



Promotion of Rural Initiatives and Development Enterprises

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POSITION PAPER

BANKING ON AFRICA

Commercial Bank Linkages with Microfinance Institutions

The world media remind us with numbing regularity that the vast majority of Africans live in poverty. With a population of close to 750 million people over half subsist on less than \$1 a day. Africa is the world's most donor dependent continent and most heavily indebted region with over 11% of the world debt and producing only 5% of world income. Over the past thirty years it has become depressingly apparent that traditional development approaches have not created the intended economic change in Africa and the growing divide between the rich and the poor within Africa and between Africa and the rest of the world is increasing. Coupled with this poor economic performance, the scourge of HIV/AIDS, malaria and military conflicts on the continent continue to threaten an already fragile fabric. Indeed on the surface the situation appears rather bleak but then the question one must really ask is "is this the complete picture?"

In a recent article, **The Three Economies of Africa**, Dr. Constance Freeman¹, highlights another perspective on Africa not widely understood which is that traditional western economic models and measures fail to capture the full picture of Africa's economic activity. While traditional indicators can measure unemployment, inflation and macro economic trends in the formal sector these same statistics "exclude the production and exchange in the informal economy that forms the bedrock of most peoples survival, as well as vast quantities of resources exiting the continent into the broader global economy."

In most countries in Sub Saharan Africa over half of the economic activity occurs in the informal sector which is rich, varied and resourceful and mostly occurring outside the formal tracking mechanisms of the national economies. While this segment could contribute to the national well being, the informal sector is harassed, ignored and excluded from the government development and private sector agenda. Ironically this group generates an enormous pool of camouflage capital which is rarely considered and which could change the continent's economic health. The challenge is to determine how we can develop effective linkages to integrate the three economies; the formal, the informal and the global.

MAINSTREAMING MICROFINANCE

Over the past 20 years Microfinance has evolved as an effective tool to provide credit on a sustainable basis to the informal sector. The majority of those who are engaged in productive enterprise operate at the Microenterprise level, defined as businesses with less than 10 employees with low income levels. Commercial banks have never targeted

¹ The Three Economies of Africa, Constance J. Freeman, African Security Review, Vol.9 No4, 2000

this vast poor population and the development banks that were intended to address the masses have failed. Macro level economic reforms have further excluded the majority from access to financial services. In most countries, only full-scale commercial banks can be licensed to take savings and on-lend to the public. Regulatory requirements imposed on those banks make lending to small-scale clients without traditional collateral virtually impossible.

At the same time, many of the largest, and often government owned, commercial banks are cutting back their branches and rural based operations, leaving the micro and small-scale entrepreneurs without financial services. Fortunately, some of the international and local restructured commercial banks are starting to expand their country and regional networks. Still, their target market has not changed to include the poor.

An effective linkage is required to bring this economically active and productive disenfranchised population into the economic mainstream and into the commercial financial markets. Microfinance institutions (MFIs) have been operating in Africa since the mid 1980s and in many countries competition for the client is flourishing. However, despite the industry's rapid growth, it has not reached the required scale around the world. The Microfinance Summit, which called for the worldwide goal to serve 100 million of the worlds poorest by 2005, estimates that MFIs have served 23.5 million through 2000. ***Therefore, a novel approach that can effectively serve as a mass instrument for poverty alleviation is required if we are to reach this important goal.***

Historically MFIs have relied on donor funding for loan capital and operations. As the industry has matured, however, this source is becoming too restrictive to support requirements needed to support this vast market. It is estimated that the microfinance field currently holds \$7 billion in assets in more than 8,000 MFIs worldwide.² While this is promising, it is insufficient for the task at hand. Demand in the total microfinance market has been estimated at \$300 billion while overall financial transactions worldwide are \$1.3 trillion a DAY!³ The lack of institutional capital restricts the number of potential clients that can be served and the overall impact that microfinance can have on poverty alleviation in the world. The MFI industry must look beyond itself for solutions and this is why PRIDE AFRICA has taken up the challenge.

Since its incorporation in 1993, PRIDE AFRICA, a United States non-profit company with regional offices in Nairobi, Kenya, has created the largest microfinance network in East and Southern Africa. Successful programs are operating in Tanzania, Uganda, Zambia and Malawi. The network currently serves over 100,000 clients through a 54-branch network currently managed by PRIDE Management Services Limited, an independent Management company. Over time, PRIDE AFRICA has refined its microfinance model to create a replicable franchise. The package includes proprietary software systems, uniform operational processes, and a training regimen for staff to easily start a branch network in a rapid, cost effective manner.

² Microfinance Summit Data

³ Data gathered from the popular press

THE SUNLINK CONCEPT

The SunLink concept was first conceived in 1995 by PRIDE AFRICA, building upon its successful Pride Standard Model. The business takes the best elements of the methodology established by PRIDE AFRICA guiding the delivery of financial services to the micro and small-scale enterprise sectors in Africa. Through a direct commercial bank link it incorporates more efficient branch based delivery mechanisms with state-of-the-art management information systems to reduce costs and improve client service.

The model that served as the basis for the SunLink is the "VISA" credit card system and structure. VISA has fundamentally altered the marketplace - how financial institutions serve and reach customers. SunLink aspires to be instrumental in promoting another revolutionary change in the financial sector. This time financial services will be directed to a market segment hitherto unserved by commercial banks: the productive poor micro-entrepreneurs. The SunLink challenge is to bundle together integrated procedures, systems and software that can act as a conduit for a commercial bank to serve customers on the back end - thereby providing a channel to permit millions poor people to have savings accounts and receive loans.

The SunLink model is designed to be replicated anywhere in Africa, and, indeed, the world. The replication process would take the form of "franchising" in order to enable rapid growth. Franchising has enabled industry giants such as McDonald's to serve food to millions of people worldwide. Once the model has been completed, tested, and then packaged, it will link micro and small-scale enterprises with the formal financial system. In this fashion unserved micro entrepreneurs can be provided with a wider range of services, including loans, savings, credit referencing, branchless banking, credit/debit cards, and money transfers among others.

SunLink's driving force as a business is to be a sustainable, viable intermediary channeling commercial bank capacity and private investment to serve the micro and small-scale enterprise sector in Kenya. By doing so, it will be a beacon to attract more resources to the microfinance field and provide a model that can be replicated anywhere.

Like most MFIs, SunLink utilizes a group lending method. Loans are given to an individual borrower who is part of a core group of five members, the Enterprise Group (EG), which collectively bears responsibility for the loan to provide security. Ten EGs are combined to form a Market Enterprise Committee (MEC) that provides a secondary level of security for the loan repayment. Each client is also required to make regular deposits to a Loan Insurance Fund (LIF) that can only be refunded upon repayment of the loan. The LIF thus provides partial collateral for loans and can be tapped in the event of a default by any borrower within a MEC.

Clients who repay the loans are eligible for subsequent loans and all clients contribute to a Loan Insurance Fund at the rate of 200 Kshs (about USD\$2.50) per week. Clients who have contributed to the LIF for a minimum of six months receive a 3% flat bonus, payable semi-annually on their LIF balance. The non-traditional collateral in the form of LIF is designed as a 3-tier group guarantee mechanism and all loan loss is covered by deductions from this fund.

The rationale behind the "bank linkage" model is that SunLink can aggregate its clients' deposits (both compulsory and voluntary) for deposit into a commercial bank; the

aggregate deposit provides SunLink favorable interest rates and preferred client status. The bank, in turn, can service a new, downscale market without having to assume high transaction costs for multiple clients. The reduction in financial risk to the banks will enable SunLink to pay competitive rates on savings and charge reasonable rates on loans, earning its interest on the spread.

Initially the bank will establish lines of credit based on the average volume of the loan portfolio. Once proposed microfinance legislation is in place and SunLink is licensed as a first tier MFI authorized to mobilize voluntary deposits, lines of credit could be negotiated on the deposit pool. Pricing on the lines of credit will be set at an agreed percentage over the rate offered on the deposits. SunLink will utilize the lines of credit to fund its expanding portfolio.

Until SunLink is sufficiently capitalized, donor lines of credit will serve as guarantees on the credit extended to SunLink. PA's management believes that this is sufficient hedge for commercial banks. These systems would not be subject to the governance of central banks, and are not currently envisioned to provide guarantees on deposits.

UTILIZATION OF TECHNOLOGY

A differentiating factor for SUNLINK in the microfinance industry is its utilization of technology. In fact, its use of technology has attracted recognition from organizations including World Resources Institute as a case study in their Digital Dividend program.⁴ These advances save money in the long run, increase staff capacity, make program replication easier, and draw attention to the business. The company makes use of technology in a number of ways:

- **Modern equipment:** The company has modern equipment to conduct its business. This ensures hardware will function appropriately and accommodate the capacity required. It also requires staff to be trained and educated. Such equipment enables operations to run smoothly, rapidly, and professionally. While there are risks, like prolonged power outages (battery back-up and solar panels are available) and having to specially train staff, they are low compared with the benefits they provide.
- **Software Solutions:** The Company has developed its own software solutions to better conduct operations. Many MFIs have developed sophisticated procedures, especially to manage their portfolios, but few have integrated systems catering to their needs. SunLink has tailored software solutions for its operational needs that interconnect and are scalable. A new strategic partnership with a major East African software development house will further enhance SunLink's ability to remain an IT leader in the microfinance field.
- **E-Commerce** -the Internet has become an increasingly useful medium through which to conduct transactions and its use is just beginning in Africa. PA is piloting technology opportunities at SunLink locations that can add value for customers and attract more business. The current plan being piloted is called DrumNet, an information portal for customers, which incorporates internet/email access for

⁴ WRI websites: www.wri.org & www.digitaldividend.org

customers - where they otherwise have no options for such a facility.

- Card technology: SUNLINK is ready to incorporate magnetic stripe transaction cards to speed service delivery. With this technology any product or service that a bank offers in association with charge or bank cards in the West could be added to our operations. SUNLINK has already done extensive testing in this area and is open to partnerships that can bring additional benefits and services to the business.

Future technological innovations are also planned. SunLink is undertaking a strategic partnership with the Credit Reference Bureau in Kenya to link its client database and increase client credit reference data. As clients establish good credit ratings and are ready to graduate out of the SunLink system, they can be introduced into a participating commercial bank with a clear credit history - thereby helping small-scale clients who are ready to access formal banking services.

The expectation is that our experience and relationship with commercial banks will pave the way for a new relationship, one that will confirm SunLink as a "financial intermediary", a mechanism for commercial banks to provide services to the informal sector.

FUTURE OUTLOOK

What sets PRIDE AFRICA and the SunLink concept apart is not just its vision of the microfinance industry as a business opportunity as well as a social cause, but the specific strategies and technologies it is developing to realize that vision and to transform the conventional MFI business model. PA plans to change the role of an MFI from a donor-dependent financial service provider to a conduit or intermediary of financial services for the commercial banking industry. In effect, PRIDE AFRICA's plans to buffer banks from dealing directly with thousands of small clients by aggregating loans and savings, providing consolidated loan tracking, accounting, credit referencing, credit/debit card processing, and cash management services--while providing financial services to its clients (through its network of branch offices) in collaboration with commercial banks.

In conclusion, PRIDE AFRICA sees promise for Africa, particularly if we can be more inclusive and innovative in forging linkages with the informal economy. We need to change our thinking and consider the poor as an asset, an untapped resource, and not as a liability or social burden. Over the past 10 years PRIDE has disbursed over 400,000 loans at above market rates of interest and maintained a 95 % plus repayment rate; the envy of any commercial bank. The SunLink initiative is intended to demonstrate how we can take this concept to scale and to mainstream the productive poor into the formal banking sector and the world marketplace.

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