Informal Finance for Private Sector Development in Africa*

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1. Introduction

More than a decade after substantial macroeconomic reforms were initiated in many African countries, aggregate growth, has at best remained inconsistent in many of those reforming countries. While the reasons for poor aggregate performance vary across countries, there is substantial evidence that in many countries, poor private sector investment response in the medium-to-long term has delayed long term growth. The poor response of the private sector might generally be attributed to varying factors in different countries. Indeed, various surveys suggest that a more vigorous response from the private sector in many countries has been impeded by a number of institutional, structural, and financial constraints. (See Box 1).

The apparent dearth of medium-term financing, the rudimentary nature of capital markets and the weaknesses in financial intermediation in general have made it difficult for private businesses to find the means of financing other than short term bank credit. On the other hand, the generally low profitability of many private firms and the low overall level of domestic savings limit the prospects for investment financing from their own resources.

While the obstacles to private sector development are many, the financial constraints have received the most attention from both governments and donors. Throughout the 1980s, it was fashionable to blame the financing constraints of the private sector on the inadequacies of banking systems and their poor perceptions of the creditworthiness of the small ventures that dominate African economies. Increasingly, however, possible solutions to the underlying factors behind the reluctance of commercial and other banks to lend to small enterprises are being sought, as more and more people begin to understand the problems of banks in relation to their structures and policy bottlenecks.

In view of the continuing problems with finance, it is not surprising that reform of the financial sector became a major component of economic reform programmes in many countries. Reforms were necessitated by the observation that various policy regimes shifted the allocation of investible funds from the market to the government. In many countries, banking institutions simply became institutions for financing the budget deficit or covering operating losses incurred by parastatals. Reforms were also made necessary by the fact that financial repression generally hindered the development of the institutional capacity of financial institutions in their development of the commercial viability of their operations. As

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Box 1: Constraints to Private Sector Expansion in Ghana

For 133 medium/large scale enterprises studied in Ghana, inadequate finance turned out to be the most significant constraint for 53 percent. Finance became more of a problem the smaller the enterprise. Half of the financial problems were associated with inadequate working capital and poor access to credit for equipment. Other important constraints identified related to poor demand for products as potential customers "had no money" and the fact that their equipment was too old. On the constraints to possible exports from the non-traditional product sectors, (e.g. rubber, aluminium, pineapples, wood products, handicrafts, etc.), the most cited problems were:

- Inadequate policy framework;
- Inadequate financial mechanisms and incentives;
- Inadequate knowledge of markets, product quality, investments and technical knowl edge;
- Inadequate institutional support; and
- Inadequate export infrastructure.

These problems arose from inadequate trade policies, poor administrative procedures, inadequate investment finance and working capital, as well as poor development of private sector organizations to protect the interests of members and poorly established public institutions that are expected to facilitate exports. For small-scale enterprises, finance was also cited as their most significant constraint to expansion. What is interesting here is the greater variation in the source of the financing problem. The small firms had more problems with access to credit than the medium/large firms, while the medium/large ones saw more problems with demand than the modern small (not micro) enterprises, even though this was not considered to be the most important constraint.

Obviously, a more vigorous response of private investment to economic reforms was impeded by a number of institutional, structural, and financial constraints. The apparent dearth of medium-term financing, the rudimentary nature of capital markets, and the weaknesses in financial intermediation in general made it difficult for private businesses to find means of financing other than short term bank credit. The generally low profitability of many private firms and the low overall level of domestic savings limited the prospects for investment financing from their own resources. Also, distortions in the tax treatment of capital and investment income, particularly the high capital gains tax (until 1990) and the withholding tax on dividends, acted as a disincentive to new investment and may have retarded the necessary restructuring of many private enterprises.

Source: Aryeetey, et. al. (1994).

banks failed to develop the capacity for risk assessment and monitoring of optimal management of their loan portfolio, they became uninterested in investing in information capital which is crucial for the development of financial systems.

The reform of financial markets has taken the form of significant liberalization as countries shifted from the 'repressive' regimes, characteristic of the pre-adjustment era. Governments are no longer required to play major roles in determining credit flows through a system of subsidies, interest rate ceilings, credit allocation and direct intervention.

But liberalization has not been effective in improving credit delivery. In many countries, a consequence of the initial growth that resulted from the structural adjustment programme was a significant increase in the demand for finance by businesses, which formal financial units failed to satisfy. In Ghana a number of interesting and important observations with regard to the financing constraints of such enterprises and their relationships with banks after the reforms have been made. A major observation was that while internal sources of finance continued to dominate the finance of fixed investments, external finance was quite significant and could not be discounted-- particularly bank loans among small- and medium-sized enterprises. In spite of that trend, only a half of Ghanaian SME applications for bank loans had any chance of being favourably considered. About two-thirds of microenterprise loan applications were likely to be turned down. While bankers attribute high rejection rates to the absence of viable or bankable projects, entrepreneurs indicate it was because they were not seen to have good collateral. As a consequence, it is now widely accepted that the obstacles to financial markets development were not simply policy-induced, but have some structural and institutional origins that cannot simply be addressed with macroeconomic policy reform.

In searching for alternatives to formal sector finance, some attention is increasingly being paid to informal and semi-formal finance (including micro-finance) for meeting private sector credit demand, particularly from small enterprises. There has been increasing pressure on informal units to provide appropriate supporting finance as would be expected by new structuralist economics. In Ghana, for example, *Susu companies* emerged soon after reforms began, guaranteeing their depositors credit after six months of regular deposits. But the difficulties of making informal finance play a modified role quite different from the one it was used to, in terms of loan characteristics and uses, became apparent with the failures of these institutions. It is now obvious that while SMEs enjoy considerable goodwill among informal lenders, current informal market conditions are generally not suited to the type of finance required by a large number of SMEs. Also, while developments in the formal non-bank financial sector and micro-finance were expected to improve the financing of small and medium sized enterprises, applying what have come to be referred to as "innovative methods" for delivering credit, the effect of these on private sector development has not been apparent.

Considering that there is still dissatisfaction with credit supply in many parts of the region, a major question arising from the recent developments is "What can be done to make informal finance and micro-finance suitable for financing growing SMEs"? This paper, which will investigate some of the constraints to informal sector financing and micro-finance for private sector development throughout Africa, is divided into five sections. Section 2 looks in detail at the growth constraints of the private sector and how finance fits into that dilemma. There is also a discussion of the private sector's use of informal finance here. In section 3, the characteristics of informal finance, focusing on size, structure and scope of activities are presented. The objective is to show that informal finance has not been very attractive for the private sector. Indeed, it is shown that the informal sector has considerable experience and knowledge about dealing with small borrowers, but there are significant limitations to what it can lend to growing micro-businesses. It is also shown that there has been little informal sector lending to private businesses, both before and after reforms, even though informal lending has grown considerably. In section 4, some recent trends with micro-finance development are discussed. While externally-driven micro-finance projects have surfaced in Africa, their performance in relation to the finance of small businesses has not been as positive as they have been in Asia and Latin America. In section 5, some possible steps towards a new reform agenda that will make informal and semi-formal finance (micro-finance) relevant to private sector development are introduced. This will focus on the links among formal, semi-formal and informal finance, and how these links can be developed.

2. The Development Constraints of the Private Sector

The constraints to the development of the private sector can generally be categorized into internal and external factors. External constraints include the policy environment and access to various markets and facilities. Internal constraints relate to the profitability of firms and the ability to pay market rates for resources, as well as management capability.

External Constraints of the Private Sector

It is usual in surveys that private sector operators suggest that various constraints to their expansion are 'beyond their immediate control'. The problems are often to do with obtaining access to various services, thus making them external.

Domestic Finance: Problems of finance tend to dominate all other constraints to expansion from surveys. (See Table 1). The problems that generally receive the most attention as the most significant constraints to expansion are a) the absence or inadequacy of credit for working capital, and b) the lack of credit for the purchase of capital equipment.

Table 1: Firms Facing Financial Constraints (%)

Ghana		Malawi		Senegal		Mali	
Micro	Small	Micro	Small	Micro	Small	Micro	Small
79	83	62	68	92	90	83	72

Source: Steel (1995).

The amount of formal external finance available to SMEs in particular is far less than expected. Despite SMEs' strong interest in credit, banks' profit orientation may deter them from supplying credit to them because of the high transaction costs and risks involved. First, SMEs' loan requirements are small, so the (more or less fixed) costs of processing the loans tend to be high relative to the loan amounts. Second, it is difficult for financial institutions to obtain the information necessary to assess the risks of new, unproven ventures, especially because the success of small firms often depends heavily on the abilities of the entrepreneur. Third, the probability of failure for new small ventures is considered to be high (See Box 2).

Other Problems: Other problems that small businesses face are generally given lower rankings in surveys. In many countries, problems with access to raw materials have been eased because of the trade and exchange rate liberalisation policies and the balance of payments support that has invariably accompanied these. Foreign exchange is often readily available for the importation of raw materials, spares and equipment (following significant balance of payments support that countries receive). Other constraints include old equipment and high transport costs. The increased flow of imported finished goods after trade liberalization appears to 'adversely' affect smaller private enterprises more than others. While firms might attach less attention to the availability of management skills, the shortage of adequate management capability, which many entrepreneurs fail to recognize, must be mentioned.

Box 2: The Relationship Between Firm Size and Credit Receipt

The SME study in Ghana showed that smaller enterprises have a greater problem with credit than larger firms as 42 percent of the microenterprises listed credit for working capital among their major constraints as against 38 percent of small-scale enterprises and 25 percent of the medium-sized firms. A similar trend was observed with credit for equipment purchase. The results were generally seen to reflect an inverse relationship between size and demand for credit, as well as access. They observed that the success ratio for large firms applying for bank loans was almost 70 percent as against 45 percent for small-scale enterprises and 34 percent for microenterprises. Thus, the smaller the firm, the more important was the lack of access to finance as a constraint.

Source: Aryeetey, et. al. (1994).

Internal Constraints to Private Sector Development

These deal with profitability as it relates to the costs of finance, labour, raw materials, equipment/ technology, infrastructure and production, as well as the management of demand for their products.

Domestic Finance: The achievement of real positive interest rates has been a major objective of financial sector reforms. But as the countries kept high inflation rates, these forced lending rates up considerably, thus making the cost of borrowing unattractive in many situations. In a number of countries, including Nigeria and Ghana, lending rates have exceeded 35 percent for more than five years in the last decade. Also, with high inflation, even when firms are experiencing rising profits, they often find it difficult to finance raw material and equipment purchases from internal sources. Complaints about the inadequacy of profits for input purchase usually come from small enterprises.

Other Internal Problems: Firms have relatively little difficulty with obtaining local raw materials, but their prices pose major problems in many countries suffering from high inflation. Also access to adequate technology by way of proper equipment is considered to be a major challenge for African enterprises. The internal management of firms appears to raise problems for some firms, including even the larger ones.

Financing by the Private Sector

An assumption underlying the characterization of growth and dynamism among small and microenterprises is that they are potential efficient users of capital, and that their capital needs, and how these are satisfied, are related to their sizes. As enterprises grow through different stages i.e. micro-, small-, medium- and large-scale, they are also expected to shift financing sources. They are first expected to move from internal sources to external sources, generally starting with informal finance. While many microenterprises may find informal sources of credit and personal or family savings adequate, their financing needs can no longer be met by these sources as they become larger. Thus, a shift from informal to formal external sources would be expected as enterprises graduate to larger sizes, and would fall back on informal finance only if cheap formal finance is not available.

The reality of business start-up and operation in Africa does not portray such a neat progression, however. It shows the domination by internal sources of funds as against external sources, even long after businesses have been established. Studies of African enterprise often report little debt in the portfolios of businesses. Only 25 percent of surveyed Ghanaian manufacturing enterprises had any outstanding debts in 1993. As is generally known about many African businesses, the majority of firms use owners' savings to finance start-up. In Zimbabwe, as many as 71 percent of different sizes of firms used owners' savings as the primary source of start-up capital in 1993. As shown in Table 2, the use of owners' savings has been much more prominent in the smaller operations, where also loans from friends and relatives (the major external sources) have made minor contributions for 8 percent. This situation is similar in many countries mentioned in the 1988 ILO African Employment Report. On average, about 65 percent of start-up capital in African businesses comes from owners' savings and most of the remainder are loans from family and friends.

Retained earnings become more important to firms that are already operating than owners' savings when raising working capital and small investments. Only some 4 percent of small and medium-sized firms in Zimbabwe, for example, used personal savings as the main source of finance for investments in 1993. For microenterprises, however, personal savings of owner still remain important, second only to retained earnings. When firms turn to external sources, (including loans from Development Finance Institutions [DFIs], equity issues, advances from parent companies), only a small number of firms in many countries can draw on these regularly. Also, while bank loans are used by some firms for working capital, the amounts involved are often far less than desired by the firms. Only 12 percent of Zimbabwean SMEs firms used bank loans in 1993 for working capital.

Even though Table 3 suggests that as firm-size rises, the use of bank credit increases, it must be emphasized that the progression is not clear as a large number of growing firms have little access to bank credit. Those who have to rely entirely on themselves or on relatives are forced to start very small.

Table 2: Sources of Start-up Finance by Firm Size in Zimbabwe

Proportion of firms which used	Micro	Small	Medium	Large	Mean
Own Savings	90	80	58	52	71
Friends/Relatives	13	2	7	11	8
Bank Loan	3	14	9	9	10
Other	13	19	22	25	19
No. of observations	40	64	45	44	200

Source: RPED study on Enterprise Finance in Zimbabwe, April, 1995.

Those who are successful appear able to generate sufficient savings out of their profits to establish a new enterprise, which is more likely to be in a larger size category. Their track record in their previous business, together with the savings that they have accumulated, may be important in giving them greater access to external finance, which in turn permits establishing a larger size firm.

Thus, it appears that investment in a new firm on a larger scale may be an important mechanism for "graduation" from one size category to another as gradual expansion of an existing enterprise. Creating new firms may also be the means by which successful entrepreneurs adapt to changing market

Table 3: Portfolio Composition by Firm Size in Ghana/Average Shares of Sources of Finance in Total Debt, (% of Total)

Source of Finance	Small	Firm Size Medium	Large
Banks	7	24	66
Trade Credit	66	64	32
Suppliers	20	36	21
Clients	46	28	10
Family and Friends	27	12	2

Notes: (a) Firm Size by No. of Employees; small 1-10; Medium 11-50, Large 51+
Source: Cuevas, et. al. (1993).

opportunities. Many entrepreneurs are able to manage this transition out of internally generated funds, as external finance only plays a limited role in facilitating this transition.

For small and medium sized enterprises, trade credit overwhelmingly dominates finance of operations. Client pre-payment is often more important than suppliers' credit for some microenterprises. The use of client pre-payment for goods as a major way of financing small businesses varies considerably among the different industrial sectors and by sub-region, however. Thus, while it is considered to be unimportant in Zimbabwe, it tends to be extremely important to the furniture industry in Ghana. In Zimbabwe also, most firms gave and received trade credit (See Box 3). Microenterprises are generally more likely to give credit to their customers than receive credit from their suppliers.

Suppliers' credit is more important to medium-sized enterprises (11-50 employees, usually) than it is to small and microenterprises. This structure of financing reflects not only the inefficiency of long-standing lending programmes targeted at small enterprises through formal banking institutions, but also suggest the futility of firm-size targeting when large firms may be precisely the best conduit to increase liquidity among medium and small scale firms through trade credit linkages.

Borrowing from informal sources has generally not been established to be important in many countries, except for a few small enterprises. Only 8.1 percent of Ghanaian SMEs have ever sought a loan from a moneylender and 2.5 percent had approached a *susu operator* for assistance. Considering the relatively large number of rejected bank loan applications, there is clear evidence of little spill-over into informal segments of the financial market. Indeed, the absence of spill-overs is characteristic of the fragmented markets of Africa. In Malawi, where borrowing from banks is relatively easy, only 35 percent of unsuccessful bank loan applicants tried to use informal sources as alternatives. This trend bears close resemblance to observations in Ghana where less than 50 percent of a sample of 55 mainly rural non-farm enterprises were successful with their last bank loan requests and yet more than a half of those who failed to secure loans did not attempt to borrow elsewhere. Spill-overs do not occur because, even though the borrower has an unsatisfied demand for finance, none of the offers made by the informal sector would provide an income benefit in excess of that which is available by not borrowing.

Even for the finance of capital investments by manufacturing firms, internal sources of funds, mainly retained earnings or personal savings, dominate for small and medium sized manufacturing firms, while bank credit and suppliers' credit tend to be important for large firms. Table 4 shows a Ghanaian example. Indeed, while there is some bank credit in most financial systems, there is considerable evidence from a number of countries that it is not the decisive factor in enterprise development. Bank finance is used mainly for large investments by large firms.

Box 3: SME Finance in Zimbabwe

In the Zimbabwean RPED study of manufacturing enterprises conducted by the World Bank in 1993, the survey results for all firm categories (micro, small, medium or large) show that suppliers' credit accounted for about 30 percent of their outstanding balances. Altogether, this was the most important source of outside funds. Small and medium sized firms were, however, more likely to benefit from such credit than microenterprises. Next in order of importance, were loans from Non-Bank Financial Institutions (NBFIs), such as finance houses, building companies, pension funds and government credit programmes. This type of financing accounted on average for 28 percent of total credit in-flows. These loans were found to benefit mostly large firms and only a few medium or small enterprises. No microenterprise benefited from such credit. The third most important source of funds was bank overdrafts (which were normally rolled-over in effect to become long-term credit) and bank loans which provided 23 percent and 14 percent respectively of total enterprise credit. Again, bank loans generally benefitted small and medium enterprises more than they did microenterprises. Indeed, larger firms in Zimbabwe made more use of formal finance as less than 20 percent of microenterprises reported ever having received a bank loan, in contrast to 75 percent of larger firms.

Source: World Bank: Regional Program on Enterprise Development, 1995.

Table 4: Sources of Finance for Investments in Capital Stock in Ghana (By Firm Size) (Land, building, equipment; (% of total investment costs).

Source of Finance	Small	Medium	Large
Internal	65.3	7.7	36.1
Banks	3.3	12.5	33.3
Suppliers' Credit	4.7	0.0	30.6
Family/Friends	10.0	15.8	0.0
Equity	16.6	0.0	0.0

Notes: (a) Firm Size by No. of Employees; small 1-10; Medium 11-50, Large 51+
Source: Cuevas, et. al. (1993).

Credit Demand By the Private Sector

Is there enough reason to believe that there is an unmet demand for credit? Demand for finance may be conceived in a number of ways: when entrepreneurs cite finance as a constraint at a time that they are in need of cash, this may often be seen only as perceived demand; on the other hand, when they generally express a desire for credit (probably not quantified) and do not act upon it, in the face of market imperfections and institutional barriers, some portion of this might represent "potential" demand [includes discouraged would-be applicants who would come forward if they thought their chances were better or if banks were not hard to deal with]. What could be interesting to bankers is when demand is revealed, i.e., entrepreneurs apply for credit at prevailing interest rates. They are interested in revealed demand that is backed by bankable projects. It is essential to go beyond what is revealed and include potential demand. It is difficult to derive a reliable estimate of such demand for credit, however. Directed credit schemes for small enterprises, such as those applied by many donors and governments in the 1970s assume that the demand for credit far exceeded supply. Criticism of the supply-leading approach has contended that non-existent demand would not necessarily emerge to follow supply and therefore lead to a misallocation of resources.

There are indications from a number of countries that there is a substantially larger demand for credit than banks would like to believe, but fewer creditworthy projects than potential borrowers believe they have. (See Box 4). Indeed the high demand for credit among existing firms is strong, expressed by the high percentages of firms that have not only expressed a desire for loans at market rates of interest but have persistently applied to banks or sought other sources if rejected. While successful, growing microenterprises often can meet working capital needs from internal finance, they need external finance to expand. Stagnant firms are more likely to need working capital to offset weak cash flow or investment capital to replace obsolete equipment.

Box 4: The SME Demand for Credit in Ghana

About 63 percent of a sample of over 300 firms had, at various times, applied for bank loans for their present business. Some 2.4 percent had put in a loan application for a different business and another 16.5 percent had enquired from banks but had been discouraged from putting in applications. Only 16.5 percent of the sample had never applied for a bank loan. The application rate varied significantly with the size of the enterprise; only 6 percent of medium sized firms had never applied for a bank loan, compared to 22 percent of microenterprises. On average, firms had applied at least twice for bank loans. Only a half of the larger firms applying for loans received them, and only a third of the smaller ones did. Microenterprises had to put in an average of three applications before one was successful, whereas medium-sized firms often received loans with their first applications.

For firms with fewer than thirty workers that had loan applications rejected, lack of collateral was the main reason given. No medium-sized firm was told it did not have adequate collateral. Also, no firms were told their planned projects were unsatisfactory or that they lacked adequate experience. The study team's assessment of projects proposed by firms indicated that about 47 percent of sample firms might be considered creditworthy, based on standard bank appraisal criteria. The overall credit ratings rose with firm size- which also was correlated with acceptability of collateral and financial management capability.

Source: Aryeetey, et. al. 1994.

Despite the evidence of little use of bank credit, many studies of enterprise finance suggest that medium- and small-sized firms that seek credit are likely to turn first to a bank. The two reasons for going to the bank are a greater perceived chance of success and a lower interest rate. Those that do not first apply to a bank consider their chances of receiving bank loans low or do not have a bank account.

The Response of the Private Sector to Inadequate Formal Credit

Under competitive financial market conditions it is expected that when firms that fail to secure formal loans, they would replace these with informal finance. But as shown above, when private sector operators fail to obtain formal credit, which is what they initially seek, they do not substitute formal finance with informal finance. The usual responses to unavailable formal credit are:

- Scale down considerably planned investment to equal received formal credit, if any;
- Use personal savings of entrepreneur, as well as enterprise, (when they can be separated) to finance part or all of planned investment;
- Delay/abandon planned investment.

The less-than-expected use of informal finance (apart from start-up capital from family and friends), reflects the highly segmented nature of financial markets. Many firms tend to view borrowing from informal commercial sources as a measure of last resort rather than a preferred means of regular finance, thus making ‘spill-overs’ minimal. Since loan applications to informal sources are almost always successful, the reluctance of SMEs to use informal finance indicates that its terms are unattractive for small manufacturing business, a point that is re-emphasized again in section 3, when the characteristics of informal finance and why it is little used by the private sector are discussed.

Table 5: Effect of Access to Finance on the Most Recent Investment in Zimbabwe (%)

Firm Response	All	Micro	Small	Medium	Large
Had to delay investment	32	57	31	18	32
Had to Reduce Investment	17	43	15	0	16
No. of Observations	50	7	13	11	19

Source: World Bank, RPED Study of Zimbabwe, (1993).

3. Informal Finance and Enterprise Development in Africa

We explore in this section the characteristics of informal finance that make it difficult for it to be accessed by African enterprises. “Informal finance” might be defined to embrace all financial transactions that take place beyond the functional scope of various countries’ banking and other financial sector regulations. This definition permits the inclusion of a wide range of financial activity whose operational scope may differ across countries. Indeed, there is a wide variety of such informal savings and lending units in the region.

The definition of informal finance pulls in such schemes as the operations of Savings and Credit Associations (SCA), known all over Africa; professional moneylenders; part-time moneylenders such as estate owners, traders, grain millers, smallholder farmers, employers, relations and friends; mobile bankers generally known as *susu* or *esusu* collectors[1] in West Africa; credit unions; co-operative societies; etc. These have been observed in both urban and rural areas. While savings collectors fall under the first category of deposit mobilizers, moneylenders, including relations and friends, do not generally accept deposits and may be placed in the second category. SCAs, credit unions/credit cooperatives take in deposits and also lend in rather varied forms. In general, most informal units deal with specific groups of people, ensuring that only people that satisfy distinct selection criteria are able to either deposit with them or borrow from them.

Informal Market Segmentation: Who Can Borrow from Where?

There is no doubt about the extreme segmentation of the financial markets of Africa. Indeed, the markets may be called “fragmented” because the various segments serve distinct groups of clients with similar characteristics and needs, and there is hardly any interaction among the different institutions. In that situation, the negative effects of weak linkages among segments far outweigh the benefits of any specialization that they could make available through the existence of segments. Fragmentation is indicated by wide differences in interest rates as well as the insignificant flows of funds between segments. These tend to limit access to funds by potential clients. Since the funds of different lenders can hardly be substituted, the fragmented markets have difficulty intermediating between savers and investors. In not being able to allocate financial resources, they cannot always transform and distribute risks and maturities efficiently. As a consequence, the deposits they mobilize as well as their credit facilities display specific differences in structure that make it possible to associate their demand and usage with distinct socio-economic groups.

Credit from **moneylenders** is often the most expensive credit available; hence the demand for it usually comes from persons without any other options. Such credit remains nevertheless the only source of informal credit that does not require borrowers to satisfy specific membership obligations. Despite the relatively high probability of loan requests being granted, the short maturity periods and high interest rates do not make this credit attractive for those seeking working capital and fixed investment loans. In most of rural West Africa, the clientele is wide ranging, including farmers, market women, other traders, non-farm entrepreneurs and other self-employed craftsmen. Farmers sometimes borrow money from moneylenders during the planting season to maintain their households until the next harvest. They may also borrow for expenditure on funerals and other social events. While rural households are generally known to borrow from their own communities, they sometimes travel far to borrow from a moneylender.

Savings and Credit Associations/Cooperatives' credit facilities are used mainly for consumption, even though they are sometimes used for working capital. In Malawi, however, the use of cooperative loans for financing farm working capital outweighs their use for consumption as these are mainly used for fertilizer purchase and payment for farm labour. A small loan for a short period only has to be used for an activity that has a quick turnover, such as cereal production. Group membership is an essential tool for screening loan applications and for ensuring that contracts can be enforced. For many associations, limitations to growth in size is imposed by expected increased risk and the increased probability of losing homogeneity as group expands. Homogeneity provides them with a sense of familiarity that engenders mutual trust. Some rotating savings and credit associations' (ROSCAs) are known for not putting together people with too different backgrounds and interests. The size limitation restricts the usage of these sources to those borrowers whose demand for loans is not regular (e.g. those requiring loans to purchase a relatively expensive consumption item).

Savings (susu) collectors grant "advances" to some of their trusted clients mainly. Other loan recipients might be traders at local markets in need of short-term credit. When collectors lend to non-deposit clients, the terms are often different from those of their deposit clients; they tend to behave as moneylenders.

Informal Sector Lending to the Private Sector

A number of recent studies (See Box 5) reveal adequately that there has been substantial growth in the activities of the informal financial sector since reforms began in many countries. Unfortunately, while the informal sector has grown and is willing to increase lending, its products are not necessarily what the growing small private sector demands.

There appears to be greater diversification in activity among some informal institutions in attempts to reach out to more borrowers than is observable among formal institutions after reforms. Indeed lending by Savings and Credit Associations has become part of a wide and growing range of informal financial activities that growing in clientele as well as growth in institutional goals and scope, including a diversification of the clientele. Even though the scope of activities of SCA has broadened over time, the socio-economic principles underlying their operations do not appear to have been correspondingly altered. Change in the scope of SCA activities, as with other informal financial units, has been induced by changing socio-economic circumstances of their clientele or membership and also by changes in national economies.

Significant growth in SCA and rural cooperative lending has been observed in a number of countries. But the growth of lending by commercial moneylenders has been slower than that of the SCAs and cooperatives in West Africa. Loan applications to moneylenders in Ghana and Nigeria rose significantly between 1990 and 1992. But rural moneylenders received more applications in a year than urban lenders. They granted loans to over 80 percent of their loan applicants in the period. Similar experiences have been reported in Malawi.

Urban informal commercial loan sizes in sub-Saharan Africa generally lie between $50 and $1000, with a median value of about $250 and have only grown marginally in many cases since reforms began. In general, the sizes of loans from moneylenders tend to be the largest in the informal sector. Urban loans are also significantly larger than rural loans. Loan sizes for moneylenders tend to be similar across countries.

Interest Rates and Maturities: The interest rates and maturities of informal lenders often make them unattractive for business. The interest rates of the different lenders vary widely, from zero to more than 100 percent per annum even though they often have similarly short maturities that seldom go

Box 5: Lending by Savings and Credit Associations in African Countries

In view of the extensive variation in sizes of SCA and cooperatives, it is difficult to compare loan volumes across regions. We therefore measure growth in the volume of lending by the proportion of loan applications that are actually successful. This may be complemented with loan size information. With this approach, there has been significant growth in lending of SCA and rural cooperatives. In Nigeria, for example, the average number of applications to SCA for loans averaged 30 in 1990 with 60% success. The applications more than doubled to 63 in 1992 and the success rate moved higher to 76%. In the case of Nigerian cooperatives, while both the numbers of loan applications and loans granted went up significantly, the success rate dropped only marginally. In Tanzania also, evidence of growth is seen in the number of loan applications increasing by 61% and adequately matched by loans granted which also rose by the same margin. Malawi has smaller sizes of SCA, but these showed no growth during the period. Interestingly, however, they granted the loan request of each application received. It is not obvious whether this is a case of supply exceeding demand. In Ghana, growth in SCA loan applications was not uniform throughout the country. They grew fastest in poor regions that were witnessing a significant boost in economic activity following structural adjustment but which lacked modern financial structures.

Source: Nissanke and Aryeetey, 1996.

beyond six months. Also, the rates do not seem to change significantly with time for a large number of informal lenders. The interest rates of Malawian moneylenders (*Katapila)*, for example, appear to be much higher than in most parts of Africa. They sometimes go as high as 100 percent per month. This rate has been applied for many years in Malawi. In all countries, moneylenders have the highest lending rates.

Table 7: Some Moneylenders' Monthly Interest Rates (1992)

Country	Mean Urban Rate (%)	Mean Rural Rate (%)
Ghana	10	8
Nigeria	19	20
Tanzania	9	6.5
Malawi	47	50

Source: Nissanke and Aryeetey (1996).

There are indications that the interest rates of moneylenders in some countries have come down since financial sector and economy-wide reforms began in Africa. It is not obvious if this is a result of competition with other existing lenders leading to declining demand or a change in their own supply situation. It is likely that this is more to do with general economy-wide alterations in economic structures. Moneylenders are having to change the scope of their lending business in response to changes in the financing needs of their traditional clientele. There is increasing pressure on lenders to provide more credit for working capital for longer periods than they have done in the past. While, this change has been observed, moneylenders' rates remain far above those of all other segments.

When other group-based lending schemes lend to non-members, their rates are often comparable to those of moneylenders. This holds for both savings collectors and SCA in a number of countries. Their rates remain far less when dealing with their members or traditional clients. Thus, for example, the mean interest on loans of cooperatives in Ghana was about 5 percent per month for their 6 month loans in 1992. For Tanzania, a mean monthly interest rate of about 2.6 percent which was comparable to the 31 percent per annum charged officially by the state-owned commercial bank has been observed. In general, loans with the above characteristics are not attractive for growing small borrowers, leading to the development of a gap in the credit market as discussed below.

Credit Gaps in African Financial Markets

As a result of the fragmentation, and the fact that each lending unit cannot alter the structure of its operations and products in the short-medium term without additional flows of resources means that there are few lending units in Africa that meet the needs of borrowers interested in credit with the following characteristics: "small loan amounts up to $1,000), interest rates far below 30 percent per annum, and maturity of up to 18 months". That is what many small businesses, often in countries with inflation rates well over 20 percent, ask for. The most affected are microenterprises wanting to expand in small towns.

The credit gaps in various countries capture borrowers who cannot enter the circles of informal lenders because they do not find the packages/contracts of those lenders attractive for their purposes, and yet cannot gain access to the formal circles as they are considered ineligible. This does not mean small borrowers who want the types of loans that informal lenders provide are adequately taken care of. But if they have not received credit, it is mainly because the nearest informal lenders (for whom they are eligible) do not have enough from their limited resources to provide them with loans. It is seldom because the informal lenders do not want to lend to them for any reasons. For the others no one can meet their demand cost effectively without significant revision of institutional structures.

How Do Informal Operators Select Clients? Loan Screening, Monitoring and Contract Enforcement Mechanisms

A characteristic of African financial markets is the weakness of modern contract enforcement mechanisms. The significance of this is that lenders must lend small amounts and have maturity periods that minimize their costs, often in a way that make them less attractive to businesses. In the absence of sound formal contract enforcement mechanisms, both formal and informal lending institutions face the problem of managing risk with loan administration practices that suggest greater emphasis on loan screening than on the monitoring of the use of such loans and the enforcement of contracts. Their approaches might suggest a greater concern with adverse selection, (the fear of selecting non-creditworthy clients) even though moral hazard (as clients change their minds about loan use later) remains a problem in the information asymmetry that lenders confront (Nissanke and Aryeetey 1996).

Screening Methods: Screening in the informal sector relies extensively on personal knowledge of borrowers. The development of personal ties and the use of borrower proximity in decision-making are mechanisms for countering adverse selection and moral hazard. The more rural the environment, the greater the need to personalize ties in confronting information asymmetry. Familiarity with borrower often reduces the significance of repeat borrowing. This explains why in such places as northern Nigeria agricultural lending among relatives, acquaintances, neighbours, etc. is the norm. *Susu* collectors in Ghana can take a decision on a loan request within one minute simply by looking on the card on which deposits are entered to ensure that borrower is a regular depositor. For a moneylender, new borrowers are often introduced by persons lender knows quite well and who are prepared to guarantee payment with their word. This confines their locus of operation to small areas.

In savings and credit associations, as in cooperatives also, loan screening is done at the time of admission to membership. It is assumed that each person requesting to join the group is interested in a loan and will be admitted to the group if he/she has characteristics similar to those of the other members, including occupation and ethnicity in many cases. In screening applicants therefore, the emphasis is not necessarily on whether members can pay back loans they have taken, but on the commitment of members to the group's goals. Since they invariably have similar incomes and similar credit requirements, knowing the individual's character and how reliable they are, is important.

Loan Monitoring: The suggestion often made that informal lenders have a better record on repayments than the formal sector mainly because of constant monitoring of the uses to which the loans are put does not appear substantiated from a number of African studies. (See Box 6). The form of monitoring often considered is regular visits to project sites. There is relatively little monitoring in this form by informal lenders after loans have been given out. They reported that a half of credit unions in Ghana never monitored any loans and another 22 percent only sometimes did. Moneylenders and other informal groups seldom visit the project sites of their borrowers. Obviously, when lending is localised, the need for project visits is reduced. For moneylenders who are more likely to have borrowers in other localities, monitoring is minimized as they always know very well the persons who introduced borrowers to them.

Loan Repayment and Contract Enforcement:

Loan repayment rates generally tend to be much higher for informal lenders than for formal lenders. The higher repayment rates for informal lenders are not necessarily the result of more "aggressive" contract enforcement procedures. There is indeed little evidence of litigation in courts. Collateral confiscation, in the absence of proper ownership documentation and malfunctioning legal systems, is very difficult. Informal lenders go to the homes of their clients to deliver verbal warnings and threats. In membership arrangements the dismissal of borrowers from groups is the most significant sanction.

The higher repayment rates of informal lenders are simply a consequence of more efficient procedures for retrieval of loans and the borrowers' knowledge that the informal lender has a higher capability of actualizing threats to foreclose on collateral.

For example, in the situation of farmland being used as collateral, a bank is less likely to foreclose on this costlessly than a moneylender would. The borrower knows that the moneylender can always find a relation to farm on that piece of land until a loan is repaid in full-- an action that a bank cannot take without incurring additional costs. Hence, for borrowers facing the two lenders, collateral has different meanings which condition their attitudes towards repayment. They would not treat the threat of collateral confiscation by an informal lender lightly. This gives reason for risky SMEs to be cautious about dealing

Box 6: Loan Monitoring by Informal Lenders

It is expected that when there is a strong fear of moral hazard, lenders will exhibit greater interest in loan monitoring. The evidence, however is that there is little attempt in many places to monitor the use of loans. Very few lenders in Nigeria, Ghana, Malawi and Tanzanian have shown interest in how loans are used. A half of credit unions in Ghana have never monitored any loans and another 22% only sometimes do. This leaves only a quarter of credit unions that always monitor loans.

Monitoring by credit unions is more common in rural areas where most lending is done with farmers, and this involves occasional visits to farms. In Tanzania, only 2 of 10 ROSCAs studied and 2 of 19 SCSs reported any form of loan monitoring. Similarly only 2 of the 22 trader lenders and only 3 of the 8 sample landlords indicated that they visited clients for purposes of loan monitoring. In Nigeria it is clear that moneylenders do not bother with monitoring.

For West African *savings collectors*, loan monitoring is taken for granted as daily visits to clients for deposit collection ensures that loans are daily being monitored. The apparent free flow of information suggests that informal lenders have little need to explicitly monitor loans. Where such monitoring does indeed occur, it is the result of an interaction necessitated by other related matters.

Source: Nissanke and Aryeetey, 1996.

with the informal financial sector.

Direct and Indirect Linkages Between Formal and Informal Segments

It is obvious that informal lenders could boost their business considerably if they could expand their lending base with resources from the formal sector and increasing loan sizes would be attractive for SMEs. Direct or institutional linkages are expected to be shown in actual flows of funds between segments. By indirect or market linkages, it is expected that activities in various segments will be affected by activities in other segments through the influence of the financial market. Both links are actually weak in most countries. Thus, there is little evidence of informal lenders obtaining bank loans for their lending businesses.

With respect to indirect interaction between formal and informal lenders, this remains even less important currently. Expected competition between an institutional lender and an informal lender presents possibilities for price interaction to occur, but this is based on assumption of an availability of “low-cost institutional credit” to informal lenders. This seldom holds for African financial markets. In view of the deep segmentation of the markets, informal lenders are hardly ever persuaded by changes in formal sector loan interest rates to alter their own rates. The fact that many informal rates have hardly been altered in the face of significant rises in formal interest rates since financial sector reforms began in many countries indicates how “unrelated” pricing in the two sectors might be.

Box 7: Linkages Between Formal and Informal Lenders

In Tanzania, only a third of the numerous trader-lenders had ever applied for bank credit, while in Malawi only 23 percent of all informal lenders have applied for and received bank loans. But these are mainly estate owners who are not known to their bankers as lenders. Indeed less than 15 percent of Malawian informal lenders receiving bank loans have used bank credit to boost their lending businesses. The remainder used bank credit to support their other businesses. The trend is not much different in Nigeria and Ghana. Only 20 percent of Nigerian informal lenders have applied for and received bank credit. When banks provide facilities to informal lenders specifically for on-lending, these are mainly to cooperatives in farming communities.

Source: Nissanke and Aryeetey, 1996.

4. Recent Developments with Micro-Finance in Africa

To counter the effects of credit market failures that result in fragmentation and the exclusion of many potential borrowers from markets, a variety of credit schemes have been introduced into many African countries. But innovative credit schemes and micro-finance activities are far better known in Asia and Latin America than they are in Africa. Apart from there being fewer programmes in Africa, their occurrence among countries varies considerably also. There are countries with a good number of micro-finance programmes, (including Mali, Guinea, Burkina Faso, The Gambia and Guinea Bissau), and others with very few, including Sao Tome, Chad, Mauritania and Sierra Leone. K-REP in Kenya is probably the best known micro-finance scheme in Africa. By 1990, there were as many as 40 organizations involved in micro-finance projects in Kenya. In general, evaluations of innovative and other micro-finance projects throughout Africa suggest that they have been less successful here than they have in Asia and Latin America.

Objectives and Strategies of Innovative Schemes

Innovative credit-retailing schemes are usually community-managed credit and savings schemes that are established to improve members access to financial services, build a community self-help group, and help members accumulate savings. Micro-finance programmes, derived from innovative schemes generally, are more likely to be born out of donor projects, and are not necessarily community-based. Indeed, over 80 percent of enterprise development programmes that donors sponsor throughout Africa have a micro-finance component. For more than a half of such projects, the focus is solely on micro-credit. For many innovative schemes, however, credit provision may not be the only operational objective. Even for those that perceive credit provision as the ultimate assignment, the extent to which direct supply of credit is present in their programmes, depends on whether they adopt the 'minimalist' or 'integrated' approach.[2]

Most of the acclaimed innovative schemes have been based on the 'minimalist' procedures. A recent trend in some of them has been the emphasis on market principles. Through donor participation, many African micro-finance arrangements have benefitted from best-practices developed in other developing regions. They have drawn some ideas from more successful projects elsewhere, including the following: 1) the issuing of short-term loans; 2) starting with small initial loans; 3) concentration on small working capital to firms with proven track record; 4) specialized services without targeting; 5) simplified services; 6) localized services; 7) shortened turn-around time for loan applications; 8) motivation of repayment through group solidarity or joint liability; 9) savings mobilization from the poor; and 10) charging of full-cost interest rates.

Village Banks, for example, emphasize loans to finance income generating activities and savings. In establishing joint liability group lending mechanisms, their members are expected to overcome collateral requirements. They lend on unsecured bases using five-person group guarantees, whereby each individual is responsible for the others and future access to credit is determined by all members repaying loans. This is a principle borrowed from the Grameen Bank. There are a number of micro-finance projects in Africa, however, that provide credit to individuals and projects. K-REP has both group lending (through *Watanos*) and individual arrangements with NGOs that on-lend K-REP facilities. A number of the schemes in Francophone African countries have a mixture of group and individual arrangements.

The loan characteristics of micro-finance schemes indicate that their loans are comparable to those of most existing informal arrangements. Loan sizes for *Village Banks* range from $10 to $160, with an average of $60. The relatively small loan sizes are to discourage the rich from seeking *Village Bank* credit. K-REP has an average loan size of $100 under its *Juhudi* scheme. A number of the schemes the World Bank has studied in Africa have loan sizes under $100. For others, loan sizes range between $100-350. *Credit Mutuel* of Guinea has the largest loan size of $1000. Loan maturities are generally short. K-REP expects groups that borrow from it for on-lending to repay within a year. Members of the small groups are expected to repay their first loans within four weeks, with the assurance that they can take a further loan from the revolving fund established by the group. While interest rates are higher than most formal lending rates in Africa, they tend to be lower than the rates of moneylenders. Nominal interest rate for K-REP loans in 1994 was 35 percent, leaving a real rate of 6.2 percent. The effective interest on loans varies considerably across countries-- interest rates of between 19 and 26 percent have been observed by the World Bank for five schemes, between 32 and 39 percent for three schemes and 54 percent for one. These rates were almost comparable to those of some of the best known schemes in Asia and Latin America. The characteristics of these loans suggest that a large of Africa's private sector cannot use such facilities to finance investments. They are useful for the very poor micro-businesses, similar to those financed by the informal sector. (See Box 8).

Performance of Micro-Finance Programmes

Assessments of the achievements of the credit programmes of *micro-finance* programmes are centred on repayment rates, loan sizes, savings levels, programme costs, and income from interest. Evaluations of repayment in *Village Banking* programmes have been high, averaging 90% in many places. Projects that have high repayment rates often have the following characteristics:

- more training programmes for participants than others;
- interest rates were not subsidized;
- they have integrated formal written membership requirements and screening measures into their bye-laws to ensure discipline among members;
- a savings programme accompanies lending;
- an appropriate socio-cultural environment, e.g., population not being transient, helps to reduce default as social sanctions are strongest in that environment.

Box 8: Credit Guarantee Company for Small Scale Enterprises (CGC): The Egyptian Experience

The Egyptian Credit Guarantee Company guarantees a percentage of loans and credit given by banks to SMEs in order to develop those enterprises and help them to achieve economic and social development in Egypt. It also encourages banks to grant credit and loans to SME projects. To achieve this objective, the Credit Guarantee Company undertakes the following,

- Guarantees part of the value of loans and credit granted by banks to the small enterprises if these projects default.
- Prepares and reviews feasibility studies on credit prepared by banks for the loans and credit.
- Confirms the guarantees issued by the Company or via third parties.
- Invests available funds in the form of share capital, loans, grants with a view to maximizing returns.

The Company was established as a share-holding joint-stock private sector company. The founders consist of nine banks and an insurance Company; in addition to thirty participating banks. Presently, CGC supports small business development in Egypt through its promising programs targeting small and medium enterprises (SMES). It has another programme for health care providers and the third is outreaching, financing and guaranteeing small businesses under the Social Fund for Development Programme. CGC programs aim at social and economic development which represent the goal for which the company was established. According to CGC, SMEs are defined as legal entities having an investment cost ranging from LE25 through to LE5 million, excluding land and buildings and including the guaranteed loan amount. It operates in any economic sector, except trade. The purpose of the financed credit is the purchase of fixed assets and working capital requirements. A small business loan/credit facility can range from LE20 thousand to LE1.4 million.

CGC launched the health care providers programme in order to upgrade the health care service to the Egyptian population at reasonable quality and cost. Under the programme, CGC targets the health community by guaranteeing credit for doctors and small medical establishments in the different fields of specialization, including medical and diagnostic laboratories, remedial centres and veterinaries. The loans/credit facilities can be used to establish or expand medical clinics, to furnish and acquire modern medical equipment, and to finance the needed working capital. CGC's health care providers (HCPS) programme excludes doctors and small medical establishments from the lower limit of the SME's definition. According to the SFD/CGC programs, CGC reaches out and packages small business clients through its branches in Menya and Tanta regions. In addition, CGC furnishes its beneficiaries under the programme with project profiles, credit and credit guarantees them in case of default. The maximum loan provided to an individual firm with one owner is LE50 thousand, however under certain circumstances, CGC agrees to offer credit a maximum of LE 200 thousand in case of partnerships. The CGC guarantee goes along with the offered loan disbursed with a number of participant banks under this specific program.

CGC started operations in 1991. As at the end of 1994, the number of guarantees was 4023 (2677 to SMEs and 1346 to HCPS). The total amount of guarantees was LE180 million (LE132 million to SMEs and LE48 million to HCPS). The amount of loans and credit facilities offered by banks from their own resources amounted to LE361 million (LE292 million for SMEs and LE69 million for HCPS). The average loan size amounted to LE90 thousand with an average guarantee amount of LE45 thousand. Moreover, CGC guarantees were allocated to all the twenty six Egyptian governorate, economic activities, and thus created job opportunities for around 10,923 people. Between 1991-1994, the default rate was less than 1%, the number of liquidated guarantees is LE208 thousand (LE118 thousand to SMEs and LE90 thousand to HCPS), and the number of liquidated guarantees was 8 (5 to SMEs and 3 to HCPD) a fact which showed that the SME sector was a promising sector contributing to the development of Egypt. The present default ratio is less than 1%.

Source: Unedited Document from ADB (requires substantial editing).

A number of recent evaluations of micro-finance projects have examined the extent of their outreach activities and their drive towards self-sustainability. Financial self-sustainability is achieved when the return on equity, net of any subsidy received, equals or exceeds the opportunity cost of funds. Outreach is measured on the basis of the type of clientele served and the variety of financial services offered, including the value and number of loans extended, the value and number of savings accounts, the type of financial services offered, the number of branches and village sub-branches, the percentage of the total rural population served, the real annual growth of the institutions assets over recent years and the participation of women as clients. Many such evaluations have questioned the sustainability of projects as well as their outreach. (See Boxes 9 and 10).

Box 9: Sustainability of Micro-finance Projects

The measurement of a Subsidy Dependence Index (SDI) for K-REP in 1995 showed a high dependence on subsidies. For other World Bank West African studies two sets of indicators were used to assess operational efficiency, i.e. those on overall institutional efficiency and those on the productivity of staff members. For the first, ratios of operating costs to average loan portfolio were derived. These ratios were found to be very high in most cases for the 9 schemes studied in detail. They came mostly with operating expenses in head offices, staff salaries and expenses associated with expatriate staff. They were attributed to a number of factors, including the ‘high-cost nature of the African environment’ as well as the marked absence of the use of volunteers as well as in-kind donations to the schemes, such as business premises. Salaries paid to staff, both local and expatriate, tended to be quite high in a number of cases, and affected significantly the sustainability of programmes. This was particularly so for three programmes, *Credit Mutuel* in Senegal, *Credit Mutuel* and *Credit Rural* in Guinea where expenses of expatriates as a share of average outstanding loan portfolio were 145%, 73% and 57% respectively.

On financial viability, the ratio of total revenues to total expenses, where revenues include interest income, fees and interest on investments have been examined by the World Bank for some West African projects. Expenses were made up of operating expenses (all administrative costs, depreciation of fixed assets and losses from loan defaults) and the cost of loan funds. They noted that with the exception of two institutions in their sample, all were covering a third to a half of their operating costs, leaving a high demand for subsidies. The conclusion drawn from the high level of dependence on subsidies is that interest rates could go up. It is not clear how high interest rates could go though, considering the obvious implications for programmes designed for the poor. Even though it is taken for granted that the poor can pay higher interest rates than they are currently paying, it is by no means obvious that the risk structure of schemes would only be marginally affected.

The World Bank’s study of West African projects measures institutional durability with the durability of its organization structure. They apply such indicators as the balance that has been achieved between social and financial objectives; issues of governance (including decentralization and participation); staff incentive and training systems; and factors in the environment that increase the institution’s chances of survival in the future. They find in all cases that lending decisions are handled locally. The principle of quick loan processing is also characteristic of all informal sector loans. The studies in West Africa as well as those of K-REP all show that micro-finance programmes have invested considerably in the training of their staff, and this is expected to improve sustainability.

Sources: Webster and Fidler, 1995; Kiiru et.al. (1995).

Box 10: Outreach of Micro-finance Programmes in Africa

The numbers of borrowers reached by micro-finance programmes are far lower than figures for successful institutions in Asia and Latin America. K-REP had only 6,943 borrowers in 1994, having grown from 1,245 in 1991. The West African micro-finance programmes studied by the World Bank had only marginally larger scales, as most had less than 10,000 borrowers. They noted that even though many of the institutions had managed develop large rolls of members, these had not been converted into large numbers of actual borrowers and savers. In effect, the largest micro-finance institutions in Africa reach only as many people as some of the smaller ones in Asia and Latin America.

The relatively low scale is in part to the sparse population in many of the rural areas they served in the Sahel. For some, significant portions of the adult population are actually members of their programmes. For the *Caisse Villageoises du Dogon* in Mali, about 44 percent of the adult population in villages where field offices were located were members. In similar circumstances, capturing large shares of the market will not result in significant scale of operations, especially where populations are small. Other institutional constraints to expansion of micro-finance programmes in West Africa include designs for regional operations that cannot be expanded to cover other regions.

On depth of service, their average loan sizes indicate that African micro-finance programmes are on the whole smaller than those of other regions, suggesting that they are more likely to reach the target group of the poorest people. They are, however, comparable to those of a number of other informal lenders in the region. Further evidence of the fact that the programmes are mostly intended for the poor is shown by the large numbers of women that participate in them (a third at least) and the high level of illiteracy among borrowers. K-REP had 1,699 women borrowers out of 2,677 in its *Juhudi* scheme in 1994. Its activities are generally dominated by women. While K-REP does not finance farm cultivation activities, it strives to meet the demand for rural and urban microenterprise activities, operating largely from small towns.

Sources: Webster and Fidler (1995); Kiiru, et.al (1995).

It is important not to compare the achievements of African micro-finance only to those of other regions. It is indeed possible to explain further the backgrounds of these programmes and to compare their achievements with other institutional arrangements within the region. Comparing the models of the innovative schemes and ascertaining their compatibility with known practices and attitudes in African countries, reflected in informal systems, introduces a better understanding of their difficulties. Various evaluations suggest that while innovative and other micro-finance projects are performing creditably in making credit available, local environments often constrain their ability to bring costs down much lower than they presently are. The truth of the matter is that they cannot go where the informal sector can with their present set-up, hence providing a justification for a link between them. Evidently both micro-finance and informal finance try to reach the same target group, but with different structures. As the African Development Bank attempts to develop a programme in micro-finance (See Box 11), it is important that care is taken to ensure a complementarity in the services provided by informal finance with a view to reaching those that are currently not reached by both.

Box 11: African Development Bank Micro-finance Initiative for Africa (AMINA)

Issues to be addressed:

Micro-finance institutions which often represent the only access to some form of financial services for micro entrepreneurs and other disadvantaged groups often lack professionalism and institution capabilities. In an attempt to encourage and strengthen these institutions, the primary objective of ADB Micro-finance Initiative for Africa (AMINA) is to increase the access of the poor to financial services through capacity-building of Micro-finance institutions. The economic and institutional viability of micro-finance institutions is key to their long-term sustainability. By developing permanent institutional capacity to serve micro entrepreneurs both outreach and sustainability are fostered, which is more effective over time than simply giving grants, disbursing loans, or even providing one-time training to micro entrepreneurs.

Weaknesses of Micro-finance institutions include lack of: suitably trained and qualified personnel; appropriate operational policies and procedures; and management information system. AMINA shall focus on long term capacity-building of these micro-finance institutions through a coordinated programme of technical assistance, creating linkages between micro-finance institutions and commercial banks, and strengthening information dissemination among micro-finance networks.

AMINA will seek to assist micro entrepreneurs, women an other disadvantaged groups in their development of productive activities. The proposed model for the initial implementation of the AMINA programme has at its core technical and other assistance designed to increase the professional capacity of micro-finance institutions to respond to the financial service needs of the target groups. AMINA will also attempt to establish and enhance linkages between micro-finance institutions and formal financial sectors, primarily commercial banks. Finally, AMINA will coordinate its activities close with existing and programmed ADB activities, and the activities of other donors especially those that pertain to the financial and private sectors. AMINA will serve as a mechanism to increase horizontal linkages between micro-finance practitioners, and to engage governments, regulatory agencies and donors in a policy dialogue on those issues of concern to micro-finance institutions.

AMINA Programme Objectives

The Overall objectives of AMINA include:

- Providing technical and other assistance to non-traditional financial intermediaries such as non-government organizations (NGOs) and others who provide financial services to the poorest sections of the population in low-income African Countries. This capacity-building sponsored by Amina will strengthen the ability of micro-finance institutions to reach large numbers of the target groups on a sustainable basis.
- Encouraging commercial banks and other formal financial sector actors to play a more active role in the provision of financial resources for the target populations. AMINA will seek to create linkages and greater intermediation between the formal financial sector as wholesale providers of funds for distribution on a local or retail level by microfinance institutions. It will also encourage microfinance institutions to place savings deposits gathered from the target populations with the formal banking sector. Enhancing these linkages between the formal financial sector and retail microfinance institutions will result in increased monetization and financial deepening of the economy as a whole.
- Facilitating cooperation and coordination among aid donors, private sector actors and others involved in providing financial services to target groups. AMINA will play an important role in encouraging and facilitating information dissemination among microfinance practitioners themselves. AMINA will also serve to facilitate policy dialogue among donors, relevant government agencies and other interested parties on subjects relevant to the provision of microfinance services such as interest rate policies, reserve requirements, and the like.

Box 11: African Development Bank Micro-finance Initiative for Africa (AMINA) (continued)

AMINA-sponsored activities seek to contribute to economic and social welfare of the programme's target populations through improved access to appropriate financial services.

- Micro-Enterprise Development: employment opportunities are created and incomes are increased among the rural and urban poor through improved access to a range of financial services, including the provision of credit and savings mechanisms. This leads to the economic empowerment of the marginalized and disadvantaged members of society.
- Increased Economic Output, Employment and Incomes: increased economic opportunities among the poor and other disadvantaged groups such as women yield more balanced economic growth for the economy as a whole, and more equitable distribution of its rewards.
- A Growing and Dynamic Private Sector: microfinance expands the ranks of new stakeholders in the economy through the empowerment of previously disadvantaged groups - women, landless rural poor, urban unemployed - by providing them a means of attaining economic advancement. In addition to jobs and income created, more broadly-based economic empowerment advances the development of a more pluralistic society.
- Transformation of the Private Sector: as micro entrepreneurs are assisted by microfinance institutions and there is an increased level of economic empowerment among previously disenfranchised societal groups, the private sector is transformed from being reactive and poorly organized into a more cohesive and effective force for political stability. A more broadly-based private sector in turn leads to a more accountable and transparent economic, regulatory and political system.

AMINA Programme Components

In order to attain these programme goals, objectives and anticipated outcomes, AMINA will engage in a coordinated range of activities. These include: technical assistance for microfinance institutions; issuance of financial guarantees to commercial banks who establish refinancing facilities for microfinance institutions; and serving as a forum for policy dialogue and an information dissemination mechanism. An important undertaking of the AMINA programme will be to sensitize ADB professional staff to microfinance issues and techniques through training sessions and participation in technical assistance activities for microfinance institutions. Their participation will likewise develop a heightened appreciation for the role of the private sector and women in the overall economic development process. AMINA will also support existing and planned ADB activities in countries selected for implementation of the pilot phase of the programme. Finally, AMINA will closely coordinate its technical assistance and policy dialogue activities with other donors and initiatives active in the pilot programme countries.

5. Towards Increased Informal Finance and Micro-Finance for Private Sector Development

It is evident that the central problem for financial development in most African countries remains how to ensure that institutional development and innovation leads to a filling of the "credit gap" facing SMEs. While they lack access to bank credit, their requirements exceed the limits of informal agents as well as many micro-finance programmes. There is currently limited scope for enhancing the allocation of credit equitably and efficiently outside of a closer relationship between the formal and informal sectors. As seen earlier, fragmentation of the financial system can be very wasteful. Closer linkages between different segments can improve the efficiency of the system by enabling different agents to specialize for different market niches and by facilitating the flow of savings and credit up and down the system. Filling the credit gap may require incentives to the formal financial sector to establish conditions and support for informal and semi-formal institutions to move up to this market following an integration of the financial markets. The approach to a greater role for informal finance and micro-finance focuses on the achievement of integrated financial markets. In addition to discussing here how such integration might come about, there is also a discussion here of possible operational approaches for bringing micro-finance closer to small African entrepreneurs.

The suggestion for integrated financial markets is based on the fact that a number of recent studies applying concepts from the "new" institutional economics, stressing information asymmetry, transaction costs and risks have provided useful analytical tools to understand the constraints that explain the persistence of fragmentation in African financial markets even when financially repressive policies have been reformed. In an integrated financial market, direct and indirect linkages between the formal and informal sectors are evident and significant. The flow of funds among them is dictated by the awareness of their respective specializations that allow each segment to utilize the information and structural advantages of the others to enhance their own activities. Information flows are a major component of such market integration.

There is the obvious need for national policy frameworks that have appropriate levels of incentive and regulatory policies as a context for achieving integrated financial development. In addition to using such frameworks to provide a developmental platform for financial institutions by helping them to reduce and share risk with an acceptable incentive structure, the framework should draw in broader economic relationships by ensuring that the approach is truly demand-driven by the real sector. Hence, while avoiding a crowding-out of the private sector, the maintenance of steady growth of the real economy is very essential. The strong revival of informal finance in a number of countries after reforms provides a good testimony to the influence of a vibrant real sector on financial sector developments.

Forging Links in Deposit Mobilization

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

Indeed, taking a cue from what *susu collectors* in Ghana have demanded of Ghanaian banks, banks in sub-Saharan Africa could be encouraged to offer informal deposit mobilizers preferential deposit rates, (higher than the rates of return on their other opportunity sets) that encourage them not only to use the facility more and more in view of financial gain, but also to discern recognition of their role in savings mobilization by banks. In many West African cities where transactions at bank branches take unusually long periods, 'special' clerks or tellers could be assigned to such frequent depositors as savings collectors at large branches they patronize in order to reduce the length of time they spend at bank counters. The waiving of all charges and fees on the demand deposits of informal deposit mobilizers by banks would be seen as encouraging an institutional link between the two.

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

Forging Links in Credit Allocation

The optimal way for banks and informal lenders to link up for purposes of credit allocation is for the development of an agency relationship in which bank loanable funds are channelled through semi-formal (micro-finance) lenders and informal lenders for on-lending to small borrowers. Here also, the operations of *susu collectors* in West Africa provide some valuable insight into how such an arrangement could be pursued. (See Box 12).

The realization of the full potential of informal finance units lies in the identification of any similar strong links between formal and informal units. This relation should ideally be oriented towards a two-way flow of deposits and credits in order to enhance financial intermediation in the region. While the potential is much stronger in some countries than in others, they must be developed wherever possible to ensure that the benefits arising are for mutual growth. In eastern and southern African countries as well as francophone countries, where cooperatives are relatively well-developed, they could be the informal institutions for developing such linkages.

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

While the principle of channelling credit through informal sources is acceptable, there is the need for caution with regard to which informal agents can serve as good conduits for such lending. It is important to rely more on well-established agents that operate from within recognizable bodies, such as associations, cooperatives, companies, unions, etc. These have greater credibility than individuals. In a number of countries also, individual moneylenders with good long-standing relationships with banks could be useful for the purpose. The policy of channelling formal credit to informal lenders can be defended on the grounds of efficiency and increased financial integration, especially among small farmers. Informal lenders can build a personal relationship with their borrowers that can ensure an extremely low

Box 12: Linking Susu Collectors in Ghana with Ghana Commercial Bank

By 1993, the Greater Accra Susu Collectors Cooperative Society (GASCCS) required its members to open accounts with Ghana Commercial Bank (GCB), both because it had the widest branch network in the country and the society hoped influence GCB to grant them credit for on-lending and exemption from charges on demand deposits. GCB showed initially little interest in them, for several reasons. First, they had no ready means of identifying which customers were susu collectors. Second, the accounts were volatile (they build up steadily during the month but drop by over 90 percent just before the end). Third, banks viewed their deposit growth as adequate without special efforts.

A study showed it to be feasible for GCB to grant an overdraft to GASCCS, which in turn could on-lend to its members. At the time of the study, GASCCS had invested ¢5 million of its members' monthly contributions (¢1,500 each) to a welfare fund in Treasury Bills, which could be used as collateral for the overdraft. In the initial design, an overdraft facility of ¢5 million would meet over 70 percent of the current requirements of GASCCS members. Although susu collectors could in principle provide advances to all the 60 percent of clients who requested it, a more prudent approach was thought to be to assume that half were creditworthy, so that collectors' loan/deposit ratio would rise to 30 percent, or an average of ¢783,000. Collectors could meet this demand from collected funds within the first 9 days of the month, or sooner if they had accumulated capital from previous earnings or had access to credit. Assuming a 10 percent delinquency rate, the anticipated shortfall at the end of the month was ¢78,300. However, to allow for variations and carryovers, collectors needed an individual ceiling sufficient to cover up to 20 percent delinquency in any given month, or ¢156,000. This exceeded the expected monthly commission of ¢87,000 by ¢69,000, which was the amount the collector needed to be able to draw on in order to undertake lending and still be sure of repaying depositors who did not receive advances. If it was assumed that no more than 20 percent of collectors would need to draw on credit in any given month (or that collectors draw an average of 20 percent of their individual ceilings), the total credit requirement would be estimated at ¢556.9 million.

It was shown that a fully-backed overdraft facility would enable GASCCS members to gradually expand their lending to existing clients and subsequently to new clients, as proceeds were used to expand their Treasury Bill holdings to back up an increased overdraft facility. The GASCCS estimated that increasing the approval rate on loan requests to 30 percent of clients could lead to doubling the number of clients. Thus, the total credit provided by its members could reach ¢783 million a month, requiring that GASCCS have an overdraft facility on the order of ¢14 million to ensure sufficient onward credit to their members. This is being attempted today by the Agricultural Development Bank in Ghana.

Source: Aryeetey and Steel (1995).

loan default rate. Encouragement of more subcontracting in the real sector would also generate more financial linkages in parallel. For example, if leasing companies could pass on tax benefits to banks to obtain better credit terms, they could in turn pass on more finance to their clients. There are good illustrations of how this works in Taiwan.

Government Policies for Enhancing Linkage Development

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

Tax relief on profits granted to banks that allocated credit through informal and semi-formal agents could be recovered by imposing higher taxes on banks that do not channel credit through the informal sector. Some banks, such as merchant banks, will have no need to use informal agents for allocating credit and will therefore be the actual financiers of the subsidy. Since the higher tax is on the profits of the bank, it should not be transferred to users of those banks.

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

In sum, the development of a three-tier approach for lending to marginal borrowers, mainly SMEs, would be very useful as it provides an appropriate framework for regulation and supervision. Banks would lend in the first instance to credible semi-formal agents[3] who would then link up with such informal lenders as susu collectors, cooperatives, savings and credit associations, etc. Rural borrowers would receive loans directly from informal agents. Where banks have good relations with easily identifiable informal agents, e.g. the Association of Susu Collectors in Ghana, there is no reason why the chain cannot be shortened by directly dealing with that informal institution. The semi-formal institutions would in general be the agencies for regulating the smaller informal units as they usually can identify the operators much better than any other external body can.

Reducing Lender Risk for Micro-finance Projects in Africa

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

At the margin, financial institutions want to know whether it is cost-effective to take deposits from and lend to small businesses. Internally, they will have to adjust the credit-delivery methodology, focusing on the way in which borrowers are identified, approved and supervised. Financial institutions that have been more successful in extending and recovering credits to small enterprises have often based their lending operations on an in-depth market assessment at the design stage, allowing them to determine actual patterns of demand and to identify and address relative levels of risk involved.

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

There are a number of innovative financial institutions that have been successful in maintaining this balance. They have employed a variety of measures to effectively reduce SME lending risk, basing their risk reduction strategies on the fundamental principles of:

- minimizing poor judgments on character and capability, through careful credit analysis;
- using intensified follow-up to track projects and loan repayments; and
- applying “get tough” policies on repayment.

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

Indeed the principle of knowing the borrower is highly regarded by the Malian Bank of Africa (BOAM), generally regarded as an “alternative” commercial bank, which bases risk management largely on “character lending”. They require that each borrower be known by and receive the moral guarantee of a member of the Loan Committee or a shareholder. In Kenya, the project “Promotion of Rural Initiatives and Development Enterprises” (PRIDE) also requires that all potential borrowers be vetted by the Executive Committee governing their community level Market Enterprise Committee, and their immediate Enterprise Group must agree to cross-guarantee the loan given.

Some institutions approach project-related risk with rigorous analysis of project viability on the business site. It is obvious that if well done, with the appropriate methodology significant gains in risk reduction could be achieved. PECA has tried this approach quite successfully. PECA field officers develop business plans with enterprise owners and conduct careful analysis of all risk factors (market, market share, cost and pricing structure), followed by similar independent evaluations of the proposed projects by PECA management.

Also, the principle of lending to borrowers with a record of good payments is generally applied by a number of successful institutions lending to borrowers at the margin. Most of the lending undertaken by PRIDE and PECA are made out to existing businesses with an established business history and reputation. Initial loan sizes are limited and maturities are short-term. This is kept so until the borrower establishes creditworthiness. PECA negotiates subsequent loans according to business needs. PRIDE provides loans in steps ranging from Kshs 5000 to Kshs 25,000, building up loan size to prepare good repayers to graduate into the banking system. PECA tailors the size of loans and repayment schedules to cash flow.

PRIDE uses a computerized accounting system to track savings and loan performance. It has developed a credit reference system for borrowers to be used as a centralized Credit Reference Bureau with banks and NGOs as partners. BOAM has introduced mobile field officers to track SME loans in areas without branches.

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

An approach that seems to be catching on with some successful financial institutions and which has been used quite effectively by a few informal lenders when necessary has been the adoption of a tough stance on contract enforcement. It has been shown that while collateral confiscation in the informal sector does not happen everyday, the knowledge that the lender could actually do it has often put some fear into borrowers and encouraged them to make repayments on time. It is interesting that some non-bank financial intermediaries have begun a ‘get-tough’ policy on repayment. PECA ensures that any client not paying within 10 days of schedule is visited by a legal officer. If loans are non-performing for more than 60 days, action is initiated to seize security.

Notes and References

1. This involves a collector (usually male) who visits shops, workplaces, market stalls and homes at agreed times on each day and collects funds towards a savings plan. Following this plan, a saver agrees to deposit a specific amount determined by himself/herself in consultation with the collector for an agreed period of time--usually a month-- after which period, his/her deposits are returned less a day's deposit.
2. By the "minimalist approach", the organization concentrates only on lending. All activities that it engages in are designed to facilitate lending. These include the training of staff and also beneficiaries to the extent that they can comprehend how the loan programme works. Under the "integrated approach", training and other forms of technical assistance are regarded as integral components of a whole scheme for assistance.
3. These would include the numerous modern non-bank financial institutions (savings and loan companies, finance houses, credit unions, etc) that are currently observed in a number of countries.

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