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Policy Issues and Recommendations

In determining how best to deliver micro-finance services to rural communities in the three IRDP pilot sites, three clear levels of policy formulation can be distinguished:

- public policy on micro-finance promotion;
- donor/investor/wholesaler policy on retailer support; and
- operational policy for retailers.

Of the three, the first two are of most immediate relevance here.

As principal, the W.K. Kellogg Foundation (WKKF) has commissioned this research to assist in achieving its objective of catalysing growth and development initially in the pilot sites and ultimately in the Southern African community at large. The most appropriate role for such a body is unquestionably that of donor/investor/wholesaler. While it would technically be possible for WKKF to set up and operate its own retail micro-finance outlets, it is most unlikely either that it would want to involve itself in the details of on-the-ground operations or that its constitution would allow it to do so. Donor/investor/wholesaler policy on retailer support is therefore of prime relevance.

The Foundation's intention to launch a Public Policy Promotion Programme (PPPP) as part of its Integrated Rural Development Program (IRDP), with the objective, *inter alia*, of improving public rural development policy (see Terms of Reference, chapter 1) also makes public policy on micro-finance promotion an area of direct concern.

Only the third – operational policy for retailers – is, in this context, of less immediate relevance, though far from irrelevant for the achievement of donor/investor/retailer goals.

This chapter deals briefly with public policy issues and recommendations for the three countries and then in more depth with policy issues and recommendations for donors/investors/wholesalers.

5.1 PUBLIC POLICY ON MICRO-FINANCE PROMOTION

5.1.1 Zimbabwe

The discussion in this section is heavily indebted to Madzima, 2000.

The Zimbabwean government has always perceived the development of the MSE and SME sectors to be part of the economic liberalization strategy. "The issues of SME support and promotion are closely intertwined with the question of indigenous promotion and development."[1] The government attitude towards the SME sector may thus be deemed positive. The efforts made in creating various windows through government departments or parastatals are a clear indication of government goodwill. The fact that the initiative has not been successful does not nullify the motive. Through various instruments and liaison with local governments, the government has provided space for SME and MSE operators termed home industries. Almost all-major towns and growth points have such areas that are serviced by the local authorities for the informal sector. Tax holidays have been granted to manufacturing businesses located at growth points in a bid to attract private sector and SME/MSEs investments into rural areas.

[1] Paper presented by O.M. Tshabangu, then Deputy Secretary in the Ministry of Industry & Commerce. Paper entitled, "Current and Planned SME Promotion Programmes in Zimbabwe – a Government Perspective" It should be noted that the term SME is all embracing and encompasses MSEs.

The somewhat "easy" registration requirements with the Ministry of Finance are further evidence of the fact that the government has a soft spot for the sector. Furthermore, while the Moneylenders & Rates of Interest Act is outdated and its provisions ridiculous, the Ministry of Finance & Economic Development has – in recognition of these anomalies – not enforced the outdated provisions. Apparently, it is willing to consider revisions to some of the provisions that are no longer applicable.

The Ministry of Finance & Economic Development plays a pivotal role in the licensing of the financial institutions, including NGOs and private companies, which operate under the Moneylender's Act. Besides being the ministry responsible for company registration, it is also the ministry's responsibility to deregister or de-license institutions when their licenses expire or if they are found flouting the laws. The ministry has helped the micro-finance sector grow by giving licenses to several NGOs and private companies that are operating as MFIs nation-wide.

The Moneylenders Act does not provide for consistent external supervision of moneylenders' operations. What is required of the moneylenders is that they maintain books of accounts that should be produced to the Secretary of Finance or his nominee on demand. The Minister of Finance & Economic Development is empowered under the Act to set maximum lending rates. The current interest rates are as follows:[2]

FIGURE 5.1 Interest Rate Ceiling as Controlled by the Moneylenders Act

Interest Rate Ceiling	Loan Amount
50% per annum	not more than Z$100
35% per annum	not more than Z$10 000
25% per annum	not more than Z$100 000

The regulations further state that a lender cannot charge a rate that is equivalent to the Reserve Bank's re-discount rate or commercial or merchant banks' banker's acceptance rate, whichever is higher. An administrative fee of 3% can be charged for loans that exceed Z$100 000. The majority of MFIs lend sums below Z$10 000. However, the regulations do not refer to an Effective Interest Rate (EIR) calculation neither do they indicate the method of calculation.

Most MFIs that are operating are registered NGOs. It is the Ministry of Public Service, Labour & Social Welfare's responsibility to register an NGO before it can apply for

[2] Moneylenders & Rates of Interest (Amendment) Regulations, 1993 (No.3)

moneylender's license from the Ministry of Finance & Economic Development. The ministry does not supervise or monitor the operations of an NGO as a moneylender. Under the PAAP[3] the ministry, through the department of SDF, has a MED programme, which seeks to promote the development of micro-enterprises by on-lending funds to MFIs. The funds are available to approved institutions at a concessional rate of 15% pa over a repayment period of three to ten years. Six institutions have so far benefited from the scheme. These are Zambuko Trust, NISSI Micro-Finance, Pundutso and WDCS, Self-Help Development Foundation and Phakama. It is remarkable that a total of Z$45 million has been disbursed to these institutions. While SDF insists that there are no credible MFIs to on-lend to, the conditions and requirements that they have set up may also be constraining access. Furthermore, the financing instruments are limited to one product – loans for on lending. Experiences from other such apex loan windows indicate that there is need for product diversification to suit the different needs of the MFIs.

The Ministry of Youth Development, Gender & Employment Creation is responsible for the registration of Co-operatives and Credit unions. As part of its mandate the ministry also facilitates the creation of new co-operatives and savings clubs. Under the Co-operatives & Savings Union Act, the registered co-operatives and savings unions are allowed to give loans only to members. The co-operative union has the right to determine the rate of interest on loans to members and can use the mobilized savings for on-lending. Lobbying for changes in the law and the creation of a conducive environment for co-operatives and credit unions is done through the ministry.

The ministry also created a department of Micro-Enterprise Development (MEDP) similar to the one created by the Ministry of Labour & Social Welfare through the department of SDF. The target group includes women, youths and unemployed people who are involved in income generating projects including agriculture. The ministry is also involved in research into co-operative development programmes and training in various skills. In 1994 the Department of Employment Creation in the ministry established a loan facility at 12% interest/annum for the informal sector and by 1998 had disbursed Z$2 million with a repayment rate of 50 to 80%.

In the Zimbabwe Agricultural Policy Framework (ZAPF), the Ministry of Lands & Agriculture has outlined clear development objectives for the agricultural sector, with emphasis on smallholder farmers. With regards to provision of financial services the major objectives are:

- ensuring that adequate credit facilities are available for input supply;

[3] Poverty Alleviation Action Plan

- provide financial support to smallholders, which is a necessary requirement for the transformation of the smallholder sector; and
- increasing investment in the rural areas by the private sector in order to complement government efforts.

The creation of the Agricultural Development Assistance Fund (ADAF) within AgriBank was a sure sign of commitment to the smallholder farmer. However, the history and precedence set within the former AFC smallholder lending is that of high defaults. Thus, until AgriBank modifies and fine-tunes its lending methods it will be difficult to expand that programme successfully. ADAF is capitalized by donors and the government of Zimbabwe, and managed by AgriBank.

It is challenging that in a country that is pre-dominantly agricultural, with 70% of the population living in rural areas and relying on agriculture, only 5% to 10% of the smallholder farmers have had access to credit. A number of integrated development projects[4] that have launched credit programmes in rural areas have had limited success as rural financial intermediaries are scarce.

The following weaknesses are apparent in the government's support for micro-finance:

- *Lack of co-ordination:* As noted from the different programmes under different ministries there is no key ministry responsible for the overall co-ordination of sectoral activities. While MSE development and micro-finance institutions should be overseen by the Ministry of Industry & Trade, the fact that the institutions provide financial services to the poor automatically makes them responsible to the Ministry of Finance. The recently launched SME White Paper that purports to encompass both SME and MSE activities was formulated without consulting all relevant ministries. During the study, key persons in the other ministries were ignorant of its existence, yet it is ready for presentation to Parliament.
- *Lack of registration cohesion:* The different forms of registration and legal status obtained by institutions providing similar services are not conducive to the sector's development. Although all MFI are "selling/trading money", the SACCOs do it under the Co-operative Act, while others operate under the Moneylenders & Rates of Interest Act. Currently, the SACCOs are working on a concerted effort to revise their act but the revisions will not cover other MFIs registered under the Ministry of

[4] Programmes such as the IFAD /Australian funded project Smallholder Dry Areas Resource Management Program (SDARMP) have for the past 3–4 years failed to disburse loans to the rural communities, partly due to the lack of credible financial intermediaries.

Finance. Furthermore, NGOs by legal form and nature cannot be MFIs as they are supposed to be registered as "welfare" organizations. Thus, many MFIs that are NGOs have been forced to register subsidiaries, which are not-for-profit companies, public companies, or even private companies. This dual registration is unnecessary and time consuming. There is a need to develop in consultation with the key stakeholders a clear policy framework within which MFIs operate. Furthermore, the SME White Paper is purported to be an all-encompassing document, i.e. it covers both SMEs and MSEs and yet there has been very little consultation with the MSE sector. ZAMFI has indicated its reservations on behalf of micro-finance institutions and stakeholders, but their concerns have not been addressed to date. It is regrettable that the concerns and critical issues that affect MSE development are not adequately covered in the policy paper.

- *Savings not a legal source of funding:* The majority of MFIs who are not members of SACCOs cannot utilise savings of their clients to on-lend. The "savings" can arise for example in the form of collateral deposit. Perhaps some linkages with the financial institutions could provide a win-win situation between the MFIs and the banks, as well as the entrepreneurs.

- *Regulatory framework:* While there is a clearly streamlined policy framework for the formal financial institutions, there is no such instrument for the micro-finance sector. Given that the industry/sector is still young, time should be allowed to ensure that the sector develops with minimum regulatory constraints. Thereafter, through a dialogue process, the framework may be instituted. The major regulatory issues that need to be urgently addressed are registration and the interest rate cap.

- *Political Stability:* The volatile political situation negates the growth and development of the micro-finance industry. MFIs operating in areas where the situation is politically hostile are forced to reduce their operations and thus their business output.

- *Political Interference within MFIs:* Political interference that influences who should receive credit and how the MFI should be managed has affected the growth of the sector. In some instances, there is political interference with the appointment of board members of NGO based MFIs.

- *Lack of incentives:* Currently, there are no incentives to attract serious players into the market. If the government perceives this sector as a high development priority with potential to create jobs and increase household incomes, there should be incentives for participants. Examples would be tax breaks for the first five years, as is the case with enterprises at growth points.

5.1.2 Mozambique

In 1998, an analysis was made as to whether the existing policy, legal and regulatory framework in Mozambique provided a favourable environment for the development of micro-finance according to the "best practices and standards". The following summarizes the changes that have taken place since then and the degree to which they have contributed to the healthy development of the sector.

In 1998, the Bank of Mozambique (BoM) issued a decree (47/98) to regulate micro-credit activities, requiring all institutions and individuals providing credit, but were not registered under another form, to register with BoM. Institutions and individuals registered under this decree were allowed to provide credit but not to capture savings. This was a significant step towards providing a framework for the development of a solid, professional and reliable micro-finance sector. However, implementation of this decree is still very weak, partly owing to weak dissemination of information about the decree and lack of knowledge about the advantages of registration.

Although some steps were taken to standardize the reporting requirements to BoM[5], little effort has been made to raise awareness or push implementation of the decree. As a result, there still are very few registered micro-finance operations and, as a result, little information on the financial performance of micro-finance providers. Clearly, additional efforts such as monitoring, publication of consolidated information or elaboration of guidelines by BoM are needed to enforce compliance. Donors can also play a role in enforcing compliance by requiring that all MFIs receiving their financial and technical support register with BoM and comply with the minimum reporting requirements.

As mentioned before, the decree represents an important step for the development of the industry as it provides a mechanism to legalize the provision of micro-credit by associations and projects of local or international NGOs. Despite the progress represented by the decree, the regulatory framework facing micro-finance institutions still poses problems for the long-term development of the micro-finance sector. Given the emphasis in micro-finance on providing savings services and on accessing funding from non-donor sources, most micro-finance programmes will seek to move from the association or international NGO form to a more permanent form as some type of financial institution. The options currently available have several shortcomings as can be seen in the summary on the next page:

[5] A form for micro-credit programmes to use in reporting to BoM was designed early in 2001 by ICC in collaboration with the Informal Working Group on Micro-Finance and BoM, and is now available for reporting.

Commercial Banks	Minimum capital requirement of US$1.2 million make this alternative unaffordable for most operators, particularly those focusing on the poor. Reporting and reserves requirements are too high for most of MFIs.
Credit Co-Operatives	Can only provide services to its members. Are not as attractive for investors. The decision making process is bureaucratic and cumbersome. The regulation is now being drafted and some constraints to membership are under consideration, which could make this alternative inadequate for MFIs.

As before, efforts should be made to find suitable alternatives that, while satisfying the legitimate concerns of BoM, also allow MFIs to become commercially and financially viable. The creation of a legal framework specifically suited for MFIs such as a "microbank", with reduced capital and reporting requirements, or for credit unions that would reduce the existing restrictions for credit co-operatives, are alternatives that should be explored by BoM and other stakeholders to foster the development of the sector.

One important issue is the distinction between shareholder-owned institutions with a corporate structure and co-operatives (credit unions). Most of the larger programmes operating in Mozambique today are moving towards becoming corporate-type institutions, a form most suited for attracting private investors and accessing commercial sources of finance. The only option available to these institutions currently is to become a bank, but the required threshold capital size for a bank is too large. The only alternative, becoming a credit union, is unsuitable for these institutions. On the other hand, there is a gap to foster genuine credit unions, as Mozambique is the only country in the region that lacks such local financial institutions. Appropriate legislation governing credit unions in most countries has minimum capital requirements suitable for grassroots-level organizations and allows small credit unions to operate without the need for central bank involvement. There are a number of international models that could be used as the basis of new regulation for micro-finance. It is most important that any new legislation should accommodate the dual structure (corporate and co-operative) that is emerging in Mozambique's micro-finance field. The best way to ensure that this happens is for the regulatory authorities and the micro-finance industry to engage in an open, ongoing dialogue, informed as needed by international experience.

Another important aspect is the need to reinforce the supervisory capacity to back up the regulatory framework. Supervising micro-finance institutions is not currently one of the BoM's priorities. One alternative should be the creation of a specific unit within the Supervision Department.

5.1.3 South Africa

The Commission of Inquiry into Rural Financial Services, better known as the Strauss Commission, active in 1995 and 1996, made a range of recommendations to rural Micro-finance Institutions provision, of which the most essential are highlighted here.

The Commission considered the major policy objectives of government and its brief to contribute towards increasing access to financial services for rural people. These services were identified as transmission services, savings products and loan products for consumption smoothing and productive loans (for farm and off-farm activities). The Commission also identified that state grants would be necessary under certain circumstances, and called for a detailed set of guidelines on the management of subsidies and grants, including their phasing out.

A role was identified for the state to facilitate, as well as co-ordinate, the provision of financial services, with special attention to the needs of women. The Commission proposed that the Land Bank be tasked to fulfil this role. It noted that the Land Bank, the state and other institutions should act in support of the market. At the same time, it acknowledged inherent weaknesses in the existing institutional fabric, noting that these institutions would not be able to contribute to the aims of rural reconstruction on a national basis without appropriate and active support.

A review of the policies and activities of different state institutions, such as government departments and parastatals, pointed to the dangers of lost development potential unless co-ordination takes place. The Commission therefore argued that the state should ensure that improved availability of rural financial services is provided as part of an integrated rural development strategy. This programme should include the land reform and housing programmes, the upgrading of infrastructure, such as the provision of water, electricity and roads, and capacity building, especially at the level of rural local government.

The Commission also argued that the state should acknowledge the current gap in rural finance delivery, and an overlap in the prospective policy briefs of the state-funded development finance institutions. International experience points to the success of multi-sector financial institutions at a retail level and a rich discussion exists on apex institutions internationally. However, there is very little experience, and little mention is made, of the advantages and disadvantages of multi-sector versus single sector wholesale institutions. The Commission accepted that all national development finance institutions have mandates to either continue or commence the extension of wholesale lending in rural areas: The National Housing Finance Corporation (NHFC) has earmarked dedicated funds; the Development Bank of Southern Africa (DBSA) will fund rural infrastructure projects; and Khula Enterprise Finance (KHULA) intends to finance Small, Medium & Micro Enterprises (SMMEs) in rural areas. The Industrial Development Corporation's portfolio already includes large-scale agro-industrial investments. The Commission supported the need for a financial institution at national level, such as the Land Bank, with both wholesale and retail activities and the responsibility to dedicate special attention to the needs of land reform programme beneficiaries. The Final Report (Strauss Commission, 1996) of the Commission emphasized that the Land Bank should focus only on agriculture, while the Interim Report (Strauss Commission, 1996) looked at agriculture as the primary focus, but did not exclude a multi-sectoral approach. A focus on a single sector can contribute to increased risk exposure for the institution. Especially in the South African agricultural setting it may imply increased covariant risk.

The Commission recommended that the future role of each of the provincial development corporations should be the result of specific consideration and consultation. This should be a joint approach of the national Ministry of Finance, national development finance institutions, provincial departments and provincial development corporations. The proposed development council should provide guidelines for this purpose, without attempting to design detailed blueprints for implementation at the provincial and retail level. This approach ensures that within a flexible framework, specific implementation strategies that reflect the reality of a specific setting or province could be worked out at provincial level, rather than being prescribed from the national level. Overall, the same rules should apply, but implementation should be realistic and pragmatic.

At the retail interface with rural clientele, the Commission recognized the important role of the Post Office in satisfying the most basic financial service needs, especially of the poorest, least mobile segments of the rural population. Commercial banks have, however, increased their outreach, and are well placed to offer savings facilities in the larger rural towns and respond to loan requests from small business entrepreneurs. The NGOs have shown themselves able to reach a micro-enterprise level that the formal banking institutions do not yet serve. The Commission proposed a multi-pronged strategy at retail level rather than a single institutional strategy. The purpose was to accommodate flexible approaches and reflects the reality that diverse circumstances in the country require diverse institutional approaches. Furthermore, the Commission's analysis showed that none of the current institutional structures proved to be highly successful in reaching rural clients, especially deep rural clients, and therefore it would be short-sighted to choose a single institutional strategy in this regard.

In order to foster an integrated approach to both urban and rural development, the Commission considered it essential to create an entity to co-ordinate and guide the activities of development finance institutions. This entity, referred to as the Development Council by the Commission, would be supported by a secretariat that could also play a part in structuring the reporting requirements for entities that make use of state support. All development finance institutions and other recipients of state financing would be obliged to conform to appropriate reporting and accounting standards, as the introduction of minimum disclosure requirements would enhance transparency and accountability. This function should be monitored and implemented by the Development Council's Secretariat.

The Commission also recommended that legislation governing agriculture, banking and land, presently in force in different areas of South Africa, should be harmonized as soon as possible. The Commission gave attention to legislation of the hitherto un-legislated sections of the financial market (for example, NGO financial service organizations, village banks, savings and credit co-operatives) and proposed that these complex issues should be attended to by specialists in the field.

The Commission argued that a process actively guided by the state, should be launched as soon as possible to transform the rural financial services sector. This process should build on the strength of existing local level institutions in the private, public and voluntary sectors. The need for a wide range of service providers delivering different products and catering for the diverse rural financial needs was accepted. The Commission favoured fostering a much wider retail financial services network. However, the Commission was concerned about longer-term sustainability and outreach.

The Land Bank's wholesale function will be geared to fostering, nurturing, supporting and co-ordinating local and provincial level rural financial institutions, be they NGOs, development finance institutions, co-operatives, commercial bank branches, local authorities, or any other kind of institution seeking to render agricultural and agriculturally-related financial services. Essentially, the Land Bank's "wholesale" function should reach those "retailers" who seek to serve the individual and small group agrarian needs of people in the "deep rural" areas, e.g. small-scale individual farmers, groups of female vegetable gardeners and small-scale poultry producers who are far away from the relatively limited retail branch network.

The responsibility of the Department of Agriculture to promote agricultural development is acknowledged. The Commission, however, recommended that the Department terminate the Agricultural Credit Board and suspend current policy initiatives, which would lead it to the role of a direct (central) wholesaler.

The Commission identified female farm workers; male farm workers; landless, unemployed rural poor; pensioners; small-holders; contract farmers; rural business-women; rural businessmen and small- and large-scale rural employers, including commercial farmers as requiring special support measures to gain access to financial services. The Commission also drafted guidelines on the application of subsidies and institutional transformation.

These recommendations of the Commission were put forward against the background of a set of guidelines, based largely on comparative international experience. The set of guidelines is important for this study and includes:

- views on the access to financial services;
- the application of commercial principles;
- diversification in terms of different financial services and sectors;
- ensuring that existing capacity is not eroded and refraining from the formation of new structures (rural areas in South Africa are characterized by a plethora of institutions with overlapping competencies and a lack of co-ordination -existing structures should be adapted, rationalized and co-ordinated to serve the needs of reconstruction);
- flexibility where locational differences are acknowledged and incorporated in policy and strategy;
- incentive-based approaches;
- improving information flows to ensure better decisions;
- management of risk and the structuring of the rural finance system in order to minimize the impact of covariant risk; and
- the detrimental effect of direct intervention by the state in retail financial markets.

Problems faced in South Africa to further the financing of entrepreneurs

There are important differences in the characteristics and needs of more formal and structured small and medium enterprises (SME) and the more informal micro and small enterprises (MSE). These differences are most apparent for business development support programmes and in the way that banks evaluate the borrower's loan applications. However, even with these differences, it is difficult to provide categorical breakdowns between types of firms, so policy and programmes must allow for a smooth transition between categories of firms and markets.

A recent study identified eight key categories of steps needed to reach the goal of improving widespread SMME access to finance in South Africa. An underlying condition for all the activities is that they achieve massive scale, or else they will not have significant impact. They are listed below.

- Removing price barriers to lending to SMMEs that will stimulate investment in SMME lending (i.e. lifting the ceiling on the exemption to the Usury Act).
- Improving market information (i.e. baselines, demand surveys).
- Developing cost-effective debt recovery mechanisms (i.e. legislative changes).
- Increased involvement of venture capital (i.e. tax incentives to entice more stakeholders).
- Use of application scoring by financial institutions (especially towards start-ups).
- Creating a homogenous government policy framework.
- Stimulating access to capital for non-banks (introduction of non-traditional role players).
- Promoting capacity building (SMMEs and financial institutions).

Of these, steps 1, 3, 4 and 6 most clearly involve changes in public policy and legislative strategy, though with the possible exception of 5, all the others reveal scope for more effective public intervention too.

5.2 DONOR/INVESTOR/WHOLESALER POLICY FOR RETAILER SUPPORT

5.2.1 Issues and Recommendations Common to All Three Sites

Donor organizations around the world face very similar sets of unknowns and policy/strategy decisions in their efforts to select and assist micro-finance retailers.

The following document set of guidelines, drawn mainly from the Consultative Group to Assist the Poorest (CGAP) 1995, is included to give an indication of what donors have learned and of what to expect in terms of performance.

It is a joint product of the Donor's Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. It was inspired by and is largely consistent with the recommended standards for support set out by a UN expert group of leading small and micro-enterprise practitioners convened by Women's World Banking in January 1994. The donor committees adopted the principles in their current form in June 1995, following consultations with key donor agencies involved in small and micro-finance. The document is intended to be used by project officers in donor and implementing organizations, managers and policy makers.

The purpose of these principles is to establish common standards for donor agencies to apply in supporting broader access to financial services for micro and small enterprises. Such enterprises have historically lacked access to the formal financial system, but the growing success of many institutions provides confidence that access can be provided sustainably in many settings. It has now become possible to identify and agree upon the basic principles that support successful micro-level finance, so that donors can work in concert to ensure that lessons of success are translated to the institutions they support.

The framework for donor support to micro and small enterprise finance centres on two equally important and complementary objectives. First, outreach embodies the aim of expanding access to increasing numbers of low-income clients. Second, sustainability provides the means to expand and maintain outreach. These concepts underpin the guiding principles described here.

Different types of micro and small enterprise clients have different characteristics and demand different services. It is therefore desirable to encourage a range of institutions that use specialized methods to serve their particular market niches. These can include commercial and development banks, credit unions, mutual or community banks, non-governmental organizations (NGOs), finance companies, co-operatives, savings and credit associations, and other specialized intermediaries. At the same time, however, this document is based on the premise that fundamental principles of finance apply widely and must be observed by all institutions if they are to succeed. Moreover, donors must design their support mechanisms in ways that are consistent with best international practices and sound financial systems.

This statement of guiding principles first identifies characteristics donors should seek in selecting institutions to support. It then describes appropriate forms of donor support. Finally, some basic reporting standards on outreach and financial performance are discussed.

Characteristics to Guide MFI Selection

Intermediaries seeking support should be able to demonstrate the following characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions. This will almost certainly apply in selecting MFI retailers for Chimanimani and Chimoio, and may also apply in Nyandeni, depending on other policy/strategy decisions (see 5.2.2).

A Institutional Strengths

1 Institutional culture, structures, capacities, and operating systems that can support sustained service delivery to a significant and growing number of low-income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and a mission and vision that create a sense of purpose, ownership, and accountability.

2 Accurate management information systems that are actively used to make decisions, motivate performance and provide accountability for funds. Such systems are essential for effective and efficient management.

3 Operations that manage small transactions efficiently, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).

4 Meaningful reporting standards. Transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data should be provided, and institutions should regularly monitor financial condition using appropriate financial ratios derived from such data.

B Quality of Services and Outreach

1 Focus on the poor. Evidence of service to low-income clients, women and men, especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.

2 Client-appropriate lending. For example, for micro-level clients, institutions should feature quick, simple and convenient access to small, short-term loans, that are renewed or increased based on excellent repayments. Use of collateral substitutes

(e.g. peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cashflow and project appraisal for larger and longer-term loans.

3 Savings services. Offering savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds – either independently or with another institution (see section 5.2.2).

4 Growth of outreach. Making significant progress in expanding client reach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

C Financial Performance

1 Appropriate pricing policies. Offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity.

2 Portfolio quality. Maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days, below 10% of loans outstanding and annual loan losses under 4 %of loans outstanding satisfy this condition.

3 Self-sufficiency. Steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency, i.e. covering all administrative costs and loan losses with client revenues within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and full self-sufficiency, i.e. covering all financing costs at non-subsidized rates within five to ten years.

4 Movement toward financial independence. Building a solid and growing funding base with clear business plans, backed by operational capacities that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programmes also provide non-financial services, such as business advisory services, health or education, they must account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this document.

It is extremely important not to task MFIs with providing training and/or other business development services to their clients. Not only does this impose an impossibly heavy cost burden on financial institutions that are mostly struggling to reach sustainability, but it also compromises their role as professional lenders: the two functions are quite distinct and require different sets of skills. Moreover, locating them within one institution often leads to conflicts of interest between the two.

MFIs ought to be self-sustainable or at least be aiming for self-sustainability, whereas it is an open question whether institutions whose role is to help build a community's human capital base should be required to become financially self-sufficient, especially in a developing economy. As a result, they should also be capitalized separately.

There is every reason to try to articulate the operation of MFIs and training/business development organizations, because they both create a demand for the other's services. If donors have the resources and their mandate allows, it is a good principle to include them both in the same country programme, or otherwise to arrange with local service providers to fill the gap.

Strategies for Donor Support

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programmes have drained resources without becoming sustainable, and have contributed to the mistaken notion that the poor are "unbankable". Funders should provide financial and other support in forms that foster the movement to scale, financial self-sufficiency and independence from donor support, taking into account the particular characteristics of different types of institutions.

A Appropriate Uses for Grants

1 Institutional development. Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective as institutions become able to meet more of their organizational development needs from within. It should also become more specialized as institutions tackle more difficult problems.

2 **Capitalization.** Capitalization or grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. Externally financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.

3 **Operating losses.** Donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business every programme will take some time to reach a break-even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.

4 **Fixed assets.** Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

B Appropriate Uses of Loans

Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine the savings mobilization efforts of savings-based institutions, such as savings and credit associations, by making loans available to them below the cost of mobilizing funds locally.

C Commercial Sourcing of Funds

The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as:

1 **Investor equity,** from both official and private sources. Donor support can help leverage private investment.

2 **Second-tier operations**, which raise funds from commercial sources and on-lend to micro-enterprise finance institutions.

3 **Partial guarantees of loans** made by commercial banks to NGOs.

D Coherence of Donor Policies

Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grants or loans) to small and micro-enterprise institutions, donors should ensure that they co-ordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied. Donors should also co-ordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

1 Included in the term micro and small enterprises are a variety of enterprises (industry, transport, commerce, services, agriculture, etc) ranging in size from part time, seasonal activities of a single person to small, formal enterprises employing several non-family members.

2 It should be understood that costs of non-financial assistance provided to entrepreneurs may continue to receive subsidies. However, it is crucial that these costs be separated from the costs of lending operations, so that the financial viability of lending operations can be assessed.

Policy coherence extends also to aligning donor and MFI vision, objectives and operating/reporting requirements as closely as possible, so as neither to hamstring the MFI and burden it unduly with meeting donors' conditions nor to dilute the achievement of donors' goals.

Basic Reporting Standards

Performance measures need to be put in place to track the performance of the institution towards commercialization. Outreach (which measures business volume and market penetration), portfolio quality (which measures the health of the MFIs main asset, its portfolio), efficiency (which measures staff productivity and efficiency of operations) and profitability (which measures its ability to cover costs and operate without subsidies) need to be monitored constantly by the MFIs and their partners.

For outreach, some commonly used measures that would probably be appropriate in the context of the IRDP are:

- total number of clients
- value of portfolio, i.e. outstanding loans at month/quarter/year-end
- monthly/quarterly/annual advances
- number of female clients
- number of "youth" clients, e.g. below the age of 25 or 30
- estimated share of micro-lending in district

For portfolio quality:

- credit in arrears at month-end – value and period in arrears
- portfolio at risk at month end.

For efficiency:

- administrative cost per unit of money loaned out (operational costs/average value of portfolio)
- administrative costs per client
- number of clients per loan officer

And for profitability:

- portfolio yield
- operational sustainability
- and, though perhaps more a measure of comparative efficiency, effective annual interest rate charged (including or excluding any fees charged)

A number of other basic policy recommendations applicable in most situations are summarized in the following box:

FIGURE 5.2 Other Important "Dos and Don'ts" for Donor MFI Retailer Support Policy

- Don't confine loans to particular groups, if at all possible – apart from being discriminatory, critical mass is essential for sustainability.
- Don't try to restrict the purpose for which cash loans are made – apart from being almost impossible to monitor, consumption and capital spending are often difficult to distinguish in households which operate micro-enterprises.
- Don't dictate retailer structure, systems and products – rather select retailers carefully and provide technical support.
- Don't emphasize outreach growth ahead of institutional capacity development for retailers without strong structures and systems – it will almost certainly result in poor recovery rates.
- Don't look to micro-loans to finance market-orientated farming or the purchase of what borrowers will regard as "large" assets.
- Do build in local capacity development requirements, where local MFIs are in partnership with international organizations.
- Do engage with government regarding legislative reforms needed to foster micro-finance.
- Do ensure that the scope and nature of the demand for and supply of micro-finance in the target areas is adequately documented and understood before making key strategic decisions about new micro-finance initiatives.
- Do use the services of organizations such as CGAP or of specialized professional consultants – on their own or as part of a broader team – in selecting and setting up relationships with MFIs.

5.2.2 Some Site-Specific Issues and Recommendations

The distinction between donor, investor and wholesaler needs to be drawn because one important policy/strategy choice that bodies such as WKKF face in their role as funders is:

- whether to act as donor, where there would be no obligation on the retailer either to repay the capital provided by the Foundation or to pay dividends on it, whatever other conditions may be attached; or
- as investor, where there would be no obligation to repay capital as long as the Foundation wished to continue funding the retailer, but a flow of dividend income would be expected after a time; or
- as wholesaler, where the capital is loaned to the retailer, possibly on a zero-interest, indefinite-period basis, but nevertheless remains a loan.

While this may be decided as a matter of principle (i.e. as an across-the-board policy applying in all cases), where it is not predetermined, the best strategy probably depends primarily on the nature of the retailer.

Where the retailer is a relatively small, indigenous organization that will need to "upscale" to provide micro-finance services to a wider spectrum of borrowers and/or whose capital has until that point been generated mainly from members' savings, the natural role for a funder would seem to be as donor. This might well be the case for WKKF in Chimanimani and Chimoio, where there are few, if any, large, well established MFIs operating locally or elsewhere in the country.

Where the chosen retailer is already well established in other areas and is being incentivized or contracted to extend its services to the locality concerned, a funder's natural role would seem to be as investor or wholesaler. This might well be the case in Nyandeni, if WKKF decides to partner an organization such as the Land Bank, TEBA-Cash or even Uvimba Bank – an innovative reconstruction of the old apartheid Transkei and Ciskei agricultural banks.

This brings us to what is perhaps the most important single policy/strategy question for funders: whether to draw in "external" bodies with an established track record of outreach and sustainability in micro-finance to drive micro-lending initiatives, or to aim to "upscale" a relatively small, "indigenous" body to provide micro-finance services to a wider spectrum of borrowers.

Of course, this is too narrow a categorization of alternatives. In reality, there will be other possible retailers that do not fit neatly into either category, while there may not be organizations in existence to put into both of the two categories. In both Chimanimani and Chimoio, the respective overviews (see sections 3.1 and 3.3) indicate that there probably is no MFI operating in either country that has an established record of outreach and sustainability in micro-finance. Even in South Africa, large as they are, the Land Bank and TEBA-Cash may only partly meet that description. A proper due diligence investigation is needed to reveal the degree to which their micro-lending operations have reached maturity. Still, with some 100 000 micro-loan clients each (current figures), with their very large capital bases and with the long experience that both organizations have in their respective fields, they are clearly in a league of their own in the sub-continent as rural micro-lenders. So the point stands.

Both routes have advantages and disadvantages that are worth brief consideration.

Using Established 'External' MFIs as Retailers

Clearly, size, experience and capital base – and all of the structures and systems that go with them – count for a great deal. To use all of these will undoubtedly accelerate the increase of access to micro-finance substantially. But while this should help boost economic activity in the area, even without removing some of the other constraints identified, it should not automatically be equated with meeting the IRDP's objectives of "increas(ing) community capacity towards sustainable economic development, especially among economically marginalized groups" and, more pointedly, of "mobiliz(ing) rural communities to work together, maximizing their institutional capacities to support sustainable and integrated development." (University of Pretoria, 2001, p3)

Two questions arise: first, are there meaningful ways in which the community can participate in the initiative other than simply as clients? Second, and more fundamentally, should people in rural or urban communities be aiming to play roles in a banking business initiative in their community other than those normally taken on by any client and local community stakeholder group? In other words, is it necessary for sustainable economic development that local people be involved in ways beyond these traditional stakeholder roles?

An answer to the second falls outside the scope of this brief discussion, but it is important for policy makers – WKKF in this instance – to ask and answer the question to their own satisfaction. In response to the first, the answer is in general that if they are sufficiently sought after, meaningful ways can almost always be found for community participation, whether on a group or on an individual basis. For example, the Land Bank's Step-Up micro-finance programme owes part of its success – in terms of both outreach and sustainability – to its appointment of local people rather than professional organizations as agents to market the loans and assist in their recovery. There is a three-way "win" in this relationship: for the agents as individuals, for the community as a whole (communities that continually display high default rates eventually fall out of the Bank's sphere of operations) and for the Bank.

The key point is that taking this route in no way precludes the possibility of meeting the IRDP's objectives regarding community participation and capacity building. These objectives should in no way be diluted on this account. It simply requires mutual determination, flexibility and innovation to find appropriate means and put them into effect.

Upscaling "Indigenous" MFIs

"Indigenous" MFIs are typically savings groups, e.g. burial societies, or savings and loan groups, which may operate on a rotating basis, such as stokvels, or on a demand basis. Invariably, only members who have been active and regular savers with the groups qualify for a loan or capital payout.

Clearly, assisting such a group or groups to grow would fulfil the IRDP's objectives of community participation and capacity building to a high degree. However, there are some tough psychological, operational and perhaps legal obstacles to be overcome in upscaling such groups to serve wider and more general micro-finance needs in rural communities.

First would be to secure the wholehearted support of existing members, especially for activities that might involve lending without borrowers first having developed a sound record of saving with the group. This is a quantum leap that may not often be easy to make. Reluctance to make this leap may be based on awareness of the need for quite different operating technologies and management skills, a challenge that donor organizations, with the aid of appropriate specialists, ought to be well equipped to help meet – but not without changing the fundamental ethos of the institution – a challenge that outside assistance is ill-equipped to meet.

The legality of expanding operations in this way would also need to be checked. In Mozambique, it would almost certainly not be legal at present without a commercial banking licence and all that entails. In Zimbabwe, it is not clear. And in South Africa, the exemptions to various aspects of the Banks Act that informal institutions such as stokvels currently enjoy, might need to be revisited.

The process would be difficult and would almost certainly take a good deal longer to improve the broader community's access to micro-loans than the "external" approach, but there are several important examples of upscaling success internationally (see section 4.3) from which encouragement can be taken.

In the end, the decision about which route to take hinges as much on *a priori* principles and preferences, incorporated into a donor organization's pre-existing policy – and often its constitutions – as it does on strategy in the particular situation. If policy is indifferent on the matter, the faster and easier strategy route would probably be to go the "external" route, paying close attention to requirements regarding community participation and capacity building. But, if the latter are a higher priority than time and energy, the decision should go the other way.

It would not be appropriate here to make a firm recommendation either way. If there are two firm interlocking recommendations that bear repeating, they are:

- To conduct a proper field study of the demand for, access to and environment of micro-finance services in each of the pilot sites, and
- To call in the assistance of specialist micro-finance consulting such as CGAP before making fundamental decisions about strategy.

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