WP/04/174

IMF Working Paper

Microfinance in Africa: Experience and Lessons from Selected African Countries

Anupam Basu
Rodolphe Blavy
Murat Yulek

INTERNATIONAL MONETARY FUND

 WP/04/174

IMF Working Paper

African Department

Microfinance in Africa: Experience and Lessons from Selected African Countries

Prepared by Anupam Basu, Rodolphe Blavy, and Murat Yulek[1]

September 2004

Abstract

Based on the experience of selected countries, this paper offers a critical presentation of the development of the microfinance sector in Africa. The paper supports the view that microfinance institutions, especially those engaged in full financial intermediation, complement effectively the banking sector in extending financial services and successfully draw on the rich experience of community-based development and preexisting informal methods of financial intermediation in Africa. Growing linkages between microfinance institutions and the banking system and the dissemination of good practices by nongovernment organizations contribute to the sound development of the sector, supported by regulation and supervision by local authorities.

JEL Classification Numbers: E26, G21, G28, L31, O16

Keywords: Microfinance, microcredit, bank regulation, Africa, savings

Author(s) E-Mail Address: abasu@imf.org, rblavy@imf.org, myulek@imf.org

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[1] The authors would like to thank Enrica Detragiache, Lennart Erickson, Michael Hadjimichael, David Hauner, Christian Josz, Ekue Kpodar, Edouard Maciejewski, Jon Shields, Francisco Vazquez, and Robert York for helpful comments.

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I. Introduction

Small enterprises and most of the poor population in sub-Saharan Africa have very limited access to deposit and credit facilities and other financial services provided by formal financial institutions. For example, in Ghana and Tanzania, only about 5–6 percent of the population has access to the banking sector. This lack of access to financial services from the formal financial system is quite striking, when one considers that in many African countries the poor represent the largest share of the population and that the informal sector is an important part of the economy.

To meet unsatisfied demand for financial services, a variety of microfinance institutions (MFIs) has emerged over time in Africa. Some of these institutions concentrate only on providing credit, others are engaged in providing both deposit and credit facilities, and some are involved only in deposit collection. Throughout the paper, the term "microfinance institutions" is used as commonly defined, that is, to designate financial institutions dedicated to assisting small enterprises, the poor, and households who have no access to the more institutionalized financial system, in mobilizing savings, and obtaining access to financial services. Institutions offering microfinance services are very diverse, including commercial banks, state-owned development banks, and postal offices.

This paper intends to identify a number of stylized facts and trends from the experience of four selected African countries: Benin, Ghana, Guinea, and Tanzania. While quantitative data is very limited, tentative conclusions are provided based on a qualitative assessment of recent developments in the surveyed countries, supported by background material and studies undertaken by the IMF and the World Bank. The main contribution of the paper is to compare experiences across Africa, and identify patterns that may guide public policy in the sector.

In Section II, we explore the main contributors to the expansion of MFIs in Africa. We focus particularly on the instruments used to overcome the obstacles that have prevented banks from expanding their outreach to the poor, the rural sector, and small and medium-sized enterprises. In Section III, we look at the extent to which the operations of MFIs can be viewed as complementary to those of banks, and how the existing links and the potential synergy between their operations benefit the economy. In Section IV, we review the roles that national governments have played in promoting microfinance and discuss policy issues relating to the licensing and prudential regulation of MFIs. Finally, in the concluding section we summarize the main conclusions.

II. Deposit Collection and Credit Extension in the Microfinance Sector

The importance of deposit collection in the development of microfinance services has arisen from the fact that the poor value both deposit and lending services. Surveys have shown that small entrepreneurs seeking micro financing for their projects constitute a relatively smaller subset of the poor population than the segment interested in accessing deposit services.[2] The poor value the availability of liquid and secure financial vehicles for savings for a variety of reasons. First, such savings help poor farmers to smooth their consumption expenditures between lean and peak harvesting seasons, and provide a cushion against income fluctuations caused by exogenous shocks. Second, savings could be used to pay for inputs needed at the start of production processes, and self-finance future investments or leverage supplementary financing for them. Third, saving deposits also provide a convenient vehicle for setting aside money for such costly future events as weddings, children's education, and funerals.

While poor households may save in the absence of deposit services, for example in cash hoards, by acquiring assets such as gold, or by stockpiling relatively non-perishable commodities between harvests,[3] saving services offered by MFIs have the advantage of security and liquidity that makes them popular among the poor, especially in rural areas. Hence, deposit collection has played a central role in the development of the microfinance sector in many African countries. Hirschland (2003) identifies the four major criteria valued by households concerned with savings mobilization as access, security, liquidity, and returns. As described in Box 1, the expansion of MFI services and outreach has been supported by a parallel expansion in deposit collection. To achieve such performance, MFIs have provided the means for overcoming three main barriers to the use of the deposit facilities commonly offered by banks (as identified by the World Bank, 1997): (i) high opening and minimum account balances, (ii) high travel time and transport costs involved in making deposits and withdrawals at the bank branch, and (iii) lack of familiarity with bank branch operations and procedures.

A. The Community-Based Approach in MFI Development

An approach commonly followed in African countries has been to rely on local communities to support the development of MFIs, outside the formal banking sector.[4] As MFIs operating outside the formal banking sector had to find their own sources of funds, the

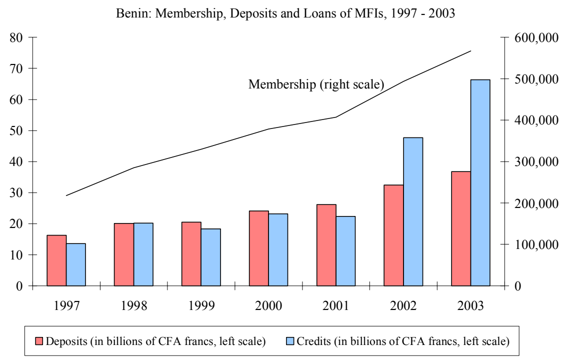
[2] The Bank of Tanzania (undated) reports the results of a survey conducted in 1997, which showed that 80 percent of the households were willing and able to save if appropriate products and saving mechanisms were there. Ledgerwood (1999) discusses evidence on the willingness of the poor to pay for saving services in India. Rutherford (1999) and Wright (2000) also discuss in detail the importance of saving services for the poor.

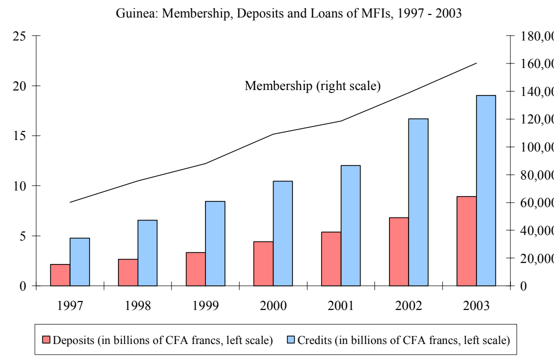
[3] Chao-Béroff (2003) notes for example that in West Africa, rural populations continue to prefer in-kind savings as they seem "more liquid, cheaper to maintain, and even sometimes more profitable (i.e., in the case of livestock reproduction)" (p.16).

[4] As presented by Bennett (1998), this approach is described as the "parallel model", as opposed to the "linking model" that "integrates disadvantaged clients into the formal financial system through building up self reliant groups that can reduce the costs and risks to banks in dealing with small savers and borrowers" (Bennett, 1998, p. 109).

Box 1. Saving Mobilization by Microfinance Institutions in Selected Countries

The experiences of Benin, Guinea, Tanzania and Ghana show that microfinance institutions have been successful in mobilizing deposits, while the outreach of the banking sector remains limited. In Benin and Guinea, the figures below indicate that the rapid increase in MFIs' membership and loan activities was supported by a continued increase in deposits.





In Benin, the outreach of the banking sector is very limited with a small number of bank branches (35 branches nationwide for a total population of 7 million) that mostly concentrate around the capital city. Against this backdrop, formal saving and loan cooperatives (SLCs), the only MFIs that collect savings, thanks to their extensive domestic branch network, have been able to mobilize a significant amount of savings. Deposits at the SLCs reached the equivalent of 10 percent of non-central government commercial bank deposits at end-2003.

In Guinea, the reach of the banking sector is constrained by the limited number of deposit money banks, and credit is concentrated on the largest domestic companies. MFIs are starting to fill in this gap, and deposits increased substantially between 1997 and 2003, although they remain a small proportion of commercial bank deposits (1.5 percent).

In Ghana, the microfinance sector has a strong savings orientation and a much greater role of licensed institutions relative to nongovernmental organization (NGOs) than in many countries. Banking institutions, in particular the Rural and Community Banks (RCBs), and nonbank institutions, the Savings and Loans Companies (S&Ls), account for most microfinance activities in the country. RCBs are relatively small, especially in terms of loan size but, with 115 institutions operating at end–2001, the total number of recorded depositors in all RCBs is 1.2 million with about 150,000 borrowers. In the nonbank sector, eight S&Ls had over 160,000 depositors and 10,000 borrowers by 2002, and offer savings and credit products similar to RCBs. In 2002, private deposits with MFIs amounted to about 6 percent of commercial bank deposits.

In Tanzania, the banking system has a very limited penetration. Only about six percent of the population has a bank account (4 percent in rural areas). MFIs have a total of about 2 million deposit accounts (6 percent of population). They hold about 60 percent and 11 percent of total commercial bank deposits and credits, respectively (2002). The primary sources of microfinance services are about 650 savings and credit cooperatives (SACCOs) with a total of 130,000 members (0.4 percent of the population) and NGOs relying on foreign donor assistance. There are three commercial (or deposit-money) banks—the National Microfinance Bank (NMB), Cooperative and Rural Development Bank (CRDB) Ltd, and Akiba Commercial Bank (ACB)—which are relatively new entrants in the microfinance sector. In addition, there are a few regional and rural banks engaged in deposit-based microfinance operations, but these have been limited in scope because these banks have lacked a branch network. Among nonbank financial institutions, the Tanzania Postal Bank (TPB) has used its country-wide network of post-offices to promote and mobilize savings, provide transfer and remittance services, and a loan guarantee service to small borrowers to cover a part of the necessary security requirement of their loans.

development of innovative saving vehicles was important and supported by participatory efforts in local communities to form cooperatives. Consequently, traditional community-based cooperative groups such as local clubs and village associations have played a central role in the savings mobilization effort and the expansion of other microfinance services in Africa.

The development of cooperative banking and savings and credit associations is a good example of a community-based cooperative approach. In Benin, the large network of MFIs is dominated by saving and loan cooperatives and mutuals (SLCs). In Ghana, Rural and Community Banks (RCBs), which are unit banks owned by members of the community (through purchases of shares), account for the largest share of microfinance services, while the Savings and Loans companies (S&Ls) are the second largest type of MFIs. Modern cooperative societies have also started expanding services to non-members, in order to overcome the resource constraint to their development. More generally, many institutions have relied extensively on establishing participatory cooperative groups.

The efforts of MFIs to work through group-schemes have the potential of yielding a wide range of benefits, leveraging the importance of local communities in Africa into schemes that have proven successful in other regions, the most notable of which have been developed by the Grameen Bank.

- At the level of the clients, group savings schemes are advantageous as individuals mobilize their savings jointly, and can use joint savings as security against loans. The aggregation of individual savings may allow group members to constitute larger collaterals and enhance their access to credit services.

- At the level of the institutions, on the saving side, the use of groups and community-based organizations provides scope for generating substantial economies of scale for the collecting institution. These schemes can facilitate the development of institutions that can operate on a full-intermediation basis, rather than specializing either in collecting savings or lending. Since most credit-only institutions eventually reach a point where they are constrained on the resource side, deposit mobilization provides a sustainable basis for expanding lending operations. MFIs have the potential for eventually graduating to a less constrained market-based approach to the management of both sides of the balance sheet. They could promote more efficient intermediation.

- At the macroeconomic level, deposit collecting institutions can help to increase domestic financial savings mobilization by tapping the resources of the poor who are otherwise isolated from the formal financial system.

- Finally, by providing financial services on both the deposit and lending sides, MFIs that serve groups and communities could empower underprivileged social constituencies to contribute more effectively to economic development and poverty reduction. While MFIs have commonly focused on women, they may also benefit other social groups.[5] One could argue that MFIs could serve as appropriate vehicles for targeting such groups.

In Africa, both group and individual savings and credit programs are used by cooperatives and associations. “Village Banking,” an adaptation of the Grameen Bank model first introduced to Africa by K-REP (Kenya), provides a good illustration of the use of group solidarity and of the linkage between saving and credit instruments. In this model, operated for example in Tanzania by Catholic Relief Services and the SNV/Netherlands Development Programme, both share capital and savings deposits are mobilized from members (sometimes with a match from donors). Loans are made to groups of ten members, but benefiting only half of them at a time and reaching the second half only after repayment of the initial loans. Also, a number of other institutions in Ghana are seeking to expand their activities and progress towards sustainability by pursuing a variety of approaches:

- In a group savings with credit scheme, a group of members mobilize and pool their savings jointly to qualify for a loan and may then use group savings as security against loans.

- In a group and individual savings with credit scheme, group and individual savings accounts coexist, both of which can be used as collateral. Group savings provide an additional security to back an individual loan. Loan repayments are made individually but handled through the group account. In such schemes, the institution minimizes its risk by basing its loan on a high collateral, and involving group solidarity. In Ghana, examples of MFIs using this scheme are Nsoatreman, Bosomtwe, and Lower Pra RBs.

- With individual savings with group lending, the group handles the collection of individual savings, receives the loan for distribution to members, and bears group responsibility for recovery. A number of MFIs use this scheme, including in Ghana, Brakwa, Nsoatreman, Bulsa Community Bank, Women’s World Banking Ghana, and Lower Pra.

- Finally, the individual approach to both savings and credit may prevail if individuals have established a credible credit history, or in cases where the group approach is not appropriate.

B. Formalizing Informal Methods of Financial Intermediation

Traditional informal systems for the collection of savings and for lending have provided substantial insight for the operations of licensed MFIs in African countries. The use of informal traditional methodologies by licensed MFIs has been instrumental in mobilizing savings from lower-income households and giving them access to financial services that are

[5] In Guinea, the Agence Autonome d’Assistance intégrée aux Entreprises (3AE) provides finance to small businesses run by handicapped poor. First Allied S&L in Ghana works with occupation-based groups such as butchers, kente weavers, carpenters, and other associations.

similar to those provided by the formally regulated financial system. In particular, licensed MFIs have benefited from interacting with informal players in two ways:

- First, savings mobilization methods developed by informal savings collectors have been widely replicated. One example is how the *susu* collector function was expanded in Ghana by licensed MFIs with "Mobile Banking" services, with officers visiting rural markets on specific days (Box 2).

- Second, informal institutions have been integrated into the saving and lending operations of licensed MFIs. Informal savings collectors that place their deposits with the larger MFIs, may be considered a part of the saving mobilization effort of the latter; notably, they provide an additional layer in the structure of the microfinance system. This is the case for example in Ghana, with licensed MFIs working with *Susu* clubs (Box 2).

C. Looking for Financial Sustainability

The technologies described above, based on the formalization of informal techniques and on group-based instruments, have been used to promote financial sustainability of MFIs. They have the advantage of addressing a number of problems faced by financial institutions when operating with the poor or with the informal sector, for example, asymmetry of information, lack of collateral, and difficult enforcement of legal rights.

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

Group lending with joint liability tends to encourage self-selection and group formation among good credit risks, addressing partially the problem of imperfect information faced by the lender, and thereby lowering the overall risk of the group lending scheme. This is because the risk of a potential default by any one individual is borne by the whole membership. A number of limits/risks may exist in group lending schemes with joint liabilities, where the behavior of one individual may affect the repayment of the group as a whole:

Box 2. Building on Informal Sector Savings and Credit Mechanisms: The Example of the Ghana *Susu* System

The informal credit sector has been very active in Ghana and covers a range of activities known as *susu*, including individual savings collectors, rotating savings and credit associations (ROSCAs), and savings and credit "clubs" run by an operator. These institutions provide a rich source of experience for the development of microfinance services—focusing mostly on savings products. The following four different types of *susu* institutions have influenced the operations of MFIs:

- ***Susu* collectors** offer a saving vehicle by collecting daily amounts voluntarily saved by their clients, which they returned at the end of the month, minus one day's amount as a commission. The *susu* collector function was expanded by licensed MFIs with "Mobile Banking" services working as a collector going locally to mobilize savings and offering additional services, such as promised loans (proposed for example by Nsoetreman Rural Bank and First Allied S&L), and life insurance benefits (introduced briefly by the State Insurance Corporation in the 1980s).
- ***Susu* associations** are either (i) rotating (ROSCAs), that is, they collect savings from their members and allocate them to each member in turn, or (ii) accumulating, which allow regular contributions to be accumulated, to cover the lump sum costs of such special future events as funerals.
- ***Susu* clubs** combined the above two systems, operated by a single agent. Members commit to save a pre-defined amount over the medium-term (50- to 100-week cycles) and pay commissions on each payment and fees when they are advanced the targeted amount before the end of the cycle.
- ***Susu* companies** are more recent (late 1980s) and registered. In addition to savings collected using traditional *susu* collectors, they provide loans after a minimum saving period.

MFIs have used *Susu* associations, clubs, and companies to expand their services. In these schemes, *Susu* club operators are clients of licensed financial institutions, attracted by safe instruments where they can place mobilized savings, and by lending facilities that they can use to offer more advances to their own clients. On the credit side, licensed MFIs may capitalize on local informal agents' intimate knowledge of their clients. A pilot program supported by RCBs and S&Ls provides funds to *susu* collectors who then on-lend to their own-clients. These interactions have resulted in greater effectiveness in reaching lower-income brackets and women. In Ghana, the two groups of clients account for between 65 to 80 percent of the clients of those *susu* schemes.

- First, under a group lending scheme, the burden of risk borne by an individual member of the group is higher than it would have been under a limited liability scheme. Thus for a group lending-scheme to be the preferred alternative to a limited liability scheme, the gains from lower overall risk under the former would have to outweigh the default risk that borrowers pass on to the nonborrowers of the group lending scheme.

- The second risk is a contagion effect whereby a default by one borrower affects the credit rating of the group as a whole and causes it to default.

- The third risk is a coordination failure problem as individual borrowers have an incentive to default when they expect other individual members of the group to fail. This may prompt a default of the group even when all its members are solvent.

Some mechanisms have been designed to reduce the risk that individual behavior may impose on the group as a whole. Sequential lending, when loans are provided sequentially to different sub-groups of borrowers participating in a given group lending scheme, is one example, that reduces contagion and coordination failure risks.[6] Also, self-selection leads to the formation of groups of relatively safe borrowers, hence limiting the transfer of risk from the group to the individual borrower. One concern is that group lending schemes have been argued to be overly conservative in risk-taking, selecting only the safest projects.

The obvious critical issue is whether MFIs have achieved financial sustainability, at least in the sense of achieving "break-even" in their current operations, if not also in fully covering their investment costs. There is little hard data available for African MFIs to answer this question, and one has only partial data at best. There is some evidence that MFIs are able to improve their financial performance, if they have autonomy over their management decisions; are allowed to set their lending and deposit rates to maintain a spread consistent with profitability; are vigilant in their efforts to avoid or reduce the incidence of nonperforming loans; and focus on addressing their capacity and skills supply constraints.

- In **Benin,** following the financial rehabilitation programs of 1989-93 and that launched in 1999 (described below in Box 4), many SLCs were able to substantially expand their deposits and loan portfolios, recover their nonperforming loans, and achieve break-even or positive net profits in their current operations.

- In **Ghana**, the performance in the rural microfinance (RMF) sector is reported to have improved in recent years. The combination of (i) a more commercial approach, (ii) a restructuring of the sector through re-capitalization and capacity-building, and (iii) strengthened regulation contributed to reduce drastically the proportion of distressed RCBs. At the level of S&Ls and credit unions, weak financial performance, mostly due to a welfare focus and policies of low interest rates, was reportedly improved through a greater commercial focus supported by better management and financial reporting. From 1996 to 2001, the proportion of "unsatisfactory" credit unions declined from 70 percent to 60 percent and that of those in the worst categories from 42 percent to 15 percent.

- In **Guinea**, the four existing MFIs are reported to have strengthened their financial performance over the period 1997–2003. They achieved this by lowering the share of non-performing loans (NPLs) in their total credit and raising their lending rates,

[6] Contagion of a default arises when the group defaults following a downgrade of its rating due to a default by a single sub-group. Coordination failure arises when each sub-group of borrowers defaults expecting others to default, even when all group members are solvent.

and improved their prospect of achieving a more sustainable financial position. The share of NPLs in the four MFIs was considerably lower than that of the commercial banks, and with the aim of achieving financial sustainability, the MFIs maintained a wider interest rate spread than that prevailing in the banking sector.

III. Links Between the Operations of MFIs and Banks, Donors and NGOs

A. Developing Complementarities between MFIs and Banks

The African experience suggests that MFIs have built on pre-existing informal sector mechanisms (among the many examples are *susus* and *tontines*) to create viable channels for capital infusions from formal sector banks, donors, and governments.[7] As a result, deposit-taking MFIs, informal microfinance institutions, and credit-only MFIs have all developed increasingly close ties with full-fledged commercial banks and other non-bank financial institutions in the formal sector (Box 4). Banks and MFIs complement each other well by servicing substantially different client bases. Banks lend and collect deposits mostly from a limited formal private sector and to the government, while MFIs service poor and rural households, and small entrepreneurs often in the informal sector.

With the increasingly closer linkages between commercial banks and MFIs, the prospects for enhancing financial deepening have improved. Both commercial banks and MFIs benefit from a closer relationship. MFIs may increase their effectiveness in having access to financial services that facilitate their liquidity management, while banks expand their client base by working with MFIs. We review below the nature and implications of such interactions, supported by evidence from the experience of our selected countries.

- MFIs reap benefits as clients—depositors and borrowers—of commercial banks. First, as observed in Guinea and Benin, commercial banks typically manage MFIs' deposit accounts, and sometimes, provide them with liquidity management services, for example emergency credit lines to cover cash shortfalls, hence reducing the risks associated with irregular cash flows. Second, extended credit facilities also allow MFIs to expand their services. In Guinea, while MFIs are currently using liquidity management services provided by commercial banks—including one of them having access to an emergency credit line—banks have been cautious in extending credit lines, given the risk that the failure of MFIs spills over to commercial banks. Conversely, these risks are to some extent mitigated by the additional benefits of interaction between MFIs and the banks, which include (a) the opportunity given to banks to expand their portfolio of clients beyond a usually highly concentrated clientele, and (b) the monitoring of MFI clients by commercial banks. The experience of Guinea supports this conclusion, although the interactions between MFIs and banks are in an early phase.

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[7] This argument was developed more formally by de Aghion and Morduch, 2003.

- MFIs and commercial banks work together in providing financial services. In a number of African countries, banks and MFIs have successfully cooperated in extending their outreach and achieving economies of scale. Branch network sharing is seen as effective in servicing a larger client base while containing costs. In Guinea, banks are looking at possibilities to use the network of MFIs to expand credit to large rural clients. In Tanzania, the example of the CRDB developing banking relationships with savings and credit cooperatives to channel funds for micro-lending is illustrative. Cooperation also entails channeling credit from banks and MFIs to clients with obvious business synergies. The NMB of Tanzania is developing relations between credit to its large corporate clients and credit to micro-enterprises that supply inputs and distribute the products of the former. The NMB lends to micro-enterprises to finance their purchases and inventories, and provides large corporate clients with collection and payment services to and from micro-enterprises.

- The links between MFIs and banks provide a platform for strengthening the links between the formal and informal sectors of the economy. While small entrepreneurs with no credit history are usually excluded from commercial bank credit, they constitute a profitable business segment for MFIs. Those entrepreneurs could eventually graduate from micro-credit to conventional bank loans, either by developing successfully into sizeable businesses or by building reputation through repeated borrowing and establishing a strong record of loan repayment, even though barriers to entry into the conventional banking sector for small entrepreneurs would still limit the possibilities of graduation to the conventional banking sector.

With MFIs linking up with banks, the supply of loanable funds to previously underserved areas of the economy and the number of small borrowers with access to credit are likely to increase. Some might argue that this would lend to increased competition and better terms for loans to small borrowers. Unfortunately, however, this may not necessarily happen. The expansion of credit to new borrowers may entail increases in default risk, loan administration and monitoring costs, strategic collusion among informal lenders (to avoid a costly price war), and contamination of the pool of borrowers for lenders who are poor at screening out the risky ones. All these potential risks suggest that the cost of borrowing may not fall, at least in the early stages of growth in the microfinance sector. This being said, the cost of credit provided by formal MFIs is generally much less than that provided by informal lenders (such as money lenders).

B. The Roles of Donors and NGOs

Donors and NGOs have generally provided support through two main channels: domestic NGOs or donor-managed microfinance projects, and microfinance institutions that function more or less like leasing companies (receiving wholesale external resources and lending to clients). These are mainly "credit-only" schemes that receive wholesale funds from external sources, often donors, instead of collecting deposits, and the lending methods (successfully introduced by NGOs) are often based on the "group solidarity" method (Box 3). Policy makers may be tempted to emphasize the lending function in the microfinance sector

Box 3. The Roles of Donors and NGOs in Credit-Only Schemes

In many countries, credit-only schemes have been developed by NGOs, often with donor support.

In **Guinea**, there are two well-known institutions that are wholly donor-financed, micro-lending entities operating solely in the urban sector: the Programme Intégré pour le Développement de l'Entreprise (PRIDE/Finance) and the Agence Autonome d'Assistance Intégrée aux Entreprises (3AE). PRIDE/Finance lends to small businesses, and its affiliate PRIDE/Formation provides training facilities independently to small businesses. 3AE, which is supported by the European Union, the United Nations Development Program, and International Labor Organization, lends primarily to small businesses run by women and projects for the benefit of the handicapped.

In **Benin**, there are nine *associations* involved in microfinance activities, two of which —PADME (Support Project for the Development of Microenterprises) and PAPME (Support Project for Small- and Medium-sized Entreprises)—constitute a significant part of the total MFI credits. Associations currently do not collect deposits and consequently, receive their funding from the domestic banking system or through external donors. Initially established as government projects; and supported by a World Bank credit, both institutions were converted into private voluntary associations in 1997. They serve mainly urban areas and their clientele consists of small enterprises and entrepreneurs. As credit-only institutions, the sources of their funds are donor institutions including the World Bank. Under a recent private sector development project (1999), the World Bank provides both institutions credits to onlend to clients and grants to finance technical assistance, training and operating costs. Both institutions have sound financial situation, with high loan repayment rates and consequently low levels of nonperforming loans.

In **Ghana**, NGOs, focusing mostly on poverty, have a deep penetration to poor clients, but microfinance is in most cases only one of their many activities and their total outreach is limited, to about 60,000 clients. Further, NGOs are not licensed to take deposits from the public and have to rely on donor funds for microcredit. NGOs, despite their limited reach, brought internationally tested methodologies to Ghana, for example, the concept of group solidarity.

more heavily than deposit mobilization, as they may assume that increases in lending would promote investment and hence enhance economic growth. The difficulties and costs of achieving the geographical outreach and managing numerous small depositors also work in favor of credit-only institutions. Deposit collection entails a different technology than lending, and if the main social benefit from microfinance is seen as the lending function, policy makers may be biased toward credit-only institutions.

Direct support from NGOs in lending schemes has received some criticism because of their potential adverse effects on the operation of MFIs. NGO support could weaken financial discipline in MFIs, and dependence on donor money rather than deposit mobilization could constrain growth and sustainability. Donor-directed lending may also crowd out commercially viable projects that would not qualify for donor funds. While increased lending may take place, this may not be directed towards the needs of the economy. This does not invalidate the benefits of donor funding of MFIs, but points to a need to weigh the options carefully. At the same time, NGO-based MFIs are limited in their outreach by their dependence on external sources of donor funds, and also by their need to allocate their limited resources to a wide range of activities outside the microfinance sector. NGOs have proven particularly efficient in working with community-based organizations, in regions where licensed MFIs are scarce[8] and their reach is generally limited to specific locations. Donor interest in supporting MFIs may partly address the resource problem, but does so only temporarily and to a limited extent.

While donors could support MFIs' lending operations with resources, they could also encourage efforts to build the resource base through domestic saving mobilization. Emphasizing full intermediation does not necessarily preclude donor involvement in assisting the MFIs with capacity building (in both physical, and human resources), which will remain essential. The experience of countries in SSA suggests that NGOs and donors can play an important role in the dissemination of best practices tested internationally and regionally and remain important in building borrowers' entrepreneurial skills and capacity to graduate to the formal banking sector. In some situations, NGOs have been engaged in building local capacity through the creation of institutions specifically dedicated to training (Box 3).[9]

In many cases, NGOs and donors have tended to focus on social programs and services for which they have particular expertise, including programs aimed at reducing poverty. NGOs have in some cases also focused on providing welfare and socially-oriented microfinance, when the push toward financial sustainability was seen to induce a reorientation of MFI focus from the very poor to the lower-middle and middle classes. While NGOs may continue to play an important role in providing social services to the very poor and the more remote areas, it is debatable whether this is more efficient in promoting poverty reduction than direct subsidization of social services (such as primary education and basic health care).

IV. The Role of Governments

In several African countries—for example, Ghana, Guinea, Tanzania and Uganda—governments have in the past relied on state-owned banks to extend rural credit and microfinance services. In most cases, these banks have incurred large losses and have had to be restructured, recapitalized, privatized or liquidated. This experience of failed state-owned banks has led African governments to focus on financially viable approaches to providing microfinance and on developing regulatory and supervision frameworks that are well adapted to supporting such an effort.

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[8] In Ghana notably, NGOs have worked extensively in the northern part of the country, where licensed MFIs are scarce.

[9] In Tanzania, NGOs and donors are heavily involved with all layers of the microfinance system, from regulators to rural MFIs, in staff capacity building and technology transfer. To mention only one of many examples, the Department of International Development (DfID) works and provides funds for capacity building to the Microfinance Capacity Building Programme for Africa (AFCAP), and to Microsave Africa—a joint initiative with UNDP to provide technical assistance to organizations to strengthen the development of saving services.

Regulatory systems in the countries reviewed have evolved through a cycle of easy entry, weak performance, and finally tightening up of regulation and restructuring. This evolution generated adaptive licensing and regulatory frameworks that proved conductive to the development of the sector, but exemplified the risks associated with lax regulation of microfinance activities. In all four countries reviewed, the failure of major institutions led to major restructurings. The success of those restructurings was allowed by the simultaneous strengthening of the regulatory environment and of the supervisory capacity to avoid moral hazard problems. Box 4 presents the experience of the four African countries reviewed.

Box 4. Restarting on a Sound Base: Restructuring and Addressing Regulatory Failures

As in the case of banking sector restructuring, microfinance sector restructuring should address future moral hazard problems while reviving or liquidating the failed institutions. This requires prompt regulatory and/or supervisory upgrading. The involvement of donors may be crucial both to alleviate financial burden on the government and to provide technical assistance at the institutional and supervisory levels. The experiences of Benin, Ghana, Guinea, and Tanzania are illustrative.

In **Benin**, the loan portfolio of the largest microfinance institution deteriorated significantly in 1998. The institution responded by stopping new credit extension and got engaged in a comprehensive rehabilitation process with technical assistance from a donor. The program aimed at (i) reducing nonperforming loans; (ii) temporary blocking of new credit extension; (iii) improvement of internal control and procedures; and (iv) restructuring the network through changing the status of some of the SLCs and putting some under tutelage. The results of the rehabilitation have so far been encouraging although the rehabilitation activity, including restructuring, is programmed to continue until 2004. The total deposits and credit expanded rapidly, progress was made in recovering nonperforming loans, and positive net profits were recorded in 2002. As a microfinance law was enacted at the end of 1997, supported with application decrees and central bank instructions setting prudential rules and reporting requirements in 1998, the authorities' response was concentrated on strengthening their supervision capacity with the assistance of donors.

In **Ghana**, the World Bank assisted in the recapitalization and capacity building of rural credit banks at the outset of 1990s. Coupled with strengthened supervision and stricter reserve requirements by the central bank, this assistance provided positive results. The number of rural credit banks classified as having satisfactory financial situation increased from 23 out of 123 in 1992 to 61 out of 128 in 1996.

In **Guinea**, donors were involved in the operational and financial audit of the largest microfinance institution after its failure. The audit identified severe liquidity problems and losses due to bad portfolio quality, mismanagement and capacity problems, and weaknesses in regulatory and supervisory environment. Immediately after the liquidation decision was taken, the central bank issued instructions to strengthen the regulatory environment and a microfinance law is currently being prepared.

In **Tanzania**, a special effort was made to ensure that the banks involved in the microfinance sector that were restructured and recapitalized complied with the licensing and regulatory requirements before being permitted to restart their operations. The largest microfinance-oriented commercial bank emerged from the restructuring and recapitalization of the state-owned bank, and it is being prepared for privatization. The privately-owned bank CRDB was also restructured and recapitalized before it entered the microfinance sector and began lending to downstream cooperatives for on lending to small businesses and rural producers.

Along with the growth of the microfinance sector, governments have played a lead role in putting in place the supporting regulatory frameworks. Approaches to designing regulation differ widely both conceptually and in practice. In this section, we discuss issues related to the regulatory framework in the light of the experience of the four countries covered in this study.

A. Objectives and Coverage of the Regulatory Framework

Overall, the rationale for microfinance regulation is to create a healthy environment for microfinance activities while not stifling the growth of the sector by imposing undue requirements. The experiences of the four countries reviewed here suggest that the frameworks for licensing, regulating and prudential supervision need to be well adapted and flexibility designed to reflect the specific characteristics and the stage of evolution of the microfinance sector in a given country. The peculiarities of the microfinance sector necessitate either a dedicated law for the sector, or that the peculiarities be addressed adequately under other legislation that can be applied to regulate the sector. For example, in Benin there is a dedicated microfinance law, and in Guinea such a law is currently being finalized. On the other hand, in Ghana and Tanzania, the microfinance sector is regulated under commercial banking laws, and separate laws for cooperatives and non-bank financial institutions. Box 5 reviews regulation and supervision practices in all four surveyed countries.

Given differences in types of formal microfinance institutions, particularly when there are separate deposit-collecting institutions and credit-only institutions, adaptive and flexible microfinance regulation has proven to be effective. In the case of Benin, the microfinance law provides the framework for regulating deposit-collecting institutions while the credit-only institutions are regulated mostly through individually signed framework agreements with the Ministry of Finance. In Guinea, the prudential regulations vary with the type of the institution, classified into three categories: MFIs that collect deposits and lend only to members, those that collect deposits and lend to non-members, and those that undertake mainly donor financed lending operations. In Ghana and Tanzania, three-tiered systems of regulation and supervision have emerged, where the most formal institutions are regulated as banks, and the semi-formal institutions as nonbank financial institutions, while the informal institutions remain unregulated. Box 5 provides more details on laws and regulations in the four countries selected in this study.

Size and linkages with other microfinance institutions or commercial banks which may increase systemic risks is a key consideration in the design of prudential legislation, given the wide variety of microfinance institutions. At the higher end of the range of microfinance institutions, there are large deposit collecting institutions with linkages to commercial banks, and at the lower end, there are very small institutions with characteristics similar to informal sector activities. Due to the high unit cost of supervising and monitoring microfinance institutions and the limited supervisory resources, there is a clear need to prioritize the tasks at hand, with the larger institutions and/or more risk-prone MFIs receiving

Box 5. Laws, Regulations and Supervisory Authority for MFIs in Selected Countries

Laws, regulations and supervisory authority for MFIs vary widely in Africa. In some countries, there is a dedicated microfinance law while, in others, the formal microfinance sector is subject to provisions of commercial banking law, cooperative law and/or nonbank institutions law. Lower level regulation is carried out by the central bank and/or the Ministry of Finance. Supervisory authority also differs; in some countries central banks and/or the Ministry of Finance are solely responsible while in others, ministries in charge of cooperatives are involved.

In **Benin**, along with other West Africa Monetary Union (WAEMU) countries, there is a dedicated microfinance law, which covers saving and loan cooperatives (SLCs). SLC activities are regulated by the PARMEC law, adopted in August 1997. The authority to grant licenses to new SLCs is vested in the Ministry of Finance and the regulations specify well-defined procedures and requirements for applications to establish new SLCs. The regulations of microfinance activities of *associations* (and all microfinance institutions other than SLCs) and their prudential rules are governed by the ministerial decree and the framework agreements (*convention-cadre*) signed with the Ministry of Finance at the time of inception of their activities. The supervision and monitoring of microfinance institutions is conducted by the Microfinance Unit (MU) of the Ministry of Economy and Finance with cooperation from the regional central bank (BCEAO). While the inspection activity, both on-site and off-site, of the MU has intensified over the years, the unit is constrained by limited resources. The MU inspections center around a number of criteria to assess the situation of the MFIs, including governance, physical security and internal control, accounting, financial management, compliance with prudential ratios, and credit management.

In **Ghana**, activities of rural credit banks (RCBs) are regulated under the Commercial Bank Act with some specific provisions such as different minimum capital requirements and limitations on their activities such as foreign exchange operations. S&Ls, on the other hand, are regulated under the Nonbank Financial Institutions Law, again with certain specific restrictions. In addition, a new law is under preparation for credit unions. The current regulatory framework provides a strong licensing system for the formal sector, formal registration for the semi-formal sector, and relative laisser-faire for informal institutions. For supervisory purposes, given the high costs of supervising a large number of RMFs and the limited supervision capacity of the Bank of Ghana, the central bank's response has been to use regulatory requirements to offset the limits of prudential supervision, including through appropriate high reserve requirement for RCBs, minimum capital requirements for NBFIs, and self-regulation of credit unions by their apex body.

In **Guinea**, microfinance activities are regulated by central bank instructions at present, while a microfinance law is being prepared. Licensing and supervision are being conducted by the central bank. The regulation is adapted to three main types of institutions: credit only MFIs, MFIs that collect deposits and lend to members only, and MFIs that collect deposits and lend with no membership restriction. To ensure compliance with the prudential regulations, the central bank relies on off-site and on-site audits of MFIs. However, this supervision effort is impeded by institutional capacity constraints. The MFIs have experienced difficulties in compiling the necessary information and data, and the central bank has lacked sufficient trained staff to carry out the supervision. To address these constraints, the Guinean authorities could benefit from donor support to develop reliable information and data base, the necessary skilled staff, and an appropriate reporting and monitoring system to strengthen the prudential supervision of the microfinance sector.

In **Tanzania**, formal microfinance institutions are subject to the provisions of the banking regulation and supervision while semi-formal institutions are subject to the Cooperative Societies Act and are supervised by Ministry Cooperatives. The licensed, regulated and supervised institutions are all the banks and nonbank financial institutions. Although the other institutional providers of microfinance—the SACCOs and NGOs—are registered under the Companies Act and had entered the sector before the recent entry of banks, they are currently not subject to prudential regulations.

greater attention from regulators and supervisors. The current practice varies widely although this principle is commonly applied. In Benin, the prudential aspects of the microfinance regulation covers all major microfinance institutions, although the prudential rules are less demanding than those on the commercial banks. In Ghana, out of the two main categories of microfinance institutions, rural credit banks are subject to prudential rules under the commercial banking law while saving and credit cooperatives are subject to those under the non-bank financial institutions law.

The stages through which microfinance institutions evolve during their life cycles, which extend from informal initiatives (such as *susus* in Tanzania or "*banquiers ambulants*" in Benin) to mature and formalized microfinance institutions are also important in the design of regulatory frameworks. Regulation should provide clear guidelines for "semi-formalizing" (becoming registered but not subject to supervision) the relatively larger informal institutions, and for fully formalizing semiformal institutions (becoming registered and subject to supervision) after satisfying certain criteria (as in the case of Benin). The authorities in Tanzania and Ghana have developed a different two-pronged approach. The first approach is to permit the nonregulated institutions to become licensed and prudentially regulated. To this end, the Tanzanian authorities have adopted a tiered structure of entry requirements, which require lower amounts of minimum capitalization for nonbank financial institutions than for banks. The second approach is to encourage the already licensed and regulated banks to develop and expand their microfinance operations.

Finally, in some countries, the microfinance institutions have found it useful to set up an apex or umbrella institution for the microfinance sector to coordinate and supervise their activities. Thus, in Benin, the Federation of Rural Savings and Loan Cooperatives (Fédération des Caisses d'Epargne et du Crédit Agricole Mutuel – FECECAM) was established in 1993, as an umbrella organization for SLCs. The FECECAM organization currently includes four levels. At the village level, the Village Saving and Credit Cooperatives are associated with the cooperatives at the town/city level. These are called Local Saving and Credit Cooperatives, with each covering between 20 to 30 villages, and organized under regional level unions, themselves members of the FECECAM. FECECAM includes also a technical secretariat in charge of overseeing implementation of the federation's policies, and providing technical support to the SLC regional unions. FECECAM coordinates and supervises the activities of the member SLCs, provides refinancing and a placement widow for excess liquidity, allows "deficit" SLCs—which are mainly in the very remote areas—to survive through special credit lines and financial contributions, offers technical support and training and serves as a lobbying unit vis-à-vis the authorities.

B. Minimum Regulatory Requirements and Supervision Practices

The principal regulatory requirements are licensing, information transmission requirements, and prudential norms. These should be used in line with the objectives of the regulatory design discussed above. Reviewing the experience of four countries shows a similar gradual approach to licensing requirements: newer and smaller institutions are encouraged to apply for licensing without much regulatory requirement while larger institutions are regulated and supervised more closely and strictly.

The scope and intensity of supervision practices applied to MFIs have varied across countries, as described in Box 4. In Benin, there are several on-site inspections during the year, which assess the financial performance of the institution and its practices in several other areas, notably with regard to governance, accounting, financial and credit management, and compliance with prudential ratios. By contrast, in Guinea, although the central bank relies on off-site and on-site audits, the supervision effort has been impeded by institutional capacity constraints, especially lack of qualified staff. In Ghana, given the high costs of supervising, a large number of MFIs and the limited supervision capacity, the Bank of Ghana has relied more on strict regulatory requirements than on actual supervision.

The experience of the four countries suggests that a minimum set of prudential rules for larger institutions include capital requirements (minimum capital limit, minimum retained earnings, or capital adequacy ratios), risk concentration limits (on single borrowers), liquidity limits, and well-defined provisioning requirements (Box 6).

C. Accompanying Measures

The capacity of MFIs has an important bearing on the compliance with regulatory requirements. It is therefore important to put in place appropriate measures in the following areas:

- capacity building at the institutional level including in bookkeeping and reporting standards, strengthening of internal controls and credit decision mechanisms, and improving technology and human resources;

- similar capacity constraints should be addressed on the supervision side, ensuring competence and effectiveness and focus (given the high unit costs of supervision) of supervising staff;

- development of the borrower database infrastructure through improved data compilation at an institutional or sectoral level and establishment of credit bureaus;

- finally, the general judicial environment also has an important bearing on the development of the sector. The enforcement of microfinance regulations and general business related laws is crucial for the development of a formal microfinance sector as it is for the rest of the financial sector in general.

The first two are areas where a coordinated effort by governments and donors can be helpful.

Box 6. Prudential requirements for microfinance institutions in Benin, Ghana, Guinea, and Tanzania

	Benin	Ghana 1/	Guinea	Tanzania 2/
Minimum capital		√	√	√
Reserve requirement	√		√	
Capital Adequacy ratio	√	√		√
Limit on total risks	√			
Limit on loans to a single borrower	√	√	√	√
Limit on insider loans	√			
Limit on total large loans			√	
Limit on liquidity ratios	√	√	√	√
Limit on coverage of non-short term liabilities by non-short term assets	√			
Ceiling on non-secured loans				√
Ceiling on fixed assets				√
Ceiling non-microfinance activity	√			
Provisioning requirements	√	√	√	√

1/ In Ghana, these prudential rules apply to microfinance institutions subject to commercial banking laws.
2/ In Tanzania, the prudential rules apply to commercial and microfinance banks (including unit rural banks) registered under the commercial banking law. Saving and credit unions are effectively not regulated or supervised.

V. Conclusions

In sub-Saharan Africa, there is ample evidence that the poor, particularly those in the rural sector, value both deposit and credit facilities. The existence and growth of cooperative banking and combined savings and credit institutions in the microfinance sector in sub-Saharan Africa reflects the growing demand for both savings and credit facilities.

There are strong linkages between formal and informal microfinance institutions (MFIs). The formal institutions have, in some cases, drawn on the savings mobilization methods earlier developed by traditional informal MFIs. In some cases, the former have also become bankers to the latter.

The group-based savings cum credit institutions that are prevalent in Africa, like elsewhere, rely on peer pressure and joint liability (rather than collateral) to ensure loan repayment. In the case of loans to individuals, MFIs tend to rely on short maturity for repayment, high frequency of payments, and, at times, a compulsory security deposit to encourage timely loan repayments.

There is some evidence in Africa that MFIs, which engage in both savings mobilization and credit extension, have faired better financially than those specializing either in deposit collection or in lending. Those engaged in full intermediation tend to grow when they are able to expand their resource base through deposit collection. MFI operations that depend exclusively on funds from donors or the government, are generally constrained by a limited resource base. Equally important, the performance of MFIs depends critically upon having autonomy in management decisionmaking, including the setting of deposit and lending rates with an appropriate profit-making spread; being vigilant to avoid nonperforming loans; and building institutional capacity, addressing skill shortages.

Growing linkages between MFIs and the banking system in Africa appear to be mutually beneficial. MFIs rely on banks for a variety of services, including deposit facilities, liquidity management services, and, in some cases, emergency credit lines to cover cash shortfalls. For banks, the benefits are the opportunity to expand their client base through MFIs, and to expand their operations through the network of MFIs (including in the rural sector). The linkages between MFIs and banks also help to strengthen the linkages more broadly between the economic activities in the formal and informal sectors of the economy, and provide opportunities for small entrepreneurs to graduate from micro credit to conventional bank loans.

Donors and NGOs have played an important supportive role in the development of MFIs in sub-Saharan Africa. Most importantly they have helped to disseminate best practices tested internationally and regionally, build local capacity, and develop the entrepreneurial skills of borrowers. The impact of NGOs directly involved in lending schemes has been more mixed, mainly because of the potential adverse effects that subsidized lending by NGOs may have on the operations of MFIs.

Finally, governments in sub-Saharan Africa play a key role in promoting the microfinance sector by putting in place the necessary laws, regulations, and institutions for the licensing, prudential regulation, and effective supervision of the sector. Official practices in each of these areas vary widely across countries, reflecting the stage of evolution in the country's microfinance sector, institutional capacity, and skilled personnel constraints, and differences in official approaches ranging between intensive regulation and a more "laissez-faire" approach. In general, regulatory requirements and prudential norms applied to MFIs need to be well adapted and flexibly designed to reflect the specific characteristics and stage of evolution of the MFIs in a given country. It appears that these requirements and norms for MFIs are financially less demanding than those applied to commercial banks; and newer and smaller MFIs have been subjected to less exacting licensing and regulatory requirements, and less closely supervised than the commercial banks and larger nonbank financial institutions. However, the growing linkages between MFIs and banks and the potential systemic effects of distress in any segment suggest that the licensing, regulation, and close prudential supervision of MFIs will become increasingly important.

The main constraints to developing the regulatory and prudential supervision framework are threefold. A first set of capacity constraints relate to the lack of bookkeeping and reporting standards, internal controls, and credit decision mechanisms at the level of the MFIs. A second set of capacity constraints are at the level of the institutions entrusted with supervision authority, mainly due to shortage of skilled and trained staff. Finally, the information or database on borrowers, their credit history, and repayment records has not kept pace with the growth of the microfinance sector.

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