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**ROLE AND DEVELOPMENT OF MICROFINANCE AND SAVINGS AND CREDIT
COOPERATIVES IN AFRICA**

David Ndi
Kenya Leadership Institute

The emergence of microfinance, or what is now often referred to as banking for the poor, is increasingly being heralded as one of the most exciting development innovations since perhaps the green revolution. Microfinance in its many variants is credited with lifting thousands of people from a life of penury and bondage in South Asia. The microfinance industry is also making significant inroads in Africa.

Savings and Credit Societies on the other hand, are not new. In Kenya, Savings and Credit Societies, referred to as SACCOs, are arguably the most successful financial innovation. The SACCO assets are estimated to have assets in the region of US\$ 1 billion, approximately 8% of GDP. There are over 3000 registered SACCOs, with a membership estimated at close to 5 million.

Beyond these formal institutions, non-formal financial intermediaries –ranging from the merry-go-rounds to the informal moneylenders (who we call here in Kenya as “shylocks”) are ubiquitous. Judging by these observations it is arguable that alternative financial intermediaries play a very important role in the economic life of Africans, and have done so for many decades.

The rise of alternative finance, and the persistence of non-formal finance is in sharp contrast with the record of Government’s erstwhile efforts to engineer financial deepening in Africa. Here in Kenya, as indeed elsewhere on the continent, these efforts have taken the form of state owned financial intermediaries and a “second tier” banking industry owned by indigenous Kenyans. The initiative to nurture indigenous financial institutions took an infant industry approach—by way of preferential placement of public deposits. As often happens, the infant industry failed to grow—

and worse. The first generation collapsed in the mid-80s. The second generation became known as political banks (in reality, the first were just as political) what was known as political banks, and wreaked even more havoc on the financial system in the 90s. State owned intermediaries, both commercial banks and development finance institutions (DFIs) have also not done particularly well. Over the five-year period x1998-2002, Kenya's five state-owned banks lost, cumulatively Ksh.17 billion (US\$ 250m). The cumulative losses of the three DFIs (ICDC, IDB, and KIE) also run into hundreds of millions of dollars.

This contrasting performance then begs a number of questions. What accounts for the success of alternative financial sector, the persistence of non-formal finance? What explains the failure of state-led financial development? What does the growing interest of policy makers and the formal sector players portend for alternative financial services?

Received wisdom tells us that financial intermediation consists of three distinct but mutually reinforcing functions namely:

- *Agglomeration of capital.* This is based on the presumption that saving are usually available in small quantities, and they need to be pooled into large quantities
- *Maturity transformation.* This function has to do with (households) liquidity preference, owing to the fact that they often suffer liquidity shocks. Transformation of precautionary savings into demand deposits and tradable securities enables funds to be invested illiquid assets while at the same time ensuring the liquidity needs of savers.
- *Risk management.* Financial intermediaries specialize in discovering the risk and return to investment that savers have neither the time nor the know how to do. Evaluating risk and return is a costly undertaking in which there are huge economies of scale to be had. This also has the tendency

These functions are such that we observe a tendency for financial intermediaries to become large. Collecting deposits from many small units requires a huge infrastructure –e.g. a branch network. Similarly, in order to conduct maturity transformation effectively, the law of large numbers tells us that the larger the risk pool, the more predictable the behaviour of the aggregate (the bigger the bank, the

lower the liquidity ratio required). And as stated already, there are large economies of scale to be had in evaluating risk and return. This also has the tendency to oligopoly, because one intermediary acquires the relevant information to price a particular risk, it is costly for a customer to move from bank to bank which has to repeat the same process at his or her cost. We can now evaluate the role of alternative financial intermediaries vis a vis the received wisdom. .

Consider microfinance institutions, and microcredit specifically. They perform the function of distributing wholesale funds from various charitable benefactors to small borrowers. This is opposite of what banks do, i.e. collect small deposits and make large loans. In effect, they cannot really be said to be agglomerating capital.

The same applies to the maturity transformation function. Their benefactors provide equity capital or long term loans, which they lend short term. In effect, the term structure of their balance sheet will typically be the reverse of the term structure of a conventional commercial bank.

As regards risk management, consider the “Grameen bank” model of group based lending is said to be the critical success factor of microcredit. The intermediary attenuates risk by peer sanction, as opposed to evaluating risk and return.

Savings and Credit Societies do agglomerate capital, but this is bounded by a simple rule that allows members to borrow a maximum of between three and four times their share capital. In this regard, they are similar to microcredit institutions in that they are financed by equity (long term funds) and lend short-term. SACCOs do not evaluate risk. Members are entitled to loans on a first-come first-served basis, irrespective of the purpose of the loan. Membership of SACCOs is based on common bonds. Typically, they are employment based, but there is a growing number of trade based, such as tea farmers and matatu (private taxis) operators.

It becomes readily apparent that these alternative financial intermediaries do not conform to the received wisdom about the functions of financial intermediation. alternative financial intermediaries.

A number of MFI's have made the transition from donor-funded outfits to commercial banking, and many others are contemplating doing so. The transformation of the more successful MFIs into commercial banks seems to be geared to fulfilling the largely unfruitful effort to nurture a second-tier banking system. It is too early to tell whether the MFI model will succeed where previous efforts have failed. While the poor have proved to be bankable, but is banking for the poor in Africa going to prove profitable as well? Observing from Kenya, while KREP Bank the flag bearer has registered respectable performance, it is the "survivor" NBFIs such as Equity Building Society and Family Finance, that seem to be growing more rapidly in that direction.

Many SACCOs now offer their members front office services (FOSAs) which have proved very popular with the members. But unlike MFIs which mobilize deposits for lending purposes, the SACCOs maintain a separation between their lending and deposit taking services, that is they continue to lend out of share capital, while the deposit taking activities are a sort of cash management service.

"Village" banks is another interesting innovation. These are community based microfinance organizations. Typically, they are self-help groups organized under the auspices of existing institutions, such as church congregations. They enable people who would otherwise not operate bank accounts. The village banks provide front office services (deposits and withdrawals) as well as credit facilities along the same lines as SACCOs, except that members hold deposits as opposed to shares.

The microcredit paradigm is clearly at a crossroad. It seems that two trajectories are possible. One is to grow into a "second tier" banking sector. The second is towards the informality such as village banks.

In Kenya, legislation to facilitate the graduation of microfinance organizations into second-tier banks has been drafted. The draft legislation proposes a minimum start up capital of Ksh.50 million (US\$ 625,000) which is about a quarter of what is required to start a commercial bank. Other than that, all the other requirements are principally the same as banks, except that it proposes to forbid the use of the tag "bank" by the microfinance organizations.

I think the business viability of this model is doubtful as it imposes on microfinance institutions the same cost structure as banks but under a more restrictive regulatory regime. The model however, may be of interest to philanthropic investors who do not expect a market return on capital (i.e. donors and “social entrepreneurs”).

Financial fragility portends a more serious risk to this model. The risk of bank runs is inherent in deposit banking, and the failure of one institution more often than not, tends to trigger runs on similar institutions.

The “village bank” model is, in my view somewhat more promising. I have at least two reasons for saying so. First, the model lends itself well to existing high trust socio-economic institutions, such as church congregations, women’s groups, kinship groups (extended families, clans) etc. Second, the potential market is huge. Surveys conducted in some parts of rural Kenya have found that over 90% of the adults have never held an account in a financial institution of any kind. Third, there are no entry barriers in terms of capital requirement (start up capital can be as low as Ksh. 50,000 (US\$ 600) and the business requires no specialized skills to run. One I am familiar with was started with an initial capital of less than Ksh. 100,000 (US\$ 1200) a year ago has been able to accumulate over Ksh.3 million and turn a profit in the first year.

I share some of the sentiments of the many pundits that microfinance is one of the most exciting development innovations of recent times. However, I am somewhat more circumspect about the current enthusiasm to “scale up” microfinance into the formal financial intermediation sector. Experience in many spheres of development shows that we should be wary of supply side solutions. DFIs (and private NBFIs in Kenya) are leading examples, that supply side solutions are to be avoided. Subsidies notwithstanding, the microfinance sector in Kenya has yet to show the dynamism comparable to the SACCO sector.

Half a century ago, the economist Joan Robinson posed the question as to whether finance leads or follows industry. Although the jury is still out, surveying the evidence, I am inclined to agree with Robinson that finance is a handmaiden to industry.