Development of Micro, Small Enterprises and Rural Finance in Sub-Saharan Africa: The World Bank's Strategy

High levels of poverty combined with slow economic growth in the formal sector have forced a large part of African's population into self-employment and informal activities. African governments need to facilitate the development of their indigenous private sector. This could be assisted by a diversified financial sector capable of meeting the full range of demand for financial services. Raising the capacity of the self-employed and rural poor to sustain the economic activities essential to their survival is equally important. Internationally, a variety of financial institutions have found ways to make lending to the poor sustainable and build on the fact that even the poor self-employed repay their loans and seek savings opportunities. The challenge in Africa is to build capacity in the financial sector drawing on lessons from international best-practice micro and small enterprise financial institutions.

Deepening Access to Finance for Private Sector Development and Poverty Alleviation

The objective of the strategy adopted by the World Bank's Africa Region is to increase access to financial services by small enterprises and low-income households by addressing three principal areas:

- **Fundamental issues**—the policy, legal and regulatory frameworks essential to allowing the development of innovative financial institutions and instruments;

- **Institution building**—exposure to and training in best practices and standards of performance that banks and microfinance institutions need to expand their outreach and develop sustainable operations; support for capacity building; and

- **Innovative approaches**—lending and other products that the World Bank can use to increase access to financial services.

While common principles apply to developing financial systems that serve the majority of African populations and businesses that lack access to banking services, the strategy differentiates between the financial and development needs of microenterprises, small- and medium-scale enterprises (SMEs), and rural households.
Microfinance Development

Microfinance refers to very small savings and credit transactions of generally low-income households, especially for microenterprises, which include self-employment and firms with fewer than 5-10 workers (precise definitions vary by purpose and country). These activities typically generate little growth of paid employment but do alleviate the severe unemployment that threatens the survival of the poor. Microenterprises are often survival-level activities whose financial needs include convenient savings and very small loans. They rely primarily on household savings and business income, supplemented by the informal system of trade credit, savings and credit associations, savings collectors, and moneylenders.

Fundamental Framework

As governments implement regulations for the banking and formal non-banking sectors, they sometimes apply regulations to microfinance institutions which are inappropriate. Frequently problematic are usury ceilings, capital adequacy regulations, and collateral requirements, which prevent microfinance institutions from charging cost-recovery interest rates and are inconsistent with character-based lending. The Africa Region supports policy forums that introduce practitioners, regulators, and government officials to international experience to improve their ability to view regulatory issues from the perspective of microfinance institutions. Assistance could also include drafting appropriate laws and regulations.

Capacity Building

The principal challenge is to build the capacity of microfinance institutions to develop sound commercial operations and to increase the outreach and sustainability of their operations, including their capacity to mobilize local financial resources. This is achieved through exposure to and implementation of best practice techniques for managing risk, reducing administrative costs and increasing revenue. The Region's strategy supports performance-based lending instruments to finance start-up costs, new management information systems, training for staff and management, expanded loan portfolios, and other institution-building expenditures.

Innovative Instruments and Approaches

The Regional strategy supports innovative pilot programs, especially those aimed at mobilizing savings and developing linkages between the formal banking system and non-banking institutions that serve the self-employed poor-for example, mechanisms to reduce the risk to banks of lending to microfinance institutions.

SME Finance Development

Small and medium enterprises (SMEs) represent "firms" in the more formal sense (usually defined in African countries as up to 50 or 100 workers), and differ from microenterprises in: the amount of finance required, the difficulty in using character-based methods to secure loans, the need to compete with larger domestic and international firms, and the potential to grow and create productive wage employment. They are more likely to require long-term investment capital as well as short-term working capital. Because dynamic small enterprises can use external finance to grow rapidly and to become competitive, strengthening the capacity of the formal financial system to serve them and improving their access to banking services can have significant payoffs. Nevertheless, problems of information, collateral, contract enforcement, and transaction costs inhibit commercial banks from serving this market.

Fundamental Framework

The development of a vibrant private sector requires financial institutions willing to lend on the basis of reasonable cost and risk. The Region focuses on developing a legal environment that facilitates the enforcement of contracts (the efficient operation of commercial courts and easy collection of collateral), and the development of a competitive financial system.

Capacity Building

International best practice institutions such as the National Development Bank of Sri Lanka, which have succeeded in building strong and profitable small-business portfolios have paid considerable attention to staff training, decentralized
decision-making, strong follow-
up, and portfolio performance
incentives. The International
Finance Corporation (IFC) sup-
ports the development of leasing
companies and, in some cases,
venture capital, which are suited
to financing fast-growing SMEs.
Other best practice methodologies,
such as credit-scoring
mechanisms (an index of char-
acteristics that predict credit-
worthiness), offer scope for
cost-effectively identifying cred-
itworthy borrowers and reduc-
ing the costs of collecting and analyzing information on loan
applicants.

Innovative Instruments and
Approaches
The World Bank potentially
has an important role to play in
facilitating dialogue with com-
mercial banks to encourage
them to expand their small busi-
ness portfolios in exchange for
project assistance to implement
promising mechanisms such as
credit scoring, loan officer or
branch incentive programs, leasing
instruments, risk-sharing
mechanisms, lines of credit for
long-term financing, portfolio
guarantees, and the development
of legal frameworks conducive to
efficient contract enforcement.

Rural Financial Markets
While many aspects of develop-
ing rural financial services cor-
respond to microfinance, partic-
ular problems in rural areas
include: very high delivery costs
due to dispersed populations
and poor transportation and
communication facilities; sea-
sonality of savings and credit
demand due to the dependence
of rural economies on agricul-
ture; and associated high co-
variance risk in case of external
shocks such as drought.

Fundamental Framework
The regulatory framework should
facilitate the emergence of a wide
range of financial intermediaries,
including village-based activities
that may lie outside the legal
framework, and the integration
of such rural financial institu-
tions into financial sector devel-
opment strategies, for example,
through formally recognized net-
works of village savings and
credit associations.

Capacity Building
Broadening the outreach of
financial services in rural areas
can be especially costly because
of dispersed populations and low
levels of education. The sustain-
ability of rural financial institu-
tions depends on their ability to
develop and manage diversified
portfolios, which in turn
depends on diversification of the
rural economy. In addition to the
types of institution-building
measures described under
microfinance, substantial invest-
ment may be needed in educat-
ing potential clients at the village
level in financial, business, and
management skills, as
well as literacy programs. Thus,
community development pro-
grams can be a useful comple-
ment to develop the clientele for
rural financial intermediaries.

Innovative Instruments and
Approaches
The Bank encourages innova-
tive pilot programs to improve
the sustainability of rural finan-
cial institutions by mobilizing
and intermediating savings with-
in rural communities and to mit-
igate the risks associated with
an agriculture-based economy.

Operationalizing the Strategy
Given the resource-intensive
nature of developing a sound
microfinance portfolio, the Africa
Region works in close collabora-
tion with the Economic
Development Institute (EDI), the
Consultative Group to Assist the
Poorest (CGAP), and Sustainable
Banking with the Poor (SBP).
Countries receiving priority
focus are those which have
demonstrated commitment to
microfinance development by
formally requesting that the sec-
tor be included in the World
Bank's Country Assistance
Strategy or the Region's Action
Research on Sustainable
Microfinance Institutions. The
Bank can work flexibly with a
country at any of four phases, as
appropriate.

Phase 1: Awareness Raising
In collaboration with EDI, the
Region is holding regional semi-
nars that introduce high-level
policy makers and practitioners
to international best practice
methodologies and standards of
performance practiced by sus-
tainable institutions and to the
policy and regulatory frame-
works conducive to microfi-
nance development.

Phase 2: Diagnosis
Program preparation begins
with a diagnosis of the institu-
tional, policy, and regulatory
framework for development of
micro, SME and rural finance,
and with country workshops in