Financial Deepening in Sub-Saharan Africa: Theory and Innovations

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FINANCIAL DEEPENING IN SUB-SAHARAN AFRICA: THEORY AND INNOVATIONS

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I. TOWARD FINANCIAL DEEPENING IN SUB-SAHARAN AFRICA: AN ANALYTICAL FRAMEWORK

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II. BEST PRACTICES IN INNOVATIVE SMALL ENTERPRISE FINANCE INSTITUTIONS

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III. INCOMPLETE LINKAGE BETWEEN INFORMAL AND FORMAL FINANCE IN GHANA

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The three papers in this volume relate to different aspects of the problem of developing the financial system in low-income countries so that it is better able to facilitate widespread mobilization of financial resources, investment, trade, and risk-taking. While these papers focus on Sub-Saharan Africa, their analysis is relevant to any low-income country with a relatively underdeveloped financial system. They are concerned with financial deepening not only in the sense of raising the ratio of monetary aggregates to gross national product, but also in the sense of improving access to financial services throughout the economy and increasing the linkages between formal and informal segments. They are intended for both policy analysts and practitioners.

Two principal themes run through these papers and are especially relevant in the African context. First, the importance of overcoming fragmentation in which different segments and units of the financial systems have little interaction with each other and funds and clients cannot move easily between them. Second, the dilemma of increasing access to financial services for small-scale enterprises (SSEs), which appear to be both underserved and underrepresented compared to fast-growing Asian countries and to what would be expected in a less constrained economic environment.

The first paper provides an analytical framework by reviewing the literature on explanations for the failure of financial systems to deepen. The analysis includes both financially repressive policies and the structural and institutional constraints that limit deepening even under a liberalized policy regime.

The second paper develops guidelines for accelerating availability of financial services for viable SSEs. Although SSEs’ access is likely to increase as financial systems develop, this process may occur too slowly for SSEs to realize their potential contribution to economic recovery and growth. Many governments and international agencies are trying to develop specialized institutions and programs to help finance expansion of the private indigenous business sector. The paper draws on the successes and problems of several such efforts in African and the Caribbean to provide guidelines for both designers and managers of SSE finance institutions.

The third paper focuses on a particular informal mechanism and indicates how better linkage with the formal financial sector could improve intermediation and efficiency in the system as a whole. It finds that informal savings collectors in Ghana have relatively low information and transaction costs, despite the small size of their transactions, and could readily play a greater role in providing credit if they in turn could obtain a formal line of credit.

These studies grew out of work that was initiated for a study on Meeting the Financial Needs of Ghana’s SMEs, and they also serve as background papers for a research proposal on Financial Integration and Development in Sub-Saharan Africa. They have been supported by Ghana’s National Board for Small-Scale Industries and the World Bank’s Research Committee, Industry and Energy Department, and Western Africa Department. We are grateful for their support and for the suggestions of those who commented on the individual papers.

William F. Steel
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TOWARD FINANCIAL DEEPENING IN SUB-SAHARAN AFRICA:
AN ANALYTICAL FRAMEWORK

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A well-developed financial system facilitates economic development through trade, saving, the efficient use of resources, and risk taking (World Bank 1989). A stable currency reduces the costs of economic transactions and promotes trade. Savings in financial form help to fund investments. Financial intermediaries evaluate alternative investments, transform savings to meet their yield and risk characteristics, contribute to the efficient allocation of resources. Well-functioning financial institutions and instruments enable an economy to exchange or pool risks.

This paper discusses the transition towards a more developed financial system from a financially repressed and underdeveloped economy. The objective is to understand the prerequisites and necessary components of financial liberalization and to draw lessons from experiences elsewhere that can help improve the design of financial sector reform in African countries.

A. FINANCIAL REFORM IN AFRICA

Financial sector reform programs in Sub-Saharan Africa began in the 1980s. At present, such programs are underway in several countries, including Côte d'Ivoire, Ghana, Guinea, Madagascar, Mozambique, Nigeria and Tanzania. They initiated steps to establish more flexible interest rates, open credit markets and enhance financial intermediation. Villanueva (1988) classifies these countries into three groups: those which had the objective of improving monetary control and those with the goal of improving the mobilization and allocation of domestic savings and the others which strived to improve the interest rate structure.

Since FY88 the World Bank has assisted seven countries in Africa with nine financial sector adjustment programs aimed at reducing direct government controls on the sector. Besides reducing controls and liberalizing interest rates, efforts are being made to restructure institutions and improve regulatory procedures to prepare the way for greater reliance on markets. Long (1991) argues that Africa's need to develop an efficient domestic financial system, able not only to mobilize financial resources but also to allocate them to the most productive uses, is even more important in the 1990s with the decline in the potential inflow of capital from the other regions.

Liberalization of financial systems in Africa has so far had little visible impact on the supply response relative to that in adjusting countries in other regions (World Bank 1992). "Although financial sector reforms have been initiated, banking systems have remained uncompetitive and saddled with poorly performing portfolios. State owned banks have directed a bulk of their credit to public enterprises regardless of their viability. Private banks prefer commercial credit and have little interest in term lending or new, small clients"

Throughout this Working Paper "Africa" refers to Sub-Saharan Africa.
Recent studies show that even in countries with several years of financial sector reforms, the impact in terms of financial widening and deepening appears to be limited (Duggleby et al. 1992). The reason for this may lie in the structural and institutional features of financial sectors in Africa (Nissanke et al. 1991).

Section B of this paper discusses the role of financial intermediation and its contribution to economic growth. Section C presents the characteristics of a financially repressed economy and the effects of liberalizing markets in an underdeveloped financial sector. Sections D and E discuss the complementary conditions within the financial sector and external to it that are needed to accelerate the development of a liberalized financial sector. Section F concludes by summarizing lessons learned and guidelines for financial deepening.

B. FINANCIAL SYSTEMS DEVELOPMENT

Financial Deepening

Financial systems development involves expanding the scope of the financial system (financial deepening) and improving the efficiency of financial intermediation. The scope of financial development refers to the stage of financial development in an economy: its evolution, its structural form, its mode of operation, and the types of financial claims it offers (Khatkate and Riechel 1980). Quantitative measures are sometimes used to measure the depth of the financial sector in developing countries. Money supply as a percentage of GDP—a measure of the level of monetization in the economy—is often used as a proxy to measure financial deepening. Another indicator is the population per bank branch. Fry (1988) points out, however, that proliferating bank branches in rural areas does not constitute a program of financial development. Expected profitability within the medium term must be a primary criterion for extending the rural branch net-work.

A recent study by Getler and Rose (1991) shows that financial deepening is an important characteristic of the growth process. Using data for 69 developing countries from 1950 to 1988, they find that a 1 percent increase in real per capita income is typically associated with approximately a 1.5 percent increase in measures of financial deepening (various monetary and credit aggregates relative to income). However, they stress that the causal interpretation of their finding is not clear. Financial intermediation may bridge the gap between savers and investors and thus promote economic growth; growth also stimulates the development of financial intermediation.

Financial Intermediation

Financial intermediation is a means of channelling funds from surplus to deficit units. Savings and investments may not necessarily be undertaken by the same economic units due to differences in their initial endowments, skills and expectations. While savings depend on the willingness of households and enterprise to set aside part of their earnings, efficient investments depend on entrepreneurship, knowledge of opportunities, and willingness to take risks. A mechanism is therefore needed to link savings and investment decisions. It can take the form of either direct transfer of funds between surplus and deficit units through bond or capital markets, or indirect transfer through financial claims (deposits) or assets (loans) of financial
intermediaries. The indirect channelling of funds through financial intermediation is more common than direct transfer, especially in developing countries (Goldsmith 1969 and Sh.Aw 1973).

When financial intermediaries perform efficiently, domestic resource mobilization is enhanced. The unit resource cost of intermediation between savers and investors (negatively related) is an indicator of the efficiency of a financial intermediary. The unit resource costs can be proxied by total operating costs (including borrower, lender and intermediary costs) as a percentage of total earning assets (Fry 1988).

Financial intermediation helps development in three ways: it facilitates savings in financial form; it widens the variety of financial claims, differentiated by liquidity, yield, and maturity; and it acts as a catalyst for the efficient transfer of funds to real capital formation (Abebe 1990). The traditional theory of financial intermediation suggests that an increase in financial intermediation necessarily accompanies growth (Gurley and Shaw 1967). However, in the context of a study on 11 African countries, Bhatia and Khatkate (1975) conclude that there is no definite relationship between financial intermediation and the rate of economic development in many African countries. They argue that growth in financial assets is not a sufficient condition for economic development.

Bhatia and Khatkate (1975) argue that if financial intermediaries are to contribute to economic growth they must meet three main conditions: mobilize savings; financialize these savings; and transform the mobilized funds into efficient investment in real capital. They argue that most financial policy reform recommendations, such as market-determined interest rates and an emphasis on financial institutional development, relate to the first two conditions; the recommendations regarding the third condition are ambiguous in most of the analytical work on financial liberalization, despite its importance for growth. It is often assumed that the allocative mechanism of financial intermediaries is necessarily a socially optimum one, so that most productive investments are financed. Financial institutions are profit maximizers and therefore tend to invest their funds where the profit rate is high, the risk of default is small, and the cost of administering loans is low. Nevertheless, these characteristics do not necessarily define the most efficient or dynamic activities, and hence financial intermediation may not necessarily lead to economic growth.

Several studies have discussed the difficult connection between credit allocation and real economic activity (Gale 1991, Plantes and Small 1981, and Von Pischke and Adams 1980). According to their view, changes in credit may not induce any shift in economic activity. In their classic paper Von Pischke and Adams (1980) argue that the fungibility of money makes it virtually impossible to evaluate the impact of credit on economic activity, especially for rural finance. Therefore, it may be inappropriate to assign the function of efficient resource allocation to financial institutions. Instead, allocative efficiency could be improved indirectly by eliminating distortions that affect lender behavior and operational capacity.

C. FINANCIAL REPRESSION AND LIBERALIZATION

"Financial repression" refers to policies that shift the allocation of investible funds from the market to the government. Prior to the 1970s the use of controls on financial transactions was a common feature in developing countries. Repression of interest rates at negative real rates enabled governments to finance
deficits at low cost. Governments have tried to manage the credit flows of the economy through systems of subsidies, interest rate ceilings and direct government intermediation, which inhibit the functioning of the price system in financial markets.

Traditional analysis of financial repression views such interventions as serious obstacles to development of financial markets and economic growth. It focuses on allocative consequences of interest rate ceilings, directed credit, government control over financial intermediaries’ decision making, excessive reserve requirements, and entry barriers in financial markets. This section reviews the literature on how repressive policies retard financial development and lower the efficiency of investment and hence economic growth.

Interest Rates

In the early 1970s, the financial repression argument presented by McKinnon (1973) and Shaw (1973) stressed that government intervention in the form of interest rate ceilings and direct credit allocation hinders economic growth. It was argued that holding interest rates below current rates of inflation reduces savings and, consequently, investment and economic growth. Individuals receiving cheap credit reap benefits but impose a cost on the others and on the society. Cheap credit constrains the expansion of the financial frontier by limiting the number of borrowers, discouraging savers and inhibiting intermediation (Von Pischke 1991). Ceilings on deposits depress the supply of funds below and raise the demand for funds above their equilibrium levels. Actual investment will be limited by the amount of savings forthcoming at the controlled rate. Unsatisfied demand for investible funds will appear, forcing financial intermediaries to ration credit by means other than the interest rate. They usually favor borrowers with substantial security or an established reputation, which tends to exclude small and medium scale enterprises and new investors.

Negative real interest rates divert domestic funds from financial savings into consumption, accumulation of goods or foreign assets. They also encourage investments with low rates of social return, such as accumulation of inventories, rather than new plant and equipment. As a result, high-return, high-risk projects may be starved of capital. The overall volume as well as quality of investment may be reduced and result in a slower rate of growth. Low interest rate policies are also said to hamper development of the securities market.

Directed Credit

Directed credit programs have generally allocated low-cost long-term funds to promote industrialization, raise productivity in agriculture, and generate employment in small and medium enterprises (Holst 1989). The techniques used include subsidized interest rates for priority sectors, differential rediscount rates, credit floors and ceilings, and establishment of specialized financial institutions. Recent studies by Fry (1989) and the World Bank (1989) conclude that, despite their good intentions, selective credit policies do not have the desired impact on resource allocation and economic growth but have undesired effects on domestic savings.

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According to Von Pischke, the financial frontier separates the borrowers who are usually considered not creditworthy by the formal financial sector and other prosperous entities that have access to formal finance.
mobilization and financial development. The studies suggest that lenders often misclassify loans to comply with lending directives. Within priority sectors, large and politically influential borrowers tend to benefit.

In addition, concessionary loan rates encourage highly capital-intensive production techniques. To the extent that banks comply, lending below the cost of capital weakens their financial soundness. Intermediaries in financially underdeveloped economies often have to be subsidized, which reduces their incentive to ensure that loans are adequately screened and monitored. This leads to poor overall performance of the loan portfolios, which in turn lowers the rate of return that can be paid to depositors. As a result, the quantity of funds the financial intermediary can mobilize is reduced.

**Competition**

There is no guarantee that a market-based financial system would be competitive. The established banks tend to resist the entry of new banks. Creation of a competitive market is especially difficult if the financial system is made up of a few government-owned institutions. Lack of competition among financial institutions could result in wide transaction margins and inhibit development of new instruments. There is a risk that the efficiencies associated with direct control would be replaced by the inefficiencies of a monopolistic banking structure (Johnston and Brekk 1991).

In some developing countries financial markets lack competition mainly as a result of restrictions on the range of activities they can undertake and of interest rate ceilings. The purpose of restrictions is deemed to be the protection of depositors from risky investment of their funds by intermediaries. But Holst (1989) argues that barriers to entry also protect vested interests of some financial intermediaries. For example, commercial banks may object if savings banks are allowed to pay interest rates above the existing market rate. Finance houses maintain that only they can organize long-term industrial finance. Each domestic institution tries to block others from spreading the range of their activities and to prevent foreign institutions from gaining a significant market share.

Holst (1989) notes that thin and fragmented financial sectors predominate in most Sub-Saharan African countries where major banks and financial institutions are government-owned. Aggressive competition between major banks is extremely rare in terms of deposit mobilization or lending activities. Development finance institutions, which usually are non-depository institutions, are dependent on donor or government funds. With such limited competition, African banks are slow to improve services or introduce new instruments that may be needed to provide credit to productive small enterprises.

Collier and Mayer (1989) argue that when the number of banks is small, pricing by one bank significantly affects the others. In this environment banks tend to retain a substantial portion of assets in liquid form rather than engage in maturity transformation—a primary function of an efficient financial system. Lack of competition also prevents banks from developing new financial instruments appropriate for efficient borrowers who do not have access to traditional credit facilities. Opening of financial markets to foreign competition may provide the incentives and the expertise needed in this regard.
Informal Financial Markets

One effect of financial repression may be expansion of informal financial market transactions. Interest rates in these markets tend to be much higher than the controlled interest rates in the rest of the economy, and credit is mostly channelled to sectors and clients not well served by the formal financial system. Informal financial intermediation tends to occur mainly in urban areas; in rural areas the agricultural cycle tends to synchronize peoples' savings and investment patterns, thus reducing the scope for intermediating between savers and investors at a point in time.

Informal markets also develop irrespective of financial repression because they are able to serve the needs of certain types of clients. Their accessibility, popular participation, organizational flexibility, and local knowledge enable them to keep down transaction costs for small depositors and borrowers. Many forms of informal finance thrive, not only in countries where formal financial markets are severely stressed, but also in countries where formal finance is operating efficiently (Adams and Fitchett 1992). The main weakness of informal financial markets is that they serve a weak indigenous sector operating on the margin of survival with limited prospects for growth (Seibel 1989).

Financial Liberalization

The solution in most of the early literature to problems caused by repression is to liberalize financial policies (McKinnon 1973 and Shaw 1973). If governments were to lift all restrictions, the market could, in principle, optimally allocate funds among different categories of borrowers, thus promoting economic growth. The evidence on liberalization-led economic growth is at best limited. Countries with positive real interest rates and high financial growth such as Japan, Korea, Taiwan and Singapore are regarded as success stories (McKinnon, 1989). However, these successes cannot be attributed simply to abolishing interventionism, since these governments continued interventionist policies (e.g., subsidized credit to priority sectors).

Financial reform can usually be subdivided into two categories: "financial repair" to reduce distress in banks, and financial deepening by eliminating distortionary financial policies and practices, changing institutions, and establishing greater efficiency in mobilization and allocation of resources (Roe 1991). For Tanzania, Ghana and other West African countries this type of financial repair has been important. The discussants at the seminar on Financial Systems and Development in Africa (Nairobi 1990) noted several factors that caused financial distress and recommended some solutions. Most banks in the region are characterized by the high intermediation costs because of overstaffing in government-owned banks, excessive reserve requirements, and the compulsory purchase of low-yielding government securities. Suggestions to avoid

In recent studies of informal financial markets there is little evidence of exploitation or monopoly profits. High opportunity cost of funds, important transaction costs, substantial lending risks and lack of creditworthiness among borrowers appear to explain the high interest rates associated with informal lending (Adams and Fitchett 1992).

Critics of McKinnon-Shaw argue that liberalized interest rates may raise working capital costs, and thereby induce higher prices and reduced output (van Wijnbergen 1982, Taylor 1983).
the problem of distressed banks included presence of a stable economic environment, more private ownership, and gradual adjustment of interest rates and exchange rate.

The Impact of Liberalization

Relaxing interest rate ceilings to allow for positive real rates would in turn generate savings, according to the McKinnon-Shaw argument. By mobilizing more deposits the financial system would increase the availability of loanable funds. Moreover, liberalized loan rates would facilitate lending to efficient private sector clients who previously lacked access because information and transaction costs exceeded allowable spreads. However for interest rates to have an appropriate impact on resource allocation borrowers have to be responsive to market prices. A high incidence of credit indiscipline and loan delinquency or arrangements where loans are expected to be covered by the government may render the interest rates meaningless in the allocation of credit (Johnston and Brekk 1991).

Whether higher interest rates substantially affect saving is a much researched issue that has not yet been established empirically. One problem is the dual impact of interest rates on saving: while higher interest rates increase the benefits of saving, they also reduce the need for saving. Fry (1989) argues that for developing countries the evidence of a positive net response of savings to interest rates is very weak. However, some empirical studies indicate that while positive interest rates do not significantly affect the level of savings, they increase the proportion of savings held in the form of financial assets and thereby facilitate a more efficient allocation of savings. This in turn will stimulate economic growth, which will increase household income and lead to a higher overall level of personal savings (Holst 1989).

In the presence of informal markets for transactions that spill over from the repressed formal sector, financial liberalization may encourage formal savings by increasing the range and quality of financial instruments available to savers and investors. Hence, the gains from financial liberalization on the savings potential may be largely in the form of replacement of informal markets by more organized formal markets. Regarding lending activities, studies of informal sector lenders in many Asian countries (including Kous in Japan, moneylenders in Indonesia and pawnbrokers in India and Sri Lanka) show that it is important to understand the existing informal financial system and attempt to build on it rather than replacing it with a new formal financial system.

Empirical studies on interest rate policy in recent years suggest that positive real interest rates can only be effective as a part of a policy package that includes macroeconomic reforms, strong bank supervision, and strengthening of the legal framework. In the past two decades a number of developing countries have adopted financial liberalization policies. In Southern Cone Latin American countries, rapid introduction of financial reforms initially produced chaos. The corporate sector suffered financial distress following rapid changes in relative prices, sharp increases in interest rates, a major devaluation of currency, and abrupt termination of external financing. As a result many financial institutions supporting the corporate sector found themselves in trouble. The non-performing assets of Chile's banks rose from 79 percent of capital and

\[\text{Adams and Fitchett (1992).}\]
reserves in 1982 to 150 percent in 1983. Monetary authorities in these countries were forced to bail out failing banks (World Bank 1989). Asian countries that liberalized gradually performed better.

Collier and Mayer (1989) suggest that financial liberalization is neither necessary nor sufficient to attain improvement in investments. They argue that Japan and Korea have achieved economic development in the presence of tight controls in financial markets. The consensus of the recent literature is that financial liberalization is not sufficient on its own to promote economic growth. Unless efficient markets and financial institutions are in place, financial liberalization may even lead to retardation of financial development by creating high and volatile inflation against an unstable macroeconomic background and shallow financial markets.

Financial systems in Africa are shackled with extensive regulations, and they tend to be dominated by few institutions (El-Nil 1991). Bank lending is mainly geared to low-risk short-term commercial credit. Given the underdeveloped nature of money and capital markets, financial institutions have been unable to develop instruments to hedge against high-risk investment. Therefore these economies are characterized by a shortage of long-term capital for productive investment. Despite evidence of a vigorous informal financial sectors in African countries, the short-term nature of its savings and its limited capital base constrains it from providing funds for productive activities.

Geiter and Rose (1991) claim that liberalization has failed to meet expectations for three reasons. First, interest rate liberalization leads to a rise in loan rates, which may drive out efficient borrowers when markets are imperfect. Second, many countries' liberalization efforts coincided with aggregate economic downturn. Third, financial liberalization has not been accompanied by a well-designed "financial safety net."

D. COMPLEMENTARY FINANCIAL INFRASTRUCTURE DEVELOPMENT

Market Efficiency

To generate positive results, financial reform requires smooth and reliable functioning of financial markets:

Information is freely available and individuals can credibly commit to honoring all agreements. Therefore everyone is able to lend and borrow at risk corrected interest rates. Market forces consequently allocate income efficiently between consumption and savings, and then in turn allocate savings efficiently across investment projects. Competitive forces ensure that lending and borrowing rates adjust to clear the markets, where the entire process is costless; flow of funds from savers to borrowers does not absorb any resources. (Geiter and Rose 1991).

However, in a more pragmatic world where complete futures and contingency markets are absent, uncertainties about the abilities and the intentions of borrowers to honor their commitments play a

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fundamental role in credit markets, which differ in an important way from goods markets. As Virmani (1982) explains, in a goods market there is a simultaneous exchange of value: payment for the good coincides with the supply of good. In the credit market, however, the payment (principal plus interest) for the "good" is made after it is supplied. On the deposit side of the market, payment (interest plus principal) for savings is also made at a later date, when it matures. In both cases financial "goods" are exchanged for a commitment to pay specified amounts in the future. As such the realization of the commitment depends on both the ability and the intention of the individual or firm making the commitment.

Uncertainties about whether purchasers will honor commitments are pronounced in the context of developing countries, where various imperfections impede the workings of the financial system. These market imperfections arise from externalities, market power and information problems (Vittas 1991). They are often cited as causes of inefficient channelling of financial resources from sources of surplus funds to productive sectors in the economy.

Vittas (1991) elaborates that externalities include risk of systematic failure (stemming from actual or threatened failure of another), infection effect (caused by excessive competition and price wars), and network effects (of linking competing institutions to a common network). Of these the externalities most relevant to developing countries is the systematic failure of banks in distress. Other externalities may arise due to macro instability, which causes distortions in relative prices, incentives and expectations (due to high inflation). Frequent and large macroeconomic shocks characterize many low-income African countries, leading to inefficiencies because banks are unwilling to undertake maturity transformation. These external shocks may come in the form of sudden changes in the political regime, severe weather changes such as droughts or floods, or falling terms of trade. In underdeveloped and controlled financial systems, banks are unable to guard against such aggregate risks by pooling with other agents in the financial market or to hedge against exchange rate movements by investing in external assets. As a result they shy away from term lending, even though borrowers are willing to pay market-determined rates to finance viable long-term projects.

Inefficiencies due to market power arise when dominant banks charge high margins and thereby earn excessive profits or offer a low quality service in the absence of competition. In many African countries, market power in the banking sector is exercised by state-owned banks. As a result the market inefficiencies tend to appear in the form of a low quality service rather than in excess profits.

A substantial body of literature points to information deficiencies as a cause of market failure in financial systems. These problems may stem from information asymmetries between borrowers and lenders and poor data on cost of inputs and price of products. Stiglitz and Weiss's (1981) seminal paper shows that even in an unregulated loan market, equilibrium can be characterized by credit rationing in the presence of imperfect information and the resulting impact on risk perception. In general, lenders are handicapped by asymmetric access to information regarding different borrowers' ability and willingness to abide by the commitment to repay. Asymmetric access to information arises because borrowers have more information than lenders about the project being financed, its viability, their ability to manage it, and their willingness to pay the lender.

Stiglitz (1989) provides an overview of the literature in relation to developing countries.
In developing countries, the information problem is aggravated by limited availability of physical infrastructure, weak communications networks and the absence of an integrated financial system that shares information on borrowers. In the case of small borrowers who supply goods to specialized local markets, lenders cannot obtain adequate information or lack the expertise to assess the viability of the projects concerned. Caprio (1992) argues that in poor developing countries with undiversified financial systems financial reform may destroy even the existing limited information capital. Therefore, policy advisors should consider the extent to which bank customer relationships will be disrupted either by failing banks or by destruction of information.

These market imperfections raise the transactions cost of lending in developing countries, especially to small, new clients. The normal information costs involved in lending include costs of acquiring information about the characteristics of borrowers, their actions to minimize default risk, and the viability of the project. Difficulty in obtaining information may raise the costs of processing applications and monitoring loans to ensure that they are used as intended. In addition, enforcement costs in the case of default may be especially high in countries with poor legal systems.

The uncertainty associated with inadequate information may be perceived by formal financial institutions as involving higher risk. Consequently these lenders try to hedge against the perceived risk by requiring collateral. New small borrowers who are unable to back their demand for credit by such collateral are therefore screened out by the formal sector lenders, regardless of true project viability.

In the context of imperfect information and lenders' inability to identify good borrowers, banks will try to attract low-risk borrowers. The expected return to the bank depends on the probability of repayment as well as the interest rate. As the interest rate increases, the expected return to the bank initially increases. However, those borrowers who are willing to pay higher interest rates are likely to involve higher risks (Stiglitz and Weiss 1981). High interest rates may also induce borrowers to undertake projects with lower probability of success but higher returns when successful. This "adverse selection" aspect of interest rates raises the riskiness to the banks of those who borrow at high interest rates. Thus there is an optimum rate that maximizes the expected return to the bank. Beyond the optimum, higher interest rates do not offset the increase in the likely default rate. One implication of this is that the demand curve lies outside the supply curve, which will result in credit rationing. It is only when an institution has accumulated sufficient information on borrowers and experience in lending without collateral that it is willing to finance projects with high returns (Anderson 1982).

Regulation and Supervision of the Banking Sector

A recent strategy to reduce inefficiencies that have plagued the monopolistic banking systems of many developing countries has been to privatize state banks and encourage competition. However, a large number of small banks may be prone to financial failures unless a proper regulatory system is in place. Therefore, banking regulation and supervision have recently been given greater attention in the financial sector development. Even liberalized financial systems need to maintain systems of investor protection. Government supervision and regulation are designed to limit risks of fraud and runs on banks.
Developed banking systems include "lender of last resort" facilities and deposit insurance to guard against excessive withdrawal of deposits. Prudential regulation also stipulates minimum capital adequacy ratios, limits on portfolio concentration, and guidelines for classification of assets by potential risks associated with them.

Supervision is needed to ensure that weak financial institutions are detected early and liquidated or merged in orderly fashion. Southern Cone Latin American countries failed to carry out this responsibility in the process of financial sector reform. Inadequate government monitoring permitted an environment of lax lending policies. What emerged was a vicious cycle of government bailouts and inefficient intermediation (Diaz-Alejandro 1985). Non-performing assets of Chile's banks increased to more than 79% of capital reserves in 1982 and 150% the following year (World Bank 1989). This was a result of industrial groups acquiring private banks and using them to make excessive loans to firms within the group, in the absence of a prudential regulation system. Failure to provide appropriate regulation and banking supervision also contributed to financial insolvencies in the Philippines and Turkey (World Bank 1989).

Institutional Development

Weak bank management is an important source of inefficient financial intermediation in developing countries. It includes inappropriate lending policies, overextension, lack of internal controls, and poor planning (Holst 1989). Diversifying lending activities to unfamiliar areas and mismatching of assets and liabilities lead to poor lending policies. Excessive lending relative to capital causes overextension. Lack of internal controls range from inappropriate credit review procedures to inefficient information systems which prevent early detection of arrears. Poor planning refers to lack of anticipation of future developments in the banking business.

The first task of institutional development is to improve management practices. This involves identifying new areas of lending, developing new instruments, improving accountability in each banking unit, and training bank staff to undertake efficient banking operations. The directions in which these efforts should be concentrated are described in the following paragraphs.

Managers of most developing country banks have traditionally focused on a market by offering the existing range of services and waiting for customers. To respond to the changing economic environment, bank managers have to act like retailers by identifying markets, determining the types of products that customers want, and developing innovative instruments while controlling costs. In this context, managers particularly need to develop innovative approaches for servicing rural poor and microenterprises. The Economic Report on Africa (African Development Bank 1987) notes that, as essentially urban institutions, banks are reluctant to extend their network to rural clients. They have difficulties mobilizing rural savings and meeting rural credit needs because of rigid procedures and centralized decision-making. Bank branches in smaller towns are merely smaller version of city banks and may be incompatible with the areas they serve. Rural customers are often unable to meet the commercial criteria imposed by these banks.

To make the banking system more market-oriented, incentives may be provided by increasing the accountability of bank branches. In developed countries many banks improve accountability by treating branches as profit centers that are judged and rewarded on the basis of profits they generate. Even though
the profit center approach is quite appealing, it may have limitations in developing countries because it is complicated and requires experience to work well (World Bank 1989). Furthermore, poor infrastructure and communication networks, traditional book-keeping techniques and non-availability of computerized management information systems hinder the development of such profit centers.

In order to achieve the above improvements, bank staff need training in appropriate appraisal, evaluation and monitoring techniques. In developed countries a large number of financial intermediaries have excellent in-house training programs where top managers assess and train future managers. Some countries like Guinea and Korea have established joint venture banks with foreign commercial banks to learn from the experiences of the developed country banks (World Bank 1989).

E. CONDITIONS EXTERNAL TO THE FINANCIAL SECTOR

Legal Framework

Unless there is a well-functioning legal system, the difficulty of recovery in case of default increases the risk perception of lenders. The government can assist by offering an efficient legal system that facilitates enforcement of private contracts and effectively punishes fraudulent activities. In the absence of such a system, bank managers tend to resort to traditional lending patterns and evaluation techniques rather than seek new markets or introduce innovative instruments for which recovery might be difficult.

Money and Capital Markets

Well-functioning money and capital markets contribute to the efficiency of a financial system in a number of ways. A smoothly operating inter-bank money market enables banks to use short-term borrowing to avoid a liquidity crisis. This, in turn, facilitates the banks' ability to undertake a maturity transformation of their short-term liabilities to long-term assets. Such a transformation is required if financial intermediaries are to sustain term lending for productive activities using their own funds (rather than external lines of credit). Developed money and capital markets also enable financial institutions to diversify their lending portfolio and spread their risky assets, giving them an incentive to undertake new and innovative lending practices. In most developed countries well-functioning money and capital markets enable authorities to sell government bonds and other securities without directly crowding out private sector borrowing from the banking system.

Capital market development can be facilitated through fiscal incentives. These may be demand incentives, which increase the volume of savings channeled to equities, or supply incentives to increase the volume of equities available. Demand incentives include removal of double taxation of corporate dividends as both corporate and income taxes; promotion of contractual and collective savings through pension funds.

\[8/\] Government borrowing through the money and capital markets from banks or non-banking lenders puts upward pressure on interest rates, which may affect private borrowing indirectly through the price mechanism.
and life insurance companies; and removal of favorable tax-free status given to time deposits or government bonds (Hoist 1989). Supply incentives include income tax credit on the purchase of stocks, mutual funds and equities of companies in underdeveloped regions (Brazil introduced such a scheme successfully); and tax holidays for investors who issue public equities (Hahim 1985).

Policy Environment

In order to develop an efficient financial system it is crucial that the pace of financial liberalization be compatible with macroeconomic and other policies, which differ vastly from country to country. Reforms carried out against an unstable macroeconomic background may make that instability even more pronounced. Complete liberalization of interest rates in countries with high and unstable inflation rates leads to high real interest rates and large spreads between lending and deposit rates.

Far-reaching programs of financial reform were carried out by Argentina, Chile and Uruguay in the mid-1970s. The measures included lifting of controls on interest rates, elimination of directed credit programs, privatization of nationalized banks and lowering barriers to entry for domestic and foreign banks (World Bank 1989). The reforms were introduced rapidly as a part of a stabilization program in a background of high and volatile inflation. However, high interest rates in the Southern Cone countries attracted large inflows of capital, which in turn caused rapid monetary expansion. Initially, these reforms produced chaotic effects in the banking sector and the expected improvement in financial sector efficiency did not materialize (Díaz-Alejandro 1985). Argentina's financial depth, which exceeded 50 percent in late 1920s, declined to around 30 percent by 1970s and further to 18 percent by 1987. Other high-inflation countries have also experienced slow or negative growth in financial depth (World Bank 1989).

In contrast, countries with reasonable macro stability are better able to avoid high interest rates, fluctuations in real exchange rates, and insolvency among firms and banks (World Bank, 1989). In countries like Malaysia and Thailand which have maintained low and stable inflation through prudent budgetary and interest rate policies, growth in the financial sector has been rapid. Malaysia's financial depth (measured by the ratio of M2 to GNP) increased from 31 percent in 1970 to 75 percent in 1987, and in Thailand the same measure grew from 34 percent in 1980 to 60 percent in 1987. It is evident, therefore, that macroeconomic stability and especially price stability are essential for successful financial liberalization and deepening, especially when financial markets are shallow.

Some countries with considerable macro instability have chosen to liberalize gradually, retaining some control over interest rates and capital flows while encouraging greater competition and making gradual interest rate adjustments to reflect market conditions. In Indonesia, the government liberalized interest rates and credit ceilings of public banks and shifted their control to bank management while still keeping the banks under public ownership. Korea also changed its financial policy in the 1980s, moving gradually away from heavy regulation to a more market-oriented approach. These reforms led to rapid growth and increased efficiency of its financial sector. Several Latin American countries not in the Southern Cone, particularly Brazil and Mexico, have proceeded with financial liberalization much more cautiously and have been more successful in building balanced and diversified financial institutional structures.
Australia, Japan, Malaysia, New Zealand and the U.S. also liberalized their interest rates in recent years. Macroeconomic policies and financial systems in these countries were already market-oriented, and reforms stimulated further competition and efficiency of the financial system. Bank deposits and loan rates rose moderately in real terms and financial depth increased substantially. Interest rate spreads and dispersion of rates in different markets narrowed, indicating greater competition and efficiency (World Bank 1989).

Financial liberalization should also be compatible with other policy reforms in the country. In the Philippines, expansionary fiscal policies, political corruption and inadequate regulation jeopardized the financial reform efforts. In Turkey liberalization affects were undermined by the financial problems of the corporate sector, which in turn made the banking system illiquid. The situation was aggravated by poor bank management, weak regulation, and inadequate supervision of financial institutions. In terms of compatibility with trade policies, if prices are distorted owing to protection or price controls, financial liberalization may worsen matters by making decision-makers more responsive to incorrect signals. Therefore, exchange rate realignments and trade policy reforms and public enterprise reforms should be carried out prior to or alongside financial liberalization efforts.

F. LESSONS LEARNED

The World Development Report 1989 reflects the thinking on financial liberalization that has emerged in the past decade: unconstrained financial liberalization can be harmful, but, if properly paced and sequenced, it can yield substantial benefits. The main objectives of financial reform are to develop the financial system to promote savings and a more efficient allocation of resources. Often in developing country markets, structure of prices is distorted, enterprises face soft budget constraints and do not respond well to price signals as a result well functioning markets may not be able to allocate resources efficiently. Hence financial sector reform has to be a part of a broader economic restructuring program (Johnston and Brekk, 1991). El-Nil (1991) suggests that in the African context it is appropriate to gradually open the financial sector to more competition.

The pace of financial reforms has to be compatible with the macro balance, financial depth and institutional structure of the particular country. Direct controls on the financial system should be withdrawn systematically, with a combination of restricted competition and active supervision by the monetary authorities. In countries where macroeconomic imbalances have precipitated an economic crisis, parallel implementation of stabilization and structural adjustment policies are needed together with financial reforms.

When financial institutions have been seriously decapitalized, stabilization policies such as devaluation and higher interest rates may even deepen the crisis when accompanied by liberalization of real and financial sectors. For example, liberalization of trade regimes may cause relative price changes that make domestic firms uncompetitive and unable to service their loans, which would aggravate weak bank portfolio performance. In such a situation banks have to be restructured initially.

Cho and Khattakate (1992) emphasize that one of the most important lessons drawn from financial liberalization across countries is that price stability is the linchpin of successful liberalization, not the
deregulation of interest rates per se, especially when financial markets are shallow. Complete liberalization of the banking system when inflation is high has severe limitations. The resulting high level of real interest rates leads to an adverse selection in the quality of borrowers and the bank's own behavior.

These problems assume serious proportions when authorities impose stringent monetary contraction, as experienced in Asian and Latin American countries to restore their macroeconomic imbalances. In this regard, financial liberalization focusing only on the banking system may create problems for the banking sector's functions as a financial intermediary. To enhance financial intermediation, the reform package should also promote non-bank financial institutions and capital markets.

The preceding analysis suggests that in the initial stages of reform many developing countries may be unable to liberalize financial sectors as extensively as developed countries. The World Development Report 1989 (World Bank 1989) suggests several steps in moving from a regulated to a more liberal financial system (although it warns against over-generalization). Usually financial reform should not precede real sector adjustment, or banks will be lending at disequilibrium prices. However it is also important not to wait till adjustment is complete, so that demand for capital by new investors can be met (Cho and Khatkate 1992).

At the outset, reform should start by getting the fiscal deficit under control and establishing macroeconomic stability. The government should then scale down its directed credit programs and adjust the level and pattern of interest rates to bring them in line with inflation and other market forces. In the initial stage of reform, government should try to improve the foundations of finance: the accounting and legal systems; procedures for enforcement of contracts; disclosure requirements; and the structure of prudential regulation and supervision. It should encourage marginal autonomy in financial institutions. If institutional insolvency is widespread, the government may need to restructure some financial institutions in the early stage.

In the next stage, financial reform should seek to promote the development of a variety of markets and institutions to foster competition. Broader ranges for deposit and lending rates should be introduced. Foreign entry into domestic financial markets should be encouraged gradually. Until such reforms are underway, it may be necessary to maintain controls on the movement of capital. In sequencing the removal of exchange controls, trade transactions should be liberalized first and capital movements later.

Precipitous liberalization can affect the public's confidence in the banking system, accelerate capital flight and lead to a run on the banks. Hence, many countries may not act until the crisis reaches such proportions that further delay is impossible. It then becomes necessary to allocate the burden of past losses, decide which firms and financial institutions to restructure, and correct the underlying problems (Long 1987). These problems may include insufficient supervision, lack of regulation, poor bank management, inefficient legal systems, weak infrastructure facilities, and market failure due to lack of information.

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2/ Stiglitz (1989) argues that market failure is not an issue governments can readily resolve. It does not involve externalities between institutions or firms, and as a consequence there is no mispricing that subsidies or taxes can easily remedy.
If the reform process as a whole is too quick, firms that entered into contracts under old agreements may face heavy losses. A gradual liberalization may also impose losses but will allow firms time to adjust and financial institutions time to develop new skills. Undue delay, however, perpetuates the inefficiencies of financial repression. The appropriate balance must be judged in each case according to the current level of financial development in the country (World Bank 1989).

El- Nil (1991) and Roe (1991) emphasize that the narrow financial infrastructure in most African countries may be unable to implement comprehensive reform in a short period of time. There is, therefore, a need for a realistically long time frame and for general external support during the transition, especially if stabilization and liberalization are pursued simultaneously. Africa is also relatively under endowed with financial experts, market analysts, bank managers, and supervisors to design and operate new regulatory and institutional structure to support financial reform (Roe 1991). In an attempt to deepen the financial markets in Africa it is therefore important to give due consideration to all the factors discussed above: existing economic environment, design and sequencing of the reform, and the resources needed to implement the program.
REFERENCES


II

BEST PRACTICES IN INNOVATIVE SMALL ENTERPRISE FINANCE INSTITUTIONS

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Each credit and banking specialist working with the financing of SSEs brings to the research process a different perspective, based upon his exposure to work of selected case institutions and alternative tools for resolving remaining problems. In this context, successful synthesis often requires sound editing and editorial guidance in translating experience into practical lessons learned. I acknowledge with gratitude the contributions of two colleagues for providing such assistance in the preparation of this Working Paper. My sincere thanks to William F. Steel of IENIN for his close editorial guidance and Carla Cuares for his thoughtful review and comments. I would like to further acknowledge the contributions of editor/translator Sorie Musa, without whom much of my case material on the institutions and their performance could not have been rendered into brief profiles appearing in Annex II.
### ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>BDC</td>
<td>Botswana Development Corporation</td>
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<td>BOAM</td>
<td>Bank of Africa/Mali</td>
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<tr>
<td>DFC</td>
<td>Development Finance Corporation</td>
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<td>EG</td>
<td>Enterprise Group</td>
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<td>HDF</td>
<td>Haiti Development Foundation</td>
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<td>JADF</td>
<td>Jamaica Agricultural Development Foundation</td>
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<td>MEC</td>
<td>Market Enterprise Committee</td>
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<td>LDCs</td>
<td>Less Developed Countries</td>
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<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>PEÇA</td>
<td>Private Enterprise Credit Agency (Senegal)</td>
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<tr>
<td>PRIDE</td>
<td>Promotion of Rural Initiatives and Development Enterprises (Kenya)</td>
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<td>SMEs</td>
<td>Small- and Medium-scale Enterprises</td>
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<td>SSEs</td>
<td>Small-scale Enterprises</td>
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<td>USAID</td>
<td>United States Agency for International Development</td>
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BEST PRACTICES IN INNOVATIVE SMALL ENTERPRISE
FINANCE INSTITUTIONS

Despite successful economic stabilization and recovery in a number of African countries, small-scale enterprises (SSEs) continue to confront a number of obstacles to sharing in growth. These obstacles include competition from imports and larger-scale industries, inadequate infrastructure and business services, a difficult regulatory environment, and conservative banking systems that have concentrated their resources on short-term commercial finance and do not have the human capability to analyze and manage small project risk.

This paper examines innovative ways of building institutions to overcome constraints on the availability of financing for SSEs in developing countries. It is intended to serve as a guide to practitioners in the design and management of adaptable and sustainable institutions. The paper extracts and synthesizes lessons learned regarding design, management, policy setting and loan recovery from the successes and problems of a variety of existing institutions.

A. BACKGROUND

Importance of Developing SSE Finance Institutions

Empirical studies in Africa and other countries indicate that SSEs typically generate significant local employment, use higher proportions of locally-sourced raw materials and often achieve higher returns per unit of capital invested (human and technical) than do larger enterprises (Anheier and Seibel 1987, Liedholm and Mead 1987, Nanjunda 1987, Page and Steel 1984). Assessments of the local private sector in a number of countries have revealed that many growing industries can trace their origins to the small-scale and informal sectors. Thus SSEs have the potential to contribute both to growth and to equitable access to the benefits of growth.

However, lack of access to external finance in the form of appropriate credits and equity capital continues to constrain the growth and expansion of viable SSEs (Webster 1991). Capital is often cited as a constraint on the ability of SSEs facing excess demand to utilize existing capacity more efficiently and on those with high growth potential to expand beyond the limits of self-finance. Established businesses cannot obtain sufficient overdrafts and fixed working capital facilities, let alone obtain medium-term project loans through conventional banking systems in many African countries.

Failure to reach larger numbers of small-scale borrowers can be attributed to several factors. Banks are not set up to analyze and service small credits. Lenders remain risk-averse due to perceived higher risks and higher transaction costs involved in securing reliable information on small borrowers and projects, carrying out more intensive loan supervision and applying alternative forms of loan security. Small enterprises, in addition to lacking reasonable collateral, often have no credit history, do not understand bank regulations, and
are typically unable to comply with banks' requirements for operating budgets, financial statements and business plans.

Although the access of SSEs to finance is likely to improve over time as financial systems develop under liberalized financial policies, the process is likely to be slow unless these structural and institutional constraints are addressed. Financial institutions may need to target SSEs as a market for expanding financial services to overcome obstacles to financial deepening, especially in the transitional phases of financial market development.

Thus, this paper derives guidelines for developing institutions and instruments that are appropriate for the SSE market. The analysis is based primarily on an examination of existing alternative institutions designed to finance SSEs on a sustainable basis. Their experiences and practices are used to derive preconditions and techniques for designing and managing effective financial institutions for small enterprises. Some useful variations are also drawn from institutions with which the author has worked that serve both small- and medium-scale enterprises (SMEs), offering primarily credit and some equity financing. As relevant lessons have emerged from them for targeting and serving the varying financing needs of expanding SSEs, these experiences have been incorporated as well.

The remainder of this section describes the types of institutions that finance SSEs and the sample used in this study. Section B of the paper surveys practices in six innovative financial institutions serving SSEs in four African countries and two Caribbean nations, showing the advantages and disadvantages of various practices in key operational areas. Section C on institution building covers ways of structuring management and organization of institutions to make them more effective in serving the SSE market. Section D summarizes the conclusions in the form of guidelines for appraising credit components of SME support projects and for managing financial institutions serving SSEs.

Typology and Sample of Institutions to Finance SSEs

Four types of formal financial institutions specialize in serving SSEs:

- non-bank intermediaries extending credit and related services under the direction of a non-government organization (NGO) or a public or private development corporation;
- special credit facilities working in conjunction with commercial banks;
- specialized banks;
- investment corporations extending debt and/or equity finance.

These problems help explain why lines of credit, including those intended for relatively small borrowers, are not attracting large numbers of SSE applicants nor moving as fast as might be expected from the evidence that credit is a primary constraint to the growth of potentially dynamic SSEs (Duggleby et al. 1992).
The focus of this paper is on debt finance. Hence, institutions surveyed are mainly from the first three categories. The experience of an "alternative" bank capitalized by and for African businesses is included, but the focus is not on commercial banks per se.

The sample covers institutions that have been in operation three or more years, have established their market niche in SSE or SME financing, and are beginning to reach or address the question of sustainability. Two of the six institutions serve Caribbean Basin countries, markets that provide useful comparisons with institutional experience in Africa.

The following institutions are used for comparative study (further details are given in Annex I and II):

1. Bank of Africa/Mali (BOAM), established in 1982 as an "alternative" commercial bank to finance private business operators in Mali and encourage more lending to viable SMEs. BOAM is owned predominantly by African shareholders (Malian and other) and emphasizes "character lending" and moral guarantees from Loan Committee members or shareholders.

2. Private Enterprise Credit Agency (PECA), a non-bank intermediary providing predominantly short-term credits to urban and rural small businesses in Senegal at market rates. Operating as a free-standing credit facility since 1989, PECA is operationally self-sustaining except for expatriate advisor support and hopes to relinquish donor funding soon.

3. Haitian Development Foundation (HDF), a not-for-profit foundation incorporated in 1983 to improve management skills and growth potential of Haitian small businesses, via extension of credit and referral to related business services. This donor-funded facility offers short- and medium-term credits at market rates.

4. Jamaican Agricultural Development Foundation (JADF), a not-for-profit foundation started in 1984 by U.S. and Jamaican private sector investors to provide debt and equity financing to Jamaican-owned SMEs in agricultural production and processing. Structurally and operationally JADF is a privately-run investment corporation.

5. Botswana Development Corporation (BDC), a development finance corporation founded in 1982 and owned by the Government of Botswana and four institutional investors. BDC provides medium-term loans and equity participations primarily for Botswana-owned SMEs and operates an investment trust for sale of its shareholdings to outside investors, including Botswana citizens.

2/ La Financière, a private investment corporation established in Côte d'Ivoire in 1983 as a vehicle for providing finance to private business operators and making direct investment in third party businesses, was also reviewed. Analysis of this corporation revealed that it did not generate effective intermediation in the form of finance for small enterprises. Therefore, it is included only for comparison in the Annexes.
Promotion of Rural Initiatives and Development Enterprises (PRIDE), a not-for-profit economic development corporation in Kenya operating an extension banking system for micro- and small-scale enterprises in rural areas. Modeled on the Grameen Bank, PRIDE was incorporated in 1989, employs multiple group guarantees and a savings requirement and is linked to a commercial bank to enable "graduation" of clients into the formal financial sector.

B. SURVEY OF PRACTICES IN INNOVATIVE FINANCIAL INSTITUTIONS

In evaluating practices of financial institutions, the analyst must first ask: "What is important in serving the target market? What steps are critical to extending finance to a small business and recovering the investment?" For the purposes of practice analysis, this paper addresses the various steps that must be taken in structuring and managing a financial institution in the order in which they are actually taken: assessing the market, setting policies, developing financial products, marketing financial services to the target market, analyzing creditworthiness, risk management, and reducing transaction costs. Given the different risk structure, management requirements and expected returns involved in direct equity investment, design and management practices for equity funds and investment corporations are treated separately from those for credit institutions.

Assessing the Market

The key to successful SSE lending is adapting the credit delivery methodology—i.e., the way in which borrowers are identified, approved and supervised—to the needs and capabilities of those businesses to use financial services. Financial institutions that have been more successful in extending and recovering credits to SSEs have often based their lending operations on an in-depth market assessment at the design stage, allowing them to determine actual patterns of demand and to identify and address relative levels of risk involved.

PECA in Senegal, for example, used a baseline market assessment covering all sectors to determine its niche, i.e., non-urban "linking businesses" in the production, service and commercial sectors of the predominantly agricultural economy. PECA's market is now expanding to urban businesses to spread costs after a similar market assessment. Its marketing success also derives from the fact that lending is non-directed, based upon business profitability not sector.

JADF has successfully served specific niches in the Jamaican agricultural market by doing detailed sectoral assessments and building a project data bank. PRIDE of Kenya has defined its market by working with Enterprise Groups to encourage savings mobilization, cross guarantees and loan repayment. In the process, it has focused on a relatively limited variety of businesses in the same market areas (heavy concentration in retail and wholesale sectors).

Identification of potential market niches has not, however, been a consistent feature of the institutions surveyed. In the absence of a policy and approach to market development, HDF in Haiti has had difficulty diversifying its portfolio and generating backward and forward linkages for SSEs in a segmented market
dominated by big business. Failure to address economic activities of women has been identified as a weakness in marketing programs by staff of all institutions surveyed.

Setting Policy

Credit institutions that have reached operational sustainability based upon income generated have extended loans at market rates of interest and have sometimes charged market-based fees for non-credit services (project preparation and follow up). One of these institutions, the HDF non-bank intermediary, offers project analysis, after-loan follow-up and assistance in problem resolution for a 2% borrower fee paid up front. This policy has enabled HDF to cover all costs except for loan loss reserves out of operating income. PECA is covering all operating costs except an expatriate advisor out of market rate interest income. JADF, on the other hand, is not operationally self-sustaining after seven years operation, having only recently established a market rate structure for project lending and a fee of 1.5% for project preparation and supervision services.

Credits extended in the start-up phase by PECA, HDF and PRIDE were largely to existing businesses with experience and some capital invested in the enterprise. This policy has reduced transaction costs and, along with regular mobilization of additional clients, has allowed each facility to become familiar with its market before assuming the higher risks inherent in new businesses. Two institutions (PECA and JADF) have required significant levels of borrower equity (30 percent counting existing equity) as a risk reduction policy. All credit institutions surveyed except BDC and JADF offer shorter terms (1 year average) and lower maximum loan amounts to new borrowers, with term and amount of subsequent loans increased with good repayment.

PRIDE in Kenya has built its SSE credit operation around Market Enterprise Committees comprised of smaller Enterprise Groups that cross-guarantee loans to members. It conducts a market survey prior to opening a branch to ensure that all the criteria required for opening the branch can be met. After the branch is opened, baseline data is collected on the clients--part of the process of enrolling them in the PRIDE program. Staggered provision of loans to members reinforces discipline in the early stages since loans to other members depend on prompt repayment by initial borrowers, a concept adapted from the Grameen Bank in Bangladesh. Loans are repayable in a maximum of 1 year and in small and frequent installments. This policy maintains high client awareness of the loan and facilitates rapid identification of problem borrowers. Successful repayers are granted step increases in loan sizes so that they can eventually graduate into the formal banking system through PRIDE's agreement with Barclays Bank of Kenya, Ltd.

Unlike other examples studied here, PRIDE has incorporated a savings requirement in its credit methodology, asking the potential borrower to open and make regular deposits to a Barclays bank account. This has provided an effective means for guaranteeing loan repayment, as well as increasing the amount of loanable funds. Numerous studies indicate that a savings requirement has often been an integral component.

PRIDE has focused on the retail and wholesale sectors because empirical evidence from informal sector surveys throughout Africa, and specifically in Kenya, show that within the informal sector (enterprises with 0 to 9 employees), 70% of all informal sector enterprises are in the commerce/trade sector. Further, 70% of all the informal sector businesses which are female-run are within the commerce/trade sector. Almost half of PRIDE clients (46%) are female.
of successful SSE finance institutions, providing the SSE client with a means of building a savings habit and establishing a credit history with a bank.

Deciding Whether to Offer Loans or Equity Financing

Experience gleaned from institutions offering several financial products and serving SMEs indicates that demand for one financial product over another is heavily influenced by the way in which the financial institution has packaged and marketed itself. JADF in Jamaica, for example, has placed heavy emphasis on assisting the entrepreneur in preparing the project document, thus taking "ownership" over project quality. This, plus the pressure to generate sufficient operating income through loan interest, has skewed JADF's portfolio toward debt financing rather than the intended "arms length" vehicle of equity finance. BDC of Botswana likewise started out to become a prominent equity investor in SMEs and reverted to primarily interest-earning loans to generate consistent returns for shareholders.

A more realistic approach to marketing financial services is to acknowledge that there is a wide range of financing needs among SSEs and to match the instrument to the need. For example, debt may not be the best means of financing an expanding small business. Equity financing would allow the business to add equipment or improve premises by deepening its capital base, without the additional burden of debt. In some cases, lack of targeting in an institution intended to offer both debt and equity products has resulted in an institution that is not successful in greatly expanding access to financing for SME (as in the case of BDC) or sufficiently profitable to offer both products (JADF).4

Marketing Financial Services to SSEs

Institutions that have effectively reached and served SSEs have generally worked within a defined strategy for market development, based upon a sound market assessment and supported by intensive outreach by field officers to develop market niches for the institution. Likewise, these tools have been used when the time comes to expand market reach, diversify risk and spread costs.

Successful marketing requires more than media advertising. In using media exclusively, JADF and HDF learned early on that reaching good clients and diversifying risk requires direct outreach and marketing of financial services by management staff and development of sectoral opportunities to do profitable lending. In the beginning, market development within the typical SSE financial institution often takes second priority to generating new loans, income and recovery. This was the case with HDF in Haiti. The institution subsequently found that it is not sufficiently diversified to achieve financial and operational sustainability, and it had to diversify its marketing strategy. In all of the institutions examined here, systematic use of a business plan could have facilitated more effective identification and development of suitable markets.

Examination of the experiences of PECA, HDF and PRIDE in marketing financial services to SSEs reveals that a successful marketing formula for reaching SSEs is based upon simple principles that include:

Where both credit and equity are offered by one institution, each should be managed through a separate window, in view of the different risk structure, returns and management requirements.
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- use of informal business premises readily accessible to clients;
- streamlined and efficient services;
- clear rules without complex entry mechanisms (e.g., extensive training);
- flexible approach to lending and willingness to tailor credit terms to needs and resources of businesses being financed;
- periodic re-assessment of the market to identify sectors for increased lending or new markets and revise marketing strategy accordingly.

Analyzing Creditworthiness

Financial institutions that have successfully financed SSEs and achieved high rates of recovery have placed the highest degree of emphasis upon the non-tangible aspects of credit analysis. These include character of the entrepreneur, history of the business operation and reputation for meeting financial obligations, experience in the business, viability of the project or ability to repay, and collateral. Following a period of very poor loan recovery, HDF has adopted the policy of lending under no circumstances to someone with a poor repayment history, no matter how much collateral is offered. PECA and PRIDE undertake very careful screening to weed out and avoid bad repayers through community-level interviews with key informants. Average recovery rates for these institutions are 95 and 97 percent, respectively.

PECA and HDF use demonstration of real growth in the business over the past year (turnover, asset size, net profit, market share) as a creditworthiness criterion. Collateral is generally considered a "second way out" after character and project viability analysis. Use of such criteria in credit analysis tends to skew lending toward existing businesses with established experience and reputation. This survey and recent studies indicate that credit criteria used by successful non-bank intermediaries financing SSEs generally correspond to those used by commercial banks extending loans to SMEs under World Bank lines of credit (Duggleby et. al. 1992).

Risk Management

In order to be sustainable, an SSE financial institution must be profitable, earning sufficient revenues to cover the cost of funds and recurrent operational and administrative costs. In order to be profitable, the non-bank intermediary must operate like a bank. It must be able to set rates freely to assure profits, and it must strike a careful balance between risk management and keeping transaction costs low as a percentage of average earning assets.

PECA has demonstrated such adaptiveness by taking a more flexible approach to loan security (liens on assets financed, contracts pledge, co-guarantors with liquid assets to pledge) in lieu of non-existent tangible security. PRIDE has adapted required savings and loan repayments to the average cash flows.
Institutions that have been successful in maintaining this balance have employed a variety of measures to effectively reduce SSE lending risk. Those SSE finance institutions surveyed that have been most successful in recovering SSE loans have based their risk reduction strategies upon three fundamental principals:

- minimizing poor judgments on character and capability, through careful credit analysis;
- using intensified follow-up to track projects and loan repayments; and
- applying "get tough" policies on repayment.

Across the board, the credit-oriented institutions surveyed have increasingly emphasized non-tangible aspects of creditworthiness (character, repayment history, motivation to succeed) to reduce the likelihood of poor credit judgment and the resulting need for intensive collection efforts. HDF and PECA address the intangibles by carrying out a rigorous risk analysis of the potential borrower and business operation. This includes on-site observation of the business operation, as well as interviews with employees and key informants in the community on the operator’s character and record for meeting financial obligations.

BOAM, an "alternative" commercial bank, bases risk management largely upon "character lending," requiring that every borrower be known by and receive the moral guarantee of a member of the Loan Committee or a shareholder. Similarly, PRIDE in Kenya requires that every potential borrowers be vetted by the Executive Committee governing their community level Market Enterprise Committee, and their immediate Enterprise Group must agree to cross-guarantee the loan given.

JADF and PECA have moved to reduce project-related risk with rigorous analysis of project viability on the business site. The PECA field officer develops a business plan with the enterprise owner and conducts a careful analysis of all risk factors (market, market share, cost and pricing structure), followed by a similar independent evaluation of the activity by PECA management. JADF has established a project data bank with detailed indicators on specific sectors to define acceptable levels of risk and address them with realistic measures for reducing lending risk.

PRIDE, PECA and HDF extend loans largely to existing businesses with an established business history and reputation. Loan sizes are limited and short-term until the borrower establishes creditworthiness. PECA negotiates subsequent loans according to business needs. PRIDE provides loans in steps ranging from Kshs 5000 to Kshs 25,000, building up loan size to prepare good repayers to graduate into the banking system. HDF and PECA tailor the size of loans and repayment schedules to cash flow, and HDF extends loans in tranches in situations where the borrower requires continuing access to finance.

A regular regime of intensive follow-up visits to supervise loans and repayment, combined with a computerized loan tracking system, has been used by HDF and JADF to reduce risk of default and non-recovery. PRIDE also uses a computerized accounting system to track savings and loan performance. It has developed a credit reference system for borrowers and is planning to convert this information to a centralized Credit Reference Bureau with banks and NGOs as partners. BOAM has introduced mobile field officers to track SME loans in areas without branches.
PECA and HDF have taken direct actions to diversify their portfolios as a risk reduction measure, to avoid sectoral concentration or over-emphasis on lending in areas vulnerable to natural calamities or external shocks.

The strongest and most effective risk reduction measure taken by non-bank financial intermediaries surveyed has been a get-tough policy on repayment. PECA provides an illustrative model: any client not paying within 10 days of schedule is visited by a legal officer. If loans are non-performing for more than 60 days, action is initiated to seize security. HDF exerts direct pressure on co-signers at the first sign of repayment difficulty. PRIDE suspends from membership any borrower more than four weeks in arrears with weekly loan payments.

PECA has had limited success with use of a bonus/penalty system for field officers, to increase credit supervision and reduce risk of borrower default. Its effect has been somewhat limited by the sporadic pattern of awarding bonus points, denying the field officer a regular injection of earned income he can count on. Careful project analysis and tough repayment policies have been more effective in achieving high repayment levels at PECA.

Reducing Transaction Costs

Successful SSE finance institutions have taken a number of measures to reduce transaction costs while maintaining manageable levels of risk. Mechanisms employed range from streamlining credit processing procedures to charging fees for services.

Each SSE institution surveyed has moved to streamline and standardize its credit extension procedures to reduce processing costs. HDF, for example, lowers the information and documentation requirements for very small enterprises whose loans cannot be based on cash flows by relying more heavily upon character assessment. HDF has also endeavored to reduce costs by developing standardized credit packages for small business with similar characteristics, needs for financing and repayment capability.

JADF has made extensive use of project data banks and sectoral specialization to reduce information costs during credit analysis. PECA and PRIDE have attempted to increase loan volume and spread costs by expanding their territorial reach and sectors served. PECA and HDF are using increased computerization of credit analysis to lower staff cost and time, and PRIDE has used it to track savings and loans more efficiently.

6/ The bonus/penalty incentive system rewards good collections through a bonus, calculated on the basis of 3% per year on the loan amount borrowed and fully repaid, and penalizes the bonus fund when loans fall into default (based on 10% of the outstanding loan balance due).

7/ One such credit package was Line of Credit Financing serving the working capital needs of proven small enterprise clients. The facility allowed businesses to draw down as much as $6000 at a time for raw materials and operating costs, with the requirement to repay in six months. The facility had to be restructured after less than a year because many couldn't work with such a long repayment period.
JADF and HDF charge an up-front fee for project development services and follow-up (1.5 and 2 percent of the loan amount, respectively), as a form of income directly offsetting these costs. PRIDE endeavors to cover its administrative and overhead costs in its interest rate (5 to 10 percent above commercial rates) and registration fees charged to clients.

C. INSTITUTION BUILDING MEASURES

The stated objectives of many SSE finance institutions are to become sustainable at the financial and operational levels and, to the extent possible, to be institutionalized in the formal financial sector. Institutionalization objectives can take two forms: (1) "mainstreaming" of clients into a formal bank on the basis of their own creditworthiness; and (2) absorption of the SSE credit operation by a bank or other formal sector institution.

Past experience of non-bank financial intermediaries serving SSEs, including PECA, HDF and PRIDE, indicates that the chances of institutionalization of such facilities within the formal banking sector remain slim, for several reasons:

- lack of profitability in small enterprise lending;
- lack of diversification in financial services offered and SSE portfolios;
- lack of forward planning early in the process of design and operationalization of the institution.

Institutionalization within the formal financial sector is a difficult passage for SSE finance institutions for both market-related and operational reasons. The experience of PRIDE in Kenya illustrates well the constraints presented by the market served and the process of graduating successful borrowers. PRIDE was established as a non-profit development corporation with an extension banking operation, with two objectives: (1) to provide access to savings and credit facilities flexible enough to generate economic growth in all sectors of small business; and (2) to establish a credit reference that would permit growth-oriented small businesses to eventually graduate into the formal banking sector. Toward the latter objective, PRIDE has established a cooperative arrangement with Barclays Bank of Kenya to move proven clients into the bank.

In building the credit program and credit rating system, PRIDE management came to recognize that the majority of their clients, i.e., at least 85 percent of the small economic activities which are their primary target, are not going to make it into the banking sector. For these clients, PRIDE has introduced the discipline of saving with a bank and repaying financial obligations. PRIDE credit funds and referral to training programs in business planning and management are designed to enable these clients to pursue a vertical growth path (microenterprises to small industries, informal to formal sector).

It is anticipated that about 10% of PRIDE's clients will graduate to form a balance sheet banking relationship with Barclays. This program's experience indicates that the process will take up to two years time...
for each borrower. The move will be based on the borrower's building of an excellent credit reference through on-time repayment of a succession of loan sizes available through PRIDE and achievement of real growth within the economic activity.\textsuperscript{6}

Though PRIDE expects to graduate its strongest clients to the formal banking system, the corporation does not intend to lose these customers. While some clients may obtain commercial bank loans to buy tools and equipment (which PRIDE does not finance), they may continue to borrow smaller amounts from PRIDE for working capital. Likewise, PRIDE does not anticipate disappearing as a non-bank financial institution for SSEs. Long-term objectives are to achieve greater levels of financial sustainability as a non-bank credit institution and to diversify to provide financial services that graduating clients cannot obtain through banks (loan brokering and sub-contracting arrangements on a fee-for-service basis, for example).\textsuperscript{7}

PECA in Senegal provides an illustration of the difficulties faced by a non-bank credit institution that is nearly self-sustaining based upon operating income, in trying to generate a takeover by a banking institution or become a privately-run local lending institution. After three years freestanding operation as an SSE credit institution and several attempts, PECA has not found an institutionalization alternative. Low profitability based upon operating income has prevented PECA from attracting a bank as purchaser. Lack of another institutionalization alternative has made it difficult for PECA to find local investment capital (from banks or businesses) to set up as a private corporation and hand over operations to local management when a USAID technical grant ends.\textsuperscript{8}

Sustainability

Experience in these and other institutions indicates that financial sustainability based upon operating income is a realistic objective for non-bank SSE finance institutions. The institutions most likely to succeed in becoming financially sustainable are those that meet the following preconditions:

- The facility is operated on a business-like basis, providing services efficiently to the private sector at market rates, with the intention of getting its money back and earning a profit.

\textsuperscript{8/} Such clients are emerging from the minority of PRIDE's 1877 credit clients (25% or about 470) who operate businesses engaged in production or higher-volume wholesale. After nearly three years of operation, PRIDE has reached agreement "in principle" with Barclays for the bank to consider extending up to 20 such clients uncollateralized loans for asset financing.

\textsuperscript{9/} PRIDE remains dependent upon outside operational grants from the Kenya Rural Enterprise Program and USAID to cover set-up and administrative costs for two of its three rural branches. It is not yet operationally self-sustaining and does not anticipate being so until 20 branches are established at a total client base of an estimated 20,000 savers cum borrowers. Value of loans disbursed was Kshs 17,964,000 (US$619,488 as of May 1992) by 3 branches in 3 years.

\textsuperscript{10/} While PECA is covering its recurrent and administrative costs out of loan interest income, USAID continues to support the cost of an expatriate General Manager. Whether the facility can continue to operate on a self-sustaining basis after the handover of responsibilities by the expatriate remains an issue.
- Credit analysis is thorough, addressing both project and borrower-related risks, while taking maximum advantage of sectoral data banks and credit reference systems of other lenders to cut information costs. Emphasis is placed upon intangibles (character, reputation for repayment) to reduce analysis costs and collection expenses.

- Sustainability has been part of the institution-building process from the beginning. The facility is operated within a business plan that projects actual patterns of demand, asset growth, income and cost structure; and a retraction plan for removing the institution from dependence on outside grants.

- A minimum volume of business can be generated annually; i.e., market potential among viable businesses is such that the facility can increase loan volume, average size of loan and portfolio diversification at rates that will offset the inevitable effects of inflation and loan losses.

- Management is willing to work continually to achieve profitability by streamlining and standardizing credit procedures, reducing transaction costs, enforcing tough repayment policies, and increasing the volume of business through marketing and portfolio diversification.

- Credit facilities are tied to a savings component, requiring that clients invest a significant amount in the credit transaction and repayment of loans.

- Close tracking of loans and repayments is done on a continuous basis, using a well-managed computerized tracking and financial management system.

- Development of the institution is accompanied by the establishment of a credit rating system that will enable good borrowers to establish creditworthiness with banks, and eventually feed into a larger credit reference bureau serving both formal financial institutions and intermediaries run by NGOs and other organizations.

- Management and field officers are motivated to generate portfolio growth and performance through an incentive system offering both financial rewards (such as regular bonuses tied to performance) and non-financial incentives (professional recognition), which derive their importance from African cultural practices and incentives.

Management Structures for SSE Financial Institutions

Management of a profitable and sustainable non-bank intermediary for SSEs requires a blending of skills not substantially different from those required to run a successful banking operation for larger-scale business. To meet the objectives of becoming financially and operationally sustainable, two types of managers are required for SSE lending:
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- a good administrator or General Manager capable of running the institution at the fiscal and procedural levels; and

- an entrepreneurial manager responsible for business and market development.

In the design of non-bank credit intermediaries for SSEs, strong emphasis has typically been placed upon identifying and training the General Manager or administrator to run a sound facility. For cost reduction and other reasons, less attention has been placed upon developing management capability to continually assess the market, expand the client base and develop new lines of business. Diversifying the portfolio and generating additional income is necessary to offset the higher average costs of SSE credit transactions. A marketing manager can often be developed through careful selection and institutional support of an existing staff member. A good management team must be backed as well by a sound financial management system, computerized to the maximum extent possible and with appropriate outside technical assistance in installation, implementation and maintenance.

Operational Structures for SSE Lending

The more successful financial institutions surveyed have operational structures that address the needs and capabilities of SSEs to use financial services and at the same time allow management to strike a reasonable balance between risk reduction and transaction costs. These operational structures permit the following:

- Administration of credit funds, loan processing and recovery by a small, effective staff, including two or more field officers who come from target areas and have been trained to do skilled client outreach.

- Provision of financial services with streamlined processing and with clear rules and procedures.

- Sufficient decentralization to offer easy access to a large segment of the target population while at the same time maintaining a minimum volume of lending at each site.

- Autonomy of decision-making within a low-key but business-like operation. In order for both managers to be effective, they must have complete autonomy from the tutelage of Government and pressure groups in making loan decisions.

- Development and application of incentives to motivate top management and field officers to generate good loans and achieve high rates of recovery.
D. CONCLUSIONS: GUIDELINES FOR PRACTITIONERS

Comparative analysis of the experience of selected financial institutions serving SSEs suggests that there are a number of preconditions for reaching this market with appropriate financial services and doing so sustainably. These are presented as working guidelines that can be employed by designers of SSE support projects and financial institutions and by managers of those institutions.

Project Design Guidelines

Specific steps can be taken during project appraisal to improve the quality and responsiveness of SSE finance institutions:

- Design should begin with an in-depth market assessment to determine actual patterns of demand among target groups and to identify and address the relative levels of risk involved. This assessment should clearly demonstrate that the market is sufficient for the facility to increase loan volume, average loan size and portfolio diversification at annual rates that will offset inflation and loan losses.

- A sound market assessment becomes the basis for determining whether there is a sufficient annual market for financial services and for developing credit policies and guidelines that match the needs and capacities of borrowers.

- Project appraisers should not presume suitability of one type of financial product or another (for example, debt over equity) before surveying a representative sample of businesses and the likely impact upon them.

- Where needs for both debt and equity finance can be documented, project design should call for management of each type of financing out of a separate financial institution or separate window, taking into account the different risk structures, management and technical requirements involved.

- Sustainability must be built into the project, beginning with a pro forma business plan at appraisal that indicates expected demand, asset growth, income and cost structure.

- A retraction plan should be developed to move the institution away from dependency upon donor grants.

- Access to credit facilities should be tied to a savings component, requiring that borrowers invest a significant amount in the credit transaction and the repayment of loans. This will later serve as the basis for assisting the borrower in opening and using a bank account and building a credit history with a bank.
Appraisal of an SSE finance institution should incorporate the requirement that management establish a credit rating system that enables good borrowers to establish their creditworthiness and eventually "graduate" to a formal bank.

It should be assumed that the majority of borrowers may never reach a direct banking relationship; therefore, sustainability of the non-bank financial intermediary becomes a priority as a prelude to exercising various alternatives for institutionalization.

Management and operational structures must be kept as simple as possible, to facilitate use of financial services by SSE borrowers unfamiliar with traditional banking systems and to contain costs as a percentage of earning assets (loans).

Project design should endeavor to strike a reasonable balance between mechanisms for risk management (staffing adequacy, credit policies and loan supervision procedures) and those for keeping transaction costs down.

Institutional Management Considerations

Whether a financial institution is free-standing or bank-affiliated, and whether it serves SSEs alone or a mixture of SMEs, it must be operated like a business with the intent of getting its money back and earning a surplus. Comparative analysis of institutions that are at or near sustainability indicates that the following practices are necessary to reach sustainability based upon operating income:

- The business plan should be used as a management tool to project asset (loan) growth, income and costs based upon actual patterns of demand, at the beginning of operations and at regular intervals.

- Management should design and pursue a strategy to implement the retraction plan through specific steps and targets for becoming profitable and self-sustaining based upon operating income.

- Every loan decision should be supported by a rigorous credit analysis that addresses both project and borrower-related risks.

- Management must be willing to continually work at profitability by streamlining credit procedures and looking for ways to reduce transaction costs without compromising risk management.

- Management and field staff must work constantly to generate new clients and to diversify financial services within a coherent marketing strategy. It is important to diversify risks during the first three operating years and to avoid excessive exposure to operations that are sensitive to sudden market swings, weather and other factors.
• From year two onward, management should diversify the financial products offered in order to maximize operating income and spread costs. Periodic re-assessment of the market will be necessary to maintain a profitable product mix.

• Close tracking of savings deposits, loan disbursements and repayments must be the daily responsibility of at least one person on the management staff. Monthly, the General Manager should examine the movement of savings accounts and performance of the portfolio in terms of loans outstanding, amounts due and payable, repayments and aging of past due amounts.

• Management should begin in the first year of operations to establish a credit rating system to track and classify borrowers by repayment performance. The system must be constantly updated with information from the loan tracking system. In the second year the institution should begin to feed this information into a larger credit reference bureau in cooperation with banks and other lenders.

• Both managers and field staff should be given an effective incentive program with timely and attractive rewards for good portfolios and high rates of recovery. Incentives should include financial and non-financial recognition, such as that meted out by African chiefs and community leaders for outstanding performance (e.g., manager or field officer of the year).

Assuring Access to Financing for Growing SSEs

A recurring dilemma in SSE development and finance is how to ensure that growing SSEs continue to have access to finance as they expand. There are two main alternatives for accomplishing this. First, a non-bank financial intermediary can "mainstream" its client, i.e., make sure that a commercial bank is ready and willing to accept the borrower based upon his established creditworthiness rating. This can be done through an agreement in principle drawn up by the intermediary with a bank and committing the bank to consider the borrower for a loan.

A second alternative for assuring access is bank takeover of the operation of a non-bank credit intermediary. This would generally involve the commercial bank's purchase of the portfolio and other program assets. From this point on, the intermediary's borrowers would become clients of the bank and would have wider access to its services. Although a more general solution, such a takeover is much more difficult to achieve than mainstreaming the most successful individual clients.

In both cases, whether a commercial bank is accepting creditworthy clients "graduating" from a credit intermediary or taking over an existing SSE credit facility, the bank should take steps to reach more SSEs and to assure that viable businesses get due attention in the financing process. The following steps can be taken by bank management to increase credit access of SSEs:

• establishing as an ongoing management practice a marketing strategy to secure future clients among growing SSEs served by non-bank credit intermediaries;
forward planning within the bank operation's business plan to develop a mixed portfolio of SSE and larger enterprise loans and thereby balance income, risk and profitability;

- adopting measures to increase the relative profitability of SSE lending (e.g., development of credit packages addressing businesses with similar needs, characteristics and capacity to repay; working capital facilities tied to SSE cash flows and capacity to offer security);

- development over time of SSE lending as a "profit center" within a larger banking operation, applying principles used in banking for larger business (this involves tailoring marketing strategies to reach growth-oriented SSEs in urban and outlying markets, setting separate management targets for asset growth and profitability, and adapting risk and cost reduction measures);

- nurturing throughout the banking organization a recognition of the importance of building relationships with viable SSEs, starting with the business as it begins to grow and serving the customer for life.
<table>
<thead>
<tr>
<th>Name</th>
<th>Jamaican Agricultural Development Foundation (JADF)</th>
<th>Botswana Development Corporation (BDC)</th>
<th>Promotion of Rural Initiatives and Development Enterprises (PRED)</th>
<th>La Financiere</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location</td>
<td>Kingston, Jamaica.</td>
<td>Gaborone, Botswana</td>
<td>Nairobi, Kenya</td>
<td>Abdijan, Cote d'Ivoire</td>
</tr>
<tr>
<td>Type</td>
<td>Financial intermediary, for profit foundation.</td>
<td>Development finance corporation.</td>
<td>Not-for-profit development corporation as non-bank financial intermediary.</td>
<td>Equity investment company.</td>
</tr>
<tr>
<td>Objectives</td>
<td>Encourage Jamaican-owned SMEs in agricultural production and processing; develop young entrepreneurs.</td>
<td>Support private investments to generate growth, jobs, tax, and other benefits; to invest where other institutions do not.</td>
<td>Deliver financial services to owner-operators of micro and small-scale enterprises without access to bank credit; graduate clients over time into banks.</td>
<td>Mobilize small investor capital; invest in businesses; assist member businesses to get loans.</td>
</tr>
<tr>
<td>Financial products</td>
<td>Medium- and long-term credits at market rates; equity participation through capitalized interest.</td>
<td>Medium-term loans; equity participation (repurchasable).</td>
<td>Short-term working capital loans; savings deposit facilities through a commercial bank.</td>
<td>Direct equity investment in private businesses; savings deposit facilities.</td>
</tr>
<tr>
<td>Technical services</td>
<td>Preparation of business plans, after-loan follow-up (fee = 1.5% of loan).</td>
<td>Project analysis; procurement of outside experts; follow-up (no charge).</td>
<td>Organization, savings and use of financial services for community-based savings and credit groups.</td>
<td>Project analysis.</td>
</tr>
<tr>
<td>Portfolio</td>
<td>$392 m. (US$17.1 m.); 75% term, 1875 rehabilitation, 6% equity, 1% lease finance.</td>
<td>P 231.3 m. (US$38.5 m.); loan 60%, equity 40%.</td>
<td>Kenya 17,964,000 ($419,488) as of May, 1992.</td>
<td>Shares in three medium-to-large companies.</td>
</tr>
<tr>
<td>SME share</td>
<td>87.5%.</td>
<td>Less than 50%.</td>
<td>100%.</td>
<td>0%</td>
</tr>
<tr>
<td>Capital structure and funding</td>
<td>Joint venture of U.S. company and Jamaican investors; credit and TA funds from USAID and IDB.</td>
<td>Government 81% (8% now divested to small investors); 19% from EFC, Netherlands FMO, Deutsche GEF, and British CDC.</td>
<td>Administrative and operating grants from USAID, Kenya Rural Enterprise Program (KREP) and Barclays Bank; credit fund through Barclays Bank and KREP.</td>
<td>Member deposits; USAID grant as seed money to develop investment program.</td>
</tr>
<tr>
<td>Expenses as % of earning assets</td>
<td>7.9% (personnel = 2.2%; 4.4%).</td>
<td>3.9% (may be under-estimate).</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Comments</td>
<td>Intended to be mainly equity, but shifted to mainly loans. Has softened collateral requirements, more emphasis on intangible collateral. Not yet self-liquidating, but improving.</td>
<td>Intended to be major equity investor, but poor investment returns have led to more emphasis on loans. 75% of investments are in 100% Botswana enterprises.</td>
<td>Intended to become non-bank intermediary extending financial services to small-scale enterprises that don't meet bank requirements. Has reached some 1577 clients. Beginning to graduate clients to bank.</td>
<td>Based on quantile approach of monthly savings; took 4 years for 360 members to subscribe $500,000 (before launching investment); with no dividends, members down to $3100.</td>
</tr>
<tr>
<td>Rate structure</td>
<td>Now 30%, was 15% for regular loans; 9.5% for hurricane rehabilitation.</td>
<td>Market rates</td>
<td>Market rates</td>
<td>n.a.</td>
</tr>
<tr>
<td>Ave. loan size</td>
<td>$220,000.</td>
<td>3-7 years; size varies widely</td>
<td>1 year; loans in successive steps according to repayment; Ksh.5000 ($217) to 25,000 ($1,100).</td>
<td>n.a.</td>
</tr>
</tbody>
</table>
ANNEX II

PROFILES OF SEVEN SSE FINANCE INSTITUTIONS

1. BANK OF AFRICA/MALI (BOAM), BAMAKO, MALI

The Bank of Africa/Mali (BOAM) is a commercial bank attempting to serve the financial needs of SMEs. It is majority African-owned with more than 50% of the capital held by African individual investors. It has been seeking to become the "bank for private business in Mali" and has entered an agreement with USAID under the Revolving Loan Fund Facility to extend 50% guaranteed loans to SMEs, combined with a moral guaranty.

BOAM makes financing available to African businesses on the basis of "character" determined by a Comité de Sages (Advisory Board) which screens all loan applications. The Bank's initial plan (for 1984-1985) was to provide access to term financing for businesses started by younger Malians not connected with the big families controlling economic activity.

BOAM started out with and continues to make mostly short-term commercial loans (estimated at 70% of portfolio) because they are less risky and because of the need to generate positive operating results for capital holders. It also makes selective medium-term credits available to established businesses.

1.1 Marketing Financial Services

Overall BOAM has perhaps the most aggressive marketing strategy of any bank in Mali. The presence of the SME guarantee facility has encouraged the bank to market more actively, e.g., by seeking potential clients known to shareholders.

1.2. Creditworthiness Criteria

In appraising medium-term loans to SMEs and other borrowers, BOAM works within conventional creditworthiness criteria. These are:

1. Character - largely evaluated through the person's being known and recommended by a member of the Comité de Sages, made up of prominent Malian businessmen.

2. Experience in the business for which financing is sought.

3. Market for the product in Mali.


5. Collateral in the form of land title, lien on equipment being financed, or co-signer with liquid assets.

As much as 50% of the loan decision appears to be made on "character" and being known and recommended by one or more Bank shareholders. This, combined with a very rigorous credit appraisal, has limited the number of smaller-scale operators who have gotten financing to less than 10% of portfolio.
1.3. Risk Management

BOAM remains fairly risk averse as a means of protecting shareholder capital. Their risk profile indicates that the bank will accept no more than 20% exposure on a loan. With the 50% guarantee provided by USAID, the Bank will seek to secure the remaining risk 100% with tangible or other security on any SME lending.

BOAM's risk reduction strategy is two-pronged:

1. Insistence upon the "moral guarantee" of a Comité member or shareholder for every approved borrower.

2. Application of the 50% USAID guarantee facility.

1.4 Reduction of Transaction Costs

The bank carries a relatively high cost structure to average earning assets (estimated from 1990 figures at 19%). BOAM has attempted to reduce the information costs of credit appraisal and verification through the requirement that all businesses receiving loans be recommended by a Committee member or shareholder.

1.5 Lessons Learned

The BOAM experience provides several lessons for design and structuring of "alternative" financial institutions for SME:

1. Banks can considerably reduce information costs by the use of moral guarantees in screening loan applications.

2. However, the need to produce positive operating results for shareholders tends to skew lending activity toward shorter-term and lower-risk credits within a commercial banking operation of this type.

2. PRIVATE ENTERPRISE CREDIT AGENCY (PECA)

PECA was developed as a high performance non-bank small business credit intermediary which would at least cover its costs, with a view toward encouraging a bank to eventually take it over. Key elements of the program strategy are the following:

1. The target group is defined as individual small businesses.

2. Lending is done to any category of business, based upon profitability not appropriateness (non-directed credit).

3. Lending is at the highest return available.

4. The credit facility is managed in a business-like manner, with careful project analysis, streamlined loan processing and a reasonably tough policy regarding loan repayment.
2.1 Market Financial Services

Through much of its history, PECA has used a simple formula to reach borrowers: it has provided financial services to clients at the local level, using informal field offices who operate with clear rules and without complex entry mechanisms (required training, etc.). Offices are located within easy access to a large segment of the region's population, and procedures are relatively streamlined and efficient.

2.2 Creditworthiness Criteria

Any business can be considered for credit, so long as it is viable and serves a demonstrated local market. In order to ensure viability of the business and its own sustainability as a credit institution, PECA uses the following creditworthiness criteria for loan approval:

1. Experience in the business being financed.
2. Significant amount of own capital invested in the business.
3. Character, as established through site visits, key informant interviews in the community, and other means.
4. Viability of the business, as established through market analysis and risk assessment in the field.
5. Sufficient cash flow and repayment capacity
6. Material security to offer, in the form of one or more guarantees that are saleable.

2.3 Risk Management

PECA reduces risk by analyzing levels of risk involved through a two-tier verification process. If it is demonstrated through market and risk analysis on site that the applicant has a history of not fulfilling obligations, he/she is not considered an acceptable risk.

PECA has evolved a risk reduction strategy geared to reducing poor judgements at the credit analysis stage, carrying out close follow-up, and enforcing tough repayment policies. The elements are the following:

1. Loans are made largely to existing businesses, with both experience and capital in the enterprise.
2. Credit decisions are made largely based upon results of a viability analysis of the project, on-site risk assessment, and character checks.
3. Loan payments are tracked reasonably closely after the loan is made, through site visits by the field officer and loan tracking on the computerized loan accounting system.
4. Field Officers are motivated with a bonus/penalty incentive system, which rewards good collections through a bonus and penalizes the bonus fund when loans fall into default.
5. If loan payment falls behind schedule, action is taken immediately to bring it current with a visit from the Legal Officer.
If loans are non-performing for more than 60 days, PECA initiates action to seize the security, beginning with a warning letter, then seizure of goods by a bailiff. Once collateral is impounded, negotiation with the client begins.

2.4 Reduction of Transaction Costs

Like other free-standing credit institutions serving small business, PECA has made a concerted effort to become self-sustaining for the purposes of being taken over by a banking institution or continuing to operate as a viable business. Several methods are being used to reduce transaction costs. These include the following:

1. Movement to more modest headquarters, reduction of staff and non-essential costs.

2. Improvement in loan recovery through closer tracking and tough enforcement of repayment policies.

3. Increasing the loan volume, through expansion in the Kaolack territory (1989) and, more recently, addition of a field program in Dakar.

4. Streamlining and standardizing of services.

2.5 Lessons Learned

The experience of PECA with successful extension and recovery of small credits in the African informal sector offers the following lessons:

1. The institutions most likely to succeed will be those operated with a "private enterprise" mentality, i.e., run like a business and providing services efficiently for the private sector.

2. The most important factors in achieving high recovery rates, are: sound project and risk analysis; close follow-up and tracking of loans; and stringent repayment policies consistently applied.

3. In order to increase the chances of institutionalization, credit facility management must work hard at increasing the profit from such operations by charging market rates, streamlining and standardizing credit services to reduce transaction costs, and applying tough repayment policies.

4. Success of any institution turns upon motivated staff, with sufficient and attractive incentives to generate good performance from their portfolios, coupled with adequate salary levels and professional esteem.

3. HAITIAN DEVELOPMENT FOUNDATION (HDF)

During its founding years (1979 through 1984) as a non-bank intermediary for small businesses, the Haitian Development Foundation (HDF) originated loans worth approximately $1.2 million to micro and small-scale enterprises in numerous sectors of the economy, creating value added and employment within what was largely the informal sector. Due to poor management, inadequate accounting systems, lack of specific and enforced collection policies, and administrative problems, the institution had by mid-1984 realized repayments on only $300,000 of the amounts due.
With USAID funding, HDF undertook a complete restructuring in 1984. It tightened procedures for credit appraisal, extension and collection.

HDF continues to extend and service loans to micro and small-scale enterprises, despite continuing political and economic instability, which tend to lower recovery rates. HDF has over the past two years implemented strategic decisions to improve portfolio performance through: reduction of the average loan size and term; strengthening of the "intangible" aspects of credit analysis (character, experience of the borrower); requiring stronger guarantees in the troublesome $7500 to $15,000 loan range; and intensifying follow-up and collection. In 1987-88, HDF installed a computerized system for operational and portfolio accounting, and began in 1988-89 to provide funders with monthly financial statements.

3.1 Marketing Financial Services

Over its 11-year history, HDF has relied primarily upon media advertising, brochures and walk-ins to generate and maintain a consistent flow of clients. Before 1989, this included regular advertising on radio and in newspapers. In recent months, the economic downturn has generated a sufficient demand for credit services without advertising. Despite advice to do so, HDF is not aiming advertising at specific small business sectors.

3.2 Creditworthiness Criteria

In order to be eligible for credit consideration, the applicant must be Haitian and have been in business for at least a year. He/she must personally manage his/her business and the project to be financed, and the enterprise must be one whose net assets are not so great that the applicant could qualify for commercial bank credit ($200,000 established as maximum asset size). The enterprise must also demonstrate real growth over the past year.

HDF has revised the application of creditworthiness criteria to place the greatest emphasis upon character of the borrower. While collateral is still required (for loans of over $2500), it is fourth in rank order in the institution's creditworthiness criteria, which are:

1. Character.
2. Experience in the business being financed.
4. Collateral (in the form of cash, mortgage on property, co-signers with liquid assets; lien on equipment being financed).

In making the credit decision, HDF Credit Officers weigh 65% of their decision on character, and about 35% on capacity to manage and repay.

3.3 Risk Management

To HDF management, the highest risks of non repayment emanate from the character of the borrower. An applicant with a questionable record for meeting obligations and dealing with neighbors is not considered an acceptable risk, regardless of the level of collateral offered. Good character references and experience in the business can significantly reduce the collateral required.

HDF management views as an acceptable level of risk of bad or uncollectible loans within the small enterprise sector a maximum of five percent (5%) of portfolio.
Because the clientele is more than 70% in the higher risk small enterprise market, HDF has evolved a risk reduction strategy to minimize poor judgements on character and capability and to intensify follow up. The following measures have been taken and are being tightened as part of an Action Plan to Improve Portfolio Quality:

1. Loans are made largely to proven businesses, with an established reputation.
2. Follow-up is done on a case-by-case basis, with good clients receiving visits 2 - 3 times yearly, and higher risk ones being visited at least six times per year; co-signers are simultaneously visited.
3. Diversification of the loan portfolio is a continuous point of emphasis, including extension of new loans (often working capital) to proven clients and financing to service and commercial activities, as well as small industry.

3.4 Reduction of Transaction Costs

Part of the struggle for sustainability turns upon reducing servicing costs. Several strategies have been employed in the current five-year operating plan. These include:

1. Streamlining of the credit process, with lower information and documentation requirements for very small scale businesses whose loans cannot be based upon cash flow.
2. Increased computerization of credit analysis, to lower personnel costs.
3. More reliance upon "character lending", which has in turn reduced collection cost on larger loans and reduced the need for cash flow lending analysis for smaller-scale businesses.

Overall, more emphasis has been placed at credit analysis upon business experience and character/reputation.

3.5 Lessons Learned

HDF's experience has shown at significant cost that:

1. A key to successful extension and recovery of credit to small business is the redefinition of creditworthiness criteria, focusing not upon traditional collateral but upon character (reputation and record for meeting community obligations, motivation to succeed).
2. Creditworthiness criteria emphasizing character and business experience tend to favor existing businesses in the initial stages.
3. In any kind of lending, the highest risks of non-payment derive from the character of the borrower, not the absence of collateral.

4. JAMAICAN AGRICULTURAL DEVELOPMENT FOUNDATION (JADF)

JADF was started in 1984 by a consortium of private U.S. and Jamaican investors. The institution was designed and capitalized as an investment corporation to extend financing to Jamaican-owned small-to-
medium-scale enterprises in agricultural production and processing, and to stimulate the development of young entrepreneurs via project services and innovative vehicles for equity building.

4.1 Marketing Financial Services

In Jamaica, a mixed marketing strategy has been used. Advertisement of JADF services and its flexible approach to agribusiness financing has been used on radio and in newspapers with some degree of success, but this alone has not been sufficient to generate a sustaining annual level of business. Significant new business has been generated by existing clients and by personal marketing contacts by management staff.

4.2 Creditworthiness Criteria

Criteria used by JADF in the early years (1984 through 1987) were heavily weighted on tangible collateral (land or building or machinery) on which a lien could be taken.

To encourage the development of agriculture and an entrepreneurial class among young rural Jamaicans, the Foundation has gradually begun to emphasize more intangibles (physical labor, relevant experience and motivation to undertake and succeed in business concerned). High ratings on these intangibles plus substantial equity in the project (30%) often substitute for low levels of tangible collateral.

4.3 Risk Management

With USAID and other funding, JADF has established a data bank on specific crop costing and supply constraints to identify profitable opportunities for entrepreneurs as clients. This data bank in turn has allowed the institution to define acceptable levels of risk and to apply risk reduction measures which are industry or sub-sector specific.

Risk reduction has been accomplished largely through: more rigorous evaluation of project proposals (aided by the data bank on sectors); a regular regime of follow-up visits to the project site; and disbursements to third parties wherever possible (for example, to equipment or inputs suppliers).

4.4 Reduction of Transaction Costs

JADF has gradually reduced its cost structure as a percentage of average earning assets since the last full evaluation held in 1987. At that time, cost structure was projected to reach 16.5% net of USAID support. By October 1990, total expenses were 7.9% of average earning assets. Personnel cost/earning assets were 2.2%, down from the anticipated 4.4% at the evaluation.

Transaction cost reductions could be attributed to several factors. These include the increase since 1987 in commodity flows from PL480, generating more local currency proceeds for lending. Costs have probably been to some extent reduced by increased efficiency. The requirement of a flat fee (1.5% of the loan amount) for project services has generated offsetting income.

4.5 Lessons Learned

JADF's experience has provided interesting lessons in serving the small enterprise market as a non-bank intermediary. These are:

(I) In order to work with a higher-risk market (agriculture-related projects) and higher-risk borrowers (young entrepreneurs), financial institutions must adopt creditworthiness criteria that meet the primary characteristics of the market. Loans must be based upon a
combination of intangibles (motivation to undertake and succeed in an agribusiness), plus personal (equity) investment.

(2) Effective intermediaries must sometimes be willing to develop creative means for deepening equity ownership in SMEs, for example, capitalized sweat equity in a production enterprise.

(3) Development and use of a data bank on specific sub-sectors can help establish profitable lending opportunities and reduce lending risk.

(4) In marketing financial products, media advertising alone will not guarantee a sustaining annual market of viable projects. Targeted, sector-based marketing outreach by credit staff is necessary to generate a good portfolio.

5. BOTSWANA DEVELOPMENT CORPORATION (BDC)

The Botswana Development Corporation (BDC) was founded as a development finance corporation to encourage the growth of Botswana enterprises that would provide employment and better quality services. With emphasis on small- and medium-scale ventures, investment activity was to concentrate upon sectors demonstrating acceptable returns and significant economic impact.

The present investment portfolio of BDC is mixed and includes a number of medium-to-large-scale companies. BDC's general policy is to invest in lower-risk commercial enterprises in order to guarantee acceptable dividends for the shareholders. Like the JADF in Jamaica, while the initial purpose was to become a prominent equity investor in the economy, the BDC has become largely a lender.

5.1 Marketing Financial Services

Marketing methods used are largely reactive and include the following:

(1) Distribution of BDC promotional brochures through business organizations, associations and chambers.

(2) Media advertising.

(3) Participation in local and international trade fairs.

(4) Direct calls by BDC officers to interested promoters.

5.2 Investment Criteria

The institution's criteria for project approval are:

(1) Generation of significant and sustainable employment.

(2) Adding to the marketable skills of Botswana.

(3) Import substitution.

(4) Investment in rural areas.
(5) Reasonable rate of return, defined as at least meeting the cost of inflation and opportunity cost of money.

(6) Security for investment (collateral backed loans, other).

5.3 Risk Management

Risks that are acceptable to BDC include the following investment characteristics:

(1) Demonstrable prior business experience and effective management in lieu of tangible assets.

(2) Sizable and consistent contract orders in lieu of hard collateral.

(3) Willingness of the entrepreneur to accept BDC assistance in management and technical oversight.

BDC's most important risk reduction measure is reaction to market demand, as opposed to seeking out higher-risk and development-oriented investments. Other measures are:

- a first disbursement audit to ensure compliance with conditions and to spot problems;
- problem-solving at the implementation stage (internal controls, etc.) through regular site visits and monitoring reports.

BDC has had recurring problems in carrying out these controls in part because of poor transition from project development to operation.

5.4 Reduction of Transaction Costs

BDC does not appear to have devoted as much creative effort to reducing costs as have the non-bank credit intermediaries. The corporation is likely operating with a higher cost structure than is reflected by the percentage reported (3.9%).

5.5 Lessons Learned

BDC has taught the development finance and investment communities some significant lessons about the financial and operational factors that affect an institution's ability and willingness to serve the financial needs of SME. Among these are:

(1) The pressures to become financially sustainable and generate acceptable returns to shareholders often outweigh SME promotion objectives and bias the investment program toward lower-risk/higher-return investments.

(2) Likewise, the pressure to reduce investment risk and maintain good returns can cause such an institution to focus more on expressed demand for financial services, which often comes from lower risk/higher return sectors.
6. PROMOTION OF RURAL INITIATIVES AND DEVELOPMENT ENTERPRISES (PRIDE)

The PRIDE credit model is currently operating in Kenya and Guinea and will soon be replicated in Tanzania. It was created by the Council for International Development, a Nairobi-based NGO dedicated to private sector development in developing countries. PRIDE is a high-volume, high-repayment credit program that provides non-collateralized credit and savings facilities to small- and micro-enterprises that are unable to obtain financial services from commercial institutions. The credit program is based on the principles of the Grameen Bank of Bangladesh and uses multiple group guarantees in lieu of traditional collateral. Unlike the Grameen bank, PRIDE participants are encouraged, when possible, to enter the formal banking system.

6.1 Marketing Financial Services

The availability of PRIDE's financial services is marketed through the education program, which is an integral part of PRIDE's activities. Before applying for a loan, members of the Market Enterprise Committee meet weekly for eight weeks learning PRIDE policies and regulations. The weekly meetings provide an opportunity for members to increase their understanding of savings, credit and financial responsibility.

6.2 Creditworthiness Criteria

Though details of the PRIDE Model vary from country to country, PRIDE establishes a common creditworthiness criterion. Creditworthiness is established in the form of multiple-level group guarantees. Those who receive credit must be members of a Market Enterprise Committee (MEC), which cross-guarantees PRIDE loans to its members. The creditworthiness of those who have already been issued credit is verified through computerized loan tracking.

6.3 Risk Management

PRIDE's primary risk reduction mechanisms are the following:

1. A loan insurance fund.
2. Membership in the Market Enterprise Committee. This is the core of the credit model. These are self-selected groups which normally come from the same local community or market center. Members meet weekly and these weekly meetings are used to collect principal and interest on loans from them. Members also contribute about $1.50 (U.S.) to the Loan Insurance Fund to cover any loan defaults and mobilize client savings.
3. A computerized management information system that monitors and controls the credit operations.

6.4 Reduction of Transaction Costs

PRIDE offsets its transaction costs by charging interest rates higher than those charged by commercial banks. These rates are generally 5-10 points above the commercial lending rate.

6.5 Lessons Learned

The operations of PRIDE furnish the following lessons about the financing of small-scale enterprises:
(1) It is possible to successfully extend and recover loans to small-scale enterprises without insisting on traditional collateral. A well thought-out credit facility can ensure payment of principal and interest on loans through the use of multiple-level guarantees and peer pressure.

(2) Charging clients above-market rates will not lead to unacceptable levels of default.

(3) Involvement of clients in the credit process through education and self-selection can lead to a large pool of sound credit clients.

(4) Credit programs like PRIDE can be replicated with modifications reflecting local conditions.

7. LA FINANCIÈRE, CÔTE D'IVOIRE, WEST AFRICA

In 1980, a group of Senegalese businessmen established in Côte d'Ivoire decided to address the ongoing problem of lack of financing from banks for small-to-medium-scale businesses. They applied the West African concept of a *tontine*, or mutual savings and credit association, to develop a financing company intended to use member deposits to make investments in local business.

Once a capital "pool" of member deposits was accumulated (about $300,000), the funds were earmarked for use in a multi-faceted investment program, including:

Phase I: Direct investments in one or more private businesses, generating profits that would be turned back to members in the form of dividends.

Phase II: Use of corporate profits from investments to either guarantee bank loans to members or provide loans directly to members/businesses.

In the process of developing Phase I and rendering the organization profitable, La Financière has deferred issuance of dividends to members. It has also deferred Phase II plans calling for guarantees or leveraging for member small businesses. The principal benefit which La Financière has delivered to members is a safe, secure savings deposit facility. This has been sufficient to attract and maintain an average membership of around 200 monthly depositor/members.

Increasing pressure from members and outside funding organizations has convinced La Financière's management that the "no dividend" investment program cannot continue to hold small investors indefinitely. Alternatives for packaging dividends for members are being considered.

The thrust of La Financière's investment program has shifted to one of direct investment in medium-scale businesses. In addition, the organization launched in 1990 a proposal to establish a venture capital company, to make investments in third-party African-owned businesses in industry and commerce. Results of a recent feasibility study will determine the size of the fund and the range of portfolio investments which can be made.

The shift to larger-scale investments has occurred for several reasons. Among these are: the limited capital base that can be subscribed from the small investor public to seed a finance company in Africa; the limited impact that seed funds in the range of $250,000 to $300,000 can have in a developing capital market; and the considerable lead time required to develop and test an investment program to the point where it will generate returns sufficient to capitalize other investment activities, such as small business guarantee funds.
The lessons learned from the experience of this experiment in small investor capital mobilization in Africa, are the following:

(1) It is possible to mobilize small savings within the informal and formal sectors in Africa and use them to generate capital for reinvestment in private investment projects.

(2) The lead time required to mobilize a significant amount of capital (range of $300,000 and above) is significant if the investor base is the small investor public (two years or more).

(3) Because of the lack of experience in Africa in development of larger-scale private investments and vehicles for promoting financial deepening, the process of mobilizing and directing such capital tends to be "top down". Successful examples have not thus far been essentially democratic as regards participation in decision-making and dividend sharing by private small investors.

(4) Extension of the benefits of financial deepening through African facilities like La Financière, is going to require: Identification of a broader base of capable African entrepreneurs with attractive business investments; development of more highly evolved financial instruments that can respond to needs of the local investment markets (venture capital, convertibles, etc.); and further technical assistance to African investors in developing and managing broader based investment facilities.
References
III

INCOMPLETE LINKAGE BETWEEN INFORMAL AND FORMAL FINANCE IN GHANA

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INCOMPLETE LINKAGE BETWEEN INFORMAL AND
FORMAL FINANCE IN GHANA

This study analyzes how the fragmented nature of Ghana's financial system prevents different segments from fully realizing their comparative advantage in terms of savings mobilization and credit allocation. "Fragmentation" is used in this paper to refer, not simply to the existence of different segments (which may represent specialization for different financial market niches), but to the lack of integration of those segments and of units within them, as evidenced in the absence of financial flows between them, lack of access of clients to different segments, and different (risk-adjusted) interest rates. At present, the volume of lending is not directly related to how much savings the system could mobilize, thus providing no incentive for savings mobilization efforts. The evidence of this study implies that closer linkage would enable both formal and informal segments to lower costs through economies of scope without greatly increasing risks, and a workable means of achieving such a linkage is proposed.

A. BACKGROUND

Financial Mobilization in Ghana

With a low level of intermediation during the 1970s and 1980s, Ghana's domestic savings and investment rates remained low and the economy generally performed badly. Between 1967 and 1987, GDP grew at an annual average rate of only 1.3% and per capita GNP declined at -1.6%. The real value of M₂ fell steadily between 1974 and 1983 by an average of 10% per annum. Savings was only 6% of GDP in 1988, down from the 1965 figure of 8%, and investment was only 12% of GDP when the average for Sub-Saharan Africa was 18%, a level Ghana had earlier attained in 1965.

The poor performance of the economy in the period preceding economic reforms \(^{1/}\) was reflected in weak growth in the productive sectors, including agriculture and industry; declining export revenues on account of low commodity prices and diminishing export volumes; mounting debt; and worsening social conditions through food insecurity, inadequate housing, rising unemployment and political instability. In the face of inadequate domestic resources, dependence on external financing grew rapidly during the reform period in order to maintain production and consumption at earlier levels. Net official development assistance (ODA) from all sources to Ghana grew from $169 million in 1979 to $372 million in 1986, while net transfers grew by almost 370% between 1984 and 1985 and another 205% the following year. Despite economic recovery, private capital inflows remained low. Foreign direct investment fell from $16 million a year during 1980-82

\(^{1/}\) Economic reforms began in 1983. These were directed at arresting the continuing deterioration of the economy, following what were regarded to be almost two decades of economic mismanagement. They sought mainly to address the distortions in relative prices, which tended to favor the less productive sectors of the economy such as trading and rent-seeking activities.
to $2 million in 1983-84 and 1984 and rose only slightly to $4 million in 1986 (compared to $68 million recorded for 1970).

By 1990, growing dependence on official development assistance signalled that self-sustaining mechanisms for growth had not yet been found, despite the generally successful Economic Recovery Program. The financial system has proven inadequate in mobilizing domestic resources for investment, in part because of its fragmentation. Reform of the financial sector since 1985 has primarily involved elimination of controls on interest rates and credit and institutional strengthening through better arrears management, removal of bad debt from the balance sheets of banks, and recapitalization of some ailing institutions. This reform program has concentrated mainly on the operational side of the formal financial sector.

Aryeetey et al. (1990) investigated the impact of a more liberal pricing approach by testing for the significance of interest rates in a McKinnon-Shaw framework. They concluded that real interest rates had not as yet had any significant impact on savings mobilization in Ghana. Thus liberalization alone was not sufficient to release and channel inaccessible domestic resources for capital formation. The study also established that commercial banks were burdened with excess liquidity, stemming from their reluctance to undertake what was perceived to be high-risk lending and from relatively restrictive credit management policies.

Fragmentation of Informal Finance

Nevertheless, evidence suggests that much greater domestic resource mobilization is possible. Aryeetey et al. (1990) estimated that between 20% of urban and 50% of rural incomes are not immediately consumed by households. A major problem with this form of savings, however, is that, especially in rural areas, over 80% of it is kept in real assets and is not available for investment. Reasons include the low degree of monetization of the economy; there are not enough instruments to channel unconsumed income into worthy financial assets. Since most of the private domestic savings that occur are found mainly in the informal sector, the importance of the informal segment of the financial system cannot be over-emphasized.

Despite the existence of a large informal financial sector in Ghana, its effectiveness in intermediation is rather limited (Aryeetey and Gockel 1991). Informal institutions that primarily mobilize deposits, e.g., susu collectors, do relatively little lending, and only of a very short-term nature. Those that lend regularly (moneylenders) typically are not involved in mobilizing deposits and thus have a narrow capital base. Greater interaction between these institutions and the banking system—the focus of this study—has the potential to improve intermediation in the system as a whole. The potential arises out of the fact that there is already substantial placement of informally-mobilized savings in demand deposit accounts held with banks. However, due to the very short-term nature of deposits and the fact that the formal system has not as yet developed

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2/ See Hettige (1992) for a review of this literature.

3/ Parker Shipton (1990) notes (in the context of Gambia) that non-financial assets enable savers to remove "wealth from the form of readily accessible cash without appearing anti-social" in the face of "an almost infinite number of relatives or neighbors with pressing needs."
effective instruments for transforming such short-term deposits, these funds remain unutilized for capital formation.

One reason financial markets remain fragmented is that information possessed by some segments is often not available to other segments. For example, while moneylenders are able to assess the character of potential borrowers more thoroughly than banks, such information is controlled by moneylenders and inaccessible to banks, whose operational norms and institutional structures do not permit intimate knowledge of clients. Similarly, while banks may be equipped to analyze the feasibility of projects and obtain clearer impressions of projected cash flows, such information cannot readily be obtained by barely educated informal lenders. The result is that the risks associated with lending tend to be higher than in the case of more complete information. The market is fragmented because the resultant prices of financial services offered by the various segments appear to be independent of one another as operators face different sets of risks, conditioned by the limited information they possess. Many potential investors with viable projects get rationed out in the absence of adequate means to establish how 'bankable' their project would be, other things being equal.

Considering the significance of the problem caused by poor information to lenders, it would appear that a more integrated financial system in which the flow of information among the sectors is unhindered and in which each sector can draw on the information collected by other sectors would help reduce individual and collective risks and encourage greater mobilization of domestic resources. The limited information available to banks on small clients makes direct lending to them a high-risk, costly venture, which they avoid.

While informal financial agents have better knowledge of the character of small borrowers and the socio-economic conditions needed to lower the risks of lending to them, the volume of such lending is restricted by their short-term liability structure and limited capital base. If these informal lending agents gained access to the relatively larger capital base of formal institutions, they could increase their volume of lending and reduce unit administrative costs. They would benefit from economies of scope (Clark 1988) involved in adding a financial service (lending) that complements the present principal activity (holding deposits) and involves relatively little additional effort. Increased availability of credit would in turn generate income and increase the amount of financial savings that would be mobilized by informal agents and deposited in the banks.

Methodology

The study presents a framework and some preliminary evidence on segmentation of the financial system in Ghana. It investigates the following hypotheses:

- Direct operational relationships between some formal and informal financial agents exist but have not been structured to facilitate financial intermediation.

- Segments of the informal sector (susu collectors) that are interested in lending to small borrowers are limited by the very short-term nature of the deposits they hold and their own lack of access to finance. When they do lend, they attempt to minimize risks by a high degree of monitoring, which tends to raise their administrative costs.
An on-lending facility from commercial banks to some segments of the informal sector would expand access to credit, reduce the overall transaction costs of lending, and reduce the cost of funds to the banks.

The study focuses on the relationship between members of the Greater Accra Susu Collectors’ Cooperative Society (GASCCS) and Ghana Commercial Bank (GCB) in order to illustrate how positive and practical linkage development may be achieved through risk-pooling measures. General information on the characteristics of the susu collection business is based on 151 interviews (Aryeetey 1991) supplemented by three meetings of the executive committee of the society that the authors attended as observers. A more detailed questionnaire on information flows, perception of risks, loan administration and default costs was administered to five typical susu collectors (selected from among the 151) for this study. The questionnaires sought data about the type of information and methods employed in obtaining such information, as well as what it costs to the lender to find and use such information.5

A specific objective of the study is to investigate the potential for an effective linkage between GCB and GASCCS that would improve financial intermediation and expand the volume of credit going to small borrowers. The issue is whether the existing one-way linkage between them in the area of savings mobilization can be developed into a two-way linkage that also caters for the allocation of credit after successful intermediation. Before discussing the existing relationship between susu collectors and GCB, some characteristics of the susu collection business are described.

B. AN INTRODUCTION TO THE BUSINESS OF SUSU COLLECTION

Susu collectors, or individual mobile bankers, take daily deposits from a variety of savers (mainly market women) and return these deposits to their owners at the end of each calendar month.4 This activity has been documented by Aryeetey and Gockel (1991), who established that 77.5% of market women in Ghana’s three principal cities saved in this manner. No interest is paid on the deposits, but rather a service fee of one day’s deposit is withheld by the susu collector. The GASCCS is an association of about 500 of these susu collectors located in and around Accra.

4/ A similar exercise is to be carried out with formal institutions to highlight the information asymmetry observed with lending in most developing countries (Hoff and Stiglitz 1990).

5/ The susu collection system must be distinguished from susu clubs (or tontines), which are rotating savings and credit associations to which a fixed group of members contribute regularly and receive the collected amount in turn. A recent variation is the "savings and loan" company, which offers credit to depositors who accumulate over a long period of time (at least six months) and hires people to make the daily collections. Most of the savings and loan companies that arose in the late 1980s have failed because of poor management of funds and loans: only two have met the standards of regulations that were issued by the Bank of Ghana in 1990.
Although most of the clientele of susu collectors are female (over 70%), 90% of the collectors are male. One explanation is the high level of illiteracy among market women; men are more likely to be capable of reading and writing in order to keep proper records of deposits. This may explain why initially most susu collectors were primary and middle school teachers who undertook the business on a part-time basis. As more and more women acquire basic education it is to be expected that their participation in susu collection would increase. Another explanation for the predominance of male collectors is that susu collection is a very physical activity, entailing long walks from house to house, shop to shop, and to hundreds of market women daily. The business is no longer a part-time activity for those who run it, but bustling with many new and young entrants engaged full-time. By 1990, 59% of them had been in business for less than 3 years, coming in after the Economic Recovery Program. For 73%, mainly between 25 and 50 years old, susu collection was their only occupation; for the remaining 27%, trading occupied about a third of their time (Aryeetey 1991). This contradicts the popular notion that susu collection is just another moonlighting activity for teachers and other public servants.

The average susu collector is able to take in deposits to the tune of C87,000 (US$218) daily from depositors who put aside amounts ranging from C100 to C1,000 daily, with an average deposit of C290. The accumulated deposits are intended to be utilized in several different ways at the end of the month, including as working capital and for consumption purposes. The collectors have on the average about 300 people saving with them each month. Large operations involve up to 1,500 persons in a month. Usually, collectors with more than 600 clients have an assistant. We estimate that members of GASCCS are able to mobilize C43,500,000 worth of deposits daily.

Use of Deposits

Susu collectors usually use the deposits mobilized from market women and others in one of five ways:

1. deposit them in a bank account (usually in a demand deposit);
2. hold the deposits at home;
3. invest in own small business;
4. lend to regular deposit clients; and
5. lend to non-clients.

For a long time, the first option has dominated the choices made, but there are some indications of increasing interest in putting the money to work. Out of the total collection, susu collectors surveyed in 1990 deposited between 30% and 100% (with an average of 74%) in their bank accounts, and 56% of the collectors

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6/ Aryeetey and Gockel (1991) had earlier estimated an average daily deposit of C500 based on interviews with market women. The estimate given here is based on interviews with collectors themselves. The exchange rate at the time of the survey was C400 to one US$.

7/ This is far in excess of what was estimated to be mobilized daily from market women (C3,850,000) in the markets of Accra in 1989 (Aryeetey and Gockel, 1991). The earlier estimate did not take account of deposits that were mobilized from homes and shops outside of the markets. The collectors suggest that the deposits of traders with their own shops are much larger than those of market women.
maintained that they deposited the entire collection. Since the financial system does not presently offer any interest-bearing short-term accounts, this high use of demand deposits may reflect either a preference for security over return or the lack of financial instruments suitable for the short period (less than one month) over which they can hold the deposit.

For those who did not place their entire collections with banks, most of the remainder was either invested by the suSu collector himself in a trading business or kept at home (although they seldom admit the latter). We estimate that over the past few years, as opportunities for trading have improved, they are depositing a smaller proportion (about 45% presently) of the entire deposits mobilized and using more for trading (Table 1). Collectors may lend to a few very trusted clients and occasionally to non-clients.

Table 1: ESTIMATED DISTRIBUTION OF THE LIABILITIES OF SU SU COLLECTORS (percentage)

<table>
<thead>
<tr>
<th>Deposits with banks</th>
<th>45</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits either held at home or invested in trading</td>
<td>40</td>
</tr>
<tr>
<td>Loans to regular clients (low-risk, low returns)</td>
<td>9</td>
</tr>
<tr>
<td>Loans to non-clients (high-risk, high returns)</td>
<td>6</td>
</tr>
</tbody>
</table>

Existing Intermediation Between Informal Savers and Ghana Commercial Bank

Members of the GASCSS have collectively undertaken to place their deposits with Ghana Commercial Bank (GCB). The decision to use GCB was justified on two grounds: the large volume of deposits they place with GCB would, hopefully, encourage the bank to grant them various facilities, including credit at concessionary rates for on-lending and exemption from various charges usually associated with demand deposits; and GCB has the widest branch network in the region and in the country, which was convenient to the collectors in terms of distance to be covered.

Despite this decision, a small number of suSu collectors still save with other banks, especially when those banks have a branch nearer their areas of operation than does GCB. Only one (who was new and in the process of opening an account) out of the 151 suSu collectors interviewed in 1990 (Aryeetey 1991) did not have a bank account at the time, and 117 had accounts with several branches of GCB in Accra. For over 75%, only a demand deposit was operated, while another 20% operated both a demand deposit and a savings account. Those who did not save with GCB often used other indigenous banks. Only three of those studied saved with a foreign bank. They preferred indigenous banks to foreign banks because they regarded their chances of obtaining credit facilities as higher.

Bank branches that suSu collectors choose for their deposits are usually within a 3 km radius of large markets because they sometimes make more than one visit to the bank in a day. An average of 3 deposits are made in a week. All suSu collectors maintain that security was the main reason for using banks, aside from it being a regulation of their association.
The significance of the observation that susu collectors use deposit facilities made available by banks for safe-keeping purposes lies in the intermediary role that susu collectors play between savers and the banking system, thereby opening up the potential for enhanced financial intermediation. The positive features of this role include:

- the magnitude of savings mobilized in this manner which would otherwise have remained outside of the banking system;

- the reduction in the savings mobilization costs of GCB, which pays nothing for the service performed on its behalf by the susu collectors;

- the reduction in the transaction costs of savers (which helps explain their willingness to pay a service fee) as they avoid travelling to banks and queuing up to make deposits and withdrawals, as is common in Ghana; and finally

- the advantages of the savings habit it helps to develop in the clients of the system.

Susu collectors are usually constrained in the amount of credit they can give by the short-term nature of their liabilities. In their attempts to play an intermediary role, they cannot usually lend beyond the month-end maturity of their liabilities. In their own words, "we lend to some of our trusted clients at the beginning of the month the savings we mobilize in the first few days of the month and hope that the clients would complete repayment by the end of that month so that we can return to the depositors the full amount of their deposits." Any outstanding loans on the last day of the month may prevent them from meeting their obligations, and such failure could jeopardize their careers as susu collectors.

The entire lending capital base is made up of (a) early deposits, (b) part of expected income from the service fee, or what they call their "commission," and (c) interest income from lending to non-clients or sometimes the returns from doing 'quick business' with high turnover rates using the deposits of the clients. It is not surprising that few susu collectors engage in the risky business of financing the clearance of goods by importers (who may not be regular clients) from ports, even though these usually attract much higher interest rates.

GCB's Relationship with Susu Collectors

Although GASCCS adopted the strategy of requiring all members to save with GCB to give weight to its requests for credit and special concessions, susu collectors generally complain that "banks do not appreciate their usefulness to the banking system." Their primary concern is to overcome their inability to satisfy the demand for "advances" by their clients. They maintain they have for a number of years requested GCB (both as individuals and as a society) to assist in their attempts to play the role of financial intermediaries by providing them with on-lending facilities, but these requests have always received negative responses, often with no explanation.
Until recently, GCB did not officially recognize any 'special-client relationship' with the susu collectors, meaning that they were treated as any other customers when making deposits and withdrawals. The unusually long time (30 minutes to 1 hour) it took to make such transactions resulted in a slowing down of their business on the days that they went to the bank. They requested that special booths be opened to serve them or that some tellers be allocated to provide them with "express service." This has now been done in three branches of GCB, but GASCCS would like to see it done in a few more branches. In addition, GASCCS has sought a waiver of ledger fees to help reduce their own costs. Even though the sum involved is relatively insignificant, they argued that it would signify GCB's recognition of a 'special client' status for them. Another issue is that GCB branches often pay susu collectors with small cedi denominations, resulting in their having to spend lengthy periods counting notes in order to make their own payments to clients. This holds them back unduly at the end of each month, increasing transaction costs as payments take more time to complete than anticipated.

One factor limiting the interest of GCB in providing credit to individual susu collectors is that their balances rise steadily throughout the month, peak just before the end of the month, and then drop sharply as accounts are run down to make payments. Data supplied by susu collectors show that individual collectors' average balance rose from C667,572 at mid-month to C1,180,940 near the end of the month (just before the account was emptied for payments to clients (Aryeetey 1991). Data obtained from one branch of GCB with 46 known susu collector accounts showed their total balance in mid-December 1989 as C7,930,963 (approximately half of the just-before-month-end balance) but only 12% of that figure at the end of the month. In another GCB branch with 31 susu collector account holders, the average balance on the last day of December 1989 per collector was C184,354, after dropping by over 80 percent of the mid-month figure. Nevertheless, in some branches of GCB, deposits originally mobilized by susu collectors in a month constitute substantial proportions of average demand deposits held during the month. In a relatively small branch near a large market, deposits from susu collectors formed over 40% of demand deposits made in one month.

In requiring all members to save with GCB, GASCCS's strategy was "that the large deposits would add weight to (their) voice" in requesting concessions. GCB is gradually recognizing the significance of susu operations to its own operations, as indicated by their beginning to identify accounts held by susu collectors. Some branch managers suggest it is not always easy to identify such accounts, since many collectors indicated other occupations when opening accounts. The obligation to indicate their being susu collectors has only come with the formation of the GASCCS.

For GCB a major question remains what maturity transformation is possible with the set of financial instruments open to it. The sharp drops in balances on the last day of each month make conservative bankers develop an attitude of indifference towards the account of susu collectors. Most bank managers spoken to in the course of this study insist that this would be less of a problem if the economy was growing rapidly and more short-term finance was being demanded. It should also be noted that the pattern of balances for susu collectors is the mirror image of that for government employees and other workers whose paychecks are deposited at the end of the month and then steadily drawn down.

On the other hand, susu collectors suggest that GCB underestimates the potential demand for short-term credit among small borrowers, particularly market women. Their argument, which is similar to those
advanced for innovative credit schemes such as Grameen Bank in Bangladesh and the BRI Unit Desa system in Indonesia (Jackelen and Rhyne 1991), is that those who save short-term are usually restrained from long-term saving by low incomes. They save in order to accumulate the lump sum they cannot borrow, mainly for working capital. If they gained access to short-term loans that had suitable repayment terms, i.e., daily in small accounts, their working capital needs would be met more promptly, thus improving their incomes and their ability to save for longer periods. The popularity of the short-term susu deposit facility can be taken to indicate strong demand for short-term finance. The collectors predict that they could double the number of clients if all those considered creditworthy were to obtain loans. Before investigating the potential for a linkage between GCB and GASCCS to better serve this demand, we provide more detailed information on direct lending by average-sized susu collectors based on five interviews for this pilot study.

C. LENDING BY SUSU COLLECTORS

When providing advances, susu collectors are generally guided by the size of their clients' daily deposits. Those who save at the usual minimum daily deposit rate of C100 very seldom obtain advances, and not more than C3,000 in a month. The average susu collector provides a total of C240,000 worth of advances to regular clients each month, only 9% of average monthly deposits mobilized. An average of 40 out of their average 300 clients (13%) receive advances, making the average loan size about C6,000 ($15). The collector normally ensures that only a part of the expected monthly deposit (C8,700 average, somewhat more for actual borrowers) can be taken as an advance (they often mention 50%). The largest monthly loan reported for 1991 was C120,000, which the collector intimated was exceptional.

Average Maturities and Interest Rates

Susu collectors seldom permit clients to repay advances over periods stretching beyond a month. When relatively large amounts are given out, as in the mentioned exceptional case, a maximum of three months is provided for the completion of repayment.

It is interesting that most susu collectors insist that advances do not attract any interest payments. What they actually mean is that there is no explicitly stated interest payment agreed with the borrower. However, the implicit interest payment built into the service fees that all depositors pay remains applicable, since clients have the option of not saving for a month and thus avoiding the fee. Thus for borrowers who only take as "advance" the equivalent of what they would normally save in a month, the monthly service fee of one day's deposit represents 3.3% of total monthly payments. Taking the advance as a loan that is amortized through fixed daily payments over 30 days, the daily interest rate is 0.2% or 119% per annum (see Annex 2). Borrowers who take an advance in excess of their normal monthly accrued deposits are obliged to raise the daily deposit to an amount that permits repayment within a month. For example, a market woman who normally deposits C500 daily and borrows C30,000 is obliged to pay C1000 daily, thus providing the susu collector an extra service fee of C500 for the month. The effective interest rate remains 119% per annum (although they see the cost as the ratio of the fee to total deposits, or 3.3%).
In some situations interest payments are explicitly stated in excess of the usual service fee, usually when loans are to be repaid over periods exceeding one month. Interest rates of about 40% for three months have been observed. For example, a market woman who normally deposits C500 daily and desires to take an "advance" of C45,000 may be asked to raise her daily deposit to C700 for three months, yielding a total commission of C18,000 or 40% of the amount lent. The daily extra interest payment of C200 might appear acceptable to some clients who have a highly profitable business opportunity, although it represents an implicit daily interest charge of 0.8% (or 17.78% per annum if compounded daily).

Many susu collectors suggest that explicit payments of interest as in the latter example are not very common since "such practices undermine the confidence that market women have in (them)." It would appear that an increase in the volume of advances and the corresponding increase in service fees would appropriately compensate them for the loan services they provide. Considering that they already derive income from accumulating deposits without lending, the incentive for increased lending is the expected increase in the number of clients and the resulting additional service fees (commission).

**Lending Capacity**

Deposits and income from service fees form the initial source of lending capital for most susu collectors. They typically begin the business by being introduced to a group of market women by one of the women who knows the collector from elsewhere. In the first few months of operation they do not go into lending until they have come to know their clients and their established saving patterns. They can add their income from commissions only if they have large enough groups that assure them of an income beyond what they require to run their businesses and maintain their own households. None of those interviewed had borrowed to sustain the lending business. Since as many as 60% of their clients regularly request financial assistance and only 13% actually receive such assistance, it would appear that their lending capacity is severely limited relative to demand.

**Cost of Funds**

The cost of funds may be measured by what it costs the susu collector to provide one client an advance out of funds mobilized from other depositors. Costs in principle may include interest payments to the depositors and handling costs. All these costs tend to be negative since the susu collector receives payment for taking deposits and avoids having to deposit them at GCB to the extent that they are lent out. Susu collectors earn interest on deposits with GCB only if their balance exceeds C1 million continuously for half of the year, which means that there usually is no interest foregone. Thus the cost of funds can be estimated as the implicit daily interest rate on daily fixed deposits accumulated over 30 days, or -0.2%, representing the collector's fee of one day's saving. This is equivalent to -6.3% per month or -54.4% per annum (see Annex 2). Thus the gross spread between the cost of funds and lending rates is 0.4% per day or 12.9% using monthly rates (assuming that the borrower would otherwise have stopped depositing).
Transaction Costs

Since the normal form of lending by susu collectors to existing clients involves only advancing the monthly collection at the beginning of the month instead of making it at the end, the additional costs of expanding lending to these clients is virtually nil. Since the risk of default for existing clients is also relatively low, the incentive to expand lending is high—except for the risk that inability to refund deposits at the end of the month would put them out of business.

Significant transaction costs would be involved only for lending to non-clients (for whom creditworthiness information would have to be sought and additional collection efforts made) or for lending agencies that wanted to hire collectors. These costs are estimated to be approximately 7.5% of the average loan amount, most of which is compensation for the collector's time and labor (see Annex 3). This is still well below the spread between the cost of funds and the monthly interest rate. Although the risk of default is higher for non-clients, susu collectors often charge them a higher interest rate (especially for loans beyond one month).

GCB does not engage in very small loans with frequent monitoring. Hence the costs in Annex 3 indicate what it would cost it to hire personnel to carry out such operations on its behalf. These costs cannot be compared to the administrative costs of GCB's more conventional type of lending, which are thought to be lower because monitoring is limited and loan size is much greater. Although no quantitative estimate is available for administrative costs, the GCB Research Department estimates that each cedi lent to its credit customers in 1991 cost 10.9% to mobilize. This figure is seen by the monetary authorities to be excessively high, and it may be contrasted with the negative cost of funds to the susu collector. The spread between gross costs and lending rates for GCB was estimated to be about 13.9% in 1991.

D. POTENTIAL FOR LINKAGE DEVELOPMENT

The preceding analysis suggests several conclusions about the lending costs and potential for susu collectors and GCB:

- susu collectors could significantly increase their volume of lending with little increase in risks or transaction costs;³⁷
- such an increase in the volume of loans by susu collectors would be made profitable by the expected increase in the number of clients who make non-interest-earning deposits and pay a commission to the collector;

---³⁷ At some point, however, new clients attracted primarily by access to credit may prove riskier borrowers than present clients, whose primary motive is saving. Susu collectors believe they can manage this risk by requiring a period (e.g., six months) of saving before a client can receive credit as well as through careful selection and daily monitoring.
- GCB cannot directly provide very small loans without a high risk of default or a substantial increase in the costs of screening, monitoring and enforcement;

- GCB could reduce its cost of funds by mobilizing additional deposits in non-interest-bearing accounts.

At a meeting of the executive committee of GASSCS in March 1992, *susu* collectors indicated that their liability structure could be positively restructured as shown in Table 2 in the short-to-medium term (compare to Table 1):

<table>
<thead>
<tr>
<th>Table 2: POTENTIAL DISTRIBUTION OF THE LIABILITIES OF <em>SUSU</em> COLLECTORS (percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum lending</td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td>Deposits with banks</td>
</tr>
<tr>
<td>Deposits either held at home or invested in trading</td>
</tr>
<tr>
<td>Loans to regular clients (low-risk, low returns)</td>
</tr>
<tr>
<td>Loans to non-clients (high-risk, high returns)</td>
</tr>
</tbody>
</table>

To achieve this, a number of assumptions have to be made, the most important being that if the loans/deposit ratio increased, the average number of clients would rise to a maximum of 600. The proportion of lending to clients could rise to as high as the 60% that request advances each month. However, a more prudent approach would be to assume that only half of these are fully creditworthy, so that collectors’ loans/deposit ratio would be 30%. When the maximum number of clients per collector is achieved, average monthly deposits per collector mobilized would be C5,220,000, of which C1,566,000 would be advanced to regular clients early in the month. If these advances are made by the sixth day of the month, C1,044,000 (or 20% of collection) could be made out of deposit collections for that month and C174,000 out of capital generated by the preceding month's collection fees, leaving C348,000. The latter amount indicates each collector's own requirement for credit in order to reach the targeted level of lending and customers, although the target could also be met by delaying some advances until later in the month when they can be met from deposit collections.

Assuming a 10% delinquency rate, the anticipated shortfall at the end of the month would be C156,600. However, to allow for variations in the delinquency rate and for carryovers, collectors would have to be able to cover a delinquency of up to 20% in any given month, or C313,200. This exceeds the expected monthly commission of C174,000. The average collector will therefore require an assurance of access to credit of C139,200 to cover the maximum expected shortfall needed to repay depositors who did not receive advances. For the entire membership, this would imply a monthly maximum credit requirement of nearly C70,000,000.
However, assuming that no more than a quarter of collectors would need to draw on credit in any given month, the total credit requirement would be estimated at C17,500,000.

Discussions with suku collectors indicate that they would be willing to extend more credit to their clients only if they had a fall-back in case their balances fell short of obligations at the end of the month. Following these conclusions, a possible linkage that would benefit members of the GASCCS, Ghana Commercial Bank and the many small borrowers who utilize the facilities of suku collectors would result from an arrangement through which GCB granted an overdraft facility either to the society itself or to its members. The facility would have to offer immediate and virtually automatic recourse within specified limits. GCB would benefit from increased deposits by suku collectors in non-interest-bearing accounts as the number of their depositors increased in response to the greater availability of advances to their clients.

**Proposed Linkage Mechanism**

To establish a two-way linkage, it is proposed that GCB grant GASCCS an overdraft facility as a pilot project. The key to establishing this arrangement is that GASCCS has mobilized contributions from its members and invested them in treasury bills. Members of the Society pay C1,500 each week towards a security fund, which is used to support members when in difficulty. The individual contributions are recognized as the shares members hold in the Society. From these contributions, C5 million worth of treasury bills had been purchased through GCB at the time of this study.

GCB could initially provide an overdraft facility up to the value of the Society's treasury bills that it is willing to pledge as collateral (maximum of C5 million). Such an arrangement could initially support less than a third of the eventual monthly shortfall as estimated above. However, that estimate is based on double the current volume of deposits with collectors. Hence a C5 million overdraft facility should be sufficient to initiate the process on a somewhat restricted basis (in terms of the number of GASCCS members who qualify and the proportion of their monthly collections that they are permitted to lend out or to cover through the facility).

In this pilot stage, the overdraft facility would be between the bank and GASCCS only, not to individual members. GASCCS' payment obligation to the bank would be independent of the repayment performance of its members. GASCCS is prepared to provide credit to its individual members, provided that it has recourse to a commercial bank overdraft facility. It maintains direct personal contact with its members, and can readily collect from them; it stands ready to cover any defaults by its members.

GASCCS would set eligibility criteria for its members to draw credit from it, including length of experience as a suku collector, amount of funds built up in the security fund, previous repayment record, and evidence of a minimum balance in bank accounts with GCB. (It may be appropriate to seek funding from a donor agency to assist GASCCS in setting up these criteria, terms, bookkeeping procedures, and perhaps a computerized accounting system, as well as training for both staff and collectors who want to lend.) Within this framework the members' equity in the Society's security fund would serve as security against its credit to him/her. The Society could call on these contributions in the event of default by the member.
It is estimated that GASCCS should be able to cover its costs of funds and transactions costs of on-lending by charging a 4% fee for credit drawn by its members. At current interest rates, it is assumed that GCB would charge no more than 2% per month for a collateralized overdraft facility. At projected maximum operation, if 20% of members use the facility each month, about 200 transactions would be involved (withdrawal and repayment for each user). This would involve about 20 hours of work, plus a maximum of 20 hours of bookkeeping and transactions with GCB, or one full-time person. This would cost about C150,000 or 1% of projected transactions. Additional office space and overhead would cost no more than 1%. To the extent that GASCCS provides credit out of the funds it collects monthly from its members, it would avoid the cost of funds from GCB. A portion of surplus funds would be invested in additional treasury bills and used to expand the size of the overdraft facility. Drawdowns not repaid by members within a month would be subject to an additional charge (e.g., 4%). These figures should be reviewed and adjusted periodically in the light of experience.

Expected Benefits from Linkage Development

With recourse to credit from GASCCS, susu collectors would be able to make loans to their clients during the month without risking default on their payment obligations on the last day of the month. If their reserves are sufficient or repayment is made before the end of the month, they may not actually have to make use of the credit facility; it is the access to the facility that offsets the current risk that lending to clients will lead to failure of the susu collector's business. Since the amount of credit they will have access to is limited, they still have to use discretion in granting credit to clients in terms of selection criteria, credit limits, and prudential guidelines that GASCCS may suggest for members' lending. Although the proposed interest rate of 4% per month appears high, it relates only to a small proportion of each collector's loans; most of the funds are mobilized at -6.3% per month, so that the net average cost of funds will remain negative.

With recourse to an overdraft facility from GCB, GASCCS can provide a line of credit to its members, at least up to the amount of the facility. So long as GASCCS has funds in its current account (e.g., in the course of building up its security fund, before purchasing treasury bills), it could issue loans without necessarily drawing on the overdraft. Again, it is the access to the overdraft facility that makes it possible to extend credit. Indeed, as it gains experience, it can leverage that facility in terms of the total amount of credit it makes available to its members.

The benefit to GCB would be increased savings mobilization as the activities of susu collectors expand. To reinforce this relationship, it could be agreed that the average daily balance of the society together with its individual members' own deposits with the bank should exceed the average drawdown on the overdraft facility. It is also possible that some smoothing of the variations in susu collectors' deposits with GCB will occur if they increase lending early in the month when receipts are rising and take in repayments at the end (i.e., retain deposits that they would otherwise have to return on the last day of the month).

Access to credit would reward susu collectors for mobilizing savings by enabling them to earn interest on lending. Instead of letting the mobilized funds sit idle at home or in non-interest-bearing bank accounts, collectors would be able to recycle them in the form of short-term (and perhaps eventually longer-term) credit. This would substantially enhance financial intermediation through the leverage provided by a simple linkage
between the formal and informal financial systems. In particular, it would monetize the collections made by *susu* collectors, who presently operate essentially as safety deposit boxes.

Access to credit from *susu* collectors would improve traders' market power in negotiating purchase prices and, more importantly, increase their ability to make purchases at any time of the week or month that it is advantageous to do so. This means that suppliers could bring goods to market with greater confidence of being able to mobilize cash customers. (At present, middlemen have to restrain the supply of goods at times when buyers are short of funds.) The result should be steadier supplies of goods to the market, with traders, middlemen, producers, and consumers all benefiting from an increased volume of goods. *Susu* collectors may become more willing to provide working capital to their clients in the directly productive sectors.
### ANNEX 1

**SUMMARY OF SOME CHARACTERISTICS OF SUSU COLLECTION**

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average No. of clients per susu collector</td>
<td>300</td>
</tr>
<tr>
<td>Mean daily deposit per client</td>
<td>C290</td>
</tr>
<tr>
<td>Modal daily deposit per client</td>
<td>C200</td>
</tr>
<tr>
<td>Total deposits mobilized per collector per day</td>
<td>C87,000</td>
</tr>
<tr>
<td>Total deposits mobilized per month</td>
<td>C2,610,000</td>
</tr>
<tr>
<td>Total deposits mobilized by GASCCS members per day</td>
<td>C43,500,000</td>
</tr>
<tr>
<td>Average proportion of susu deposits saved with banks</td>
<td>45%</td>
</tr>
<tr>
<td>Proportion of clients requesting loans each month</td>
<td>60%</td>
</tr>
<tr>
<td>Proportion of clients receiving loans each month</td>
<td>13%</td>
</tr>
<tr>
<td>Average total loans from susu collector per month</td>
<td>C234,000</td>
</tr>
<tr>
<td>Average monthly loan request</td>
<td>C15,000</td>
</tr>
<tr>
<td>Average monthly loan granted</td>
<td>C6,000</td>
</tr>
</tbody>
</table>
ANNEX 2

IMPLICIT INTEREST RATES AND COST OF FUNDS FOR SUSU COLLECTORS

This Annex estimates the interest rates and cost of funds implicit in the daily susu collection system. We first examine these rates from the viewpoint that most collectors and depositors themselves take: as ratios of fees to total amount. We then calculate the daily and annualized interest rates on equivalent savings accounts and loans. Examples are based on a daily deposit of C1000 with C29,000 returned at the end of a 30-day month (or advanced at the beginning of the month).

Monthly Commission Ratios

Depositors pay a commission of 3.3% = 1/30 of their monthly savings (or 3.4% = 1/29 of their net proceeds) for the services provided by the susu collector. Why do they not simply accumulate the funds at home? A principal reason is security, but not simply from the risk of theft. Perhaps more important is that available cash is subject to many pressing demands by immediate family members, relatives, friends and neighbors (Shipton 1990). Money reserved for the susu collector (or the group susu, which is a rotating savings and credit association) is generally recognized as a priority obligation and therefore shielded from other demands. A common use of the accumulated funds is to purchase stock for sale during the next month (70% of clients requesting advances stated this purpose). Hence the system represents a means of setting aside working capital to restock supplies at the beginning of each month, when demand and profits are highest just after people have been paid. Why do they not save at a bank? Banks in Ghana do not pay interest on small demand deposit accounts, and the transaction costs are high, both for traveling to the bank and waiting to make deposits or withdrawals (up to an hour).

By the same token, clients who receive an advance of their monthly total (e.g., C29,000) and pay it off through daily deposits (C1000) over the month incur a cost of 3.4% of the loan amount. Those who receive loans for longer periods, especially non-depositors, are generally quoted an interest rate as a proportion of the loan amount, e.g., 40% for a three-month loan.

From the viewpoint of deposit mobilization by the susu collector, the average daily balance over the course of the month is 15.5 times the daily deposit (i.e., \( \text{SUM}(i=1 \text{ to } 30)/30 \), assuming deposits are made at the beginning of the day). The "cost" is -1 day's deposit, or \(-1/15.5\) = -6.45%. For a depositor who maintains daily deposits over the entire year and withdraws deposits at the end of each month, the average daily deposit over the year remains 15.5 times the daily amount, but the total "cost" is -12 days' commissions, or -77.4%. In other words, for acting as a safe deposit box by holding an average of C15,500 of the client's money per day, the susu collector earns C12,000 over the year.

Daily and Annualized Rates

From the depositor's viewpoint, saving with a susu collector may be compared to putting a fixed daily amount (D) into a savings account with interest calculated on the average daily balance during the month.
Because the depositor pays a commission instead of receiving an interest payment, the amount in the account at the end of the month is less than the sum of the daily payments and the implicit interest rate is negative. The daily interest rate (r) that would make the saver indifferent between the two (ignoring transaction costs) can be calculated as:

\[
\sum_{i=1}^{30} D_i r = -D \quad \text{(the commission charged by the susu collector)}
\]

Since \( \sum_i = 465 \), \( r = \frac{(-D)/465}{D} = -0.00215 \)

To annualize this daily rate of -0.2%, we take:

\[
(1+r)^{365} - 1 = (1-0.00215)^{365} - 1 = -0.554 \text{ or } -54.4\%.
\]

In some variations of the susu collection scheme, depositors save for longer periods of time, e.g., six months or a year, to accumulate larger sums or to qualify for possible credit. Someone who saved C1000 a day over 365 days and paid a monthly commission of on day's deposit would accumulate 365,000 - 12,000 = C353,000. The daily interest rate on the average daily balance in an equivalent savings account would be:

\[
\sum_{i=1}^{365} D_i r = -12D \quad \text{(the commission charged by the susu collector)}
\]

Since \( \sum_i = 66,795 \), \( r = \frac{(-12D)/66,795}{D} = -0.00018 \)

To annualize this daily rate of -0.018%, we take:

\[
(1+r)^{365} - 1 = (1-0.00018)^{365} - 1 = -0.0635 \text{ or } -63.5\%.
\]

The implicit interest cost of keeping money on deposit with a susu collector falls sharply with the length of time of the deposit because the average daily balance rises while the monthly commission remains the same. However, by leaving funds on deposit, the saver must forgo the stream of benefits (or profits) that would accrue from the goods purchased with the monthly lump sum.

A borrower receives the anticipated monthly accumulation net of the commission (30D-D) as an advance at the beginning of the month, and repays it through the daily deposit (D). This can be considered equivalent to a loan of 29D that accumulates interest (r) on the remaining balance at the beginning of each period and is amortized through fixed partial payments (D) over 30 periods (i.e., days). This loan would be amortized at precisely the previously calculated implicit daily interest rate for monthly accumulation, i.e., 0.215%. However, since this is a positive interest rate paid on the loan balance, the calculation of the annual compound equivalent differs slightly from that of the corresponding negative rate:
\[(1+r)^{365} - 1 = (1+0.00215)^{365} - 1 = 1.1904 \text{ or } 119.0\%.

If a borrower receives an advance equal to an entire year’s accumulation \((365D-12D)\) and amortizes it through daily payments \((D)\), the implicit daily interest is again the same as above, or 0.018\%. This corresponds to an annualized rate of 6.8\%.

However, as noted in the text, loans that exceed the regular monthly accumulation and that are for terms beyond one month normally involve increased daily payments or additional charges. For example, if a C1,000/day depositor received a loan of C90,000 repayable over 3 months, they might have to raise their daily payment to C1,200, raising the total commission over the period from C3,000 to C19,200 (over 91 days), or 21\% of the amount lent. This amortization schedule represents an implicit daily interest rate of 0.435\%, or 388.4\% per annum when compounded over 365 days.

The cost of funds can be represented by the implicit interest rate on a savings account that accumulates funds in the same pattern as the susu collector. The rate is the same as that calculated above that would make the depositor indifferent between the two schemes, i.e., -0.2\% daily or -6.3\% compounded over a month and -54.4\% per annum. These rates are not widely different from the simple ratios calculated above.
ANNEX 3

INFORMATION AND TRANSACTIONS COST FOR SUSU COLLECTORS

This Annex investigate the nature of transactions between susu collectors and their clients by outlining information requirements and flows and the costs of procuring them, as well as other costs involved in their operations, based on interviews with five average-sized susu collectors. The costing is aimed at showing how much it would cost an outside lender to engage in the type of lending activities undertaken by susu collectors, or a susu collector to lend to non-depositors. Hence we take average costs. It must be noted that the actual marginal cost to an existing susu collector of making additional advances to regular clients would be much less because they are already incurring many of the costs described (representing economies of scope).

To determine the transaction costs attributable to lending, we first estimate the proportion of total personnel time devoted to each aspect and cost it as a proportion of income from deposit collection. The time involved is costed in terms of estimated average monthly earnings for a susu collector, or C87,000 (3.3% of average monthly deposits of C2,610,000). To this are added other administrative costs, to the extent that they are relevant to screening, monitoring and enforcing loans. Susu collectors generally spend C20,000 per annum or C1,666 per month on the printing of cards, and their monthly tax obligation is C2,000. Their average monthly transport bill is C5,600 for moving cash to banks; for the purposes of contacting clients, no transport costs are involved as they travel mainly on foot. Thus total administrative costs average C9,266 a month.

Screening and Risk Assessment

Applications from clients are always verbal. Clients ask collectors for advances as the latter come round for daily payments. Although not usually obliged to state what they require such advances for, clients believe that letting the lender know the intended use strengthens their case for credit. For 70% of loan applicants, advances are ostensibly to be used as working capital—usually to purchase items for sale at the market. For a market woman or trader, the working capital provides an immediate opportunity to purchase goods when stocks run out and a better ability to bargain with wholesalers. For a microentrepreneur, working capital for production helps to purchase raw materials to satisfy an order or build up stock. In a number of cases, advances are explicitly intended for household purposes, such as the payment of school fees and settlement of medical bills (which could be considered as investments in human capital).

Exhibiting an understanding of the fungibility of money, many susu collectors suggest there is often no point in asking loan applicants too intensely how they intend using advances since the lender has no way of controlling this. They are also aware that there is a number of demands on money in the hands of relatively poor persons. Susu collectors realize that a part of advances is often diverted into consumption, but this is not an important issue in screening loan applicants.

The ability to repay is the most important factor in assessing creditworthiness of applicants. Susu collectors make use of their information on the regularity with which clients make payments and the length of time over which they have been saving. These are taken as indicators of cash flow in business and degree
of commitment to financial contracts, and thus of the moral hazard involved. They would also not lend to persons known to be indebted to other susu collectors. This is about the closest they come to determining risk. Most of them screen out clients who have not saved regularly for 4 to 6 months on the average and those whose payments are irregular (i.e., sometimes postponed for a day or two).

The information required for assessing creditworthiness is mostly available from the records susu collectors keep on each client, in the form of individual ledger cards on which all daily payments are entered. Irregular payments are quite conspicuous from the number of empty spaces. Information on indebtedness is often available from other collectors, who exchange information regularly with colleagues about their difficult clients during the regular monthly meeting of members of the GASCCS. In assessing creditworthiness, such factors as religion, gender and ethnicity play no significant role. Hardly any more information is required than is available on the clients’ ledger cards and what is exchanged freely among collectors.

Given that about 60% of personnel time for the first three days of each month is devoted to receiving and screening loan applications (based on the proportion of clients who apply for loans), it may be estimated that in the average month only 6% of total personnel time is allocated to loan screening, or C5,220. This is a real cost of lending to susu collectors because it reduces time available for deposit collection. Since the information on the collection cards is the principal basis for screening and 60% of clients apply, C1000 can be attributed to screening. Since advances are usually made out of daily deposit collections, no transport costs to banks need be assigned to screening. Total screening costs of C6,220 are equivalent to about 2.6% of total monthly loans.

Loan Monitoring and Collection

Susu collectors monitor loans on a daily basis as they visit their clients for payments. In monitoring loans, lenders are primarily interested in cash flow and any signals of eventual default. Thus the information required is obtainable from the entries they make against names and days on their individual ledger cards, whose cost has already been attributed to screening. Given that 13% of clients are borrowers and that monitoring begins after the third day, 11.7% or C10,179 of personnel time can be attributed to loan monitoring and collection. (For an existing susu collector, however, this involves no real opportunity cost because it is precisely the deposit collection activity that the susu collector would be undertaking in the absence of lending). We may, in addition, apportion 9% (the share of loans in total deposits) of monthly taxes and transport costs of taking collections to the bank, or C684. Total collection costs then come to C10,863, or 4.5% of the total loan amount.

Contract Enforcement

Between 0% and 10% of borrowers are typically delinquent in the sense that they do not complete repayment at the end of the month. Delinquent loans are usually repaid by the end of the second month, and actual cases of complete default are very few. The risk of default is substantially reduced by the daily monitoring and repayment procedures. Additional costs of enforcing delinquent loans may be estimated as a maximum of 10% of normal monitoring costs, i.e., C1,018 or 0.4% of the total loan amount.
Total Transaction Costs

In general therefore, transaction costs form about 7.5% of the total loan amount for this type of lending. This appears relatively high for an informal activity, compared to our preliminary estimate of 2.6% for moneylenders (Duggleby, Aryeetey, and Steel 1992), although it is commensurate with the monthly spread of 12.9% between the implicit cost of funds and the lending rate. The cost is high partly because of the rather small size of the loans disbursed and the daily monitoring and contract enforcement procedures.

More importantly, actual out-of-pocket costs to the collector for increasing lending to existing clients are in fact much lower. Most of the estimated transaction costs are for personnel time for the same revenue-generating activities that the collector would be doing in the absence of lending and involve no opportunity cost (the only exception is screening). From the viewpoint of an existing susu collector, the marginal cost of making loans to existing clients is virtually negligible, which is consistent with their failure to charge any interest in addition to the collection fee. For non-clients, however, the cost would be approximated by the estimate of 7.5% of the loan amount, which is consistent with the relatively high rates charged to non-client borrowers.
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