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“Financing small, medium and micro enterprises in post-conflict situations
Microfinance opportunities in the Democratic Republic of the Congo”

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Summary

This paper was produced as part of the OECD Development Centre’s project “Public Private Partnership for the development of the Democratic Republic of the Congo (PPP DRC)”\textsuperscript{1}. The document hopes to provide useful discussion topics on the subject of financing small, medium and microenterprises (SMME) in a post-conflict situation (PCS) through microfinance initiatives. Such discussion tools are intended to help promote a constructive dialogue on this issue among public and private sector representatives in the DRC, as well as international organisations and civil society members\textsuperscript{1}.

The document underlines the importance of SMME’s in African economies and argues that they should be given particular attention in a post-conflict scenario when national reconciliation and peace consolidation are at the center of policy-making. SMMEs play an important role in poverty alleviation and reducing vulnerability of poor households, potentially providing a quick response to the need of jump-starting the post-conflict economy.

Financing is one of the most important obstacles facing SMMEs in developing countries and the document discusses the particular difficulties to be found in post-conflict. It also highlights the fact that in PCS, financing is usually not sufficient to support the development of SMMEs as there is a strong need for capacity building. As a possible solution to the financing needs of SMMEs in post-conflict, the paper focuses on microfinance, giving a brief overview of the sector and its lending technologies, which include peer selection and monitoring, dynamic incentives and collateral substitutes. Economic agents face substantial challenges in PCS such as political uncertainty, macro-economic instability, disrespect for the rule of law, rapid growth of the informal sector and depleted human and physical infra-structure. Microfinance operators are negatively impacted by this adverse business climate, but also face additional challenges, which reduce the efficiency of several of their specific lending methodologies. Such factor are population movements, disruption in social capital, lack of collateral and donor induced distortions.

Bearing in mind the context for microfinance in PCS and that there is no unique solution to the development of financial institutions, the paper introduces some general discussion topics for designing a strategy for microfinance drawn from experiences of other conflict affected countries. It suggests a greater coordination of relief and development efforts in deciding when to introduce microfinance operations in PCS and that microfinance is not always successful, especially with the severely destitute. On the business model of MFIs in PCS, experience shows broad client targeting works best and that technical assistance should be contemplated. Successful MFIs often adopt business

\textsuperscript{1} The Monterrey Consensus adopted in March 2002 by the UN Conference on Financing for Development recognises in its paragraph 24 that knowledge broadening PPPs are important tools for building business enabling environments.
like approaches with strong marketing orientations to signal intentions and products. They also pay close attention to the development of human resources and creating performance incentives for its personnel.

Coordination of donor efforts is seen as major success factor in developing a sustainable MFI sector due to their fundamental role in financing microfinance projects. Some of the major problems identified in respect to donor coordination are the confusion created between grants and credit, giving continuous support to inefficient operations and promoting just temporary credit programmes with no exit strategy.

The paper gives an overview of the current economic and political situation in the DRC and the enormous challenges faced by the government, private sector and international organisations. The DRC is now one of the poorest in the world following a long lasting war and deep economic mismanagement. According to The World Bank, around 80% of its 52 million inhabitants survive with less than US$ 0.2 per day and some estimated 16 million are estimated to be starving or malnourished. There is, however, some positive developments with the Joseph Kabila administration managing to gather international support for the country’s reconstruction and accomplishing major steps into a political solution to start the process of national reconciliation.

Unsurprisingly, the country’s financial sector is at this stage unable to provide support to the DRC’s private sector development and much less to SMMEs. Besides the need for a deep restructuring of the financial sector, which should take time, it is also necessary to contribute to the development of strong MFIs capable of providing financing to small scale entrepreneurs. Based on a short analysis of the DRC’s situation, several opportunities are identified in this context. There is a strong case for a regional coordinated approach to the development of MFIs, exploring “islands of stability” where conditions for microfinance are closer to optimal and avoiding those areas where emergency grants and other safety nets are more appropriate. Since technical assistance to micro-entrepreneurs is identified as a major success factor, partnerships between public and private sector players or including donors are an opportunity for sharing costs in providing training and simultaneously separate pure financial services from “social services”, increasing visibility of each MFIs performance. In promoting an enabling environment for microfinance in the DRC, local MFI associations and donors may promote the use of ratings and attract international microfinance specialists. Finally, on donor coordination, it is important that international aid organisations communicate well among themselves eventually setting common standards for microfinance development and that they leverage on the existing MFI associations already operating in the country for better project coordination.
1. Introduction

Following peace agreements with its neighbour countries and the start of the reunification process, known as the inter-congolesse dialogue, the DRC is currently facing major challenges, as it is starting its transition to development. The country has suffered enormously from conflict and economic mismanagement and, despite its well-known natural resources potential it is currently one of the poorest in the world with its 52 million inhabitants living on an average of less than US$ 0.2 per day. The process of reconstruction of the country has already started through close cooperation with the World Bank and the IMF, as well as other bilateral and multilateral donors. During the two years of President Joseph Kabila’s administration results have been quite encouraging with the DRC starting many economic reforms, putting a halt to hyper-inflation and managing to gather increasing international support.

Post-conflict situations always present a big challenge to local governments and international institutions taking up the different, but inter-related tasks of consolidating peace and economic reconstruction. An extensive literature has analysed different cases of difficult transition of post-conflict countries and the need of giving priority to peace keeping in any development strategy. Peace keeping is to a large extent a question of raising rapidly the living standards of the post-conflict society. It means a successful re-integration of displaced people, demobilisation of military men and restoring confidence of other war-affected populations.

This discussion paper discusses the role of small medium and micro enterprises (SMMEs) in a successful post-conflict transition, as a bottom-up development tool and a way to reinforce the success of post-conflict transition. It then focuses on financing, which is one of the main obstacles to SMME development. In the DRC situation today, credit activity is extremely low, as the formal banking sector has been substantially downsized. Traditional SMME lenders in the country such as the COOPEC (credit and savings cooperatives) suffered from plundering and monetary reforms and are still in a difficult situation to be able to provide adequate financing.

The discussion paper is organized as follows. The first chapter gives a broad view of the importance of SMMEs in post-conflict situations and the second chapter focuses on financing as one of the main obstacles to SMME development. The third chapter introduces microfinance and analyses how some of the main components of its lending technology are impacted by the specific environment of PCS. In the fourth chapter some topics on developing the microfinance sector in a PCS are introduced. Finally the last chapter of the paper looks at specific case of the DRC and suggests opportunities for the development of microfinance.
2. The importance of SMMEs in post-conflict situations

In developed countries, great attention has been given to creating an enabling environment for promoting small, medium and micro-enterprises. In June 2000, the OECD issued the “Bologna Charta on SME policies” (OECD, 2000), in which governments from OECD member countries and invited non-member states recognised the importance of the SME sector and recommended policy orientations conducive to SME growth. Policy orientations have been backed by research work highlighting some of SMMEs appealing characteristics such as being more labour-intensive than larger corporations and thus more capable of employment creation. Some studies suggest that SMME’s create more value added per unit of capital and thus generate both more employment and output for a given investment (Haggblade, Liedholm and Mead 1990; Steel and Takagi 1983).

2.1 The role of SMMEs in African economies

The development of small and medium sized companies has often been regarded as a “missing link” in development strategies of African countries, as several import-substitution policies have favoured large corporations at the expense of SMMEs. Several arguments have been given for putting SMMEs at the centre of development strategies. The main reason lies on the simple observation that they constitute the largest portion of employment in developing countries (especially the micro-enterprise segment).

It is, however, somewhat difficult to assess the weight of SMMEs in the developing world’s economies. This is mainly the result of lack of statistical data and research on industrial structures in developing countries, but also of problems associated to including the informal sector. However, SMMEs are normally considered to employ a significant part of the working population in developing countries. Liedholm (2001) review of national surveys conducted in several African countries estimates that between 17% to 27% of the working age population is employed in micro and small enterprises, being nearly twice the employment of large scale enterprises and the public sector. USAID considers that microenterprises often employ a third or more of the labour force in low income countries. In Uganda, a survey of small and medium enterprises commissioned by USAID in 1995 established that 22% of all households in the country engage in some sort of small business activity and that these activities employ around 29% of the country’s labour force. In Kenya, for example,

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1 Parker et al. (1995) p.18 describe some of the regulatory and policy constraints impacting SMMEs in Africa.
2 Liedholm (2001) examination of surveys of micro and small enterprises conducted in Africa and Latin America reports that “a key finding from the house-to-house baseline surveys is that the micro and small enterprise sector is far larger than is reported in most official statistics, which often cover only registered firms”.
3 The countries surveyed are Botswana, Kenya, Lesotho, Malawi, Swaziland, Zimbabwe and South Africa.
4 USAID’s Office for Micro-enterprise development defines micro-enterprises as very small, informally organised, non-agricultural businesses.
Mullei & Bokea (1999) indicate that the SMME sector employs around 2.3 million people and generates around 14% of the country’s GDP.

Besides the relative weight of SMMEs in total employment, other reasons have been suggested to justify policy-makers giving special attention to the SMME sector. The main arguments given are usually related to SMMEs labour-intensiveness. Some of the available empirical evidence shows, however, that labour intensity is more related to industry types rather than firm size (Snodgrass and Biggs 1996), which in developing countries (due to the particular industry mix) translates into SMMEs being more labour-intensive than large corporations. Labour-intensity results into a lower capital cost being associated to job creation and therefore SMME’s are associated with higher employment generation. In addition, SMME’s “labour-intensiveness” is also responsible for SMME’s being closely linked to “labour force supply-driven” survival strategies, most common during recessions, natural disasters, conflict and post-conflict situations.

Another factor is that SMMEs are more able to succeed in smaller urban and in rural areas. This is mainly the result of SMMEs having less need of capital and support infrastructure, when compared with larger firms. The regional reach of SMMEs is a critical factor for African countries where agriculture represents up to 46% of GDP and where it employs on average 72% of the economically active male population and 85% of the female population. SMMEs are therefore responsible for a more even income distribution and also play a very important role in stopping migration flows from rural areas to cities.

SMMEs are also seen to be more able to leverage on and expand local capacities. As opposed to larger companies, which usually import know-how from developed countries. Moreover, they are also often recognised as being a breeding place for entrepreneurs. Finally, SMMEs are considered to be more flexible in adapting to client requirements, being known for their ability to adapt quickly to market trends, as most of the operating costs are variable.

2.2 SMMEs as policy priority in post-conflict situations

Post-conflict situations are characterised by partially destroyed economies with human capital and infrastructure being depleted, institutions not functioning well or at all and a high level of dependency on foreign aid.

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1 Liedholm (2001) finds evidence that in periods of economic decline, employment growth was more linked to net firm creation then expansion of new firms. In periods of recession several of these new firms are just one-person enterprises.

A deep discussion on post-conflict transition is, of course, outside the scope of this paper, namely the triple transition usually analysed (from conflict to peace, from exclusion to national reconciliation and finally from economic mismanagement to quality economic growth). However, it is important to highlight the fact that post-conflict situations are characterised by a great challenge to local policy makers and international organisations: the one of simultaneously starting the heavy work of reconstruction while achieving the consolidation of peace. These tasks are usually inter-related as the re-establishment of a stable economic environment conducive to growth is normally needed to secure peace as returnees, refugees, internally displaced persons, the inhabitants and former soldiers have to be re-integrated into the post-conflict society. The success of post-conflict transitions requires a very efficient co-operation between international organisations and local governments, especially regarding the tasks that are assigned to each counterpart during transition.

In post-conflict situations, the emergence of SMMEs is, to a large extent, the natural result of excess labour supply from re-integration of war-affected populations, an increasing fragmentation of the private sector due to economic decline and structural adjustment measures taken by governments as they start rebuilding the economy. Moreover, it is a consequence of the lack of social and physical infrastructure, as well as insecurity and political instability, which do create an enabling environment to attract large investments. The SMME sector is therefore the emerging private sector in the post-conflict regions and its development has a positive impact on the post-conflict situation, as it can help support the “political priority”, i.e. peace consolidation. Small sized and micro-enterprises can have a key role in jump-starting economic activity following conflict, as they need much less requirements to start operations and are also on average less dependent of political and physical infrastructure. The main arguments supporting a leading role for SMMEs in post-conflict situations are the following:

- **SMME’s contribution to new employment generation.** The fact that SMMEs are seen as more efficient in employment generation and short-term poverty alleviation (often being a result of supply-driven survival strategies) makes them a preferred vehicle for improving living conditions of the poor and therefore contributing to reducing the probability of new conflict. Measures aimed at providing even just temporary employment could have a very positive impact on the social environment while longer term development strategies, which need a higher infrastructure level take time to be implemented.

- **Social impact of SMMEs through greater income distribution.** In a post-conflict situation, there is often the need to disregard equity principles in order to maintain peace (for example through entitling the conflicting parties to some of the country’s wealth). This can lead to more

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1 For a discussion on the challenges of post-conflict reconstruction (in particular the case-studies of El Salvador, Kosovo, East Timor and Democratic Republic of Congo) see del Castillo, 2001 and 2002

2 An example of such a situation was the post-conflict re-integration strategy for Mozambique’s war-affected population. The bulk of re-integration benefits was awarded to demobilized soldiers, while refugees and the dislocated (by far the largest groups) just received very little assistance (mainly in the form of emergency relief supplies such as food).
dramatic economic situations for the poor and vulnerable. Development of SMMEs in poverty affected areas can lead to reduce the negative impact of such post-conflict policies.

- Strong support to re-integration efforts of the existing military. A key issue in preventing a new conflict situation is a successful re-integration of refugees, returnees and military men. SMME promotion strategies can be useful in re-integration efforts, as they open new opportunities to this group of conflict-affected people. In particular, SMME targeted strategies including technical assistance and working capital finance can have a positive effect on achieving sustainability of the numerous micro-enterprises created with donor funds channelled to the demobilised.

- Role in mitigating negative impact of restructuring of state-owned companies. Post conflict economic policy is often directed towards rehabilitation and privatisation of state-owned companies. The process of restructuring state-owned companies can have an important social impact and lead to political de-stabilisation due to massive lay-off schemes (in Mozambique, for example trade unions and the local press refer to around 100,000 workers having lost their jobs since structural adjustment and privatisation). SMME development strategies may help incorporate a large number of these workers through adequate training and financial aid.
3. Financing: a cap on SMME development

SMME development is constrained by a certain number of factors such as: input availability (financing, labour, technology), regulatory constraints (high start-up costs such as licensing and registration, costs associated to settling legal claims), managerial constraints (lack of entrepreneurial and business management skills) and institutional under-development (SMMEs are often not capable of defending their collective interests due to lack of representation). In post-conflict situations, the amount of restrictions to SMME development is even higher due to the difficult overall socio-economic environment.

Among the large number of problems commonly associated with SMME development, financing is often mentioned as a key issue. Parker et al. (1995) in their review of surveys on small and micro enterprises in Africa observe credit constraints relative to working capital and raw materials being cited by micro and small-scale enterprises as one of their major problems (between 24% and 52% of respondents in Malawi, Mali and Ghana). The same World Bank document reports that micro and small enterprises considered access to credit and its cost as the main constraint to new investments\(^1\).

In a survey of literature and based on interviews of representatives of SMME promotion institutions, Erastus-Sacharia et al. (1999) concluded that lack of financial services was one of the main obstacles on SMME growth in Namibia. In South Africa, a 1999 World Bank survey of SMMEs in the Greater Johannesburg area\(^2\) showed that interest rates and credit access were considered as the most important conditions for employee expansion following growth in demand.

3.1 Market failure in financing SMMEs

Corporations finance their investments (initial and for further growth) through internal financing (retained earnings) and external finance (equity and debt). Despite the preference for internal finance in funding most investments (pecking order of financing choices), there is usually a stage at which external finance is inevitable to sustain growth. The financial sector through institutional investors, banks and other financial institutions, play therefore a central role in the development of the private sector.

The argument of a market failure in financing SMMEs is usually based on the fact that they are the victims of adverse selection resulting from information asymmetry. Credit rationing results from the

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\(^1\) Access to credit was quoted as a major problem by more than 90% of the sample in Senegal, 81% in Ghana, 65% in Malawi and 76% in Mali.

\(^2\) The survey included 792 formal firms across 4 manufacturing sectors and 4 service sectors.
fact that banks cannot really measure well the risks of lending to SMMEs\(^1\), companies are also not able to provide adequate guarantees or collateral and often the value of loans demanded is too small (leading to “financial exclusion”\(^2\)). Credit rationing can also become stronger as a result of monetary tightening leading to a “credit crunch” situation.

Lack of developed equity and bond markets and venture capital, in particular for SMMEs also do not provide alternatives to the banking sector. The banking system is, however, often unable to provide quality services to SMMEs as it suffers from serious inefficiencies and lacks a competitive environment to develop lending to small clients. Capital adequacy requirements also can put a break on bank lending to SMMEs that lack proper collateral. Equity and bond markets in developing countries are normally extremely small and rarely

Finally, the low initial income level of entrepreneurs and their households also does not enable SMMEs to expand substantially\(^3\). Prior to establishing a business, most developing country entrepreneurs usually have a low income (especially in the informal sector). This contributes to severe restrictions on the amount of own financing available for starting-up or expanding a business.

In a post-conflict situation the argument of a market failure in financing SMMEs is even more powerful since the main sources of start-up capital for entrepreneurs have suffered severe depletion and the financial sector is often severely damaged. In fact, post-war reconstruction often involves very deep restructuring of a country’s financial through steps such as:

- **A new currency.** This is normally due to having achieved national independence (the case of Eritrea four years after independence from Ethiopia) or may be the consequence of security considerations or the need to restore economic activity (two of the main motivations of Rwanda’s currency reform following the 1994 genocide).

- **Re-opening or creating a central bank.** Conflict may lead to a complete shut down of the country’s central bank (example of Congo-Brazzaville and Rwanda among others) and therefore creating a central bank ranks highly in the list of priorities for institutional reform in post-conflict situations. Capitalising a newly created central bank or a re-opened one can be a problem, as it needs support from fiscal revenues or donor funds and the expense competes with other spending such as social projects (which can be critical to consolidating the peace process).

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\(^{1}\) There are different reasons for this such as: lack of clear business plans, inadequate accounting methods and accounting history, difficulty of understanding market where the SMME operates, unavailability of comparable companies.

\(^{2}\) “Financial exclusion” derives from the fact that the costs associated with making and administering the small loans are too high when compared with the potential return and the risk uncertainty (banks therefore prefer to lend to larger corporations). This is even a deeper problem in rural areas, where transaction costs are exacerbated by geographical isolation.

\(^{3}\) Parker et al. (1995) report that personal savings along with loans or gifts from family and friends and profits from other businesses where the main sources of start-up capital.
- **Re-establishing the banking system.** This is normally a priority as it is a necessary condition for normal economic activities to re-start (they require deposit accounts and clearance of payments). In post-conflict situations the banks normally lack personnel and capital (accumulation of NPL (non-performing loans), pillage and fraud are factors that aggravate the situation). As an example, in Rwanda, the Union des Banques Populaires (UBP) had only 20% of its staff left following the 1994 genocide, which also led to US$ 7m to be transferred to the refugee camps in DR Congo. The demand for banking services is also negatively impacted by uncertainty on collateral (due partly to non-defined ownership structures), absence of insurance markets and radical increase in information asymmetry between lender and borrower. Normally the re-capitalisation of the banking system takes the form of complete or partial privatisation of state-owned banks given financial restrictions imposed by extensive reconstruction spending. As a result of post-liberalisation financial crises (and the threat on macro-economic stability), the process of restructuring the banking sector in post-conflict situations is increasingly focused on beefing up prudential regulation and banking supervision through institutional development.

3.2 The need for capacity building in post-conflict

The argument that financing is not a sufficient condition for effective SMME development is mostly linked to the low productivity levels of the targeted population. Low levels of capital and labour productivity are a result of both conflict (which has not allowed access to school, has caused severe depletion of infrastructure and other) and the pre-conflict situation (where often productivity levels are already very low to start with). Lack of sufficiently high productivity levels has two main consequences, both of them negative for SMME development:

- **Low demand for credit and other financial services.** Because of insufficient technical ability, business opportunities are not identified and therefore new SMMEs are not established. Moreover, when business ideas are generated, low productivity reduces returns on investments and for a given risk profile this in turn lowers the number of projects which meet investment criteria. In El Salvador’s case, the low productivity of farmers has been pointed out as a serious obstacle to the development of SMMEs in the rural areas.

- **Lack of sustainability.** Low productivity levels also increase the vulnerability of SMMEs to market factors and therefore result in greater mortality rates for SMMEs. As an example, in post-conflict situations such as Mozambique and Uganda, hurriedly conceived re-integration schemes

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1 IMF Staff Country report 4 “Rwanda: Recent Economic Developments” 2000
2 For a discussion on weaknesses of prudential system reforms in developing countries see brownbridge and Kirkpatrick 2000.
3 In Mozambique, soldiers lost on average 10 years or more of education and many suffered from psychological disturbances and alcoholism due to the trauma of war.
for the existing military have in their majority not really created the conditions for successful small and micro businesses to last. ² The Mozambican case shows how often technical assistance was not provided to individuals, which were not specialised in their activity (for example animal breeders without knowledge of feeding techniques and disease control). In particular, this was the case for the de-mobilised soldiers (the population that received most attention because of the peace process), which often were given credit and low skills to pursue activities that they did not really know well. ILO³ reported that there were very few cases of Mozambican demobilised soldiers in 1999 that continued any of the activities for which they received financing just after the end of the war.

¹ See Gonzalez-Vega 1999.
³ De Vletter 1999
4. Microfinance in post-conflict situations

The difficulties identified in small, medium and micro enterprises accessing credit and the consequent negative implications on their development have stimulated the search for innovative approaches to finance such companies. The traditional approach to developing SMMEs had consisted mostly in directed and subsidised credit programmes, which have proven to be inefficient in increasing access of SMMEs to credit, being faced with very quick capital erosion. More recent approaches, such as microfinance focus rather on the characteristics of SMME lending (such as transaction costs and risk management) that make it so unpopular. Practitioners try to reduce transaction costs associated with lending, to build up capacity of existing financial institutions to serve SMMEs and fosters competition in financial services to these companies.

4.1 Overview of Microfinance

Microfinance generally refers to the provision of financial services to poor and low-income households, which are deprived of access to mainstream financial institutions. The financial services provided by micro-finance institutions (MFIs) vary considerably and may include any or all of the following: deposits, loans, pension and payment services, money transfers and insurance. In addition, to financial intermediation, several MFIs provide “social services”. This type of services normally tries to support the poor in terms of literacy, basic education (in fields such as health or nutrition), but also may be combined with the financial services in order to boost productivity and improve sustainability of the micro-projects. Such services include technical assistance in specific business sectors, managerial training and accounting techniques.

The objective of microfinance institutions is to have a direct impact on poverty alleviation but also on the development of small and micro-enterprises. Microfinance clients are typically the self-employed and low income entrepreneurs producing different types of activities such as traders, street vendors, artisans and farmers. Loan sizes can start at very small amounts of below US$ 100 being repaid over several months or a year and only some of the institutions require collateral. The most common type of organisations that develop micro-finance activities are: NGOs, savings and loan cooperatives, credit unions, governments, development banks, standard commercial banks and non-bank financial institutions(figure 1 shows this breakdown with data from the MicroBanking Bulletin (MBB), which includes 147 MFIs). NGOs are normally associated to direct poverty alleviation objectives, but also to SMME development without traditional collateral, while development banks and government objectives focus in developing the financial sector and fostering SMME growth through flexible types of collateral. Commercial banks and other privately-owned financial and non-financial institutions normally have profit targets and are more prone to demanding formal collateral.
Figure 1: MFIs by charter type and scale of operations

Note: Large: Total Loans Outstanding (TLO)>US$ 5 million; Medium: US$ 5 million<TLO<US$ 800,000; Small: TLO<US$ 800,000.
Source: MicroBanking Bulletin, November 2002

Microfinance institutions are therefore unsurprisingly diverse in their approaches and size\(^1\) (figure 1). Some success stories have become famous such as BancoSol in Bolivia, which started as NGO in 1987, became a formal bank in 1992 and by June 2002 had an outstanding loan portfolio of US$ 67 million with 50,525 clients, being the largest institution in the Bolivian financial market in terms of number of borrowers (representing 35% of the total). Another example is Grameen Bank in Bangladesh, which became a formal bank in 1983 and by December 2002 posted an outstanding loan portfolio of US$ 218 million and a total of almost 2.5 million members. In terms of deposits, in December, Grameen Bank reported US$ 154 million in deposits, 82% of which from its members\(^2\).

Microfinance has registered strong growth worldwide since the 1980s as it began attracting donor interest and consequent funding. It also benefited from a steady increase in criticism of the traditional subsidized credit model (an important part of many countries' development strategies since the 1950s\(^3\)), because most programmes accumulated large loan losses and very low loan reimbursement rates, becoming increasingly unsustainable without frequent recapitalisation. Donor funds therefore concentrated on the building up of local, sustainable institutions committed to achieving substantial outreach. This trend has also led to changes in MFI operations with many shifting from integrated services (both credit and training or other) to focusing in providing only financial services. Such change accompanied the transformation of several NGOs, trust companies and other institutions into

\(^{1}\) In the MBB survey of November 2002, the 147 MFIs covered showed a range from US$ 58,000 to US$ 816 million in gross loan portfolio.

\(^{2}\) Figures on Grameen Bank taken from the bank’s December monthly update and using an exchange rate of US$ 1=Taka 58.

formal financial institutions such as the above-mentioned BancoSol in Bolivia, but also K-REP in Kenya¹ and the Centenary Rural Development Bank (CERUDEB) in Uganda².

It is difficult to fully assess the actual size of the microfinance industry today. For example, the MBB from November 2002 indicates that the MFI s included represent at present 9 million borrowers and almost 29 million savers accounting for a combined gross loan portfolio of around US$ 2 billion and US$ 2.4 billion in voluntary deposits. According to the same data, the average MFI has offered microfinance services for 8 years, has around 12,000 borrowers, a gross loan portfolio of US$ 4 million and operates with 100 employees. It reaches a clientele with an average outstanding loan size of US$ 450 or around 45% of GNP per capita in the country.

4.2 Microfinance technology

In order to achieve their goals of outreach and sustainability, micro-finance institutions have developed innovative banking techniques that allow them to circumvent the natural obstacles of lending to the poor.

Lending to SMME or even poor individuals when compared to standard commercial banking involves: (i) a greater level of risk (due to the lack of collateral, business plan and other) and (ii) higher costs (to select and monitor clients), especially given the small amount of the loans. One of the characteristics of microfinance operations, and in particular financially sustainable ones, is to charge high interest rates. These vary from MFI to MFI, depending on the type of operations, target clients and the economic environment among other factors.

Several arguments have been put forward to defend the capacity of low-income households and MFI s to pay high interest rates³, such as:

- Informal credit markets already exist in developing countries and interest rates charged are usually far higher than the ones charged by formal MFI s.

¹ K-REP started as an apex in 1984 providing funds to NGOs for microlending and expanded to work on USAID’s Private Enterprise Development Project in 1987. In 1997, K-REP Bank Limited was created as a subsidiary of K-REP Group, becoming the first commercial bank in Kenya directly targeting the poor.

² The origins of CERUDEB can be traced to an early 1980’s initiative of the Uganda National Council of Lay Apostate designed to promote the provision of appropriate financial services to the rural population of Uganda. In 1983 the Centenary Rural Development Trust was registered as a financial institution, and operations commenced in 1986. The Trust was transformed into a commercial bank in 1993.

³ Muhammad Yunus, President and founder of Grameen Bank, in his very interesting auto-biographical work, “Banker to the Poor”, makes a description of his observations of economic inter-actions among low-income people in Bangladesh. In particular, he highlights how the self-employed would often be pushed below the poverty line because of extremely high interest rates charged by their input suppliers. Credit for working capital from Grameen at lower rates was therefore capable of freeing these low-income workers from usurers and allowed them to increase income and accumulate assets.
The reports on repeat clients, asset accumulation, social benefits and other results from microfinance impact studies indicate very strong demand despite the high level of interest rates charged.

SMMEs do not have sufficient working capital or fixed assets. A marginal increase in any of these can usually unlock significant returns for the same amount of labour invested, which allows them to pay high interest rates on credit.

From a cost perspective, interest charges may represent a very small percentage of total cash production costs of SMMEs.

There is a great diversity of mechanisms used to optimize repayment rates and to screen clients that build up to a so-called lending technology. The most common way to classify MFI lending technology is according to the way it groups borrowers when attributing credit. In fact, group lending is one of the distinctive features of MFIs when compared to commercial banks. The MBB, for example, suggests three types of MFI lending methodologies: (i) individual lending, which accounts for 50% of the total survey MFIs; (ii) solidarity groups, which consist of lending to groups of 3 to 9 borrowers and that is used by 32% of MFIs in the survey and (iii) village banking, which consists of lending to groups of more than 10 borrowers and that is employed by 18% of MFIs included in the MBB.

Several of these technologies have in fact been built on the long experience of informal lending institutions in developing countries, such as rotating savings and credit associations (ROSCAS), rural and urban credit unions, family-type insurance schemes or informal moneylenders and this is also one of the reasons for their diversity. Since the early 1990s, the study of microfinance technology and in particular group lending has attracted international organisations and academics. The following main mechanisms have been identified:

- **Peer selection and monitoring.** Group lending creates incentives for individuals with similar attitudes towards risk, approximately equal probability of defaulting on repayments and reasonable good degree of knowledge about each other to group together. This allows banks to overcome some of the problems of asymmetric information, raise repayment rates and lower interest rates. Group lending also induces individuals within the group to monitor each other to enforce the contract with the MFI, thereby preventing individuals to take on risky projects which would undermine the lending group’s existence.

- **Dynamic incentives.** Whether using group or individual lending, MFIs traditionally start by giving out only small amounts of loans to their clients and following good repayment allow greater quantities of credit to be disbursed. Because of the threat of being excluded from future credit, borrowers are induced to repay their loans. This effect is magnified if borrowers can expect

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1. For a more theoretical review of microfinance mechanisms refer to Murdoch 1999, which also includes valuable references.
2. The contract with the MFI usually stipulates that members of the lending group are co-responsible for paying off the loan, i.e. if one member does not pay the others will have to help him.
to be qualified for larger loans in the future or they sense in some way that their repayment track record has value. Another positive aspect of starting with small loans is that it allows MFIs to do an early screening of their customers.

- **Regular repayment schedules.** MFIs typically ask clients to start repaying the loan almost immediately after disbursement. In addition, principal and interest are collected in small amounts regularly (in some MFIs weekly or even daily) over the maturity of the loan. This mechanism allows loan officers (also peers in the case of group-based lending) to receive early warnings about potential defaulters and act accordingly. In some cases, MFIs impose regular meetings to clients to promote efficient peer monitoring.

- **Collateral substitutes.** The majority of MFIs do not demand proper collateral, but some use substitutes such as forced savings from members in the lending group, which can take the form of an emergency fund or insurance. MFIs that use an individual lending technique often rely on the incentive aspect of collateral. In this case, MFIs usually produce a very simple and easily enforceable collateral contract linked to a “social status-type” of durable asset such as a television or refrigerator. The menace of losing their social asset may constitute a powerful incentive for repayment.

- **Targeting women.** Due to factors, such as responsibilities in raising children, low level of mobility, social and cultural issues, women are often found to be safer borrowers than men. In certain countries, when excluded from most economic activities and with limited access even to informal moneylenders, women also carry a greater potential for improvements in empowerment and for unlocking “hidden capital” in the form of labor. Targeting women, in such contexts, can therefore translate into marginally higher social and economic impact of microfinance. For some MFIs, such as Grameen Bank, lending to women has an important characteristic of their technology. In December 2002, 95% of the Grameen’s 2.5 million members were women, compared to around 40% in the early 1980s.

There are many other details that make lending to low-income people and SMMEs possible. Lending technologies usually take time to be perfeetioned and depend heavily on the local market characteristics. One of the major items is operating cost efficiency and in particular, optimisation of transaction costs. To a great extent this has to do with some of the above mentioned lending mechanisms that allow MFIs to reduce credit risk analysis costs, monitoring and other expenses. MFI cost efficiency is also explained by organisational issues of the individual firms: how they structure

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1 This can be the case of MFIs that allow clients to become members after a period of good repayment. Membership, in certain cases, gives the possibility for example to suggest new clients, which will have easier access to loans. Another example is that of Novobanco in Mozambique, a very successful MFI whose main shareholder is Banco Internacional de Moçambique (owner of 30% stake), the country’s largest commercial bank. Novobanco gives first-time borrowers only small loans informing them of the possibility to be eligible for further loans issued on more favourable terms and conditions if they comply with their repayment obligations. Novobanco calls it the “graduation principle”.

2 Among others, this is part of the lending methodology of Novobanco in Mozambique that testifies on how clients feel humiliatied in the very rare occasions when bank officers had to exercise one of such collaterals with a high value in terms of social status.
the efforts of loan officers to improve productivity or choose the geographical location of the agencies typically placed in front of the main markets in urban centers. An interesting example is that of Financiera Calpià in El Salvador\(^1\) where loan officers have to very cost disciplined because of the specific difficulties of rural lending, namely in terms of transaction costs. Loan officers therefore employ gradual client screening methods that start with the less costly (meeting the client with others in the town and referrals from other borrowers) and ends up with the most expensive techniques (visiting the client in its farm) only if the client passed the other filters. Because the loan officers costs are also taken into consideration in his performance review (and consequent bonus salary), they are highly motivated to act this way.

4.3 Current Challenges in Microfinance

Following rapid growth and increasing attention being given to microfinance from developing country governments and the private sector, but also from International Financing Institutions (IFIs) and the academic world, several challenges and questions have been raised. One of the most often mentioned discussion topic is the relationship between outreach (the capacity of MFIs to reach the poor) and sustainability of the operations (normally seen from a financial point of view). This debate is all the more important, as it may provide some answers to the arguments in favour of MFI subsidization. In fact, MFI reliance on subsidies to finance operations raises several worries: (i) the volatility of donor funds may compromise the sustainability of operations and even their credibility to clients to start with, (ii) the constraints of donor financing limit the size of the operations and reduces ability to respond to demand, (iii) efficiency of operations may be at risk if donor funds are abundant and this may even lead to distortions in the local financial market and (iv) the fact that subsidies might just become a windfall for a small group of people instead of having a significant impact on poverty.

There are two main dimensions to this issue. On one hand, the problem is to establish empirical evidence of the relationship between outreach and sustainability, which is still lacking full consensus in the international community. Table 1 highlights this with data from the above-mentioned MicroBanking Bulletin. In the table, financial self-sufficiency is defined as the ability of MFIs to cover operating costs through income adjusted for subsidies, capital erosion and provisioning for portfolio at risk. Outreach is measured through the ratio of average outstanding loan size to the country’s per capita GNP\(^2\). From the table, one sees that only 31\% of MFIs lending to the poorest of the poor are currently financially self sufficient, as opposed to 67\% of MFIs giving credit to the

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\(^1\) See Gonzalez-Vega and Navajas (2000) for more details on Calpià and their specific rural lending technology.
\(^2\) Average outstanding loan size is the most common proxy for client poverty levels in most empirical studies dedicated to the impact of microfinance. AOLS is used in the absence of more detailed data about the clients; it assumes that poorer clients demand smaller loans.
“richest of the poor”. In the total sample of 147 MFIs, 62 or only 42% are financially sustainable\(^1\). The sample of course does not provide a complete view of the MFI world and may suffer from selection bias with several subsidized microfinance projects not being included\(^2\). However, it already gives an indication that it is not clear that microfinance projects, especially those targeting the poorest of the poor, become financially self-sufficient (FSS). In addition, the survey shows that among the more mature (over seven years existence) and large MFIs, the ability to cover adjusted costs is higher, although many of these institutions have not reached a FSS stage (respectively 41% of mature and 27% of large MFIs are not FSS).

### Table 1: Relationship between outreach and sustainability

<table>
<thead>
<tr>
<th>Target market</th>
<th>Classification</th>
<th>Financially self-sufficient (FSS) MFIs</th>
<th>Non-financially self-sufficient MFIs</th>
<th>Total MFIs</th>
<th>FSS as % of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low-end</td>
<td>AOLS/GNP(^1)&lt;20% or AOLS&lt;US$150</td>
<td>18</td>
<td>40</td>
<td>58</td>
<td>31%</td>
</tr>
<tr>
<td>Broad</td>
<td>20%&lt;AOLS/GNP&lt;149%</td>
<td>36</td>
<td>41</td>
<td>77</td>
<td>47%</td>
</tr>
<tr>
<td>High-end</td>
<td>150%&lt;AOLS/GNP&lt;249%</td>
<td>4</td>
<td>2</td>
<td>6</td>
<td>67%</td>
</tr>
<tr>
<td>Small Business</td>
<td>AOLS/GNP&gt;249%</td>
<td>4</td>
<td>2</td>
<td>6</td>
<td>67%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>62</strong></td>
<td><strong>85</strong></td>
<td><strong>147</strong></td>
<td><strong>42%</strong></td>
</tr>
</tbody>
</table>

\(^1\) Average Outstanding Loan Size / Gross National Product per capita

*Source: MicroBanking Bulletin, November 2002*

On the other hand, even if one concludes that sustainability is not compatible with reaching the poorest, the question remains whether microfinance may still be a cost-effective mechanism to channel international aid. There is therefore still a need for additional impact studies on microfinance activities that may highlight not only the financial but also social benefits of these institutions\(^3\).

### 4.4 Microfinance impact

Microfinance impact has been the topic of an increasing number of studies that have ranged from a “proving impact” approach, seeking answers for donors and policy makers on the positive impact of Microfinance, and an “improving practice” approach that tries to give insight on how programs can better respond to client needs and improve productivity. The latter are aimed at MFIs and are often conducted by the institutions themselves. The studies provide a mix of quantitative and qualitative

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\(^1\) For a discussion on profitability and outreach of MFIs and, in particular, an analysis of Grameen Bank’s performance, refer to Morduch (1999).

\(^2\) To participate in the Bulletin, MFIs have to be able to fulfil “fairly onerous reporting requirements”, which could leave many potentially important players out.

data and many have been criticised by the academic world due to the lack of statistical validity. In fact, impact evaluations are too often based on anecdotal evidence or assumptions.

Since 1995, USAID’s Assessing the Impact of Microenterprise Services (AIMS) project together with the Consultative Group to Assist the Poorest (CGAP) from The World Bank have worked on establishing general principles for assessing the impact of microfinance\(^1\), providing a middle-range approach to studying impact, i.e. aimed at “improving microfinance products and services and justify investments in microfinance programs”. The general framework suggested has evolved over time and leaves room for adaptations by MFIs undertaking the proposed research. It also tries to have a cost-effective approach to the topic of impact assessment, as several of the more academic studies are beyond the reach of many stakeholders in microfinance.

Microfinance impact studies normally look at how programs contribute to alleviating poverty and reducing vulnerability of the poor through analysis of different units such as: individual, household, enterprise, project and economy. Some of the variables used at the various levels are shown in figure 2 below. According to AIMS, they “represent variables identified on the basis of their demonstrated validity in previous studies, their cross cutting nature, and their meaningfulness in understanding the contribution of microfinance programs to household economic welfare, enterprise stability and growth, and individual empowerment”.

\(^{1}\) For a synthesis of the studies conducted under the AIMS project funded by USAID and a description of the conceptual framework suggested for impact assessment, please refer to AIMS Team, December 2001, “Conceptual Framework for
Table 2: Examples of variables with demonstrated validity in previous impact studies

<table>
<thead>
<tr>
<th>Household welfare</th>
<th>Enterprise stability and growth</th>
<th>Individual empowerment</th>
</tr>
</thead>
<tbody>
<tr>
<td>-Household income (level and sources)</td>
<td>-Corporate profits$^4$</td>
<td>Personal income</td>
</tr>
<tr>
<td>-Household assets</td>
<td>Company fixed assets, especially among repeat borrowers</td>
<td>Client’s control of money earned (over purchases)</td>
</tr>
<tr>
<td>-Expenditure, borrowing, saving and lending patterns</td>
<td>Paid and unpaid employment generated by the enterprise</td>
<td>Assets owned and controlled by client</td>
</tr>
<tr>
<td>-Children’s education$^1$</td>
<td>Business practices (including use of technology)</td>
<td>Pattern of savings towards more formal channels</td>
</tr>
<tr>
<td>-Seasonal fluctuations in per capita food expenditures</td>
<td></td>
<td>Self-confidence and self-esteem for women$^5$</td>
</tr>
<tr>
<td>-Household’s effectiveness in coping with shocks$^2$</td>
<td></td>
<td>Increased mobility, especially for women</td>
</tr>
<tr>
<td>-Practices related to non-financial program services$^3$</td>
<td></td>
<td>Participation in decision-taking</td>
</tr>
<tr>
<td>-Difference between household poverty and poverty line</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes:
$^1$ expenditure, percentage of school age children in school
$^2$ types of shocks and coping strategies
$^3$ health, nutrition or family planning services
$^4$ reflected in marketing margins, sales value and volume
$^5$ improved self-image; increased capacity to manage specific tasks within the enterprise; extent to which respondent values her own contribution to the household

Source: AIMS, 2000

The following is a short review of two recent impact studies on microfinance operations:

In Central and Eastern European Countries and the New Independent States, evidence from EBRD, a survey of 57 MFIs in the region and available individual impact studies suggest that MFIs have been successful in fulfilling their objectives of enterprise growth, job creation and direct poverty alleviation$^1$.

In these transition economies, “MFIs generally target micro and small enterprises, contributing to fill the gap left by local government initiatives that have mainly focused on developing small and medium-sized companies”. The majority of MFIs in the region register loan repayment rates above 90%. According to the survey, on the short term, microfinance has a positive impact on household income. Case study and survey evidence point to a positive impact of microcredit on microenterprises in the longer term, as translated by higher employment, sales/profits and asset accumulation. Moreover, repeat borrowers showed a relatively stronger positive impact of microfinance than new

Assessing the Impacts of Microenterprise Services”. See also Carolyn Barnes and Jennefer Sebstad, March 2000, “Guidelines for Microfinance Impact Assessments”
ones. Individual empowerment has been often quoted to have changed as a result of microfinance indicating improved levels of self-esteem and standing in the community.

In Zimbabwe, a 2001 AIMS study\(^2\) assessing the impact of Zambuko Trust\(^3\) suggested that “the results from the impact analysis of the survey data, which controlled for specific differences, make a strong case that Zambuko’s program has a positive impact on its clients”.

The project involved a survey conducted in 1997 and then repeated in 1999 with the same respondents, as well as a random-sample of non-client entrepreneurs who met Zambuko’s basic eligibility criteria. In addition, the project also included case-studies of Zambuko clients in order to assist the interpretation of the survey results, pre-survey qualitative interviews and data from Zambuko’s information system. The typical profile of a Zambuko client interviewed in 1997 is that of a married woman about 41 years old, with seven to eight years of education and with a household of five to six persons. Two thirds of the new and half of the repeat clients included in the survey were from households with per capita income below US$2 per day.

Regarding the impact of participation in Zambuko at household level, the study suggests it improved client ability to make lump sum expenditures. There is a strong relationship between participation in Zambuko and client households acquiring assets, in particular durables such as stoves or refrigerators and also on the value of funeral-related assistance that clients provided to other households. Regarding education, in 1999 the share of household boys aged 6 to 16 attending school was higher for the clients than the non-clients surveyed. Zambuko participation also seems to have a positive impact on the frequency of consumption of nutritious foods in extremely poor households and diversification of income sources. Regarding impact at the enterprise level, the difficult economic environment resulted in lower average monthly net revenues (inflation-adjusted) in 1999 compared to 1997 for most categories of poor. The average decrease from 1997 to 1999 across all categories was of 4.2%. Zambuko seems, however, to have had a positive impact on clients that had already taken loans before 1997 and that continued to be active borrowers of the MFI by 1999. This category of borrowers registered an average increase in enterprise net revenues of 12% from 1997 to 1999. However,

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1 See Astrid Manroth, 2001 “How Effective is Microfinance in CEEC and the NIS? A Discussion of Impact Analysis to Date”, London School of Economics. She reports that there are around 300 MFIs operating with over 140,000 active clients in the region.

2 This section is essentially drawn from Carolyn Barnes, Erica Keogh and Nontokozo Nematundwe, 2001, “Microfinance Program Clients and Impact: An Assessment of Zambuko Trust, Zimbabwe”.

3 Zambuko Trust, a partner of the Opportunity International Network, started operations in 1992 and by 1996 became the largest MFI operating in Zimbabwe. At end 2000, it reported a total loan portfolio of around 10,000 loans with an average loan size of US$ 185. It does both group and individual lending coupled with business management training and aims at being a sustainable MFI. Individual loans have to be backed by guarantors and individuals have to own a microenterprise that is at least six months old and that is deemed to be financially viable. Loan maturity ranges from nine to twelve months and repayments are on a monthly basis. Credit disbursements are accompanied by an orientation session to teach good business practices and loan officers also play a role in advising entrepreneurs on management issues. To target the lower-income households, Zambuko has another loan product with potential borrowers required to undertake eight hours of business management education.
evidence from the study does not suggest that participation in the program had a major impact on employment nor in the value of assets of the enterprises. Finally, at the individual level, taking part in the program suggested a positive impact on clients having an individual savings account and on the number of ways the very poor continuing clients’ saved. The case-studies also supported that participation in Zambuko improved self-esteem and enhanced clients’ ability to plan for the future.

Despite recent progress being achieved in producing better quality impact studies and efforts to benchmark MFIs from different countries, this item remains a priority for international development practitioners. This is particularly true in the case of post-conflict microfinance where MFIs are often of small size and operate in more hostile environments, making it more difficult to conduct field studies. However, the specificities of post-conflict situations may also provide very useful insights on how microfinance can help sustain household coping mechanisms and how it contributes to SMME development. Simultaneously, PCS provide an opportunity to study the development of a microfinance industry and to compare it with the overall financial sector’s performance. Such research issues are important especially since limited donor funding in PCS has to be allocated into several often considered priority projects.

4.5 The post-conflict situation: additional challenges

Despite the promise of microfinance in terms of poverty alleviation and SMME development and some of the good results obtained in developing countries, particular attention has to be given to the specificities of post-conflict situations. In fact, PCS impose new challenges to microfinance operations and, more generally to the development of financial institutions. The post-conflict transition encompasses several stages from emergency to development with different degrees of overlap according to each particular situation\(^1\), as well as speed of transition, which need to be accounted for. Below we identify a first set of particular challenges in PCS common to most private sector operators:

- **Political uncertainty.** In many PCS, the initial stage of relief is accompanied by intense political struggle for power among the different factions, but also within factions for the newly formed political institutions. The political battle may lead to continuous changes in government heads, making reforms more difficult and therefore having negative economic consequences. In certain cases, peace is only achieved intermittently across the territory, with moments of military struggle accompanying the establishment of more durable peace. In addition, insecurity may subsist while the full demobilisation and re-integration of soldiers is not achieved. Uncertainty has a negative impact in the demand for financial services as it is difficult for economic agents to plan their

\(^1\) Overlap of transition stages may be geographical (relief and development co-existing in different regions of the same country) or by type of activity (several actions are part of peace efforts, but also contribute to economic development).
investments. It also forces financial institutions and other companies to adopt special measures to protect their assets, which involve additional costs.

- **Macro-economic instability and economic policy distortions.** Several symptoms of macro-economic instability, such as inflation, currency depreciation, sluggish economic growth and high State indebtedness, have a negative impact on the private sector. In the financial sector’s case it usually translates into lower demand for financial services. Moreover, high inflation produces a quick erosion of the financial institution’s capital base and reduces the value of savings and loan funds when interest rates are not adjusted. It makes credit activity very difficult except with very short maturities. State indebtedness may also lead to an increase in taxation, making it more difficult for institutions to become sustainable and often pushing them to the informal sector (where it becomes harder to raise capital and other financing). The national currency in a PCS is often very unstable, partly due to the small size of the currency market. A weak and volatile currency is usually the result of lack of confidence from economic agents, leading to disavings, capital flight and the use of alternative currencies. The lack of trust in the national currency is aggravated by (i) the length of the conflict, which usually relates closely to monetary policy mismanagement (in particular, monetisation of budget deficits to finance military expenses) and (ii) currency reforms (in chapter 2 we mentioned Rwanda’s case, but a similar situation can be found in Angola in the early 1990s when 95% of the monetary value of bank accounts was frozen when the Kwanza was replaced by the New Kwanza with no convertibility being allowed\(^1\)). Such situations may lead to depletion of a financial institution’s asset base and also make loans in local currency very difficult. Finally, PCS often results in serious economic policy distortions, as new government institutions have to pursue development goals (including macro-economic stability), but are also often constrained, in particular due to the fragility of political power, to spend disproportionately in maintaining confidence of the existing military and other stakeholders in order to secure peace.

- **Disrespect for the rule of law.** Issues such as theft and general banditry have an obvious negative impact on economic agents, and naturally on financial institutions, which in some cases become privileged targets, since they accumulate savings. In addition, a very high level of corruption among public officials and politicians may result in higher costs to conduct business properly and also contributes to undermine the culture of loan repayment\(^2\). Harassment through unofficial taxes by tax agents or the military (usually for the use of infrastructure) is one of the most commonly reported forms of corruption and disrespect for the rule of law.

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\(^1\) In chapter 4 of this paper we discuss the DR Congo’s case, where currency reforms had a substantially negative impact on MFI development having contributed to the poor financial situation of the existing traditional lending institutions, the COPEC (Coopératives d’Epargne et de Crédit – Savings and Credit Cooperatives).

\(^2\) In El Salvador, for example, frequent loan pardoning by the State has also contributed to this.
- **Rapid growth of the informal sector.** In PCS, the difficult business environment, the lack of proper regulation and also of enforcement, leads to a growing “informalisation” of the economy. In some cases, this leads to the emergence of criminal schemes, such as money laundering. A growing informal sector presents difficulties for tax collection, but also leads to situations of unfair competition, contributing negatively to private sector development. Regarding financial institutions, competition from informal microfinance schemes in PCS is often cited as a serious obstacle to the development of more stable institutions.

- **Depleted physical infrastructure and human capital.** The destruction of roads, railway, irrigation systems and other public service infrastructure such as schools and health centers is one of the most visible consequences of prolonged conflict. The lack of transport infrastructure increases transaction costs (especially in rural lending operations) and reduces the level of integration between markets (in some cases it completely disrupts long-existing market exchanges), thereby impacting demand for finance services. In every conflict-affected country, schooling rates are hurt and human capital accumulation disrupted (in particular, there is substantial skilled labour migration to foreign countries). This, of course negatively impacts demand for financial services because of the low productivity levels registered in most sectors, but also contributes to emerging financial institutions having supplementary difficulties in finding qualified personnel for their operations. Health has a substantial impact on productivity and is often cited as a reason for loan default.

- **Damaged financial system.** As we mentioned in chapter 2 this is one of the reasons for the particular difficulties of SMME and overall private sector financing in PCS. It also has an impact on the development of microfinance operations, since they often need to rely on commercial banks for deposit accounts and as a source of financing. Moreover, a financial system which is overly exposed to risk or is showing signs of collapse also contributes negatively to the overall environment for the development of financial institutions.

As a result of their specific lending technologies and business approach, MFIs face specific challenges (some of them actually derive from the ones mentioned above), which can be analysed by looking at the impact of PCS on the microfinance mechanisms. The main problems are:

- **Population movements.** Doyle (1998) provides an interesting identification of the types of populations found in PCS according to their ownership of productive assets, savings or land and attitude towards other populations resulting in a simple framework for credit risk consideration.

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1. Addison, T., Le Billon, P. and Murshed, S.M., 2000 « Finance in conflict and reconstruction », UNU/WIDER working paper nr. 20, identify 12 out of 33 licensed private banks in Cambodia to be laundering money from drug trafficking and illegal logging in the 1990s.
and judging demand for different financial services¹: (i) inhabitants (individuals who remained in their community for most of the conflict), (ii) returnees (former refugees or internally displaced persons (IDPs) that return to their original community or a new region within their home country), (iii) IDPs (people who fled their community but remained in the country), (iv) refugees (people who fled their country) and (v) demobilised soldiers. For financial institutions that want to engage in credit activities, all these populations in PCS present difficulties, especially regarding uncertainty on whether their potential clients will stay in the same place or not. Apart from increasing costs with peer selection and monitoring, population displacements also reduce the extent to which other mechanisms of MFI lending are efficient (for example dynamic incentives are weakened and regular repayment schedules or meetings may be more easily interrupted). Finally, collateral substitutes are frequently less powerful. Regarding Doyle’s population types, the ones that normally present lowest risk for credit are inhabitants and returnees (especially if they can integrate well into their home communities). IDPs risk is linked to how they wish to integrate in the new community and if they are welcomed. Refugees and demobilised soldiers traditionally present the highest risk. In the case of refugees they usually have less probability of being allowed to participate in normal economic activities in the host country. Demobilised soldiers are especially risky if they don’t dispose of any prior civilian experience and if they expect to be automatically entitled to credit.

- **Disruption of social capital.** Social capital is the basis for mechanisms that facilitate contracts and transactions. Household and community structures are deeply changed by conflict, through the loss of human lives, population movements (young people have to take on responsibilities sooner and households are often headed by more than one element) and myopic vision of life span due to insecurity and diseases². This leads to substantial damage to the way communities and households cooperate, which is often aggravated by suspicion and occasional violence in PCS. For MFIs, the lack of personal knowledge about each other and lack of trust among potential clients has a clear impact on the extent to which peer selection and monitoring is possible. An example of the impact of social capital disruption is the case of ROSCAS in Mozambique or Uganda (locally called Xitique and Kibiina respectively), which were practically destroyed during conflict because of population movements and lack of trust within the community.

- **Lack of collateral.** In PCS, potential clients are usually poorer, have often lost their assets and it is also more difficult to gather reliable information about them. In addition, there is significant uncertainty about property rights. It is therefore difficult for financial institutions to demand

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¹ Karen Doyle’s review is based on the experience of 16 programs in 4 countries (Bosnia-Herzegovina, Cambodia, Rwanda and Mozambique). The research also included interviews of US-based practitioners and donor agencies.

² Regarding diseases, programs in Uganda have reported serious difficulties from the fact that HIV positive clients did not have incentives to enter long term investment or savings contracts. URWEGO, a Rwandese MFI
collateral for loans disbursed. In the case of MFIs, lack of collateral may not be a major problem since alternative screening and monitoring mechanisms are used. However, the difficulties in gathering information about clients increase costs with credit analysis. Moreover, since clients are poorer and often do not have any “social status” type of assets, the use of certain collateral substitutes becomes impossible.

- **Distortions introduced by donors.** Donors are present in PCS since the beginning through relief and emergency aid. Despite their positive impact on demand for financial services, aid also brings distortions such as: (i) creating dependency (the fact that grants are given for a long period of time may result in a change in people’s mentality leading to a greater level of dependency and may hurt microfinance repayment rates), (ii) exploiting aid (it is common for local people, especially the most qualified, to build local consultancy firms and NGOs to profit from donor funded temporary projects), (iii) donor assisted financial institutions normally focus on poverty lending at heavily subsidised interest rates creating difficulties for other institutions willing to operate in the same region. Moreover, donor funded projects during conflict and the relief stage are usually not prepared to undertake development activities such as technical assistance or to provide financial services. In fact, these activities require a completely different approach to emergency relief and it is difficult to change staff mentality, as well as convince clients that repayment will be monitored.

Donor actions and, in particular, the coordination between grants and credit is an important factor for a successful development of financial institutions.
5. Topics on setting up a strategy for microfinance in PCS

Demand for microfinance exists during and following conflict, the market being mostly supplied by informal moneylenders often practicing usury interest rates\(^1\) or alternatively just based on household safety nets such as relatives or friends and participation in ROSCAS. Microfinance can play an important role in improving access of SMMEs to financing in the PCS. From the experiences of other countries it is possible to draw some general topics for governments, donors and the private sector on how to support the development of microfinance institutions with the following goals:

- **Permanency.** Maintaining a long term supply of financial services
- **Scale.** Attaining a large number of clients.
- **Outreach.** Reaching SMMEs and the poor.
- **Sustainability.** Attaining financial self-sufficiency.

In order to follow these objectives, important issues need to be addressed when designing a strategy for the sector. These are: (i) the timing for intervention in the post-conflict transition, (ii) the type of intervention (clients, lending techniques and other business model characteristics), (iii) regulation and (iv) donor coordination.

5.1 Relief and development: When to intervene?

With several additional challenges, it is much harder for MFIs to be fully sustainable in PCS. Geetha Nagarajan’s 1997 review of post-conflict microfinance operations in Cambodia, Uganda, El Salvador and Mozambique illustrates this point, suggesting that no MFI surveyed at the time had reached financial self-sufficiency following several years of activity. An important issue is which type of minimal environment is needed for MFIs to start operations and in which conditions. Karen Doyle (1998) on her review of different post-conflict microfinance experiences suggests that the initial set of conditions is quite small with practitioners being able to start up and operate microfinance projects in the most difficult situations. She identifies the following essential conditions:

- Low intensity of conflict.
- Reopening of markets.
- Long-term displacement of refugees and IDPs.

Such conditions, are unsurprisingly, not sufficient for microfinance projects to become sustainable in PCS with Doyle suggesting a set of preferred conditions for MFIs to develop and achieve sustainability:

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\(^1\) For example in Rwanda, Tamsin Wilson (2002) reports the highest interest rate being 100% per day charged by informal moneylenders.
- Functioning banking system.
- Absence of hyperinflation.
- High population density.
- Social capital.
- Availability of skilled workforce.
- Enabling regulatory framework.
- Trust in local currency and financial institutions.

The several conditions are normally not all fulfilled at a certain moment in a PCS and they can be naturally improved with a country’s development. Moreover, conditions may be present in a given country just in certain regions and populations. It is therefore important to analyse not only if conditions are met to start a minimum microfinance operation, but also to define well what kind of operation can be put in place and subsidies needed, as well as if that is a better solution than alternative mechanisms to support SMMEs.

This is specially relevant in the early relief stage of the post-conflict transition, where conditions in general are sub-optimal for microfinance. In the immediate post-conflict scenario, an important upsurge in emergency relief will normally be undertaken by international and national NGOs, as well as IFIs with implications for the success of microfinance operations, such as generating confusion between grants and loans. This is one of the reported problems of early start-up of MFIs, common to many PCS such as Mozambique. There are several ways through which confusion may be built, such as NGOs supplying credit and handing out grants at the same time, some particular programme receiving donor funds for a heavily subsidised credit project or even NGO grant projects being called microfinance. In the short-term, grants, heavily subsidised credit or in general humanitarian approaches to microfinance, reduce demand for credit and may hurt the development of financial institutions targeting SMMEs. On the longer term, a more serious issue is a change in mentality of potential clients, which do not build a culture of repayment. This confusion is not exclusive to differences between relief and development, but also to non-business like attitudes of MFIs. In general confusion translates into increased costs with signalling its true intentions.

Another important factor is that financial services often not being the best solution to some of the early transition needs. This is the case for the DDRRR, where financial services could rather play a complementary role. In fact, for certain war-affected populations such as demobilised soldiers, it has been found that it is best to rely on different poverty alleviating mechanisms such as grants and training services. Microfinance can, however, be introduced later, to supply some of the ex-soldiers

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1 See de Vletter (1999) and Fraser and Candido (2001) for details on Mozambique.
2 Navajas and Gonzalez-Vega (2000) illustrate such costs in the activity of Financiera Calpia in El Salvador. Between 10 and 60% of the MFI’s clients in rural areas had previous experience with former borrowing and Calpia’s loan officers had to invest considerably in differentiating their product and giving explicit signals about their intention to enforce contracts.
with working capital financing for their activities or/and further training. As we mentioned in section 2.1, these factors were seen in Mozambique as the main reasons for the lack of sustainability of SMMEs created by ex-soldiers and other war-affected populations.

The experiences of Mozambique, El Salvador and other PCS do not give an obvious answer of when MFIs should start operations in the relief to development transition. In fact, if many donor-funded microfinance projects in PCS have been short lived, some operations that started early in the post-conflict transition with small operations aiming at sustainability have developed considerably. An example is Financiera Calpia in El Salvador that started operations in 1988, before the war ended, with a small project called AMPES (Small and Medium Enterprise Association) which provided loans to its associates at market rates. The project’s credit division then expanded to non-members and received technical support from Internationale Projekt Consult (IPC), leading to its transformation into a formal financial intermediary certified by the Central Bank in 1995.

However, there are benefits to be explored through greater coordination of relief efforts with financial services provision for SMME development, namely regarding: (i) regional planning of where MFIs may operate and where it is best for relief institutions first to prepare conditions for a later development of financial services, (ii) defining how to minimise impact of grants and heavily subsidised credit and avoid overlap with market-based institutions and (iii) establishing a strategy to maximise synergies between emergency relief efforts and MFI operations. To accomplish such goals, coordination of Government, donors and MFIs will have to be a central part of the microfinance strategy in PCS.

5.2 Type of intervention: selecting clients, products and technology

As in any business, when entering a new market, MFIs need to design a strategy on the type of clients that will be targeted, products that will be offered and the lending techniques used. There is no unique rule on the design of successful microfinance operations in normal or even post-conflict situations and different methods can provide good results. Overall it is found that successful operations in PCS have strong marketing approaches to their businesses, such as conducting market studies to help design appropriate products to meet demand, branding of the institution, selecting simple and efficient technologies capable of adapting to the rapidly changing environment of PCS.

Client targeting

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1 As an example, Financiera Calpià and FINCA registered strong growth in loan portfolio, maintained low non-repayment rates and improved operating performance, while employing different lending methodologies. Calpià provided essentially individual loans, while FINCA is known for its village banks.
The choice of clients to supply financial services in PCS has been done in several ways in the past. Projects select clients by sector of activity, gender, geographic area or according to their poverty level.

- **As in normal development conditions, microfinance practitioners in PCS have found that broad targeting works best in terms of achieving sustainability of operations.** Exclusive targeting of a group of people in post-conflict dramatically increases risks for MFIs and may lead to inefficient interventions. For example, practitioners conclude that it is best not to exclusively target the extremely poor as the less poor also do not have access to formal financial services and are a set of more profitable clients. A diversified portfolio of clients reduces risks and may provide cross-subsidisation of the less profitable very poor.

- **Caution should be taken when supplying microfinance services to high risk post-conflict populations (PCPs) such as ex-soldiers, IDPs and refugees.** Reported experiences of lending to the demobilised have shown that in most cases, the demobilized considered credit as an entitlement, they are not really able to invest it productively and may just end up by selling most assets and not repaying the loans. The main issue is that several ex-military (especially the ones with no past civilian life) have low skills to start-up businesses and often not much willingness to do so. Civil life often bears less status and remuneration than being a soldier (when they can easily collect illegal payments regularly). It is therefore preferable to focus on alternative schemes for demobilisation, not exclusively based on credit, but rather on grants (or for example buying weapons from soldiers) and/or training. Attention should, however, be given to the fact that this is done while minimising distorting effects on MFI development and in close coordination with the DDRRR, normally led by the UN. A possible option is to have short-lived programmes that give a clear signal of their focus on targeting the ex-military and their duration. IDPs and refugees are also considered risky clients because of unpredictable displacements, precarious conditions (living in refugee camps for example) and being often unable to interact economically in their new location due to ethnic, religious or political factors. IDPs’ situation is normally less dramatic than the one of refugees since there is a higher probability that they can interact economically and integrate well with the host community\(^1\). As with demobilised soldiers, MFIs may provide services to these post-conflict populations (PCPs), but exclusive targeting is not advisable and probably less cost-efficient than other strategies to alleviate poverty and reduce vulnerability. However, a careful analysis of the conditions of IDPs and refugees, as part of market studies that precede MFI start-ups, may conclude that they present sufficient conditions to be eligible. With these high risk PCPs, MFIs may, however, play an important role in supporting relief programmes to help the transition towards development\(^2\).

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1. In certain cases, host country regulation does not allow refugees to start any type of economic activity.
2. Doyle (1998) gives the example of World Relief’s activity with IDPs in Mozambique.
Type of products offered: credit vs capacity building?

The choice of products to be offered by MFIs in PCS involves a decision on whether to provide only financial services (so-called minimalist approach) or also to offer “social services” to clients. Secondly, within financial services, MFIs have to select what type of products should be developed.

The following implications can be drawn the experience of post-conflict countries:

- **Due to the lack of skills of individual entrepreneurs in PCS, technical assistance of SMME should normally be contemplated.** There is a great variety of combinations of financial and social services in MFI operations in PCS (maximalist approach) with certain programmes having a greater focus on business training while others provide assistance only as a support to the credit activity (some also make credit conditional on taking part in training programmes). The impact on repayment rates and client performance of a maximalist approach compared to a minimalist one is not really clear from available evidence. However, it was found that in certain cases, training programmes did not respond to any specific demand and were basically supply driven and led to unsuccessful operations. The main concern with a maximalist approach is the extra costs and the different staff mentality required for social services compared to credit. In addition, integrating products other than credit may lead to more complex organisations, with high operating costs and lower flexibility to adapt to the volatile conditions of a PCS. In certain cases, the lack of specialisation of employees and the complexity and size of their tasks may translate into poor client selection and monitoring for the credit activity. Such situations endanger or make it difficult for an institution to become sustainable. There are, however, possibilities to reduce costs of providing technical assistance and other services to MFIs, such as partnering with other MFIs to share such costs or with local universities and other public institutions. Alternatively, MFIs may also consider using their own technical personnel charged with training loan officers to provide training in basic accounting and financial planning. This may actually prove more efficient than having loan officers perform a broad range of tasks. Moreover, training services may also be considered as part of the client screening process for the financial services, translating in some synergies between the two different activities.

- **Products offered in the immediate post-conflict situation should support household coping mechanisms, which were triggered by conflict.** Due to conflict, households adapt to the more difficult conditions through mechanisms such as: (i) reducing consumption (education expenditure is normally cut and food consumption is directed towards cheaper products), (ii) focusing on basic activities such as exploiting natural resources (wood cutting and trading is a very common activity in PCS) and small trade that provides quick returns with low investments and risk (activities with a longer payback period and requiring more investment and risk, only take place once security returns), (iii) diversifying income sources (this is done for example through having family members working in different locations or households being employed in different economic
activities), (iv) using informal financial services for credit and savings to smooth consumption (ROSCAS and moneylenders continue to be extremely active during conflict and in the post-conflict) and (v) liquidating assets because of risk concerns. The implications are the following:

- Clients in the immediate post-conflict situation often prefer short maturity small loans with regular repayments. Experiences in PCS suggest that interest rates are not a major issue, but rather the ease of access and flexibility of the services. An example is loan specification, which in PCS is not really appreciated by clients since they actively diversify income sources.

- Savings services are in demand even during conflict although deposits are usually difficult to mobilise. The success of savings services is normally linked to security considerations, since clients need to trust the country’s stability and the financial institution. Efficient signalling of a strong security organisation can have a positive impact on collecting savings for an MFI. However, to assure good security levels, MFIs often have to engage in high costs, which, depending on the business volume per outlet or “security perimeter”, may become unsustainable. To mitigate security costs, MFIs may to a certain extent engage in partnerships with public institutions, international organisations, private companies or other MFIs to share costs or to simply profit from existing security devices. Savings services are important for MFIs as they help reduce donor dependency. However, because of the risks involved with taking deposits, MFIs must be financially and institutionally capable of meeting the required obligations.

- In rural areas, which are found to have conditions to start microfinance services, products have to be especially adapted to the particular features of rural life. Because of the seasonality of the agricultural cycle, clients have periods of excess liquidity, when they require deposit facilities and periods of limited liquidity, when credit products are in demand. The cycles therefore impose products such as short term seasonal credit to finance working capital during the sowing season and short to medium term loans for investments in fixed assets. Due to the lack of flexibility of rural cycles, clients in periods of very low liquidity often demand loans with principal and interest paid simultaneously in one single payment. This of course increases risk for the MFI, since there is no dynamic monitoring of repayments up to maturity of the loan. In rural areas, due to limited monetisation of the economy, in-kind loans are also often in demand.

* Products should be adapted to the change in demand patterns that accompanies post-conflict transition. With a security situation in place, clients normally start demanding larger loans with

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1 Regarding the possibility of depositing savings in a secure place, Tamsin Wilson (2002) points to households in PCS facing a trade-off between liquidating assets and depositing money (and having more difficult access to it) and maintaining the assets (and supporting the high risk of theft).

2 Several countries have adopted regulations that do not allow MFIs to collect savings.
longer maturities and MFIs should be attentive to the change in demand. In any case, MFIs should charge interest rates to cover costs instead of subsidized credit, since it supports reaching sustainability. With the transition into development, MFIs may have to choose between lending to the very poor and improving sustainability ratios. Despite the overall purpose of having the greatest possible outreach, MFIs may also benefit from securing their financial self-sufficiency first, especially in an environment where donor funds may be rather volatile.

Selecting a lending technology and other business model items

As we mentioned above, there is not a unique lending technology for microfinance, which should be privileged and adapted by practitioners everywhere. On the contrary, many of the best MFI designed lending techniques resulted from a continuous learning and innovation process through interaction with the local communities and with the support of market studies and specialised consultants. Some of the major conclusions from past PCS experiences regarding MFI business models are:

- **MFIs should generally adopt a business like approach to their activity with a strong marketing orientation.** This is done through: (i) conducting market studies to assess demand and competition from MFIs and other institutions, (ii) careful location of outlets (MFI branches are normally most successful when placed in front of markets in order to reduce transaction costs from visiting current clients and also to more easily attract new ones), (iii) planning financing needs and (iv) formulating financial targets. In addition, showing that the MFI is privately owned or differentiating it from its main shareholder and source of funding through a new image and different location, for example, is often a good way of improving repayment rates, as clients will not view the firm as a typical wealthy NGO that is handing out grants. A good example of a very strong marketing approach, which has proven very successful is NovoBanco in Mozambique, which in just one and a half years following start-up of operations became the leading microfinance institution in Mozambique. Regarding marketing, Novobanco has completely differentiated from its shareholders in terms of image and operations and built up a solid reputation in the country. Its outlets are clearly recognisable in front of the main city markets and the bank aggressively advertises its credit and savings products even through promotions. Having begun its activity just in Maputo, the bank expanded to other cities in the country in 2002 and in September 2002 (less than two years after having started operations) had an outstanding loan portfolio of around US$ 2 million with arrears (more than 30 days) just representing 1.4% of loans outstanding.

- **The choice of lending technology should take into consideration the relative efficiency of the different microfinance mechanisms traditionally used to secure good loan portfolio quality, in the particular environment the MFI will be operating.** For example, in situations were social...
capital levels are very low due to lack of trust in the community, village banks and solidarity group lending may be difficult to implement compared to individual lending based on character, business plans, dynamic incentives and collateral substitutes. On the other hand, in places where it is relatively more difficult to have client information and collateral substitutes are difficult to implement, peer selection and monitoring through forms of group lending may be more appropriate. Finally, popular credit and savings informal institutions may also provide useful insights on which type of mechanisms may work best in given situations.

- **Selecting lending technology should also be driven by cost efficiency and investment considerations.** Certain type of organisations may be more expensive than others to operate and also require more upfront investments in fixed assets. Regarding operating costs, Webster and Tucker in their 1996 report on the Cambodian NGO ACLEDA, note that the institution stopped expanding its village banking lending methodology due to high labour costs when compared to solidarity groups, which were less labour intensive.

- **Whenever possible, credible institutions can also profit from money remittances from diasporas in foreign countries.** In fact, in several post-conflict situations the volume of such remittances has been reportedly considerable. For example, in El Salvador at the end of the civil war in 1992, 15% of the urban repatriated and 17% of the urban IDPs received dollar remittances from family abroad, which allowed them to attain income levels above the national poverty line. At present remittances in El Salvador still represent around 12% of GDP. In Eritrea, since independence from Ethiopia, remittances also have been a major contributor to the country’s economy.

- **Human resources policy should deserve great attention.** MFIs have often mentioned that finding good human resources is one of their most difficult tasks. Studies on human capital of MFIs have shown that often personnel lacks proper training and incentives to be efficient in screening and monitoring clients with negative consequences for portfolio quality (in certain cases collusion with borrowers has been identified). One of the serious problems encountered is when staff already had former experience in social services, relief work and even commercial banking. Financiera Calpià provides an interesting example of successful MFI human resources policy. The institution takes on average four months in the selection and training process of its loan officers. In addition, Calpià shows preference for candidates that are recent graduates out of university with no previous working experience, since biases can then be avoided and uses several filters to screen the best, which in some cases comes to choosing just 4% of the total number of initial applicants. During selection, candidates pass an interview and written exam and the ones selected (normally around 50%) have then to pass a field exam to test their abilities with borrowers and in front of peers. When selected, the new loan officer passes two months in training, of which two weeks being taught financial and credit analysis, as well as institutional policies and the remaining time he accompanies an experienced loan officer. Calpià imposes an initial contract of a minimum of two years to the loan officers to compensate for the training expenses.
5.3 Regulation: weighting costs and benefits

Some of the main traditional objectives of regulation\(^1\) are to protect the financial system from collapse, secure the holdings of depositors and manage the money supply. In addition, in developing countries, regulators also see it as a way to promote the development of new financial institutions and, in particular, those targeting SMMEs and low-income households. For all such purposes, regulation is only beneficial if enough resources and political will are present for a proper enforcement of the legal framework, which in certain cases may lead to closing down non-performing financial institutions.

Regulation for financial institutions in developing countries is usually in place and donors assist central banks in defining such rules. However, they usually only cover the commercial banking sector and do not take into account microfinance practitioners (in PCS it is even rarer to find regulation targeting MFIs). There are several reasons that explain such a situation:

- **Supervisors in developing countries lack resources.** It is common for supervisors to be struggling with insufficient resources and high corruption levels to deal with the commercial banking system’s structural problems. They are therefore unsurprisingly reluctant to increase the number of institutions under their coverage. Moreover, given that commercial banks pose more of a threat to the country’s financial system than MFIs, supervisors also prefer to pay attention to banks first. Finally, since many financial licenses also include bail out clauses for depositors, Governments carrying tight fiscal policies are also often resistant to certifying MFIs.

- **Typical ownership structures of MFIs do not create incentives for careful supervision of MFI managers.** In fact, since governing boards are often made of NGO or international non-profit organisations they do not have the same type of invested interests as private shareholders in monitoring management’s decisions.

- **In the case of MFIs, supervisors often cannot make use of some of the typical remedies for institutions in financial trouble.** Tools that are normally used with commercial banking institutions such as capital calls and stopping new loans, cannot usually be applied to MFIs. In fact, shareholders of MFIs often do not have the same financial capability to raise fresh capital (when shareholders are IFIs, red tape may also result in a very slow decision process, in situations where capital is urgently needed). Because of dynamic incentives normally used by MFIs, the decision to stop lending activity, translates into the MFI not fulfilling its contracts with borrowers and may end up destroying the whole loan portfolio. Other type of solutions to financial trouble

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\(^1\) Regulation of financial institutions takes generally two main forms, prudential and non-prudential regulation. The main difference between the two is that with prudential regulation, the financial authority assumes a certain level of responsibility for the soundness of licensed financial institutions. Non-prudential regulation usually includes requirements such as regular disclosure of information on the financial institutions owners, publication of financial statements (includes also establishing rules for reporting of financials and for auditing) communicating names of borrowers, interest rate caps and other.
such as supervisors looking for mergers or acquisitions of the troubled institutions are also difficult to apply to MFIs because loans do not have collateral.

- **Cost of supervising MFIs is usually much higher than that of normal banks.** This is essentially because of the larger number of MFI clients and their decentralised organisational structures. CGAP estimates the cost of supervision of a 10,000 client MFI at between 1% and 5% of total assets, while for normal banks it is on average around 0.1% of assets. The costs are also higher for MFIs than banks, since with smaller but very complex operations they need to comply with similar official reporting to the supervisor agency.

However, looking at the experience of several countries, regulation does not really seem to have been a major obstacle to MFI development. In many cases, it may actually be more dangerous for MFIs to have excess regulation than the opposite, since the requirements introduced by such legislation may contribute to:

- **Less competition among MFIs due to barriers to entry.**
- **Blocking innovation, which is normally necessary to create sustainable and sizeable MFIs.**

Once central banks start regulating MFIs they may start modelling the ideal type of institution regarding client targeting, products offered, lending technologies and other. As we have mentioned above, there is no single rule for creating a successful MFI and the same applies to PCS. It is important to note that in countries where MFIs have developed to become major players in the local financial market (such as Bolivia), they were allowed to experiment rather freely.

One of the dangers of initiating a process of regulatory reform is also that authorities may end up introducing interest rate caps, which in the context of MFIs (with high administrative costs relative to their loan portfolio) would translate into unsustainable operations\(^1\).

Regulation and supervision of financial institutions is therefore a difficult and costly task, which in certain cases may not be justified. **When analysing the type of institutions that should be the target of non-prudential and/or prudential regulation, authorities should bear in mind not only the possible theoretical benefits of it, but also the inherent financial and non-financial costs and exactly how it can be enforced given the supervisor entity’s resources.** From the experience of PCS it is possible to draw some topics for discussion on regulation:

- **Allowing NGOs to provide credit.** In PCS, the commercial banking system is usually not interested in developing products for the poor and it is NGOs that start operations first. However, in many countries regulation only allows certified operators to provide loans and certification is out of the NGOs reach, since it was made for banks.

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\(^1\) CGAP (2000) argues that starting regulatory reviews specifically for MFIs may in certain cases lead to interest rate restrictions since normal banking regulations impose them on commercial banks. They give the example of Latin America, where in the 1980s setting up a special regulation for MFIs would not be politically feasible without interest rate caps, which would undermine the development of the MFI sector.
In the case of MFIs that only provide credit or do it with compulsory savings, it is normally advisable not to submit them to prudential regulation. This is because of the high costs involved for a correct supervision and the low risks involved for the country’s financial system from MFIs that only provide credit. Even with the purpose of excluding the non-performing players from the market, it is found that since they are capital-constrained such MFIs leave the market naturally without the need for prudential regulation. Non-prudential regulation in the form of registration with the central bank, and non-cumbersome reporting such as identifying owners, producing simple financial statements, and other. There is not really an obvious limit to non-prudential regulation, except that it should not become too cumbersome for MFIs or even becoming a serious obstacle to development and be realistic from a supervisor’s resources point of view.

In the case of deposit-taking MFIs, it may be difficult to discriminate which ones should be targeted by prudential regulation and receive an “MFI license”. The usual problem, especially in PCS, with full licensing of MFIs to be able to accept deposits is that they are normally not eligible. In fact, most MFIs are not really in a position to even expect to become profitable, covering current operating costs, as well as administrative costs linked to deposits and other commercial funding. In these situations, when MFIs are just consuming equity to cover their costs it is really difficult to argue that a supervisor should give a license to an MFI and secure its deposits. The argument of scale economies in microfinance is also not an obvious one for licensing MFI, since (i) in post-conflict little is known about the institutions, their managers and even business plans and (ii) some authors argue that in a range of 5,000 to 10,000 clients, most scale economies in microfinance are achieved. However, some authors argue that small deposit taking MFIs without a license, operating in certain remote regions where there are no alternative savings services, should be allowed to continue. The main arguments are that: (i) the local populations would probably be worse off without such services (they already measure the risk of the institution against the risk of maintaining savings at home), (ii) the impact on the overall financial system is minimal and (iii) excluding an MFI from certification, the authority already gives an implicit signal to the market that the MFI does not correspond to certain criteria. Finally, with deposit-taking MFIs the ideal situation would be to supervise all the institutions, which is too costly. Authorities have therefore looked at ways of defining the limit for supervision through a mix of parameters such as assets, number of clients, and supervision substitutes. Regarding the

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1 Compulsory savings do not constitute a major risk for borrowers, as they are normally net debtors to the MFI. Because of their small size, they also do not pose a major threat to a country’s financial system.
2 Of course this argument excludes the possibility of donors continuing to provide funding to unsustainable institutions for a long time. However, experience (especially in PCS) shows that donor funding strategies are normally the opposite, i.e. to just give funds for a short period of time.
3 This can be done through giving MFIs a certificate comparable to commercial banks or even creating a new type of MFI specific regulation.
4 Source of this estimate is Richard Rosenberg and Robert Peck Christen, CGAP 2000.
5 In certain countries, supervisors force MFIs in such situations to clearly inform clients that they are not fully licensed operators.
latter, it can be found for example that if owners are also the main clients (the case of ROSCAS), there will better monitoring within the organisation.

- **Promoting best practices and attracting new MFIs.** Besides the fact that most MFIs in PCS are not profitable, some practitioners believe it is important to create a special regulation to promote the sector in terms of best practice among existing MFIs and also attract new ones. Regarding best practice, maintaining a reasonable record of activity has been identified as one of the main problems of post-conflict microfinance operations. Regulation may therefore provide some incentives for MFIs to invest in reporting just to receive a license, but in PCS it is not given that such mechanisms will work\(^1\). In fact, it is probably easier to motivate investments through a common standards platform with the providers of funding to MFIs. Alternatively, external ratings can also be promoted to attract new funding for local MFIs\(^2\).

- **Authorities may also facilitate the use of typical banking regulation by certain MFIs.** The question on regulation is also one of timing. Since it is not really probable that sustainable MFIs will be identified in the first stages of the post-conflict transition, regulation also does not need to be deeply developed (authorities may well develop only a simple framework that will evolve with the transition). It is, however, useful to maintain an active role in accompanying the sector’s evolution, in order to avoid obstacles to innovative approaches such as excluding banks from starting microfinance operations\(^3\), partnerships between NGOs and commercial banks or MFIs putting deposits in a secured bank account to reduce depositor risk. However, it may be identically dangerous to “facilitate too much” in the sense of, for example, lowering minimum capital requirements without hardening other types of regulation. In addition, given current investor interest for MFIs, institutions that become profitable or that have an attractive business plan backed by solid partners, may usually respond to the minimum capital requirements.

### 5.4 Donor coordination

The role played by donors is very important since they are the major funding source for the majority of MFIs starting operations in PCS. In this sense, donors have tremendous responsibilities in the design and timing of microfinance operations.

In a sense, several of the major topics on designing MFIs in PCS also apply to donors, which should of course strive to build sustainable institutions capable of reaching the poor. However, donor actions have often come under fire in PCS, essentially because of lack of coordination among different donors and with governments and local institutions. Coordination may provide positive results for the development of financial institutions targeting SMMEs, namely through:

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1. One important issue regarding the effectiveness of these incentives is the short term nature of many post-conflict credit projects.
2. Several organisations provide such services at present. Examples are MicroRate and PlanetFinance.
3. Banking regulation is normally does not take into account the specificities of microfinance, such as unsecured lending.
- Eliminating unfair competition.
- Avoiding duplication of efforts.
- Obtaining good market knowledge more quickly.
- Promoting improvement in MFI standards.

The following discussion points on the role of donors are most common to coordination problems in post-conflict situations:

- **Separating relief from development.** Critics have stated that donor projects in microfinance do not always access well the transition from relief to development and create confusion among beneficiaries and waste of resources. The fact that different donors finance contradictory projects such as relief and development services in the same area is an example of this. Another important issue is that once development projects start, donors should essentially support those projects, which are conducted by specialists in microfinance. Supporting projects by relief workers, which aim to transform emergency interventions into MFIs, has proven to obtain just poor results in most post-conflict situations.¹

- **Minimising distortions.** As we already mentioned before, donor actions introduce several distortions, which should be minimised. One of the major issues is donor subsidies to MFIs (direct or through loans at concessionary rates), which in excess may hinder the development of financial markets. Donor funds can be used for capacity building in PCS, as it is normally the case, but they should not contribute to continuously cover loan losses and therefore artificially support inefficient operations that may hurt other MFIs’ performances² and also contribute to establish donor dependency, reducing mobilisation of local resources³. This is especially important, since the supervisory authorities normally do not have enough resources to control MFI standards and also to shut down inefficient operators. That said, most MFIs will need funding to start their operations in PCS and due to the difficulties they face, donor funding is normally required for some time. Donors then have to select the best projects, when investing but this is not an easy task as structural inefficiency of microfinance operations may be hard to determine in a PCS because of MFI diversity and the existing constraints to development. Donors may, of course, conduct their individual appraisals and judge factors such as management quality, business like attitude or how objectives have been met. However, they may also benefit from dissemination of information regarding best practices of MFIs and this can be done through a common platform with other

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¹ For example in Mozambique, several of the relief organisations that started operations during the civil war tried later in the transition to development to start credit schemes. Most of these schemes which combined some sort of technical assistance with credit were facing serious difficulties in the late 1990s and did not seem to have the capability of becoming sustainable MFIs (de Vletter 1999).

² Certain IFIs are increasingly focusing on capacity building of MFIs instead of subsidising the operating costs of NGOs.

³ The abundance of donor funds sometimes works as a deterrent for MFIs to provide savings services.
donors, international organisations specialised in microfinance, local MFI federations and the supervisor authorities\(^1\).

- **Designing an exit strategy.** One of the main difficulties in PCS is that institutions are often constructed with a short term idea somewhere halfway between relief and development. In fact, projects in PCS tend to have high mortality rates simply because they are designed in such a temporary way with no donor exit strategy planned from the beginning. Of course this undermines credibility of institutions with clients (which are deprived of further loans from one day to the next), not contributing to a sustainable development of microfinance. Donors should therefore aim at supporting projects that may at least become partially sustainable, in order for MFIs to be able to seek alternative funding or even becoming fully independent. An apparently successful strategy is to support projects incorporating valid local partners and international microfinance specialists.

- **The role of apex institutions\(^1\).** Apex institutions have been used by donors to capitalise MFIs, sometimes in the form of revolving funds and to provide technical support. They have also been promoted by MFI associations and public authorities, as a way to define a clear window to attract and coordinate donor funds and also to promote capacity building of MFIs, among others. In fact, there seem to be several potential benefits from creating apex institutions such as: (i) concentrating and attracting donor funding through greater visibility, (ii) MFIs sharing some of the costs such as SMME capacity building, security costs and other (iii) possibility to raise MFI standards through training programmes and peer pressure. Several experiences of apex institutions have, however, faced difficulties such as (i) pressure from donors to disburse funds to MFIs, while funds made available are exaggerated for the number of feasible projects, (ii) problems in harmonizing donor requirements and (iii) difficulties in linking MFIs to commercial funding. It is therefore important that the designers of apex institutions look for innovative ways to face these issues. In particular it should be considered that: (i) many of these institutions are normally temporary and therefore MFI dependency should not be constantly promoted, (ii) they need strong management capabilities in order to do a proper selection of MFIs to fund, (iii) donor harmonisation should not be done at the expense of increasing significantly administrative costs for MFIs, (iv) solutions should be sought that avoid conflicts of interest as apexes have links to donors, public sector and MFIs.

\(^1\) In Mozambique, only seven years after the end of the war did international donors consider a common statement on common standards for MFIs. Such action was due to an increasing lack of coordination which was starting to impact negatively some of the credit projects, as well as the need to promote sustainable institutions.
6. Opportunities in DR Congo’s context

6.1 Overview of the economic and political situation in DRC

The situation of the Democratic Republic of Congo is a very complex one. The country is now one of the poorest in the world following a long lasting war and deep economic mismanagement. According to The World Bank\(^2\), around 80% of the country’s 52 million inhabitants survive on less than US$ 0.2 per day and around 16 million people are estimated to be starving or malnourished\(^3\). As some of the local individuals the DEV mission met in January 2003 commented: “everything is to be done”.

Economic situation

On the economic front, the government of President Joseph Kabila has managed to re-initiate close cooperation with the Bretton Woods institutions, as well as other IFIs. In December 4 and 5, 2002 The World Bank organised a meeting in Paris with a delegation of the Congolese Government and representatives from 13 donor countries and 12 international organizations including the IMF. According to The World Bank’s press release “Participants welcomed the progress made by the Government of DRC and recognized the international community’s support as a key element for the success of the country’s recovery. They announced or confirmed financial contributions for a total exceeding US$2.5 billion”. In August 7, 2002 the World Bank agreed to lend US$410m to DR Congo aimed at improving agricultural production and restoring infrastructure. In addition, the bank’s International Development Association also supplied a US$ 44m grant to DR Congo, targeting support to projects on AIDS prevention and treatment. In addition, The World Bank is already heavily involved in designing restructuring measures for DR Congo’s state-owned companies, rehabilitation of the country’s infra-structure and fostering private sector development and competitiveness. The IMF resumed work with the DRC in 2001 and, following the payment of arrears by European countries (Belgium, France and Sweden), the institution has approved in June 2002 a US$750 m loan under the Poverty Reduction and Growth Facility. It has been providing significant technical assistance to the Congolese authorities and monitoring the implementation of reforms.

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One of the government’s first priorities in 2001-02 has been macro-economic stabilisation. In 2002, inflation has been finally brought down to a two digit figure through restrictive budgetary and monetary policies and having put a halt to the monetization of the deficit. The country’s inflation rate, according to the Finance Ministry, stood in 2002 at around 15% against 135% in 2001 and 511% in 2000. The country’s GDP growth rate, also according to the Finance Ministry, should have reached 3% in 2002, while the IMF estimates between 2 to 2.5%. Such annual growth is above what has been registered over the last 12 years.

Stabilization was accompanied by several structural reforms since the beginning of 2001, such as:

- Liberalisation of the diamond trade;
- Liberalisation of oil imports;
- Implementation of a floating exchange rate system in May 2001;
- Implementation of Central Bank independence. In April 2002, new statutes of BCC (Congo’s Central Bank) were published, establishing its independence in the conduct of monetary policy and the setting of interest rates, with the overriding objective of domestic price stability;
- Taking the first steps towards restructuring of the State-owned companies by a new unit created to that purpose: the COPIREP (Comité de Pilotage de la Réforme des Entreprises Publiques);
- Publication of several new codes, as well as a law creating commercial courts (July 2001). The new investment, mining, forestry and labour codes were published in 2002. A Code of Ethics and Good Conduct applicable to all levels of the civil service was also published to try to tackle governance problems;
- Reform of the tax-collecting institutions in 2002 and creation of a large enterprises’ unit within the Direction Générale des Contributions (DGC). The World Bank is currently studying the fiscal system and there is work being done to reduce taxes from 3000 to 900;
- Creation of ANAPI (Agence Nationale pour la Promotion des Investissements), a “one stop shop” for national and foreign investors wishing to invest in DRC;

Following these structural reforms and close cooperation with the IMF and The World Bank the country has thus been able to re-gain international credibility and break out of its financial isolation. Recently, the US Government has decided to include the DRC in the group of countries benefiting from commercial advantages in the context of AGOA (African Growth and Opportunity Act).

Despite good progress in reforms over the last two years under the Kabila administration, the country is still in a very fragile situation and has a lot to do in terms of creating an appropriate business
enabling environment. A good example of the latter is the country’s public administration’s performance, which has been the target of much criticism from the private sector operators due to:

- **Opportunistic behaviour of tax officers.** Companies in DRC that produce positive results are constantly harassed by tax officers that try by all means to deprive them of their profits. One of the main reasons for this is the difficult working conditions with civil servant wages averaging US$15 per month. As a consequence, reliable companies working in DRC employ one or two individuals exclusively charged of discussing with tax officers that visit them almost on a daily basis.

- **Inefficiencies and corruption in the customs administration, which is contributing to increasing illegal imports.** A study being carried out by the French Cooperation indicates that only 12 to 15% of the products entering the Matadi port facility are referenced by the customs administration and of those listed, little is known whether they pay tariffs.

- **The State’s indebtedness vis-à-vis local operators.** This is seen as a serious obstacle to improvements in the Government’s domestic credibility and to private sector development. According to some of the domestic operators, only the recently accumulated part of the internal debt is estimated at around USD 900 million, while its full amount is of US$ 3 billion.

There are several other problems impacting negatively the development of the country’s private sector such as:

- **The existing legal insecurity and increasing weight of the informal sector in the economy.** There is a critical lack of courts and existing ones are unreliable and hurt by corruption. Regarding the several new laws approved during 2002, some of them have very good contents and structure, but they are still far from being implemented “on the ground”. In such a context, an increasing number of companies join the informal sector or simply leave the country, occasionally selling their activities to informal sector operators (this was the case of Unilever that sold its Congolese operations to an Asian group in 2002, which already operated in the informal sector). The growing weight of the informal sector in DRC (for example, the formal private sector in Kinshasa - 7 million inhabitants - is estimated to employ only 20,000 people) is putting pressure on formal sector operators due to unfair competition, as well as contributing to lower tax income to finance the national budget.

- **Local production is not competitive with imported goods.** In part, this is explained by high electricity and water costs, but also due to a degradation of the country’s industrial equipment. Regarding the latter, the political uncertainty and plundering lived during the nineties did not allow capital-intensive industries to maintain adequate levels of maintenance capex. There are only 8 big industries in the country (brewing, tobacco, cement, milling, sugar and textiles), which work on average at 25% of installed capacity and are nearly bankrupt. Rich country subsidies to their products, also severely hit the local producers.

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1 This section draws on interviews to private sector operators, international organizations, civil society members and
**Lack of several of the key transport infrastructures necessary to reactivate the economy.**

This is the case of navigation on Congo river from Kinshasa up to Kisangani. Navigation still has to be secured from pirates. The river route to Kisangani (15 to 20 days sailing) is vital for evacuation of products, in particular agricultural ones, to local and international markets as well as to supply both agricultural inputs and general goods to the populations.

In spite of this environment, some FDI has entered the country and established companies have shown commitment to stay. FDI inflows have been important in the telecommunications, mining and forestry sectors. In the case of telecoms, one of the main players, Vodacom (South Africa), which recently invested US$ 180m, made its fund raising in Europe and was partly secured (30-40%) by ECIC (Export Credit Insurance Corporation of South Africa). Lately, the European private sector has also shown interest for the DRC. Examples are the MEDEF (Mouvement des Entreprises de France) mission in November 2002 with 30 French companies and a mission of FEB (Fédération des Entreprises Belges) that took place in February 2003 with 120 companies.

**Political situation**

The political situation has also seen some progress with the Kabila administration, advancing the process initiated with the peace agreements signed in 1999 in Lusaka with Rwanda and Uganda, the two countries taking part in the war in the Eastern provinces of the Congo. There have been further deals to organise the retreat of the troops from these nations stationed in the East of the DRC. Regarding the process of national reconciliation, on December 17, 2002 in Pretoria, the Congolese government signed an agreement with all the other parties participating in the country’s civil war. The all-inclusive power-sharing deal previews the establishment of a government of national unity and puts an end to four years of war. Under the agreement, President Joseph Kabila will remain in office for the next two years until the country's first elections. He will be assisted by four vice-presidents, respectively representing the Government, the Rassemblement Congolais pour la Démocratie-Goma (RCD-Goma), the Mouvement de Libération du Congo (MLC) and the unarmed political opposition. The all-inclusive deal is, however, still to be implemented as there are still many points that lack a clear consensus, such as the interim Constitution for the DRC, the integration of the various warring groups into a national army and the security for the leaders of the transition process in the capital and elsewhere in the DRC. These topics have been recently discussed in Pretoria with representatives from the parties of the all-inclusive deal and normally the inter-congolesian dialogue should come to an end in a final meeting in April 1 and 2 in Sun City, paving the way for the transition government. Moreover, the peace process has been troubled by news of inter-ethnic fighting, pillages and severe human rights violations, such as the recent events in the Ituri region (eastern part of the Orientale province), which
led Presidents Museveni of Uganda and Kabila of DRC to launch the Ituri Peace commission on February 19, 2003 to oversee the peaceful settlement of the conflict in northeastern Congo.

6.2 Main obstacles to SMME development in DR Congo

SMMEs: development or survival?

The private sector in DR Congo has suffered from the overall deterioration in economic activity due to the war situation and persistent economic mismanagement. Professor Kalonji Ntajala from the Faculty of Economics of Kinshasa provides and interesting analysis of the evolution of the private sector structure¹. He suggests that the private sector in the DRC during the second half of the XXth century has been through three main stages:

- the “foreign industry” stage from 1956 to 1974, when the Congo had a GDP per capita of around US$² 760.
- the formal small and medium enterprise (SME) period from 1976 to 1985, characterised by the oil crisis, the “zairisation” and structural adjustment programmes with the Bretton Woods institutions.
- And the informal SME stage from 1986 to 1995, where the progressive decline in income levels led to the development of a new type of private sector firm: the informal SME, which is part of household survival strategies. There is also a proliferation of NGOs that come to assist the population through relief projects.

This last phase still persists today, most probably as a consequence of the continuous decline in living conditions in the country. Such fragmentation of the private sector is therefore the result of some of the household coping mechanisms that we have mentioned above in this document and which are common to post-conflict situations. According to CADICEC (Centre d’Action pour Dirigeants et Cadres d’Entreprise Chrétiens) in 1996, the formal private and public sectors only employed around 1 million Congolese or around 2% of the country’s population. The CADICEC also estimates that most of the Congolese are now self-employed in the form of micro-enterprises.

The SMME sector is therefore, unsurprisingly, one of the main concerns of several civil society associations and NGOs. It has recently become also one of the priority issues for the Government agenda, which has created a Ministry specially dedicated to SMMEs (Ministère des Petites et Moyennes Entreprises).

¹ See CADICEC publication nr. 79/80, fourth quarter 2000.
² 1990 US$. 
It is difficult because of lack of information, to understand the current structure of the SMME sector in DR Congo. A CADICEC study in the period 1995-1998 on a sample of 1,500 SMMEs from Kinshasa, Matadi and Mbnza-Ngungu (Bas-Congo province) provides some guidance on the sector’s structure (table 3). From the characteristics of SMMEs and managers profiles in the CADICEC report, one can see how self-employment has become a survival strategy for most Congolese. Of course, it would be necessary to have more detailed research on SMMEs in order to understand better their contribution to development. However, from the CADICEC experience and from evidence of other post-conflict situations, one can argue that a majority of SMMEs in their present condition are not part of a development process, but rather household coping mechanisms, which do not allow their owners and employees to increase income, accumulate assets or substantially reduce vulnerability to external shocks.

**Table 3: Selection of results from CADICEC’s study on a sample of Congolese SMMEs**

<table>
<thead>
<tr>
<th>Characteristics of SMMEs</th>
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</thead>
<tbody>
<tr>
<td>Around 70% of SMMEs in the study are recent, having started in the 1990s, which coincides with the deterioration of the economic and social climate.</td>
</tr>
<tr>
<td>In urban areas SMMEs are usually well known from the local public authorities. CADICEC estimates, however, that around 40% of SMMEs do not have any legal working permit.</td>
</tr>
<tr>
<td>A great diversity of economic activities is conducted by SMMEs (services, manufacturing and subsistence agriculture).</td>
</tr>
<tr>
<td>Technology is mostly inexistent, making use of second hand production capacity with very low productivity levels.</td>
</tr>
<tr>
<td>Around 41% of the sample SMMEs have weekly sales in the range of US$ 200 – US$ 500 for the trade and services sectors and a range of US$150 – US$ 300 for the other sectors. During their average 5 year life, SMMEs record average growth rates of 10% in sales. 25% of SMMEs register weekly sales below US$ 200 (trade and services) and US$ 150 (other sectors).</td>
</tr>
<tr>
<td>Only 2.2% of the sample SMMEs produce business plans, most of the interviewed stated that due to uncertainty it was not really useful to do it.</td>
</tr>
<tr>
<td>80% of SMMEs register low indebtedness, mostly because of lack of access to credit.</td>
</tr>
<tr>
<td>In 77% of SMMEs, salaries are paid as a function of the company’s sales and are therefore not regular and guaranteed. To satisfy their needs, most workers have to maintain several different income sources and household organisation is crucial on this issue. Providing social services to the workers is in most cases seen as a favour and not a duty.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profile of entrepreneurs</th>
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<tbody>
<tr>
<td>42% of entrepreneurs have ages between 30 and 40</td>
</tr>
<tr>
<td>55% have attained high school level and 28% university studies</td>
</tr>
<tr>
<td>Entrepreneurs normally prefer to work alone or exclusively with family members. Lack of trust on</td>
</tr>
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</table>
other individuals is the main reasons given for this attitude.

SMMEs and the household are usually not separate entities with the SMMEs cash balance being used to smooth household consumption and for other expenses.

The majority of micro-entrepreneurs are women. Most of women-managed SMMEs are not really sustainable operations mainly because income is almost entirely directed towards household consumption. In the sample an average of 60% of women’s income is spent on food for their family.

Source: Adapted by the author from CADICEC publication nr. 79/80

Obstacles to SMME growth in DR Congo

In order to identify strategies to foster the development of SMMEs, in a way conducive to reducing poverty and vulnerability of owners and employees, it is important to understand the main difficulties faced by SMMEs in their development. Data of course is a major problem and we have used some of the CADICEC study results in this section (table 4), as well as from interviews conducted in Kinshasa from January 18 to 25, 2003.

Table 4: Selection of results from CADICEC’s study on a sample of Congolese SMMEs

<table>
<thead>
<tr>
<th>Main obstacles to SMME development</th>
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<tbody>
<tr>
<td>53% of SMMEs have stated their main problem is financing, especially for working capital. 99% of the sample SMME have not received loans from formal institutions and only 8% have benefited from informal credit</td>
</tr>
<tr>
<td>60% of SMMEs have working capital needs and the most common found solution is to use client advance payments, credit from suppliers and loans from friends and family.</td>
</tr>
<tr>
<td>There is no concern from SMME managers in improving their production tools through investments.</td>
</tr>
<tr>
<td>Social-cultural factors such as lack of respect for contracts and family interference contribute to the lack of a proper business-attitude.</td>
</tr>
<tr>
<td>SMMEs state that fiscal charges are one of the main problems they face. Two main factors are mentioned: (i) the large number of different taxes, (ii) fiscal contribution is often based on sales and not on net income.</td>
</tr>
</tbody>
</table>

Source: Adapted by the author from CADICEC publication nr. 79/80

Several of the problems faced by SMMEs are comparable to the ones mentioned for the DR Congo’s overall private sector. However, regarding difficulties specific to SMMEs, three main types of obstacles can be suggested:

- **Largely insufficient production and management skills.** This is mostly a consequence of the war and consequent interruption of education. Moreover, the climate of uncertainty does not help
entrepreneurs investing on a more medium to long term horizon and their strategy is mostly short term and part of a household logic.

- **Disrupted social capital.** An example of social capital disruption is the lack of trust among individuals being referred to as a major problem leading to individuals favouring family-type structures to more formal enterprises in CADICEC’s research. In DR Congo, the plundering during the nineties has magnified such distortions, which reduce the capacity of community members to associate. They also impact negatively the costs of establishing contracts and enforcing them.

- **Financial constraints.** As can be seen from table 4, financing (especially for working capital needs) remains one of the major problems for SMME development.

### 6.3 Financing SMMEs in DR Congo

Access to financial services, especially credit seems to be one of the main problems impacting SMME development in DR Congo. The reasons for such a situation are also similar to some of the factors identified in other PCS. In DR Congo’s case we highlight the following:

- The formal banking system is almost inexistent.
- The microfinance sector is underdeveloped.

**Formal banking system was downsized considerably**

The DR Congo’s banking system has suffered tremendously with conflict and economic mismanagement that characterised the country for a long time. Banks are operating in a survival mode, trying to keep costs to a minimum in order to maintain their presence in the country and wait for a more stable situation. The diversity of banking services available is therefore very small and outreach (geographical or in terms of client types) is minimal, concentrated in the large urban centres and some specific large clients.

In DR Congo there are currently 9 banks accredited with the central bank (the BCC – *Banque Centrale du Congo*), of which only 5 to 6 work properly. The number of total bank accounts in the country is ridiculously small, estimated at around 35,000. Savings are, unsurprisingly at an extremely low level, estimated at only USD 150 million for the whole of the Congolese banking sector. Credit activity represents less than 1% of GDP.

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1 Data on this section collected through interviews by the author with the BCC and private banks such as Citibank and Banque Commerciale du Congo.
The DRC’s banking sector activity consists essentially of currency exchange services and trade financing (around 80% of bank revenues on average). Corporate banking and other only account for 20% of total bank revenues. Commercial banks have suffered more than the overall economy and they had to go through deep restructuring. For example, Citibank Congo went from 150 employees in the 1990s to just 40 at present and BCDC (Banque Commerciale du Congo), DRC largest financial institution, saw its activity fall by 80% since 1990 and has reduced headcount from 3,000 (1990) to just 280 at present. Moreover, rural outlets have been closed down.

Regarding clients, formal banks estimate that only between 100 to 200 companies in the country are worth considering as reliable clients. Credit activity with SMMEs does not take place as Congolese banks openly confirm that they do not lend because collaterals are insufficient and difficult to exercise, and they do not find good clients. 80% of credit outstanding is in USD and the maximum maturity is of roughly 6 months, which for several of the players in the market is already considered to be long term.

**Microfinance sector is underdeveloped**

*Traditional microfinance*

Microfinance has already deep roots built over a long period of time in the DR Congo. It has been one of the supporting mechanisms for the Congolese, especially in areas far from urban centres. The main historical players have been NGOs, supporting different types of development at the community level, but also COOPECs (credit and savings cooperatives) along with informal moneylenders and the tontines (type of ROSCAS).

The main Congolese traditional type of financing institution reaching SMMEs even in more remote areas is the COOPEC. The majority of COOPECs have started operations in the 1970s and in the 1980s expanded to low-accessibility areas where the banking system was not present, through leveraging the infrastructure of schools and religious centres. Most COOPECs were affiliated to a union, the UCCEC (central union of the credit and savings cooperatives). In 1987, these cooperatives accounted for 7% of the total savings of the country’s banking sector and in 1989 the UCCEC included five regional networks totalling 145 cooperatives, more than 270,000 members and US$ 4.9 million in savings. In the early 1990s, the joint effect of plundering, hyper-inflation and political instability have caused severe damage to the COOPEC system, which lost around 80% of their clients and 66% of the funds placed with commercial banks between 1991 and 1993. In 1993, the monetary reform to implement the new currency, “new Zaire”, also hurt the COOPECs, as most of its bank accounts were frozen and became inconvertible. At present, it is difficult to now how much of the COOPEC system is still on its feet, but it has become much smaller and faces severe problems, in
particular, lack of trust from the population due to the dramatic episodes of the early 1990s. The COOPEC are, at present, concentrated in two structures, the already mentioned UCCEC and the CONACEC, which in turn are part of RIFIDEC (group of decentralised financing institutions - *Regroupement des Institutions de Financement Décentralisé*).

Another important type player in microfinance in DR Congo are NGOs. There is a great diversity of NGOs with different approaches to development including mixes of technical assistance and credit. Many NGOs have been federated in a structure, the CNONGD (national council of development NGOs), which acts as their representative. NGOs have played an important role in assisting and fostering community development throughout the serious difficulties the country has seen. Their experience in DR Congo provides very useful insights on social and cultural factors in implementing development strategies. In financing, ADI-KIVU (action for the integrated development of the Kivu) for example, started their operations initially by giving assistance to communities in the utilisation of savings they had accumulated in COOPECs. Later on, the NGO started its own credit operations, through rotating credit schemes directed to rural associations. Because of inflation, member often decided to have credit in the form of physical assets. The experience of ADI-KIVU in Bushi (South Kivu) described by M. Kabarhuza highlighted the impact of credit on: (i) women groups raising cattle and developing small trade activities, (ii) small coffee producers financing the transportation costs of their products to Bukavu (largest town in South Kivu) and Rwanda, (iii) fishermen in Katana renovating their fishing equipment.

Finally, small moneylenders also constitute part of the microfinance system, which is also a characteristic of most developing countries and PCS. They are mostly present in the urban centres and are normally seen as very flexible but tremendously expensive source of funding, which often is linked to illegal activities. These informal operators often demand 50% weekly and sometimes daily interest charge to micro-entrepreneurs, and therefore do not allow any capital accumulation by borrowers.

*Present microfinance initiatives in DRC*

The lack of financial services in DRC, the prospects of some political stability and the high demand for credit, has led several additional NGOs and firms to start providing financial services to SMMEs.

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1 For insight on the important work of NGOs since the mid eighties in assisting the development of the rural poor in DRC, please see the book by Baudouin Hamuli Kabarhuza “Donner sa chance au people Congolais: Expériences de développement participatif (1985-2001)”, ed. Karthala.

2 Some products became quite well-known such as the “crédit chèvre” (goat credit) and other, which were in high demand from rural populations. Some of the success factors of this type of products in rural areas, where the fact that it was based on individual lending and targeted women, which saw in it an opportunity to access ownership of assets and improve their status on family decision-making.
An example is Micro-Yield, a company established in 2001 with 7 employees, giving out a total of USD 120,000 in credit to 250 clients with a repayment rate of 85% in its first year of operation. The company charges a rate of 0.45% per day for its loans with a maturity of usually slightly less than a month. Most of its client base is composed of small traders in the “cités” of Kinshasa. An important feature of the lending technique is that the group allows clients to become associates of Micro Yield following repayment of three loans. These associates can then suggest new clients that they know are respectable. Such a system reduces client screening costs for the MFI.

It is, however, difficult to assess the size of the microfinance industry in the DRC today. The available institutions are estimated to be largely insufficient and lacking quality by practitioners on the field. One of its main organisations, the RIFIDEC registered at the beginning of 2003, 75 effective members (of which 57 MFIs, 15 COOPECs and 3 technical assistance providers) and 126 non-effective members (of which 113 MFIs and 13 COOPEC). The RIFIDEC has been created in 2000, as an initiative of COPEMECO (confederation of small and medium sized enterprises in Congo1) with financing from GTZ. Its main objectives are (i) to promote and improve the overall quality of the microfinance sector in DRC, (ii) to reinforce the organisational capacities of its members and (iii) to defend their members’ interests. The RIFIDEC has been conducting several projects such as training to improve MFI management capabilities, dissemination of best practices (including from other countries through participation in sector conferences), market studies to improve services made available by MFIs, structuring an active dialogue with the national authorities2. The institution, which already is seen as a valid partner in DRC by MFIs and the BCC and is present in several regions (Kinshasa, Bas-Congo, Katanga and the two Kasai) is trying to evolve in the sense of becoming an apex with separate divisions for capacity building and refinancing of MFIs. Regarding the latter topic, RIFIDEC already started an experimental fund of US$ 250,000, which gave slightly more than US$ 24,000 in loans to 6 MFIs during 2002. It is, however, still too early to measure well how successful the refinancing activity is.

Other initiatives include CECI-PME (savings, credit and investment cooperative for SMMEs), an affiliate of COPEMECO, which collects savings and gives credit to its members. The lending technique is based on an initial screening of clients through knowledge from their membership in the confederation and also from having taken part in the training courses. SMME’s can ask for credit three months after having joined the confederation and additional screening is based on the SMMEs financial situation, but also on business plans for use of loans. CECI-PME demands collateral and 30% of equity investment, although it allows collateral to be substituted by other mechanisms such as

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1 This NGO which receives support from GTZ was created in 1991 and represents the interests of 3,500 SMMEs. Its main goal is to support the development of SMMEs through training and financing services, as well as promoting the sector with government and international organisations.

2 In this sense, the RIFIDEC has been active in the dialogue that led to the adoption of the regulation on COOPECs in February 2002 and also on the new regulation for MFIs to be adopted in 2003.
group lending. The average maturity for a loan is between 6 and 12 months, and monthly interest rate is 5%. In the period from 1996 to April 2001, CECI-PME had given credits for a total of USD 555,000 in the Kinshasa area, representing just 20% of the total amount demanded during that period. Average loan size stood at US$ 2,700 showing that CECI/PME’s clients are not among the poorest. The institution also provides savings facilities in US$ and local currency. It has also started a micro-bank project for women with the experimental phase having taken place in 2002 in several regions of the DRC, based on community lending techniques for groups of around 30 women.

Recent steps in central bank regulation of microfinance

The Congolese government has shown interest for the development of SMMEs and microfinance operations. In this sense, the government has created a ministry specially dedicated to SMMEs and has set up a microfinance special unit at the central bank. The microfinance unit at BCC has been created in September 2000 with two main objectives:

- Produce a reliable and updated database on the sector and follow its performance
- Control the compliance of MFI and COOPEC operations with regulation

Since then, the BCC has produced legislation on COOPECs and is in the process of doing the same for MFIs. The unit has started a dialogue process with RIFIDEC and other associations, as well as individual MFIs and COOPECs.

The current regulation on COOPECs and MFIs is basically a set of non-prudential requirements, such as:

- Official recognition by a local authority of the existence of the association.
- List of the shareholders of the institution and transcripts of money transfers when raising capital for the institution.
- CVs and judiciary reports of all top managers of the institution.
- Description of their accounting rules and financial procedures.
- Business plan on the start-up of operations.
- Details of initial capital and number of employees.

As the sector is just starting to be developed in the DRC, such regulation leaves room for innovation without really putting any major risk on the country’s financial sector.
The development of microfinance services in DR Congo presents an opportunity to provide financing to SMMEs and thus play an important role in alleviating poverty, reducing vulnerability and contributing to economic and social development of the country. There is no “one way” to develop financial institutions able to finance SMMEs and normally competition and innovation should be promoted to achieve the best results. Through a brief analysis of the DRC situation and the review of post conflict microfinance projects in different countries, some topics seem to deserve particular attention for discussion on the development of microfinance in the country:

- A regional approach to microfinance
- Public-private partnerships for capacity building
- Creating an enabling environment for microfinance
- Coordination of donor efforts

A regional approach: exploring “islands of stability”

It is difficult to estimate what is the exact demand for financial services in DRC at the moment given that no appropriate market research has been conducted. The reports from practitioners on the field and the experiences of other post-conflict situations suggest that demand is high at this stage of the country’s transition. In addition, adapting Doyle’s necessary and preferred conditions analysis to the present situation of the DRC shows that several of the conditions for the development of MFIs are already in place (tables 5 and 6).

The analysis of necessary and preferred conditions, also suggests that as in other PCS, they are not fulfilled in the same way across different regions in the DRC. In turn, this suggests that a regional approach to the development of microfinance operators may be most successful. Microfinance practitioners can probably achieve better results in terms of sustainability, permanency, outreach and scale of their operations by selecting those pockets of stability in the country, which present the best conditions in terms of market demand and lower operating cost structure. An example is the Kinshasa area, which with over 6 million inhabitants has one of the largest populations of African cities (together with Lagos, Cairo and Johannesburg), where banks are available to make deposits to secure funds and it is probably easier to find skilled personnel.

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1 Interviews conducted by the author in DRC to MFIs, private companies and representatives of the government.
Table 5: Analysis of necessary conditions for microfinance in DRC

<table>
<thead>
<tr>
<th>Necessary conditions</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low intensity of conflict</td>
<td>It has been fully achieved in regions of the country controlled by the government, but is still lacking in some others, especially in the Kivus, Orientale and Kasai Oriental provinces. The situation may improve dramatically with the full implementation of the agreements resulting from the inter-congolesse dialogue, as well as the full evacuation of foreign military in the DRC.</td>
</tr>
<tr>
<td>Reopening of markets</td>
<td>In the areas where conflict has not taken place over the last two years, markets are now operating. In addition, in the Kinshasa region there has been a large effort put by authorities on facilitating circulation of goods and people, greatly helping market functioning. There is still great potential for improvement with progress in the peace process and re-opening of the Congo river to traffic.</td>
</tr>
<tr>
<td>Long term displacement of refugees and IDPs</td>
<td>According to a UN inter-agency mission report dating from February 2003(^1), there are around 2.7 million IDPs in the DRC, against 2 million reported one year before(^2). The hardest hit provinces are North Kivu and Orientale where around half a million people have been displaced in the last six months(^3). However, the number of IDPs in Bandundu, Bas-Congo, the Kasais and Kinshasa is not as high and in most provinces pockets of peace and stability can be found(^4). Despite the peace process, the situation in the Eastern part of the country might still take some time to improve, as the IDP and refugee situation has been deteriorating and in certain cases is has been prolonged(^5).</td>
</tr>
</tbody>
</table>

Source: UN reports, Interviews conducted by the author in Kinshasa

Stability areas with strong potential across the country should be identified in order to promote the development of strong microfinance institutions. In situations of: (i) emergency, (ii) chronically disadvantaged rural areas or (iii) illness keeping people from productive activities, the provision of microfinance services is not always the best option. With the destitute microcredit may only work if efforts are undertaken to provide an initial safety net, to build skills and increase confidence. In some cases it is probably preferable to have well-targeted heavily subsidised schemes or simply micro-grants and training programmes being supplied in such areas. Microfinance institutions that carefully select their markets, may be able to find enough funding to expand their activities to less profitable areas. They can also use their initial market to cross-subsidise operations in places of higher risk.

SMMEs in a regional context: a tool to facilitate regional integration, leveraging potential commercial ties with neighbour countries. Due to the geographical situation of the country, a regional approach to developing financial support to SMMEs is important.

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\(^1\) For more details refer to the UN Office for the Coordination of Humanitarian Affairs (OCHA) report of February 21, 2003.

\(^2\) In 1999, the total number of IDPs in the DRC was estimated at around 800,000 by UN OCHA.

\(^3\) Other provinces such as the South Kivu and Katanga also register each more than 400,000 IDPs.

\(^4\) In all these provinces, the number of IDPs is reported by OCHA below 100,000. There are no IDPs reported in Bas-Congo and Bandundu, while in the Kinshasa province the number of IDPs is estimated at 40,000 or far below 1% of the population.

\(^5\) This is the case, for example of the more than 400,000 IDPs in Katanga, which are in this situation for almost three years now.
Table 6: Analysis of preferred conditions for microfinance in DRC

<table>
<thead>
<tr>
<th>Preferred conditions</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functioning banking system</td>
<td>Despite the overall underdevelopment of the country’s banking system, prospective MFIs can use local banks for disbursements and to protect their funds. However, bank coverage is almost inexistent outside Kinshasa. The development of the banking sector is dependent on growth in the economy and improvement in the security and business conditions.</td>
</tr>
<tr>
<td>Absence of hyperinflation</td>
<td>Following the structural adjustment process, the country’s inflation rate was estimated at 15% in 2002 and therefore presents no major problem to MFIs. However, the current situation is still very fragile and there may also be problems in terms of currency convertibility in certain regions of the country, especially in the East and far from urban centres.</td>
</tr>
<tr>
<td>High population density</td>
<td>The country has a very low overall population density (around 20 per square kilometre) due to its sheer size. However, some agglomerations have high population densities. This is the case of Kinshasa with more than 6 million inhabitants. Population density may increase in urban areas with the peace process, as some of the war-affected in the East may rush into towns in the West.</td>
</tr>
<tr>
<td>Social capital</td>
<td>This is probably one of the greatest challenges in the DRC, as the conflict situation and plundering has strongly damaged social mechanisms, as testified by several private sector operators. Peace and stability may help re-establish some of the deeper community values, however, at present, some experiences such as women group lending by CECI-PME seem to indicate that peer selection and monitoring is feasible.</td>
</tr>
<tr>
<td>Availability of skilled workers</td>
<td>The situation in the DRC has become increasingly dramatic in terms of education due to the persistence of conflict in part of the country. However, compared to other African countries, the situation in the DRC is not necessarily worse in terms of literacy or education. There are several universities and institutes in Kinshasa, but also in cities such as Lubumbashi, Bandundu, Matadi, Mbandaka, Kisangani and Bukavu among others.</td>
</tr>
<tr>
<td>Enabling regulatory framework</td>
<td>The central bank’s microfinance unit has created enabling regulation for credit and savings unions and MFIs. However, it is of course still difficult to enforce contracts such as the ones referring to collateral.</td>
</tr>
<tr>
<td>Trust in local currency and financial institutions</td>
<td>Trust is still at low levels, especially in the areas where insecurity is still a problem. Moreover, in Kinshasa, the 1991 and 1993 pillages, as well as the effects of past monetary reforms have contributed to lack of trust in financial institutions. Regarding the currency, the situation has improved.</td>
</tr>
</tbody>
</table>

Source: UN reports, Interviews conducted by the author in Kinshasa

1 In the regions not controlled by the Government very low face-value bank notes (FC 10, 20 and 50) are still being used, as well as barter trade.
2 According to CECI-PME’s, the exploratory project in women group lending has showed promising results in Kinshasa, Matadi and Kikwit. However, in Lubumbashi (Katanga province), it did not work due to non-repayment. In this city, the population was historically used to receiving aid from the mining giant GECAMINES and had therefore not really developed any repayment culture.
3 For more details on Sub-Saharan Africa education figures, please consult UNESCO’s regional report, 2001. For example, in terms of secondary education the gross enrolment ratio is estimated at 18% (24% for male students). Despite being very low in absolute terms, it is just slightly lower than Cameroon or Côte d’Ivoire and higher than Mozambique or Senegal. A similar relative situation is found with tertiary education figures where gross enrolment is estimated at 1.4% in the DRC.
Public-private partnerships for capacity building

As can be seen from the approaches of several practitioners on SMME development projects in DRC, the technical assistance component seems to be fundamental in order to improve productivity levels and secure better management practices. This is fully in line with observations in post-conflict Mozambique or in El Salvador. Building up skills, especially with the very poor is needed to reduce mortality rates of SMMEs and also to be able to graduate some of these firms from a survivalist mode to a more sustainable development strategy. However, there are several additional direct and indirect costs in providing training services to clients. Direct costs are higher operating charges with training and indirect ones are linked to how training services create an additional burden to the organisation structure of the MFI (hurting client selection and monitoring) and how they create mixed signals for clients (create the need for a greater investment in signalling the institutions intent). This is why, MFIs that start with a maximalist approach often prefer to spin out their financial services division when a certain size is reached.

In the post-conflict situation of the DRC, several opportunities may be explored in order to reduce such costs such as:

- Partnerships between public institutions and MFIs for the provision of training in basic accounting and management for micro-entrepreneurs, leveraging on existing management schools.
- MFIs may also associate to share costs of training offices. They may set up regional training offices that provide such services, with a commonly decided number and contents of training programmes to exploit scale economies. Such centres could benefit from the already large experiences of local organisations, such as the CADICEC or COPEMECO and other. For financing such services, MFIs could agree on fees according to the relative size of each of them, which could be managed by a simple apex institution.
- MFIs in groups could also partner with donors. In fact, training centres could more easily attract the support of external technical assistance. In addition, the greater size and the fact that it would become a visible and well-focused activity providing training to micro-entrepreneurs could also facilitate work with donors and attract more funding. One of the great advantages for MFIs and for donors is that it would isolate financial services from capacity building and it would become more simple to identify the best and the non-performing MFIs in the market.

Public-private partnerships may also have a different dimension in supporting the development of SMMEs and maximising the potential of credit. Microfinance institutions and the technical assistance projects may, through their direct contact with SMMEs, help public authorities identify exterior constraints to SMME development. They can be part of consultative groups to help identify policy options and how to better apply them. For the public authorities, such partnership may constitute a
valuable contact with the semi-formal and informal private sector, which accounts for such a large part of employment and where good policy making may have very strong impact on supporting the most vulnerable and destitute. Such contact may be more valuable in a PCS, when the political priority is a major topic in decision-making.

Creating an enabling environment for microfinance

Public authorities and donors, as well as the MFI sector should promote an enabling environment for microfinance in order to help develop the best institutions, achieving greater outreach and sustainability.

The challenge of creating an enabling environment for MFIs is very complex and to a certain extent it is the same work that has to be done regarding the private sector. A major necessary condition is of course maintaining peace, security and stability in the country. In the DRC’s case, the final stage of the inter-congolese dialogue and the transition period to democratic elections along with the effective re-unification of the country are matters of uncertainty and will require strong commitment from all stakeholders. It is also necessary to promote sound macro-economic policies, as hyper-inflation, currency volatility and other instability factors may hurt severely microfinance operations. Moreover, policies, which promote the quality and development of SMMEs are also factors that help improve demand for financial institutions.

In addition, some other policy topics should also be considered:

- **Regulatory issues.** As was discussed above, the recent legislation on COOPEC and the one being implemented for MFIs allows a good degree of freedom to operators to foster innovation. In addition, banking institutions should also be allowed to start microfinance operations, as well as creating joint-ventures with MFIs. With the development of the sector, experience shows that there may be increasing pressure for more regulation. In creating new prudential and non-prudential regulation it is, however, important to bear in mind the possible negative impacts on innovation and development of financial services provision and also the resources available to enforce such new laws.

- **Promoting quality and transparency.** Public authorities and associations of MFIs may also try to improve transparency of operations as much as possible, trying to create incentives for MFIs to have minimum accounting standards and give technical assistance in management issues (in the DRC, this is one of the objectives of the RIFIDEC). Public-private partnerships could also be an interesting option in capacity building of MFIs, promoting quality and transparency. Moreover, using international microfinance rating agencies could also help promote quality in the sector.
- **Attracting international MFI specialists.** In comparison to other PCS, when development of microfinance was still at its early stages, the DRC may now benefit greatly from the experience of international MFI specialists. Marketing efforts through disseminating information on the sector and its potential in the DRC to these specialists and fostering links with domestic financial institutions may have a positive impact on the development of the sector. The combined work of international specialists, local financial institutions and donors can be very efficient in creating large and sustainable MFIs.

**Coordination of donor efforts**

With the progress in the peace process and stability in the DRC, an upsurge of donor projects is usually to be expected. Donors play a pivotal role in the transition due to funding and technical assistance and coordination is therefore important to obtain the best results and avoid situations that endanger the development of financial institutions.

Some of the topics that may be considered in the present situation of the DRC are:

- **Coordinating relief and development projects to avoid undermining financial institutions.**
  The relief effort is normally led by the UN institutions and it is important that a permanent dialogue is promoted, incorporating most donors. Regarding MFIs and COOPECs, they could probably also be informed or participate through their associations such as the RIFIDEC, the UCCEC and others. It is important to avoid a geographical approach of donor efforts, each with completely different type of projects, which has proven not to be very efficient in PCS. Finally, donors should try to give clear signals on heavily subsidised credit, grants and other temporary projects in order to avoid confusion with sustainable MFIs.

- **Setting common standards for microfinance.** To avoid major distortions, donors should agree on a common set of principles that orientate their action in microfinance development. These may include for example certain eligibility criteria and interest rate policies that promote fair competition and sustainable, permanent microfinance operations. To produce such a chart, donors may gather information from local MFI associations and the central bank’s special microfinance unit.
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