

AFRACA

—NEWS—



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AFRACA Secretariat Address

PO Box 41378–00100
Nairobi, Kenya
Tel: +254 20 271 7911/271 5991
Fax: +254 20 271 0082
Email: afraca@africaonline.co.ke
Website: www.afraca.org

Production

AFRACANews is originated, compiled and edited by
Ms. Mbita Mary Nandazi – Secretary General
Mrs. Dorothy Nduku K. Kipsang – Programme Coordinator

Layout and production: Support to
Development Communication
dalimwagore@iconnect.co.ke

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Dear readers,
It is with great pleasure that I bring you AFRACANews for the period July–September 2008.



Mbita Mary Nandazi
Secretary General

The Secretariat organized several workshops and forums during this period. First, the 5th AFRACA Microfinance Forum was held in July 2008 in Cotonou, Benin. Attendance and participation in the meeting were excellent. This was followed the East African subregional workshop which was held in Addis Ababa and hosted by the Commercial Bank of Ethiopia. Third, the Central Banks forum was held in Livingstone, Zambia. In case you were not able to attend all the meetings, this issue offers you further reading, which can also be found on the AFRACA website at www.afraca.org.

Alongside the workshops, AFRACA has been organizing the regular Technical Cooperation among Developing Countries programme. It continues to be valuable to all members who get to attend. I thank the institutions that have hosted the programme in the past and have provided members of staff an opportunity to learn from them. I encourage all institutions to take advantage of this programme.

In this issue we share some papers which were presented and discussed at the various AFRACA workshops and forums. The paper entitled *MFI–bank financial linkage: Ambara Credit and Savings Institution's experience and future trends* highlights the theoretical concepts and experiences with of linkages. This is a classic example of a bank–microfinance institutions (MFI) link which has worked and from which others could learn.

The second paper, *Contribution of regulation and supervision to growth of microfinance institutions in Uganda*, gives a synopsis of the experience of deposit-taking MFIs and how regulation has contributed to their current status. Another paper discusses *Policy initiatives for improved service provision in Ethiopia*, and the last summarizes the contribution of regulation and supervision to the growth of microfinance in West Africa.

Finally, the period 24–28 November 2008 is here with us. Preparations for the 16th AFRACA General Assembly and technical workshop on *Innovations in addressing rural finance challenges in Africa* are now complete. If you have not yet registered, do so at afraca@africaonline.co.ke.

God bless you abundantly.



News in brief

5th Africa Microfinance Forum

The AFRACA Secretariat organized the 5th AFRACA microfinance forum, *Optimizing financial service delivery to the rural areas*, 2–4 July 2008 in Cotonou, Benin. This forum, which brought together over 100 participants, was hosted by the L'Association pour le Promotion et l'Appui ou Développement des Micro Entreprises with support from other AFRACA members in Benin and the Government of Benin. The forum was officially opened by Hon. Sakinatou Alfa Orou Sidi, Minister for Microfinance, Small and Medium Enterprise Development. Participants represented banks, central banks, microfinance institutions and agribanks as well as the ministry of Microfinance and Small and Medium Enterprise Development. Development partners in attendance included Planet Finance, Planet Rating, Grameen Bank, Credit Agricole Foundation and MoneyGram.

To affirm its commitment to microfinance, the Government of Benin extended support to the forum. Notably, the government sponsored all entry visas and some key items in the budget. While noting that the theme of the forum was timely, Hon. Sakinatou Sidi noted that his government was exploring the best options to enhance access to financial services by the rural poor. She said that her government was putting vast resources to support the microfinance sector and any lessons that can be drawn from other successful institutional structures would be useful to Benin.

Some of the papers presented during the forum have been loaded on the AFRACA website.



Hon. Mme Sakinatou Sidi (in white trouser suit, front row) with participants during the 5th microfinance forum in Benin.

2nd AFRACA Central Banks forum

The Bank of Zambia hosted the 2nd AFRACA Central Banks forum whose theme was *Promoting inclusive financial sectors with increased investment in agriculture*, which was attended by over 70 delegates from 11 countries. Despite his busy schedule Mr. Caleb Fundanga, the governor of the Bank of Zambia, participated in the workshop.

While opening the forum, Hon. Ng'andu P. Magande, the Minister for Finance and National Planning, indicated that despite broad consensus on the importance of financial inclusion as a poverty alleviation tool, it is estimated that between two and three billion people around the world are still excluded from accessing financial services. The situation is particularly dire in developing countries where the majority of the population does not have access to the formal financial system.

He pointed out that most people in developing countries do not have savings accounts, do not receive credit from formal financial institutions, and do not have any type of insurance. They rarely make or receive payments through formal financial institutions. This limited use of financial services has become an international policy concern.

Global concern over the widespread financial 'exclusion' in developing countries stems from the fact that access to a well-functioning financial system has the potential to economically and socially empower poor people and low-income earners as well as micro-enterprises. This can help them to better integrate into the economies of their countries. Access to financial services also actively contributes to their human and economic development, to the economic growth of the countries where they live, and to the social safety nets that can help protect them against adverse economic shocks.

The Government of Zambia supported the forum. The ministers for Finance and for Southern Province attended and participated in the forum, as well as the mayor of Livingstone city among other senior personalities in Zambia.

Field visits to a timber company and banana plantation enabled participants understand how financial institutions could work with entrepreneurs to positively affect communities.



From left: Her Lordship the Mayor of Livingstone; Hon. Munkombwe, Minister for Southern Province; Hon Ng'andu Magande; Minister of Finance and National Planning, Dr Caleb Fundanga, the governor of Bank of Zambia; and Mr Emund Mkwawa, AFRACA vice-chair and managing director of Dar es Salaam Community Bank.

In closing the forum, Dr Tukiya Kankasa-Mabula, deputy governor for administration at the Bank of Zambia, re-iterated that affordability and physical access were key constraints that must be addressed if those who are financially excluded are to access financial services. Strategies chosen to be implemented to improve financial inclusiveness will only be effective to the extent they include these two key challenges.

Dr Kankasa-Mabula also emphasised that policies aimed at improving financial inclusiveness should include a vision for the financial sector; an enabling legal, regulatory and supervisory framework; and an improvement in the lending environment. She urged participants to learn from the Kenyan experience that had clearly demonstrated that informal services can supplement formal financial services. This is an important revelation, particularly for countries such

as Zambia where informal financial services are largely underdeveloped.

Commenting on the global surge in food prices, which presented both risks and opportunities particularly for Africa, it was assuring that delegates deliberated on policies and initiatives that can allow countries to exploit the opportunities presented by rising food prices. In this regard, financial inclusion particularly of rural communities is fundamental in facilitating increased investment in food production.

East Africa Sub Regional Workshop

The East Africa Sub Regional Workshop (EACRAT) was held from 22 to 24 July 2008 in Addis Ababa, Ethiopia. This workshop marked the end of the subregional workshop series on *Innovations in addressing rural finance challenges in Africa*. It was hosted by the Commercial Bank of Ethiopia (CBE). This workshop was officially opened by His Excellency Ato Mekonen Manyzewal, State Minister for Finance and Economic Development. CBE also organized an educative study tour to livestock farmers and small-scale entrepreneurs in Oromia region. The planning was faultless and the outcome of the whole process was worthwhile. Keep it up CBE!

All presentations and the EACRAT workshop report have been loaded on our website: www.afraca.org. Following are two papers from this workshop: one on Amhara Credit and Saving Institution and the other by the National Bank of Ethiopia.



Participants during the EACRAT workshop included the Ethiopian State Minister for Finance (arrow pointing).



Microfinance institutions–bank financial linkage: Amhara Credit and Saving Institution’s experience and future trends

by Mekonnen Yelewem Wessen

In Ethiopia microfinance has been considered as one of the best entry points for achieving sustainable development. Microfinance is one of the most prominent instruments in most of Ethiopia government’s pro-poor development programs and strategies. Over the last decade, microfinance institutions (MFIs) in Ethiopia have served productive poor people mainly with savings and credit services. Governmental and other development organizations are credited with positive achievements made in the country’s MFI sector.

As of July 2007 there were 27 MFIs licensed by the National Bank of Ethiopia (NBE) that were serving over 1.73 million active clients. This means that there are still more unreached people; a situation partly attributable to lack of adequate capital for MFIs and the challenges of dispersed populations among pastoralists.

Microfinance institutions–bank linkage: theoretical and practical explanations

MFIs have created new opportunities for millions of poor people to use modern banking in a sustainable manner. Such effort has not been without challenges. Major challenges, such as shortage of loanable funds, have constrained MFIs’ scale of operations. As Kirsten puts it: ‘Millions [of the poor] are still not reached with any form of sustainable or reliable finance, with many of the existing providers of MFIs being completely dependent on donor subsidies’.

To address the challenge of capital limitations, MFIs have been urged to initiate or improve financial links with commercial banks. This will help mitigate MFIs’ continued dependency on donor subsidies, which many consider as major hindrance to creating sustainable financial services for the poor.

Financial linkages

Links between established and formal banks and MFIs can create new possibilities for the current pro-poor microfinance programs. The literature on financial linkages points out that information and enforcement problems in credit markets result in a mismatch of resources and abilities between formal and informal lenders. While formal financial institutions have extensive infrastructure and systems and access to funds, they are usually further removed from rural poor clients, making it difficult for formal financial institutions to obtain adequate information to help them reduce risks. In contrast, informal and semiformal financial institutions including MFIs operate close to rural clients and the poor in general, possess good information and enforcement mechanisms, and are typically more flexible and innovative. However, these categories of financial institutions are constrained by shortage of resources and infrastructure to serve their clients in depth.

Two types of financial linkages have been identified. First, direct financial linkage established between financial institutions with the main purpose of diversifying sources of funding and resolve MFIs’ liquidity shortages. A typical example of this type of linkage is a bank or apex organization offering bulk loans to MFIs. Second, facilitating linkages are linkages between institutions in which the formal institution ‘hires’ the less formal institution to act on its behalf. This type of linkage facilitates transactions such as remittances, payment of utilities, mobilizing savings or even facilitates loan pay outs. This paper emphasises the first category of financial linkage approaches of bank–MFI–clients.

Many private banks have entered the microfinance market by establishing direct financial links. Examples of such banks include CRDB Bank Limited, a private bank in Tanzania; PCFC, a government-owned apex organization in the Philippines; and K-Rep, the recently privatized microfinance bank in Kenya. By establishing



a direct financial link, banks have been able to minimize costs and further their business, and have contributed to the growth in scale of their partnering MFIs.

The motivating factor for the above and other financial links can be external or internal to the institution starting the linkage. Research carried out in India by the World Bank shows that the motivating factors are usually external rather than internal or spontaneous. For example, in India, bank regulations require commercial banks to invest at least 40 percent of their net credit in priority sectors such as rural areas, small industries.

Financial links also need contractual agreements related to the lending conditionality made between the bank and the MFI. In this case, MFIs are often compelled to accept restrictive terms and conditions from funding banks, which often leave the MFI with no choice but to accept restricted lending and high interest rates.

Ultimately, financial links should add value to the partnering organizations, that is, previously underserved segments of the rural population should be reached, or a bigger variety or improved quality of financial products and services should be offered. These may be best tools to expand the amount and nature of financial services in rural areas.

MFI-bank links in Ethiopia

Formal microfinance in Ethiopia, though a recent phenomenon, has been accepted by both the government and development NGOs working towards alleviating poverty. The regulatory framework for MFIs allows them to operate and expand their services to rural and urban areas in the country. As one of the positive aspects, the regulatory framework allows licensed MFIs to accept deposits from the public to finance a significant portion of their lending businesses.

As at December 2007, there were 27 licensed MFIs in Ethiopia covering about 1.73 million active borrowers and 2.7 million borrowers. As of December 2006, about 13 MFIs were operationally sustainable (a rise from 6 in 2003), and 8 (up from only 2 in 2003) were financially sustainable. Though these achievements are impressive given the short period of operations of the MFIs (not more than 10 years for most), the huge unmet demand existing in the country portrays gaps in the performance of the microfinance sector. These 27 MFIs have met less than 20 percent of the demand for microfinance services of the active poor.

Institutional capacity and lack of loan capital are the main constraints to growth in outreach and sustainability of the MFIs. It points out that even if some of the MFIs operating in the country were to become self-sustaining or profitable, it would still be impossible to guarantee that their accumulated profits would support the large-scale growth required to reach the large number of poor households.

Savings mobilization has not sufficiently met the loan demand and other sources of loan funds have to be found. Figure 1 shows the source of loan capital funding for MFIs in Ethiopia in 2006.

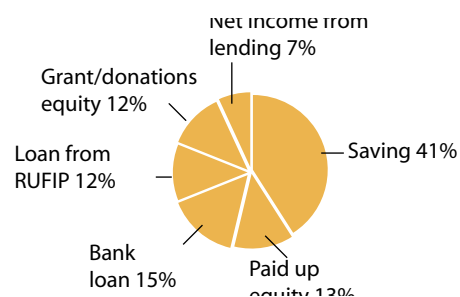


Figure 1. Source of funds for MFIs in Ethiopia, 2006

ACSI's link with banks: past experience and future outlooks

Amhara Credit and Saving Institution (ACSI) is one of the largest MFIs operating in Ethiopia. Its main market is the low-income population particularly of Amhara region. It started its operations in 1995 and was licensed in April 1997. ACSI's primary mission is to improve the economic situation of low-income, productive poor people in Amhara region primarily through increased access to lending and saving services.

ACSI has achieved remarkable performance in its microfinance activities. It has experienced impressive outreach growth in its operation. Its lending activities have seen positive socio-economic impact on its clients through helping the poor increase their income; asset position and their empowerment status. There are now more than 590,000 borrowers and more than birr 1 billion in outstanding loan portfolio, covering more than 35 percent of the national outreach. This shows that the microfinance coverage in Amhara region is critically unsatisfied. Only 25–30 percent of the potential demand for microfinance is estimated to be reached.



Past financial performance shows that a significant portion of ACSI's financing comes from savings (figure 2); more than 70 percent of the total funding liabilities in the last five years was clients' savings.

ACSI has been applying a savings-led lending model whereas the demand for loans is higher. As a strategy to bridge such liquidity gap, ACSI has considered different funding sources (figure 2). As a priority, next to savings ACSI emphasises financing its loans from commercial sources. It has been working together with commercial banks operating in the region. The strategy however was not successful for many years. Banks have been reluctant to invest their excess liquidity into the MFI market. For banks, the approach is a new area of investment requiring different outlooks. Lending to ACSI without tangible collateral is deemed impossible and risky business for most local banks. As a result, the banks wanted to evaluate their lending process using conventional approaches such as collateral-based lending and interest rate settings. They require of the MFI, legally acceptable collateral among others, which take the form of fixed assets. Unfortunately, as a new MFI, ACSI could not easily fulfil those requirements. A greater proportion of its total assets (about 80 percent in 2007) constitute the loan portfolio invested in clients business giving it no room to fulfil fixed collaterals required by banks. Given donors' high-level focus on the microfinance sector, ACSI was not also, as was true for many of the other MFIs in the world, crucially considering commercial financing alternatives. Subsidized loans and grants have covered its immediate loan-financing requirements.

ACSI has been initiating links with banks but initially, it was difficult due to stringent loan conditions as well as collateral requirements. However in 2007, ACSI obtained a loan of birr 50 million from CBE with a loan guarantee scheme (Stand by Letter of Credit—SBLC) implemented with the collaboration of Grammeen Foundation USA, an international foundation working towards promoting the MFI sector. The SBLC covers 50 percent of the collateral requested and the remaining 50 percent is covered from ACSI's own fixed assets, particularly the headquarters premises. The facility's loan term is five years. As the SBLC has a declining loan repayment schedule, it will stay for the next two and half years only. This is because Grammeen Foundation's policy is in contrast to CBE policy. CBE in this case has taken the initiative to adjust its internal lending policies to accept international or US laws.

Along similar lines, ACSI is now accessing additional commercial loans from CBE with the loan guarantee from the regional state that wants to expand microfinance outreach in urban areas to adequately finance small and microenterprises.

Nonetheless, recent efforts to create links that ACSI and its partners have tried to initiate with CBE have There is potential for the banking sector to consider the microfinance sector as a niche investment area. CBE is now initiating a financial link with ACSI and has even started to adjust its internal policy to fit the real microfinance demand. As an example, the value of collateral to loan ratio while 100 percent for other sectors, CBE requires 75 percent for MFIs. CBE and other commercial banks are now looking at the MFI sector as a feasible market in which to invest their excess capital. In general, better relationships and links between banks and MFIs are expected in the future.

Conclusion

Microfinance has become a crucial entry point in efforts to reduce poverty in Ethiopia. However, to accomplish that responsibility MFIs need to be strengthened. Their challenge to get on-lending capital needs to be resolved through designing innovative mechanisms, among others, through improving bank–MFI links at the local level.

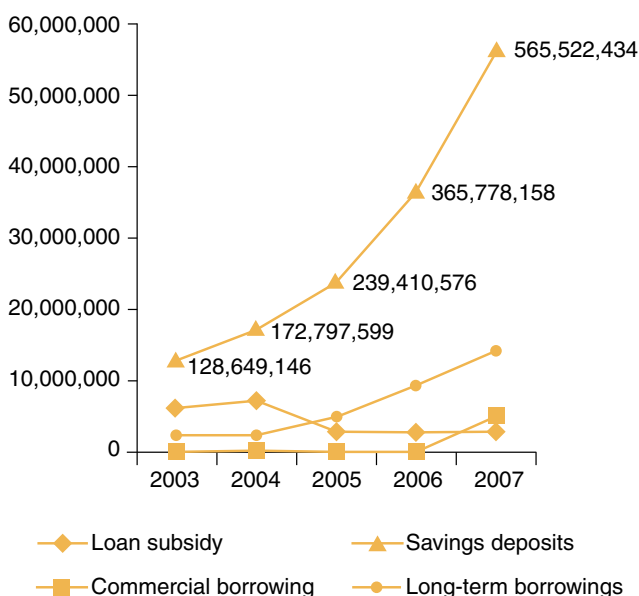


Figure 2. ACSI borrowings, 2003–2007



Contribution of regulation and supervision to growth of microfinance in Uganda

by Mathias Katamba, Uganda Finance Trust

Over the years, microfinance institutions (MFIs) have grown in number, size, outreach, loan portfolio and deposits, to a level where they have become key players in the financial industry and attracted the attention of government, donors and other stakeholders. This resulted in the need to regulate large MFIs taking or intending to take deposits from the public. This paper addresses the impact of regulation on MFIs.

Background to regulation

The adoption of sustainability and profitability alongside the social missions of MFIs meant that sponsors and management of MFIs moved from seeing microfinance purely as a social service to running the institutions with a focus on profitability and long-term commercial viability.

The dual mission drove MFIs to seek greater outreach and the number of clients grew significantly. By the end of 1999, for instance, the larger MFIs like PRIDE and UWFT (now Finance Trust) each had more than 30,000 clients. FINCA, UWESO (now Success Microfinance Ltd), Faulu Uganda, Feed The Children, and a few others had between 5,000 and 25,000 and were growing.

At the same time, stakeholders of the microfinance industry (MFIs, government, donors, other development partners and people with interest in the industry) started the Microfinance Forum (MFF), an informal but very effective information-sharing mechanism.

Among other developments, the MFF started discussions on how to mainstream microfinance into the formal financial sector and create conducive conditions for MFIs to become sustainable, thrive and grow.

The MFIs also looked forward to being regulated because this would afford them better recognition and deposits to finance growth in their loan portfolios. The rapid growth in the numbers of people served by MFIs and the fact that some of them were already taking

savings in some form or were interested in starting to mobilise savings, attracted the attention of Bank of Uganda (BoU) as a regulator in 1998.

BoU at the time saw a clear mandate to regulate MFIs taking and intermediating deposits from the public. The main reasons for proposing to regulate microfinance were to:

- Enhance orderly growth of the financial sector by extending regulatory focus to large and savings-taking MFIs.
- Build client and public confidence in the institutions by increasing the safety of their savings and monitoring performance in all aspects.
- Recognise microfinance as a line of business that can be operated by any regulated financial institution such as a commercial bank, credit institution or licensed MFI.
- Provide a framework, law and regulations to supervise MFIs that desire to intermediate micro-deposits.
- Define the scope of BoU's microfinance regulation / supervision, since the bank realized it did not have the resources and capacity to oversee the whole microfinance industry.



One of the branches of Finance Trust in Uganda



- Maintain and improve stability of the financial sector.

In November 2003, the MDI Bill (microdeposit) was passed by parliament. It became law on 1 July 2003. In October 2004, BoU issued the implementing regulations under the Act.

Contribution of regulation to growth of microfinance

Joanna Ledgerwood and Victoria White summarize international experience with transformation as follows. In addition to facilitating the mobilization of savings, expanding the funding base and increasing the numbers of clients reached, these institutions, through transformation, have also diversified their ownership and governance structures, increased the professionalism of their staff, improved management information systems, and improved overall internal controls.

Benefits of regulation

Infrastructural improvements

Management information systems Because there were no specific mandatory reporting requirement for MFIs prior to licensing, the unregulated MFIs often sought cheap management information systems (MIS) solutions, which were not effective or efficient. With the Act and regulations in place, MDIs are required to use MIS that enable them to prepare accurate weekly, monthly and quarterly reports. The MDIs have accordingly upgraded or changed their banking and accounting software to more reliable ones.

Improved MIS has enhanced speed and accuracy of information processing and reporting. The MDIs are also working on connectivity. Finance Trust has fully connected its branches to the head office, and the others are working on this, which will further improve the efficiency of reporting.

Improvements to image and premises All MDIs have changed or improved their corporate logos to be more pronounced and appealing to the public. They have also improved their business premises to look like bank branches, with well-secured teller cubicles, well-designed banking halls, customer care desks, strong rooms and security guards. These security provisions are part of BoU's requirements. This has

served to boost public confidence in the MDIs as safe places for customer deposits.

Improvements to ownership, governance and management

All MDIs used to be NGOs but are now companies limited by shares as required by law. All, except FINCA, had to bring in new investors—being purely commercial, social investors, domestic and international investors.

The four MDIs have improved their board composition in terms of complementarity and relevance of skills. This is largely attributed to the strict BoU requirements, including vetting all directors, senior managers of MDIs using the BoU's fit-and-proper test, as well as to the coming of new shareholders with international experience in corporate governance.

Prudence and accuracy in reporting

Regulation has made both operational and financial reporting by MDIs more reliable. MDIs have become more worthwhile corporate clients and now have better access to wholesale loan financing from commercial sources.

Annual publication of MDIs' audited accounts four months after the end of each financial year has introduced discipline in producing audited accounts timely and accurately. It has boosted transparency by MDIs and given them impetus to strive for better performance.

Insuring deposits and cash

Regulation has created public confidence in the MDIs putting them at the level of commercial banks. It has also increased access by low-income earners to safe saving facilities. According to the Act, all client deposits will be covered under the Deposit Protection Insurance of each MDI, once up. Furthermore, the Act requires MDIs to take insure both cash on the premises and cash in transit. This provision offers a last-resort safety net for depositors in MDIs.

Competition

Transformation brought the MDIs to closer competition with commercial banks. The banks were downscaling to serve small and medium enterprises while the MDIs, in a bid to improve profitability and sustainability, were



in part up-scaling to serve SMEs in addition to their traditional micro-level clients. This forced MDIs to strive and measure up in customer care, to the advantage of all types of clients. The new status and increased competition from other MDIs and commercial banks has forced MDIs to diversify their product range, look for innovation and improve customer care so as to serve their clients more satisfactorily.

Quantitative growth indicators

Since licensing, MDIs have become more business-oriented and innovative.

Financial and operational performance

Profitability For three MDIs, the pattern was similar: they made modest operating profits before the transformation, profits reduced during the transformation years, and then started rising again in 2006, after licensing (figure 1).

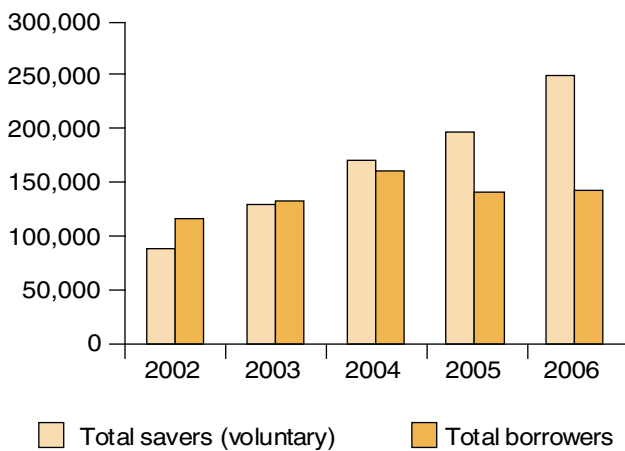


Figure 1. Total savers and borrowers in Ethiopia

From unaudited figures, the rise in profitability during the first quarter of 2007 was even more substantial. This means that the seemingly disruptive effect of transformation on the performance of MDIs was temporary and after they had fully streamlined their structures and operations, improvement in performance started. The fourth MDI continued to show declining profitability in 2006 but has since reversed this trend with an impressive performance in 2007.

Portfolio yield Overall, the portfolio yield of MDIs has seen a modest increase since 2004. It could be

argued that this is good for the institutions from the sustainability viewpoint, and counter-argued (more importantly) that regulation has not on the whole made MDI loans any more affordable for its clients.

Capital / funding structure Generally, the MDIs have leveraged their equity after licensing. This reflects both the more commercial orientation that licensing brought and the growing confidence of commercial and other lenders' in the MDIs after licensing. Another reason is that the two MFIs that were already intermediating savings had to free up the compulsory savings, called loan insurance fund, which they previously intermediated, as BoU regulations require these to be held in liquid assets. To do so and maintain their portfolio volumes, MDIs had to increase their overall borrowing.

Outreach / Focus on the poor The general trend is that the number of clients seeking loans from MDIs has tended to follow their natural growth. For MDIs that experienced the most drastic fall in the number of borrowers (while the loan portfolio was growing), another cause was the speedy switch from predominantly group to individual loans (between 2003 and 2006, the ratio between the group and individual portfolios changed from 81:19 to about 25:75).

The number of voluntary savers has increased more rapidly. This is not surprising as this was a new line of business for the MDIs.

The average loan balance and average savings balance for the four MDIs grew substantially after licensing. To enhance sustainability, MDIs have had to add more of the not-so-poor among their borrowing clients and to develop products for this new category, without abandoning their focus on the poor.

Looking at the numbers of loans disbursed below US\$200,000 (USD100) and above US\$3 million (USD1500), there is a general trend that MDIs have increased the number of large loans granted. The trend for small loans is not as clear, but overall the number has decreased between 2004 and 2006. This limited data suggests that MDIs now have a stronger focus on better-off customers, although it is not obvious that this is at the expense of poorer customers.

MDIs asserts that they have not abandoned the low-income people as their core focus. They explain that they have had to spread their focus to include the less poor. This has been done to focus on profitability and sustainability drive.



The pattern on outreach is that MDIs have focused more on the not-so-poor than they did before licensing. The average loan and savings sizes went up while the percentage of people accessing services as group members declined significantly. These are both indicators that after licensing, MDI's focus on the poor clients, who were previously their major focus, reduced. The percentage of MDI loan clients being served by rural branches has remained the same: 72 percent in 2006 and 75 percent in 2004.

Conclusion

The major benefits of regulation and supervision—increased deposits, profitability, stability of MDIs, branching out into rural areas, product development, and outreach through linkages with other institutions—are yet to be seen. The immediate results are already showing in terms of improved profits of MDIs, better structured and organised institutions, improved governance and management, increased access to funds from the commercial money market, and safety of poor people's deposits.

Policy initiatives for improved financial service provision: the case of Ethiopia

by Getahun Nana, National Bank of Ethiopia

Introduction

Accelerated and sustained economic growth is on the top of the Ethiopian Government's policy agenda. In its various policy and strategic papers, the Government of Ethiopia (GoE) has clearly documented that the country's long journey to industrialization and transformation to a middle-income nation should be led by agriculture. Thus there is a need to enhance agricultural production and productivity. Finance is at the heart of boosting investment and thus growth in the country. Financial systems mobilise scarce financial savings from the public and channel it to productive investments. They reduce risks to investors and thus lessen the barriers to new entry. Similarly, they lower risk of savers and help to raise financial savings. They also facilitate efficient exchange of goods and services by operating the country's payment and settlement systems. It is, therefore, very difficult, if not impossible, to achieve the GoE's goal of rapid and sustainable economic growth and development objectives without having vibrant, efficient and strong financial system which is accessible to majority of the population, if not all.

To make the financial system accessible to all, there is a need to create enabling environment for the expansion and growth of the financial institutions and markets. In absence of enabling environment, financial institutions

fail to improve their services on sustainable basis as to quality and quantity. Creation of enabling environment for financial systems includes, maintaining stable macro-economic condition, ensuring their soundness and developing stronger underlying infrastructure including in information and legal dimensions.

This paper briefly presents policy initiatives taken by the GoE since early 1990s to foster development and accessibility of finance to the rural areas in particular and the country in general, and presents overview of Ethiopian financial system while section two outlines important policy measures taken by the government. The last part concludes the paper.

Financial systems in Ethiopia

Financial markets and institutions interact and combine in various ways to form a country's financial systems. At the centre of the system there are financial instruments in which financial institutions deal in the market. Financial systems evolve over time. They reflect a country's political and economic history. Financial systems in many African countries, for example, evolved from colonial times. Evolution of modern institutionalized financial system in Ethiopia started in 1905 following the establishment of the first bank by historically reminiscent name of Bank of



Abyssinia. This Bank introduced for the first time in Ethiopian financial systems history banking services and instruments such as deposit accounts and export financing.

In pre-1974 Ethiopia, the financial system operated in a free-market economic environment. However, in the 1980s, it was restructured and reorganized to serve centrally planned economic system, which was created following the change of government in 1974. During this period, GoE nationalized all financial institutions in the country and created three specialized banks (excluding the central bank) and one insurance company. Private ownership of financial institutions was prohibited. Following the principles of mono-banking, the three state-owned banks and the insurance company were administered by the central bank—the National Bank of Ethiopia (NBE). Indeed, the NBE used to run those government-owned financial institutions like its own cost-centred functional units. Among the specialized banks, the then Agricultural and Industrial Development Bank (the current Development Bank) was responsible for financing agricultural and industrial projects with medium- and long-gestation period, while the then Housing and Savings Bank (the current Construction and Business Bank) used to lend for construction of residential and commercial buildings. The third bank, Commercial Bank of Ethiopia, was the only bank engaged in trade and other short-term financing activities. The only insurance firm, the Ethiopia Insurance Corporation, was responsible for providing all types of insurance services. Although there were efforts to reach the poor through rural and urban cooperatives, particularly, by extending farm input loans, access to finance during the previous regime was virtually not possible for the rural poor. By the end of the socialist-oriented regime, because of the failure of most cooperatives to repay their loans, banks totally pulled out of lending to rural farmers.

In the 1990s, as a result of the shift from socialist to market economic system, Ethiopia reformed its financial services industry. The reform measures included comprehensive restructuring of government-owned financial institutions and opening the sector to local private equity participation. The three government-owned banks and insurance company inherited from the socialist regime were recapitalised and made autonomies (in terms of managing their business). While there was no change in the role of the Commercial Bank of Ethiopia (as short-term financier),

the Development Bank of Ethiopia (as provider of medium- and long-term development finance), the Ethiopian Insurance Corporation (as provider of both general and life insurance services), and the Construction and Business Bank have been allowed to engage in short-term financing activities.

Opening the financial services industry for local private equity participation resulted in establishment of 9 banks, 8 insurance companies and 28 MFIs, by June 2008. The newly established banks and insurance companies are all wholly owned by local private shareholders. Ownership of the newly established MFIs, however, is mixed: some are owned by regional governments, others by local NGOs or private shareholders.

Financial institutions other than banks, MFIs and insurance companies operating in the country include a government-owned pension fund and saving and credit cooperatives. The pension fund provides long-term compulsory contractual saving services to only public sector employees. Moreover, there are no other financial institutions that specialize in provision of contractual savings services to the general public. Life insurance service, for example, is underdeveloped.

Financial markets in Ethiopia are underdeveloped. The inter-bank money market is almost non-existent; little or no local currency is traded among banks. The major source of liquidity for banks is public deposits. The inter-bank foreign exchange market is also not active. NBE is the only bank that sells foreign exchange to all other banks. Over a 12-month period (2006/07), banks (excluding the NBE) traded among themselves foreign exchange equivalent to only USD59.4 million, while the NBE sold USD130.4 million to them and bought nil from the market.

Financial instruments available in financial markets are limited to government papers (treasury bills and bonds) and a few corporate bonds. CBE recently purchased bonds with 10-year maturity from Ethiopian Electric Power Corporation and Ethiopian Telecommunication Corporation. Moreover, there is no secondary market for these financial securities. Government paper, especially treasury bills, however, can be liquidated using the discounting window at NBE. Unlike many central banks, NBE does not use the open market to implement its monetary policy.

Banks provide largely traditional financial products. On the liability side, their products mainly include



demand, saving and time deposits. On the asset side, they offer short-, medium- and long-term loans, all of which are not tradable in the market. Loans are not secured. Because the money and securities markets are underdeveloped, banks in Ethiopia are forced to hold high amounts of liquid assets to minimize liquidity risk. As at the end of June 2007, for instance, average loan to deposit ratio for the banking system in Ethiopia stood at less than 50 percent, which is very low by any standard. This relatively high liquidity ratio kept by banks in turn suggests inefficiency in financial intermediation.

Currently, Ethiopia has no formal stock exchange market. Initial public offerings of equity shares are rare. With the exception of banks, and to some extent insurers that are widely owned by the public because of deliberate government policy, companies usually are created by families or a group of people closely related in some way. After initial public offering, equity shares are traded informally between a buyer and a seller.

In short, Ethiopian financial systems, like in many African countries, are bank dominated. Underdeveloped money markets and long-term securities along with a limited number of financial institutions have resulted in this bank-dominated financial system which, like in most African countries, is not easily accessible to a large segment of the population. A study conducted recently by the World Bank showed that only 20 percent of adult population (19 percent in Ethiopia, table 1) has accounts in financial institutions in the median African country. The number of deposit and loan accounts are crude indicators of accessibility to finance, because some individuals or firms may have multiple accounts while others have none.

Table 1. Number of accounts

Financial institutions	No. of institutions	No. of accounts	Share in total accounts (%)
Banks (deposit accounts)	11	3,403,959	64
Microfinance (loan accounts)	27	1,535,093	29
Cooperatives (loan accounts)	5437	380,000	7
Total	5475	5,319,052	100

Source: NBE for banks, data for end-March 2008; Access to Finance, for MFIs and Cooperatives; data for December 2006 for MFI and September 2006 for Cooperatives.

Low geographic and demographic penetration

Ethiopia has low geographic and demographic penetration of bank branches. Although the expansion of banks in terms of branching since 1994 is significant, most rural people have to travel long distances under poor transportation infrastructure and facilities, sometimes even on foot, to access bank branches. All banks have their headquarters in the capital city, Addis Ababa. Their branches too are concentrated in the capital. The number of bank branches went up from 215 in 1994/95 to 562 in mid-2008. As of 30 June 2008, population per branch in Ethiopia stood at 135,404 and there was one branch per 1964 square kilometres. Compare these figures with 96 branches per 1000 people and 790 bank branches per 10,000 square kilometres in Spain. Thus, mainstream bank branches are hardly accessible to rural poor.

At macro level, expansion in the number of banking institutions and their branch network improved financial intermediation in the country.

Affordability

For a small, subsistence landholder, the minimum account opening balance, which is birr 50 for a bank requiring the lowest, might be unaffordable. The only financial service that banks are comfortable to provide the rural poor is limited to remittance or payment.

Policy initiatives for improved financial services

The Ethiopian Government in its Agricultural and Industrial Strategic Plan published in 2002, and in the Plan for Accelerated and Sustained Development to End Poverty (PASDEP) has declared that the only way to get out of poverty is accelerated and sustained economic growth. (For extensive coverage of Government's economic strategies, see Ministry Information, 'Agricultural Development Policies, Strategies and Methods', and 'Industrial Development Strategies', both published in 2002 in Amharic.) Agriculture is expected to play a central role in bringing about rapid economic growth and development



in the country. To achieve this far-reaching goal, finance is considered as a key input. Financial Sector Strategy of 1998 is also consistent with the goals of accelerated economic growth. This strategy aims at improving access to finance in the country as a whole and in rural areas in particular, by creating a conducive environment for financial institutions and markets to expand and operate. It extensively outlines policy measures to be taken by the government to build and preserve a stable, efficient and inclusive financial system. All strategic documents by the government stated above recognize that access to finance and stronger financial systems promote growth by financing entry into business of new firms (particularly small and medium enterprises which are often most dynamic and innovative) and expansion and growth of existing enterprises.

Government has a central role in creating an enabling environment for expansion, competition and growth of financial services industry in the country.

The GoE strives to provide financial institutions and markets with the necessary framework and incentives to deepen and broaden the financial system. To this end, it issues new or updates existing laws governing contract administration and enforcement as well as establishment, ownership, corporate governance and operation of financial institutions. Furthermore, it strives to maintain stable macro-economic environment. The GoE has taken a number of policy measures to enhance the development of the financial system in the country since 1991. Some of these policy actions and initiatives are discussed below.

First, maintaining sound macroeconomic condition is essential for deepening access to finance: Given the inter-temporal nature of financial contracts, macroeconomic stability is a prerequisite for financial system development. Over the last five years, the country enjoyed a robust economic growth which stood at about 11 percent per annum. The country's inflation rate has been below 10 percent until recently while its exchange rate continued to be stable.

Second, promulgating and implementing laws that promote financial sector development, soundness and accessibility has been among important policy measures taken by the government. In 1994, laws for licensing and supervision of banks and insurance companies were issued. Similarly, in 1996, the law for regulation of MFIs was promulgated. These three laws

allowed local private sector participation in financial sector. The issuance of **MFI law is one of important policy initiatives of the government that helped improve access to finance in the country.**

A law that allows for establishment and operation of leasing companies has also been enacted by the government. The objective of the law is to encourage the creation of non-deposit taking institutions that provide both financial and operational leasing services. The law sets rules for granting and administration of leasing services.

With the aim of improving credit repayment culture of borrowers and ensuring soundness of banks, the GoE issued a law that empowers banks to foreclose on collateral held against loans without passing through the court system. Clear legal rights of borrowers and lenders are crucial for financial sector deepening. The foreclosure law allows for speedy resolution of bank claims by stating the rights of the creditor on properties held as collateral if the borrower fails to repay the loans in line with the original agreements. The system of foreclosure is working well in major cities and towns of Ethiopia.

A study is underway to develop legal and regulatory framework for electronic payments. Electronic payments are not currently covered in Ethiopian legal system. Lack of such legal framework may thus hinder the introduction of cost effective modern electronic payment instrument such as ATMs, credit and debit cards, mobile/telephone/internet banking. Other policy initiatives which is currently under consideration is the development of securities market, particularly, that of long term debt instruments.

Third, improving availability of borrower information to banks has been important policy imitative implemented by the GoE. Experience world wide indicate that sharing information of borrowers among banks minimizes information asymmetry and adverse selection. It also helps improve competitiveness of banking institutions.

Fourth, efforts are being made to expand modern telecommunication network to rural areas. This will allow the use of ATMs, Debit and Credit Cards, Mobile banking among others as they enhance access to financial services.



Fifth, the government has launched the Payment System Modernization Project

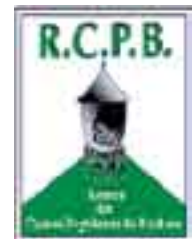
Sixth, to mitigate market failure and thus enhance access to credit in rural areas, GoE has designed several pro-poor credit programs. One such program ensures availability of agricultural input loans to small land-holding farmers providing guarantee to the lender (currently, the Commercial Bank of Ethiopia) for repayments of loans granted to the farmers. This program is consistent with the government's policy of rapid growth in agriculture.

Conclusion and the way forward

The role that finance plays in bringing about accelerated and sustained economic growth is well recognized by the government. Since 1991, the government has taken a number of policy measures to improve access to finance. Yet Ethiopia is one of the countries in the world where access to finance is very low. The challenge thus is what additional measures should be taken to make finances accessible to most people, if not all, in the country. The Government should continue doing all it can to improve access. Also, the recent cases of rising prices, the government will need to find mechanisms to ensure that this does not affect the country very much.

Contribution of regulation and supervision to growth of microfinance in the WAEMU zone: the case of Federation des Caisses Populaires du Burkina

by Saidou Ouedraogo



Introduction

The idea of regulating and supervising came from the will of the authorities to create and maintain a conducive environment for financial systems of proximity. This allows the authorities to:

- improve the security of clients' savings
- establish better structures for enhanced communication channels in the sector
- reinforce coordination and control of the financial systems of proximity
- reinforce the capacities of MFIs and their control mechanisms
- harmonize and improve MFIs and their control structures
- harmonize and improve all practices with regards to management and control
- improve the accounting systems and processes
- improve both the level of expertise and professionalism within the sector

Evolution of the regulation

In most of the WAEMU member countries, the first financial systems of proximity were set up on a mutual

basis under the direction of the agricultural ministries that are traditionally in charge of the rural sector. In Burkina Faso, the first experiences came in 1960 with the creation in 1969 of the first saving cooperative in Fakéna, a village near Dédougou, a town located in western side of the country. And as with all cooperatives, the structures of this first cooperative were governed by law.

At that time, the government had little interest in the sector and thus established minor regulations governed the existence of the cooperative movement.

From law 1/73/AN to 9/5/1973 (1st National Cooperative Law) to one of 1994 via the ones of 1983 and 1990, the object of the laws that governed the financial systems of proximity in Burkina Faso were to:

- Law N° 1/73/AN of 09/05/73 related to organizational structures of cooperatives in Haute-Volta
- Law N° 83-021/CSP/PRES/DR of 13/05/83 related to the status of cooperatives and pre-cooperatives in Haute-Volta
- Law N° AN VII 0035/FP/PRES of 18/05/90 related to general status of pre-cooperative



movements and cooperatives societies in Burkina Faso. Owing to the fast development of the financial systems of proximity in 1990, the governing bodies both at the national and regional level saw the need to regulate their activities through passing a law in 1993: law N°59/94/ADP of 15/12/94 relative to the regulation of mutual institutions or savings and loans cooperatives.

This law that has since been now revised, led to the regional law in 2007 that is applied to financial systems of proximity in the WAEMU zone.

Evolution of supervision

During the period that the financial systems of proximity were governed by the ministries of agriculture, they were considered and treated like the other cooperative societies. Consequently, their financial aspects were neglected.

Following the need to organize and regulate all the financial activities in the country, the sector was transferred within the portfolio of the Ministry of Finance that established a department specifically in charge of supervising and controlling the cooperative sector.

Since 2006, this department became the Microfinance Board. This structure has three functions:

- 1 Regulation
- 2 Supervision and Control
- 3 Research and Statistics

Contribution of regulation and supervision to growth of microfinance

At the institutional level, regulation and supervision contributed to the growth of MFIs through the following:

- openings to limited liability or sole proprietorship associations
- authorization to practice (licensing)
- adherence to professional associations
- expansion opportunities
- redeuction of tax payments
- opening of the sector to both national and international investors from.

On security:

- establishment of a Deposit Collateral Fund
- establishment of a minimum capitalization fund of 10%
- risk limitation from 10% to 1% on individual client basis
- contribution to the national reserve (30%)
- random inspections by the Central Bank banking commission
- obligation to avail regular performances (balance sheets)
- obligation to regularly audit the accounts.

On accounting:

- improvement in the accounting data collection channels
- accounting of all operations including the non-balance sheet
- obligation to avail all accounted documents.

RCPB regulation and supervision

Overview

RCPB is a network of savings and loans cooperatives structured in three levels:

- **Front office** where all members get financial services
- **Regional union**—the service center for all front offices
- **Federation** in charge of organization, management, financial surveillance / control and advocacy.

By 31 December 2007, RCPB had 101 front offices; 48 service points; 552 949 members; 42 400 000 000 CFA francs in savings and 38 840 000 000 CFA francs as total loans.

RCPB and the regulation and supervision systems

Like all the other financial systems of proximity, RCPB is governed by national laws (Loi et Décret d'application), by the regional law (BCEAO instructions laws) as well as the OHADA treaties that give it all the legal rights to operate in the country.



The external systems of regulation and supervision that apply to RCPB are

- BCEAO and its banking commission due to the size of RCPB
- the Microfinance Board
- External auditors

The internal systems of regulation and supervision that apply to RCPB include:

- Federation Inspection Department
- Regional Union Technical Services
- Surveillance Committee of the various structures (federation, front office, regional unions)

- front offices controlling committees
- information systems that guarantee the communication of all accounting and financial data.

Conclusion

Regulation and supervision have contributed to the growth of microfinance through:

- improved risk management
- better access to finances
- reinforcement of control measures
- better governance (transparency and soundness)

New AFRACA members

The AFRACA Secretariat takes this opportunity to welcome the following institutions into the AFRACA family. We look forward to serving your institutions.

- U-Meck, Comoros
- Banque Congolais SARL, DR Congo
- Reliance Financial Services, The Gambia
- Trust Bank Ltd, The Gambia
- Farm Concern International, Kenya
- National Bank of Kenya
- Azania Bank, Tanzania
- Kagera Farmers Cooperative, Tanzania
- Mufindi Cooperative, Tanzania
- Development Bank of Zambia

Announcements

We at the AFRACA Secretariat take this opportunity to invite you all to the 16th AFRACA General Assembly and technical workshop, which will be held in Dar es Salaam from 24 to 28 November 2008. More details can be found on the AFRACA website: www.afraca.org