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Status of Financial Intermediation for the Poor in Africa

Through the years, many policies and programs have addressed the need for financial services among the poor. This policy brief is based on a literature review* that analyzes 30 recent survey articles and more than 50 case studies that focus on financial intermediation for the poorest of the poor, notably rural residents and women.

Financial intermediation refers to actions that aid in exchanges between individuals with idle funds and individuals in need of funds. Many of those in need of funds are rural residents and women, two groups that have not traditionally been well served by formal financial institutions. Ultimately, economic growth is essential to improving standards of living and reducing poverty. Appropriate financial services can help the poor spread savings and expenses over time, thus enabling them to cope with periods of vulnerability and take advantage of opportunities. The following brief offers guidance for designing appropriate regulatory regimes for financial institutions in Africa and for building cost-recovering financial institutions that serve the poor.

Create a policy and regulatory environment that supports financial intermediation for all segments of the population

Transparency in financial intermediation is particularly important. Depositors need to know who is monitoring the management of the financial institution–whether it is the government in the case of commercial banks or members in the case of credit unions. Therefore, in most countries, financial regulation has been designed to strict standards that stress the protection of depositors. In developing countries, these regulations limit or make illegal the actions of informal financial institutions although regulatory regime that allows various supervision formulas is preferable for these countries.

Different countries have addressed the inadequacy of their banking laws in different ways. South Africa has exempted credit unions and rotation savings and credit associations from banking legislation when such institutions belong to an accredited supervisory body. The Philippines and Indonesia have introduced separately monitored village-owned banks that operate with lower capitalization and reserve requirements than commercial banks. Indonesia claims 14,000 self-supporting village banks serving clients with loans as small as $50, daily savings collections, and other services. Uruguay and Bolivia have encouraged banks to allocate a certain percentage of their loan portfolios to small enterprises.

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Grameen Bank in Bangladesh provides credit without collateral to the rural poor (primarily women), who make up 96 percent of its borrowers. It combines lending with social services and skills development. Grameen lends up to $250 through peer groups that jointly guarantee repayment.

Address usury laws and interest rate ceilings

Many countries have enacted usury laws that dictate specific interest rates or ranges. Interest rate ceilings are well intentioned but generally limit the credit opportunities of the poor. Credit programs with subsidized interest rates have been subject to abuse and often fail to reach the target group. High interest rates are generally acceptable to the poor and may be essential for institutions to cover the full cost of services without subsidies. Reformers want to replace usury laws with laws based on consumer information so that borrowers may choose among competing financial services providers.

In Indonesia, village credit programs have evaded interest rate limits by offering a 12-week loan with weekly payments equaling 10 percent of the amount borrowed–for an effective annual interest rate of 55 percent. In Niger, credit unions offer a loan option with fixed fees instead of interest. Although the fee far exceeds the allowed interest rate, it avoids legal ceilings and Islamic strictures against the charging of interest.

Develop linkages between formal and informal systems

Informal institutions deliver services more efficiently than formal institutions, especially in rural areas, where they serve geographically dispersed customers with low-volume transactions and often risky agricultural investments. Some of the successful techniques, processes, and products of the informal financial sector may be adapted to the services of formal institutions.

Several institutions worldwide are intentionally linking formal and informal sectors to increase lending to small yet productive enterprises operated by the poor. In Senegal, the agricultural development bank and a small financing company lend to sound borrowers who in turn provide suppliers with working capital in the form of cash advances. In South Africa, a new company spun off from the Development Bank of South Africa serves as a financial intermediary by raising funds from the commercial banking sector that is a net deposit-taker in poor areas. The commercial banking sector also provides wholesale on-lending to NGOs, community banks, and other organizations that are net lenders.

Design financial services that provide full service to the poor

Evidence is growing that a diversity of services, rather than credit only programs, is preferable in reaching the poor. Financial institutions help clients by facilitating payments and transfers, managing liquidity, taking deposits, and providing mechanisms for savings, credit, equity building, and dealing with risk. Each of these services can help alleviate poverty. For example, transfers are an important coping mechanism for the poor. When institutions fail to provide transfer services, the poor must often rely on individuals to carry cash long distances for purposes of either family support or trade. Until recently, postal savings systems were widely available throughout Africa. In South Africa, commercial bank networks are assuming the function of these systems. In most of West Africa, the network of postal savings systems has largely collapsed but could be rejuvenated.

Promote deposit and savings services

Deposit facilities are valuable to institutions, helping to sustain operations and reduce donor subsidies. Deposits provide information about potential borrowers and facilitate the accumulation of a down payment or equity share. Among the poor, deposit facilities are in high demand. In the absence of such facilities, the poor often entrust savings to informal money keepers who pay no interest and even charge a fee to maintain their funds. Money-holding cycles are typically very short–weekly or fortnightly–and are used for security and to ensure working capital. Many institutions fail to offer savings options that permit funds to be withdrawn as needed. Forced savings schemes with required regular payments that cannot be drawn upon or that must be made as a condition of eligibility for credit are more common. Clients generally perceive forced savings as a cost of credit. Offering both voluntary and forced savings options is important to meeting the needs of the poor.

Address the needs of women

Among the poor, women represent an important subgroup of micro-entrepreneurs. Often, the formal legal system and the traditional value system hinder women's access to financial institutions. However, some of the strongest informal financial institutions are women-led or maintained for women only. Nonetheless, some legislation intended to help women has been misguided. For example, credit union laws that prohibit discrimination in membership on the basis of sex have led to situations where less responsible men damage a successful all-woman organization.

Institutions that serve women successfully recognize women's preferences and needs. In general, women prefer personal interaction, an informal banking atmosphere, small loans, alternative collateral requirements, and simple application procedures. In addition, women prefer a choice between credit for productive purposes and credit for consumption. They may spend cash for their business and borrow to cover family expenses. Women have consistently demonstrated higher repayment rates than men.

Create incentive structures that reward performance

Incentive structures are important in the design of sustainable and efficient programs. Policies governing interest rates and transfers, for example, affect both clients and financial institutions. Performance rewards within institutions affect the behavior of staff and the outcomes of their interaction with clients. Several successful organizations have used a participatory approach to institutional design to help address clients' sociocultural and economic constraints. For borrowers, incentives work to ensure repayment. Rigorous monitoring enables institutions to intervene rapidly to prevent repayment problems. Options for frequent repayments help the poor repay loans, especially if they have small but regular incomes.

Examine group guarantee options

Group guaranteed loans are made to individuals who are members of a group that jointly guarantees repayment. Group guarantees can be effective in reaching the poor and reducing the default risk. The Grameen Bank experience indicates four important aspects of group guarantees. First, groups with an existence independent of the award of credit are more successful than those organized expressly to receive credit. Second, after several rounds of lending, the situation changes and groups tend to become unstable either because the needs of some members have been met or loan sizes tempt other members to take the money and run. Third, financial services organized exclusively around credit are less successful than those offering other services as well. Finally, Grameen ruthlessly enforces guarantees to ensure loan repayment discipline.

Utilize new technologies

Personal computers have revolutionized the accounting necessary for small loans and credit programs. Innovations in computer technology make it possible for banks to move down-market, NGOs to move up-market, and new agents to enter the market. Increasing competition for the financial services of the poor should improve efficiencies.

Transaction technologies are also reducing costs. Deposits and withdrawals can be made at unstaffed neighborhood outlets. In South Africa, ATMs are delivering pensions to villages too small to be served by branch banks. Smartcards, which are ATM cards with an embedded microchip, allow transactions to be made without expensive terminals or telecommunications equipment, even without client literacy. In South Africa's pension-cashing program, digitized fingerprints on Smartcards are matched with fingerprints on an ATM electronic scanner. Because Smartcards can function with battery-powered readers, they can be used even in remote areas.

Conclusion

The opportunities abound for policy and program reform in the area of financial intermediation for the poor. Implementation requires dedication, innovation, and ongoing research to identify the services that best respond to the needs of the poor and benefit the institutions that serve them. Both formal and informal financial systems are needed. The two systems must complement each other and require efficient regulation. Policy reforms to remove interest rate ceilings and foster linkages between formal and informal systems will strengthen financial intermediation for the poor.

At the program level, experience provides several lessons. The poor have a diversity of financial needs and benefit from the full range of financial services, not just access to credit. Deposit and savings services are in high demand and are essential for the sustainability of financial institutions. Women represent an important group of micro-entrepreneurs who face legal and cultural restrictions but require financial services, they demonstrate consistently high loan repayment rates. Incentive structures and new technologies are important in the design of sustainable and efficient financial intermediation to meet the needs of the poor.

***This policy brief is based on EAGER Discussion Paper Number 10, *Financial Intermediation for the Poor: Survey of the State of the Art*, 1999, by Eric Nelson, Development Alternatives Inc., Bethesda, MD.**

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