Discussions

Implications for Microfinance In Africa

- MFIs and SACCOs need to work through the informal financial sector, particularly through organisations like RoSCAs and ASCAs if they are to achieve long-term sustainability. MFIs and SACCOs also need to change their approach in dealing with the informal financial sector to a bottom-up, demand driven approach.

- Best practice in the provision of financial services should be adopted not just from the microfinance industry (e.g. from MFIs and SACCOs) but also from the informal financial sector.

- MFIs/SACCOs and informal financial organisations should form complementary alliances rather than see themselves as competitors.

- Capacity building should be carried out for informal organisations that have linkages to MFIs and SACCOs.

- MFIs should carry out primary research to identify existing gaps in service provision to their target markets, and thus develop client responsive products and delivery systems.

- MFIs should also carry out secondary research and use existing information on the requirements of the informal financial sector and the groups served by this sector. This information can go a long way in instructing MFIs on means of improving the services they provide to their target markets.

- It is critical for the microfinance industry to develop more appropriate products that are demand driven and require simple procedures to deliver.

- The microfinance industry in Africa should not rush to institute regulation through central monetary authorities. Rather, it should explore alternatives with industry practitioners and other stakeholders. The question of self-regulation and internal controls needs to be revisited to develop a viable regulatory framework.

- The industry needs to recognise the contribution of the informal financial sector, and find means through which to build on existing structures and strengthening any weaknesses that exist within them. The informal sector provides a number of financial service delivery options that can be achieved sustainably without the intervention of donors. MFIs should explore these options more seriously.

- MFIs and other service delivery institutions in the microfinance sector need to exploit synergies of working together, as well as capitalizing on the experience of other stakeholders and actors in the microfinance industry, including development or public sector agencies. Networking and strategic partnerships will be increasingly important in raising the capacity of the different actors in the microfinance industry to develop new products and services for low-income people.

- Deposit guarantees should be developed to enable MFIs to develop savings products for low-income clients. Such strategies will require the support of government agencies that are responsible for the regulation of the financial sector, or may even require the introduction of new supervisory and regulatory agencies within the financial sector.

- The primary stakeholders in the microfinance industry are the informal sector, MFIs, commercial banks, donors and other service providers, both non-bank financial service providers and non-financial service providers. For MFIs to continue being competitive in the microfinance industry, they will have to look for opportunities for innovation through signals from the informal sector, by analysing their own internal capacities and creating strategic alliances with service providers who, traditionally, may not have been providing services to low-income people. MFIs will also have to address crucial issues like human resource development. Without an adequate pool of skilled staff at all tiers of the institution, MFIs will not be able to effectively deliver or expand their services. Integrating lessons from both the informal and formal sectors, MFIs will also be better placed to deliver more market-driven products that will enable them to expand their market share, and penetrate new markets.

- With more cooperation, coordination, and honest sharing among MFIs, more progress will be made towards dealing with some of the key challenges that MFIs face in their operations.

- Donors have to start sending the correct signals to the microfinance industry. Donors will have to be selective and clear on the MFI programmes they will continue to seed in order to support the growth of innovative and market driven institutions. Similarly, donors also have to set parameters of engagement with MFIs and other service providers in the sector, and make their period of engagement finite, so that it is very clear to the service providers that external support will not be definite, and for planning purposes, when that support is likely to run out. These parameters of engagement should also provide for the option for failure. If an institution cannot continue to operate sustainably, then the donors should allow for that institution to cease providing services to the microfinance industry, rather than continue propping up inefficient institutions that will not have any significant impact on the industry.

- Donors should encourage a more commercial approach to operations within the microfinance industry. The support emanating from development agencies should become increasingly commercially oriented, so that MFIs are relying less heavily on grants, but have to increasingly go to the market to seek financing mechanisms for their own operations.

Recommendations to *MicroSave* on Continued Support to the Microfinance Industry

- ***MicroSave*** should coordinate and facilitate interaction within the microfinance industry to promote its growth and development through information sharing sessions held in conjunction with apex associations. In addition, ***MicroSave*** should come up with more creative ways of disseminating information beyond e-mail.

- ***MicroSave*** should have a proactive approach with regulatory and supervisory bodies by disseminating best practice information on operations within the microfinance industry.

- Conduct more research across Africa and publish the results in the major languages used on the continent – English, French, Portuguese and Spanish.

- Support the capacity building and training of consultants who can carry on the key activities initiated by ***MicroSave*** beyond the life of the project.

- Commercial banks are increasingly interested in entering the microfinance industry and may be encouraged to do so more aggressively if they get research results that point to the profitability of operating in down market niches.

- ***MicroSave*** should continue to support more MFIs develop market oriented products and services to enable them to increase their outreach numerically and geographically.

- ***MicroSave*** should assess its own capacity to diversify its activities beyond market research, possibly by increasing linkages with other institutions that are providing technical support to the microfinance industry in Africa, e.g. AFCAP, in order to expand its capacity to work with the large number of research partners and other institutions that need market research and product development support.

Informal Sector Financial Systems and the Lessons for MFIs: Some Concluding Remarks

Graham A. N. Wright

Introductory Observations

Before poor people can begin to access opportunities to generate income/employment they need to reduce their ***vulnerability*** and the mechanisms to manage ***risks*** they face. Essentially, they need to create a stable platform on which to build income generation activities/businesses without falling pray to the crises that so regularly beset poor households.

Without this stable platform to allow them to cope with crises, poor households will be forced to use their traditional mechanisms to respond when their children fall sick, thieves visit them, animals die etc. Many of these traditional mechanisms have direct impact on the loans that MFIs may have advanced to support their business. These include:

- De-stocking existing business (at below cost prices, thus causing significant loss in the rush to liquidate assets)
- Diversion of loan funds (in the event that the loan disbursement coincides with the crisis or when the household has borrowed temporarily in the informal market in anticipation on the loan disbursement)
- Time away from business (to manage and organise all of the above)

The poor need financial services for a variety of reasons, most of which have underlying risk protection and risk management dimensions. Risks are factors beyond the control of the affected individual or household. They temporarily or permanently disrupt the functioning of the household economic portfolio to such an extent that the income stream required to fulfil the household's basic needs can no longer be maintained. The poor use different strategies to manage different risk factors. It is therefore of utmost importance that microfinance institutions analyse and understand these differences to be able to design products and service delivery structures that are appropriate to the risk management needs of poor people.

What Risks Do the Poor Face? (From Mutesasira, 1999)

Life-cycle Risks

Life-cycle risks are related to such events as marriage, birth, education, healthcare, homemaking, widowhood, old age, death and the need for an inheritance for one's heirs. Most life-cycle risks have a degree of predictability that makes planning and managing them somewhat feasible. However, these life-cycle risks can become or generate crises if they are not adequately planned for and insufficient savings have been accumulated to manage them. ***MicroSave*** found that there are typically four overwhelming life-cycle events that require relatively large amounts of money: wedding ceremonies, secondary and tertiary education, prolonged illness and the death of a spouse.

Structural Risks

Structural risks tend to be long-term, cyclical or permanent changes in the national or international economy. In East Africa, as in many other developing regions, some of the most conspicuous structural factors are strongly linked to the implementation of governments structural adjustment programmes, and seasonal factors that affect income and expenditure. In East Africa many micro-businesses suffer from instabilities caused by seasonal variations in income and expenditure.

Crisis Risks

Crisis risks are sudden, unexpected shocks to the household that disrupt its ability to generate income. They demand emergency interventions. They require the adoption of either short- or long-term strategies that may include the sale of productive assets or a permanent downward revision of the household consumption budget. Short-term coping strategies enable the household to manage the immediate stress situation before it can resume functioning at its pre-crisis level. Illness or the premature death of major bread earner, fire, accidents, thefts and cheating were frequently mentioned as triggering crises in East Africa.

Successful financial service provisions and innovations are dependent upon understanding and responding to client needs and preferences. This can only be achieved by understanding the client's complex risk environment as well as the strengths and weaknesses of their current coping mechanisms.

The Main Money Management Problem: Assembling Large Sums Of Money (From Rutherford 1999)
Despite their small incomes, the poor are faced, surprisingly often, with expenditure needs which are large in relation to the sums of money that are immediately available to them. Although day-to-day household expenditure – food is often an example – can be roughly matched with income, there are many other expenditure needs which call for sums of money much larger than they normally have in their purse or pocket.

There are three main categories of such occasions:

- ***Life cycle needs***. The poor need usefully large sums of money to deal with life cycle events such as birth, death and marriage, education and home-making, widowhood, old age and death, and the need to leave something behind for one's heirs, and for seasonal variations in consumption.
- ***Emergencies***. In order to cope with impersonal emergencies such as floods, cyclones, and fires, and with personal emergencies such as illness, accident, bereavement, desertion and divorce, large sums of money are again required.
- ***Opportunities***. As well as needs there are opportunities that require large sums of money, such as starting or running businesses, acquiring productive assets, or buying life enhancing consumer durables such as fans, televisions and refrigerators.

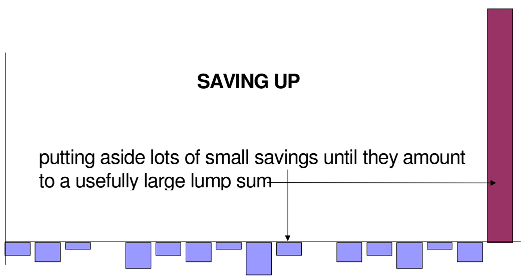
Finding these large lump sums of money is the main money management problem for poor people.

The poor themselves recognise the need to build savings into lump sums and contrary to popular belief the poor ***want*** to save and ***try*** to save, and all poor people except those who are entirely outside the cash economy ***can*** save something, no matter how small. When poor people do not save it is for lack of opportunity rather than for lack of understanding or of will.
The predicament of the poor can be expressed in the phrase "too poor to be able to save much; too poor to do without saving".

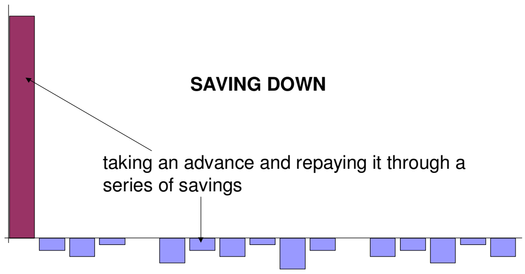
Three Ways To Convert Savings To Lump Sums (From Rutherford 1999)

There are several ways in which savings can be built into usefully large sums of money, but they fall into three main classes, as follows:

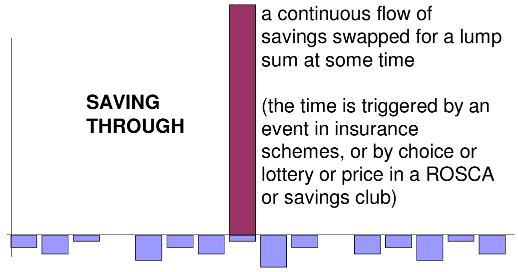
1. ***Saving up***. This is the most obvious way. Savings are accumulated in some safe place until they have grown into a usefully large sum. Many poor people lack a safe and reliable opportunity to save up. As a result, they may be willing to accept a negative rate of interest on savings, in order to be able to make deposits safely. We see this in the case of the deposit collectors that work in the slums of Asia and Africa.



2. ***Saving down***. In 'saving down', the poor are lucky enough to have somebody give them an *advance* against future savings. The savings then take the form of loan repayments. Many urban moneylenders offer this service at high cost. MFIs, like Grameen Bank in Bangladesh or PRIDE in East Africa, offer a similar service but do so at a lower cost and with greater reliability. The recipient of a PRIDE or Grameen Bank loan makes a large number of repayments at short intervals and these repayments can be sourced from the borrower's capacity to save. The advance can therefore be spent on any of the uses in the three classes listed above[33].



3. ***Saving through***. In this third case savings are made on a continuous and regular basis, and a matching lump sum is made available at some point in time during this flow of savings deposits. The services offered by insurance (in which case the savings take the form of premium payments) are of this type, though the poor are very rarely offered formal insurance services. "Saving through" is also offered by many forms of savings club, including, notably, rotating savings and credit associations, or RoSCAs (known in East Africa as merry-go-rounds or cash-rounds). 'Saving through' therefore constitutes the most common class of device that the poor are able to provide for themselves.



So What Are The Poor Doing?

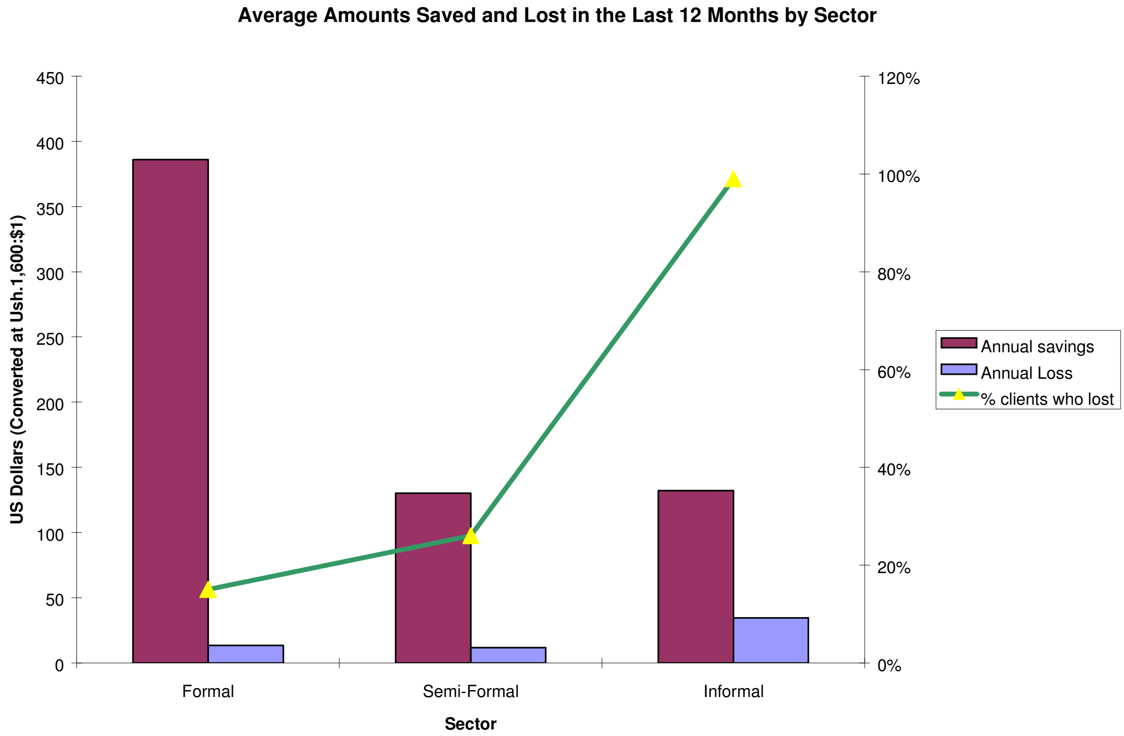
As this workshop has discussed, the vast majority of poor households are forced (through lack of alternatives) into using a wide variety of mechanism to save up, down and through in the informal sector. But all of these informal mechanisms whether RoSCAs, ASCAs, savings clubs, indigenous insurance schemes, money guards, deposit collectors or pawn-brokers are characterised by high risk and high levels of loss. The use of the group guarantee system by MicroFinance Institutions – particularly when high drop-out rates rapidly result in groups of members who scarcely know each other – results in high levels of loss to defaulting members.

Losses – the Big Picture from Uganda (From Wright and Mutesasira, 2001)

99% of clients saving in the informal sector report that they have lost some of their savings. 15% of those saving in the formal sector report that they had lost some savings and 26% reported lost savings in the semi-formal sector. Thus the formal sector, for those lucky enough to have access to it, is safer both in terms of likelihood of losing any savings and in terms of the relative loss (amount loss to amount saved). Those with no option but to save in the informal sector are almost bound to lose some money – probably around one quarter of what they save there each year.

[33] That is, it is not necessary to spend the advance on 'income generating activities' that produce an immediate stream of additional income. Of course, the source of the savings that are used to make the repayments may or may not be a business.

People who have access to the formal sector reported saving three times as much ($386) in the last 12 months than those who saved in the semi- and informal sectors. The people saving in the formal sector also reported a lower incidence (15%) of loss and a lower rate (3.5%) of loss in the last year. Almost all (99%) people saving in the informal sector reported that they had lost some money through informal savings mechanisms and on average they had lost 22% of the amount they had saved in the last year.



How Do the Poor Seek to Mitigate This Risk? (From Wright 2000)
Stuart Rutherford differentiates between the two strategies pursued by outside agencies (be they development or private sector) and poor people themselves as they seek to design and deliver financial services. The former tend to use a strategy of "permanence and growth" and look to create sustainable institutions that deliver financial services to an ever-increasing number of clients - MFIs, banks, co-operatives etc. By contrast poor people themselves generally use a strategy of "replication and multiplication" and look to create many small self-contained, often self-liquidating schemes - RoSCAs, Christmas clubs etc.

There is another important difference between these two strategies and the types of schemes they spawn. The permanence and growth institutions tend to encourage the long-term build-up of funds through relatively slow, but steady, saving (and are therefore extremely well suited for addressing longer-term savings needs such as house building, pensions etc.). The latter replication and multiplication schemes tend to encourage the rapid accumulation and disbursement of funds (and are therefore better suited to meeting shorter-term savings needs such as purchasing small assets or financing festivities or rituals etc.).

These differences explain why the poor will often hold accounts in permanence and growth institutions while enthusiastically participating in a variety of replication and multiplication schemes - the different schemes are fulfilling very different needs. Furthermore, it is because of their differing roles that RoSCAs and other shorter-term schemes often attract markedly more savings than secure, interest-bearing accounts with financial service institutions.

Are MFIs Not Addressing the Financial Service Needs of the Poor? (From Wright 2000)
Sadly, the evidence suggests that MFIs are not meeting the needs of the poor. Drop-outs from East African MFIs are (typically) around 50% per annum. There is compelling evidence to support the contention that a significant majority of "drop-outs" occur because MFIs' financial services are inadequate or inappropriate to meet the needs of the very clients they are trying to serve. Drop-outs are expensive for MFIs, both in terms of money already invested that is lost as the member leaves, and in terms of lost potential future business from the member. MFIs seeking to develop permanent sustainable organisations should seek to

improve the financial services they are offering in order to reduce client dissatisfaction and thus drop-out. Such a strategy is likely to prove cost-effective.

There is also increasing evidence – particularly from Bangladesh - that the "group guarantee" system, while probably useful in the initial loan cycles, has a declining ability to secure repayment of loans. Continued access to follow-on loans has long been viewed as one of the most important incentives for clients to repay. Given the value that the poor place on having access to financial services (both credit and savings facilities), it is clear that the better the quality of these financial services, the more the poor will value access to them, and thus the more likely they are to continue to meet their obligations (including repayment of loans) to the MFIs that provide them.

For all these reasons, MFIs should pay (and indeed are paying) increasingly close attention to the nature and quality of financial services they offer. The trade-off between the quality of the services and cost of providing the services is a clear one, but getting the balance right is difficult. There is evidence that, to date, MFIs in East Africa have put too much emphasis on trying to implement standardised, inflexible low-cost, credit-driven systems when their clients are asking (and willing to pay) for a better quality and broader range of financial services.

What Are "Quality Financial Services" for the Poor? (From Rutherford 1999**)**
Financial services for the poor are services that help the poor turn savings into lump sums. Good financial services for the poor are a matter of doing this:

- In as many ***different ways*** as possible (saving up, saving down and saving through)
- Over as many ***different periods*** (varying from very short term for quick needs, to very long term for old age or widowhood, for example) as possible. In ways that are ***convenient, quick, appropriate, flexible*** and ***affordable***

From Product-Led to Market-Led MicroFinance (From Wright et al. 2001)
The microfinance industry is one of the few remaining industries in the world that is primarily product - rather than market-driven. With the rising recognition of the costs associated with high levels of drop-outs and their implications for achieving sustainability, there is a growing appreciation of the need to deliver client responsive products. Increasing levels of competition in many markets have also highlighted the importance of a market-driven approach to microfinance. There is little reason to doubt that the microfinance industry will follow the trend of the commercial world towards a market-driven approach and that MFIs that do not respond to the needs of their clients will eventually fail.

As noted above, careful analysis of the reasons for drop-outs almost invariably points to inappropriately designed products that fail to meet the needs of the MFIs' clients (see for example Wright, 2000 and Hulme, 1999). Much of this problem is driven by the attempts to "replicate" models and products from foreign cultures and lands without reference to the economic or socio-cultural environment into which they are being imported. This has been exacerbated by the lack of competition in many of the markets in which MFIs started. This lack of competition and the demand for credit meant that the MFIs could offer almost any product, however client-unfriendly, and there would be demand. Now, with the growth of competition amongst MFIs in many of the markets in which they operate, clients have choice and are voting with their feet. And yet only a few MFIs have started developing client responsive, market-driven products.

Market Research
Market research is an activity designed to understand the environment in which the MFI is operating and to identify the needs and opportunities of the MFI's clients and potential clients. Many of these needs are currently being met through recourse to the high risk, high loss informal sector financial systems. It is by studying these systems that we can learn a great deal about the financial service needs of poor households and how MFIs might usefully respond to these.

Market research is usually conducted with a view to responding to the needs and opportunities of poor households by:

- improving current marketing/promotion/outreach activities,
- refining existing products,
- developing new products, and/or
- re-engineering delivery systems.

The process of market research and product development can be described as follows. The *research objective* is usually driven by initial analysis of secondary data and then focuses the market research effort on the specific issues to be examined. This in turn allows the development of a *qualitative market research plan* typically involving a variety of *qualitative research* techniques including focus group discussions and Participatory Rapid Appraisal (PRA) sessions. The results of this work then allows the product development team to *develop a product concept* which is subjected to appropriate costing and pricing analysis to ready it for the process of refining the *concept into a prototype*. In some cases the product prototype is subjected to *quantitative research* to provide a final check of the marketability of the prototype before investing in the *pilot test* (Wright, 2001).

MicroSave specialises in assisting MFIs to develop new products and refine their existing ones – visit our website: www.***MicroSave***.net! There you will find descriptions of ***MicroSave***'s internationally recognised "Market Research for MicroFinance" course together with listings of trainers who have been trained and certified to deliver it. In East and Southern Africa, trained trainers include:

- Kamau Kabbucho/Nthenya Mule in **Kenya**
- Henriquetta Hunguana in **Mozambique**
- Kalipe Mashaba/Gerhard Coetzee in **South Africa**Altemius Millinga in **Tanzania**
- Sylvia Osinde/Evelyn Stark in **Uganda**
- David Musona in **Zambia**
- Petronella Chigara in **Zimbabwe**

And Finally Some Concrete Suggestions

- Learn from the informal sector – not only is it MFIs' largest competitor, it is also an important source of information and inspiration for developing client-responsive financial services.
- Think outside the Grameen/FINCA box – not all microfinance services have to depend on solidarity groups of 5 or 30 members
- Invest in market research and product development: it is your future and the returns on investment will warrant the initial outlays to get the product and supporting systems right!
- Look at rapid-response emergency loan products – they'll protect your capital loans
- Look at alliances/linkages to offer insurance/ leasing and other financial products
- Look for alternative approaches to assisting the poor to save … even though you're not a bank!

Alternative Approaches to Offering Savings Services

- Strategic alliances with banks (e.g. Ghetto-KPOSB and PRIDE-Standard Chartered)
- Offering savings services & depositing the savings straight in bank (no intermediation) – Note: this is flying close to the wind (e.g. UMU and UWFT)
- Supporting and federating ASCAs/SHGs (e.g. NABARD/AFRACA)
- Supporting ASCAs/savings clubs within solidarity groups (e.g. PTF and FINCA)
- Creative registration (e.g. *SafeSave* – registered as a co-operative)
- Creative institutional form (e.g. CASHPOR, India – manages the savings trust of its members and SAGA – manages front office functions of ASCAs' Cooperatives)
- Creative products (e.g. UK Credit Unions operate current accounts by selling/buying-back "shares" in a passbook account)

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