VIABILITY OF SECOND TIER BANKS IN NAMIBIA

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BANK OF NAMIBIA
BANKING SUPERVISION DEPARTMENT

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LIST OF ABBREVIATIONS AND ACRONYMS

AMFI	Association of Microfinance Institutions
AMFIU	Association of Microfinance Institutions in Uganda
ASDSET Trust	Adult Skills Development for Self Employment
ATM	Automatic Teller Machine
BOU	Bank of Uganda
BoN	Bank of Namibia
BSD	Banking Supervision Department
CFM	Commercial Microfinance
CERUDB	Centenary Rural Development Bank
DFID	Department for International Development
FINCA	Foundation for International and Community Assistance
FIRST Initiative	Financial Sector Reform and Strengthening Initiative
FSDP	Financial Sector Development Program

FSDT	Financial Sector Development Trust
FSLTAP	Financial Sector Legal and Technical Assistance Program
FTBs	First Tier Banks
FU	FINCA Uganda
KWFT	Kenya Women Finance Trust
MDI	Microfinance Deposit-taking Institutions
MFEP	Microfinance Outreach Program
MFI	Microfinance Institutions
MIS	Management Information Systems
MTI	Ministry of Trade and Industry
NBFI	Non-Bank Financial Institutions
NDP2	National Development Plan 2
NEPRU	Namibian Economic Policy Research Unit
NGO	Non-governmental Organizations
NSB	Nampost Savings Bank
SACCO	Savings and Credit Co-operatives
SBCGT	Small Businesses Credit Guarantee Trust
SME	Small and Medium-sized Enterprises
STBs	Second Tier Banks
STRs	Second Tier Regions
UCSCU	Uganda Co-operative Savings and Credit Unions Limited
UMU	Uganda Microfinance Union
VISION 2030	Namibia's national vision for the year 2030

EXECUTIVE SUMMARY

Following the findings of the FinScope Namibia 2003 survey conducted by Namibia Economic Research Unit (NEPRU) that rural areas of Namibia have less access to formal financial services; the study on competition in the Namibian banking sector by the BSD of the Bank of Namibia that concluded that the extent of competition in the banking sector is limited; and the baseline survey on SMEs by the MTI that found that the majority of informal SMEs have no access to bank credit, the Bank of Namibia embarked on a project to study various models of banking with the poor with a view to improve access to financial services for the rural under-banked areas of Namibia and to increase credit to SMEs. Overall, the project aimed at exploring the viability of introducing a second tier banking system in Namibia as a way of improving access to finance.

The conclusion of this report is that STBs would not be viable in Namibia.

In reaching this conclusion, the paper outlines the findings of a literature review on operation of STBs in other countries, surveys on co-operatives (Co-ops), microlenders, NGOs, NSB, and commercial banks, fact-finding missions to Kenya and Uganda, and highlights some insights for Namibia. It concludes on the viability of STBs in Namibia and suggests alternative solutions for Namibia.

The literature review discusses the key preconditions determining the success of second-tier type banks in Bangladesh, Ghana, Uganda, and Kenya and attempts to tie this to the Namibian environment. The identified benchmark factors are: ***macro-economic situation; political stability; profitable investment opportunities; population density,*** and **a culture of *savings clubs***.

Comparing Namibia to these benchmarks found that:

- Namibia's low economic growth (2004: 4.5 percent) is likely to curtail the emergence of SMEs, resulting in the unsustainability of STBs for which SMEs and low-income households are the target clientele. Political stability appears not to be a critical factor to the success of MFIs.

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- Namibia's well developed financial infrastructure could benefit the STBs in terms of low risks and costs on provision of financial services. However, the well developed commercial infrastructure could impose a lot of competitive pressure on SMEs and hence impede their progress.

- The small population size and density of Namibia is also a negative point since a sizable population and high density are crucial for STBs to attain a critical mass and economies of scale.

- With a high level take up and variety of SMEs and other savings accounts at commercial banks, and NSB, Namibia appears to have a relatively good savings culture.

The objective of the surveys was to evaluate the capacity and ability of the existing Namibian MFIs to graduate to STBs, and the provision of financial services by banks to SMEs. In particular, the surveys explored the strategies of banks to enter the currently under-banked rural areas and improve access to financial services.

The key findings from the surveys were that the microlenders, Co-ops, and NGOs are not, at the moment, fit to transform into STBs. In contrast, NSB appears to be having adequate capacity and well developed infrastructure to convert to a STB. However, NSB is skeptical about the idea of conducting banking business. NSB would, reportedly, only consider acquiring a banking license of a limited scope, provided that there is assurance that the existing tax benefit would remain intact, and that it would not carry credit risks or be subject to liquidity requirements.

During the past two years, all commercial banks in Namibia operated a microfinance portfolio which provided loans to salaried individuals and SMEs in different sectors. Since SMEs are subject to bank's normal lending procedures, many SMEs failed to access credit from banks. In recent years the Government of Namibia introduced the SBCGT scheme to provide collateral for SMEs to access bank loans. However, numerous SMEs, especially in the informal sector who can not meet the banks' requirements do not qualify for SBCGT.

Commercial banks are making inroads into the currently under-banked rural areas by opening up new branches. However, while this is commendable, it is doubtful whether increasing the number of branches alone without the provision of products tailor-made for SMEs and the poor would alleviate the plight of the poor and informal SMEs presently neglected by banks and microlenders.

The principal findings of the study tours to Kenya and Uganda were that the MFIs environment in these countries differs from Namibia. The two countries have a large number of SMEs and greatly higher population densities than Namibia. Uganda, particularly, has a high rate of entrepreneurship, a key attribute which Namibia lacks. In both countries donor funds played a significant role in financing emerging MFIs operations and support governments in MFIs policy formulation.

The two countries have tiered banking systems which are subject to regulation by the central banks. The regulatory frameworks for tier I and II in these countries have already been implemented and the focus now is on developing a regulatory framework for tier III and IV, which comprises MDI and all other non-deposit taking MFIs, respectively. Like in Namibia, corporate governance in member-based organizations (such as Co-ops), NGOs, and donor supported entities has been a concern to the governments of Kenya and Uganda.

This paper concludes that, at this point, **tier two banking is not viable in Namibia** due to lack of well developed MFIs that would graduate to STBs. However, the paper recommends the following alternatives solutions that Namibia can consider:

- BoN and other stakeholders should look at ways of working within the current banking system and build on existing capacity either of commercial banks, NSB, or larger microlenders rather than looking at creating a new regulatory framework.

- The Namibian Authorities should devise ways to incentives existing banks to extend banking services and credit to low income sevtors and SMEs, for example, look at ways to assist SMEs to become more creditworthy.

- BoN should welcome NSB's envisaged joint venture with a commercial bank that would seecredit facilities extended to rural areas through NSB's extensive branch network. Although this arrangement will not necessarily change the sponsoring bank's risk acceptance criteria, it may improve distribution of the existing credit products.

- BoN could encourage the use of political pressure or moral suasion to make banks engage with the low-income and SMEs markets.

- A Namibian Financial Sector Charter could be useful in this regard.

INTRODUCTION

During 2003, the Bank of Namibia conducted a study to determine the extent of competition in the Namibian banking sector[1]. The study concluded that competition is limited and that measures to encourage competition need to be developed. In addition, the Finscope 2003 survey (conducted by NEPRU) on access to financial services concluded that the poor and those living in rural areas have limited access to financial services, as the majority of banks are located in urban centers and focus on the more affluent parts of the population.

Another study on SMEs that was conducted by the MTI in 1998 found that the majority of SMEs have no access to bank credit[2]. The study also found that many SMEs had never applied for bank loans because of the complicated loan application procedures employed by banks.

As a result of these studies, the Bank of Namibia decided to look for ways to increase competition, improve access, and open up credit for SMEs. It decided to embark on a project to assess the viability of establishing a two tier banking system and to determine whether such banks would increase access to financial services by the low-income households and SMEs. The project is funded by First Initiative (First) because it will support the development and deepening of the Namibian financial sector, a key First objective.

The rest of this paper is organized as follows:- chapter 1 defines the STBs concept and its key features. Chapter 2 discusses the methodology used in testing viability of STBs in Namibia. Chapter 3 reviews the existing Namibian banking sector and its micro-financing activities to SMEs. In chapter 4 the paper reviews the literature on factors that influenced the success of second-tier type banks in other emerging economies. Chapter 5 presents analyses of findings of the surveys on the status of institutions conducting micro-financing activities in Namibia. Chapter 6 outlines and discusses the results from the study tours to Kenya and Uganda, as well as the lessons for Namibia. Lastly, in chapter 7 the paper concludes on the viability of STBs study and suggests alternative solutions for Namibia.

[1] Competition in the Namibian Banking Sector: Possible Measures for Enhancement – Research Paper by Banking Supervision Department, Bank of Namibia.
[2] The Small Business Baseline Survey 1998: The Four Northern Regions – by the Ministry of Trade and Industry.

CHAPTER 1

DEFINITION AND PROBLEM STATEMENT

1.1 PROBLEM STATEMENT

At the moment, poor people; informal SMEs[3]; and rural communities in Namibia have limited access to financial/banking services. Banks are mainly based in urban or peri-urban centers and only cater for salaried people and formal businesses. Banks are not keen on accessing the lower end of the market since it is costly and not profitable for them to do so. Additionally, the poor also finds it difficult to meet bank's stringent lending and service criteria.

Given that banks seems to be reluctant to get involved with any venture beyond their usual traditional credit evaluation process (Genesis Analytics, 2003:6) and because of their distaste of the high costs and risks associated with the lower end of the market, there is a gap left within the less affluent sector.

The gap left by commercial banks could potentially be solved by adopting non-traditional banking techniques. However, considering the reluctance of banks to implement appropriate techniques to service the poor and SMEs, introducing a different type of banks in the form of STBs, specializing in servicing the rural poor and informal SMEs could be a solution to bridging this gap.

This project investigates whether STBs are viable in Namibia, if so, it will then:

- propose a framework for such a system;
- determine the regions in which STBs will be most successful;
- provide guidelines on legal and supervisory issues related to STBs;
- determine additional resources the Bank requires to ensure the sustainable operations of STBs in Namibia;
- determine what assistance other organizations could provide during the implementation of a two tier banking system; and
- determine the timeframe within which STBs should be implemented in Namibia.

[3] Defined by the Ministry of Trade and Industry as: any entity employing less than ten people, have a turnover of less than N$ 1million, and capital employed of less than N$500 000.

1.2 DEFINITION OF STBs

STB envisaged in this paper can be defined as small banks that:-

- will be subject to less stringent prudential requirements than the FTBs
- will be allowed to conduct a limited range of banking activities
- will be allowed to accept deposits from the public and extend credit
- will be serving the poor and informal SMEs as their target clients
- will be providing services and products which are suitable for their target clientele
- will not insist on conventional form of collateral but will consider alternative forms of collateral which the poor are able to provide

CHAPTER 2

METHODOLOGY

The project to assess the viability of STBs in Namibia is organized and conducted in five phases, as follows:

Phase 1: Literature Review

This phase reviewed the literature on various models of banking with the poor as well as tiered banking systems implemented in other countries, such as Bangladesh, Ghana, Kenya, and Uganda. Particular focus was placed on factors influencing the success of these model banks and the challenges other countries experienced in implementing and operating them. The review highlighted six preconditions for the successful introduction and sustainability of small banks, namely: ***macroeconomic stability***; **investment opportunities**, ***political stability***; ***developed infrastructure***; ***population size and density***; and ***savings clubs***. Namibia was then benchmarked against these preconditions, in comparison with the above stated countries, to infer the viability of STBs in Namibia.

Moreover, the literature review also evaluated the extent of excess demand for financial/banking services that is currently not catered for by existing banks. In addition, the review was also informed by the findings of past studies on the operations of SMEs in the northern regions of Namibia conducted by the Ministry of Trade and Industry (MTI), as well as the Finscope 2003 by NEPRU.

Phase 2: Stakeholder Consultations, Surveys, and Analysis of findings

This stage of the study involved designing questionnaires for local survey - stakeholders, i.e. commercial banks, NGOs, NSB, co-operatives, and microlenders. Prior to the actual surveys, questionnaires were tested with a sample of stakeholders in order to ensure clarity of questions and enhance the response rate.

Surveys were then conducted in Caprivi, Ohangwena, and Oshana regions during the first quarter of 2005. These regions were chosen because of their high population densities and the increased likelihood of STBs succeeding.

During the surveys, 9 microlenders, 7 Co-ops, 2 NGOs, NSB, and 4 commercial banks were interviewed. The purpose of the surveys was to evaluate the scope of institutions conducting microfinance activities in order to assess their capacity to graduate to STB status and to determine the extent of the gap left by banks in providing financial services to SMEs in the country.

Phase 3: Fact-finding Missions

This phase involved a study tour to Kenya and Uganda, which was undertaken during May 2005. The two countries were selected because of their advancement in implementing regulatory frameworks for tiered banking systems. Lessons from these countries provide useful insights for Namibia.

Phase 4: Viability Study, and Recommendations

This part consolidates and discusses the key findings from the data gathered under phase 1 and 3. Based on the aforementioned findings, conclusions on the viability or otherwise of introducing STBs in Namibia are derived. In addition, a number of alternative solutions that could be adopted by Namibia are provided.

Phase 5: Implementation

The implementation phase will be undertaken upon completion of phases 1 through 4. This process involves adoption of the selected approach recommended under phase 4.

CHAPTER 3

THE BANKING SYSTEM IN NAMIBIA

This chapter gives an overview of the commercial banking environment in Namibia. It outlines key legislative requirements governing commercial banks, in particular, the licensing criteria, and the supervision and regulation of commercial banks. The chapter also presents the findings of a survey on commercial banks: covering the provision of microfinance services to SMEs, the location of bank branches, types of products and services offered, and clients served.

3.1 Licensing, Supervision, and Regulation of Banks in Namibia

Banks are licensed by the Bank of Namibia (BoN), in terms of the Banking institutions Act, of 1998 (the BIA), to conduct banking business. Banking business is defined under the BIA as the business of taking regular deposits from the public and using such funds to extend credit or invest.

To qualify for a banking license, an institution is required to meet licensing requirements. For instance, an applicant should have capital funds of at least N$ 10 million. The applicant must also demonstrate ability to continually comply with prudential banking regulations relating to, inter alia, minimum liquid assets, minimum capital adequacy ratio, minimum local assets, loan loss provisioning requirements, and lending and credit concentration limits. Moreover, applicants are required to have proper internal control and robust risk management systems in place. Further, to ensure safety of depositor's money, licensed banks are subject to regular inspections by and reporting to BoN.

Registered banks in Namibia

There are currently four banks in Namibia, which are: Bank Windhoek Limited; Nedbank Namibia Limited; First National Bank of Namibia Limited; and Standard Bank Namibia Limited

Type of Products and Services offered by Banks

All banks offer a wide range of fairly standard products and services including:- short and long-term loans; credit cards; letters of credit; savings and current accounts; time and fixed deposits; investments; unit trust; e-banking; ATMs;

mortgage financing; forex; international banking; vehicle financing; and trade financing.

Categories of Clients Served by Namibian Banks

Banks cater for individuals, businesses and corporate customers. Individual clients are normally those employed, earning a salary, who can meet the documentation requirements of banks. Similarly, a business should be duly registered as a business with the relevant authorities, and must be able to furnish its financial statements and business plans to the banks in order to access banking services. Unemployed individuals and informal SMEs are not being serviced by banks due to their inability to satisfy these bank requirements.

3.2 Survey on Namibian Banks

The following are analyses of findings of the survey on the activities of banks conducted by the Bank of Namibia during the third quarter of 2004. The purpose of the survey was to evaluate the extent of banks' financial services to SMEs, and to assess the challenges banks experience in serving SMEs, as well as to explore banks' expansion plans and strategies to improve access to banking services for the un/underbanked areas and poor people. Analyses cover the following areas:

- Information required for credit extension to SMEs
- Reasons why commercial banks did not provide loans to SMEs,
- Credit/Loan products,
- Forms of collateral,
- Reasons for customer default,
- Mechanisms for collection of outstanding money,
- Deposit mobilization and products,
- Frequency of deposits,
- Lending and deposit rates,
- Number of branches, service centers and agencies,
- Strategies to promote financial services,
- Cost of doing business in rural areas, and
- Diversification strategies.

3.2.1 Information Required for Credit Extension to SMEs

Currently, a number of banks operate a micro loan portfolio, which provides small loans to individuals who have salaries and to SMEs through the Small Business Credit Guarantee Trust (SBCGT) (Mushendami, et al, 2004). The SBCGT was introduced by the Namibian Government to assist formally registered SMEs with collateral in order to access bank loans.

It is a business practice of banks in Namibia to require certain information from borrowers, including SMEs, before credit is extended. This information include "bankable" business plans, ability to provide a 10 percent deposit, personal financial statements, proof of business registration, bank records, guarantee, and adequate security or collateral. Notwithstanding the necessity and purpose for requiring such information, it is recognized that these requirements are too "strict" for some SMEs to meet. For instance, the information required by banks can be "strict" in the following sense:

- Business plan, registration of business, and guarantee might not be met by SMEs that are not registered with the Ministry of Trade and Industry (informal SMEs);
- Production of bank records, personal financial statement and ability to provide at least 10 percent deposit is strict because some informal SMEs might not have bank savings account and proper financial records keeping; and
- It is only well established SMEs that can provide acceptable security/collateral.

The SBCGT has enabled a number of SMEs to acquire bank loans. However, it has neglected informal SMEs that obviously have more than just the issue of collateral to contend with. SMEs must first pass the bank's lending criteria, which are "strict", before benefiting from the SBCGT.

Due to the stringent lending measures employed by banks, many SMEs have failed to access banking services. The introduction of STBs could change the current status quo, because such banks will employ banking-with-the-poor approaches that have been used successfully in other countries. Some of these techniques include group-lending methodologies as opposed to traditional forms of collateral required by FTBs. This would enable SMEs that currently cannot meet traditional lending conditionality to access banking services.

3.2.2 Credit Extension to SMEs

Commercial banks offer various credit products to SMEs that include short-term, long-term advances, overdrafts, credit cards and letters of credit. While the level of preference for short-term advances, long-term advances and overdrafts is average, fair and good, that of credit cards and letters of credit is poor.

All commercial banks extended loans to SMEs during 2003. This is a corollary of the fact that they have established microfinancing division/department that caters for micro borrowers.

During 2003, as shown in Table 2 below, commercial banks extended a total of about N$449 million loans to SMEs across the country. The figure is spread over 10,206 loan accounts and represents 2.7 percent of the gross loan portfolio of the entire banking sector.

Table 1: Commercial Banks SMEs Loans by Region

Regions	Total Loans to SMEs (N$)	Total # of Loan Accounts of SMEs
Caprivi	524,957	5
Kavango	3,468,689	61
Otjozondjupa	45,597,639	710
Oshikoto	7,921,484	247
Oshana	36,232,812	813
Ohangwena	155,000	5
Omusati	1,921,928	45
Kunene	8,727,401	169
Erongo	61,698,107	1,217
Karas	18,977,352	452
Hardap	9,864,725	417
Omaheke	11,170,291	290
Khomas	243,352,344	5,775
Total	**449,612,729**	**10,206**

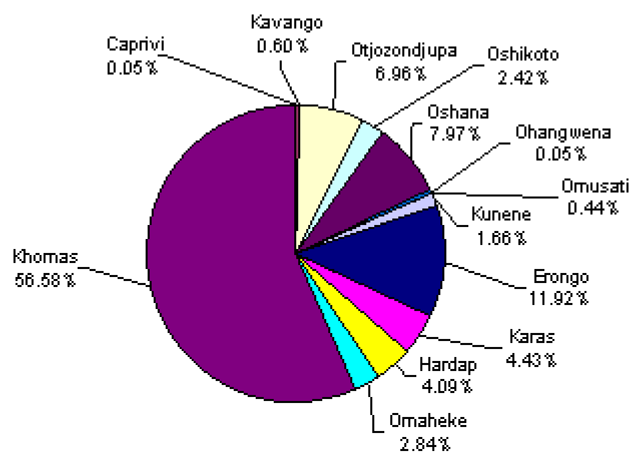
While commercial banks have made inroads in lending to SMEs, a lot still needs to be done to cater for numerous SMEs, especially in the informal sector, that are currently not catered for by banks. Looking at the total number of SMEs in the country (33, 403) compared to the number of SMEs loan accounts (10, 206) at banks, it is clear that about 69.4 percent of SMEs are still not getting credit from banks.

The reason why many SMEs do not acquire loans from banks could be two fold. While, for various reasons, some SMEs might not have approached banks for loans, many more might not have met conditions to warrant them getting credit from banks.

The failure of most SMEs to get loans from commercial banks and the insignificant proportion of SMEs loans to gross loans of the banking sector (2.7 percent) signifies limited banking services to these businesses. This conclusion is in line with other studies that showed high unsatisfied demand for financial services from SMEs in Namibia. It has been suggested that STBs could improve the status quo by employing unconventional banking approaches to effectively serve the poor and SMEs.

In terms of credit extension to SMEs, commercial banks have not established themselves well in the regions with highest and growing population densities. As noted in the literature review, the regions (excluding Khomas) with highest and growing population densities are Oshana, Ohangwena and Caprivi. It was also mentioned that it is in these regions (second tier regions) where tier two banks are most likely to succeed and prosper. Figure 1 shows credit to SMEs by region. The second tier regions received about 8.1 percent of the total loans granted to SMEs and the non-second tier regions (all other regions excluding Khomas) got 35.4 percent. The figures underline the dearth of financial services, especially, to SMEs in the regions in which tier two banks might be more likely to succeed.

Figure 1: % share of loan accounts of SMEs per Region



3.2.3 Type of Collateral Required by Commercial Banks

Commercial banks require various forms of collateral for their loans. Table 3 apportions these forms of collateral into “strict” and “less formal” collateral. Strict form of collateral is the form of collateral that is required by commercial banks only. Normal collateral is collateral that is required by both commercial banks and rural/community banks (in other countries).

Table 2: Forms of Collateral

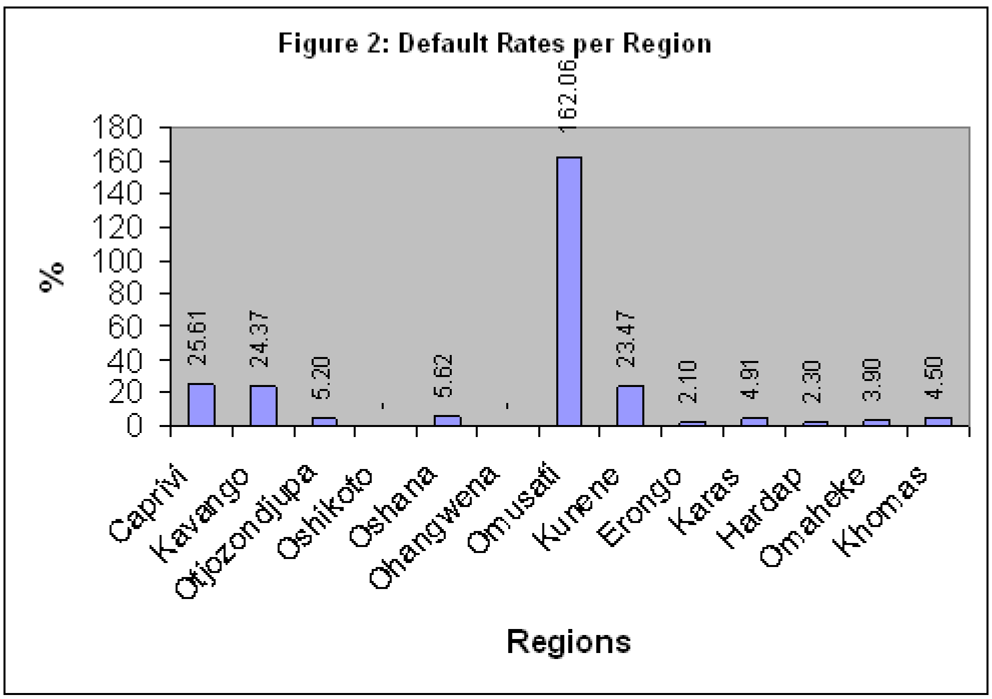
Strict	Less formal
Insurance	Joint Collateral
Salary/Income	Savings
Investment	Physical Assets
Guarantees (SBCGT)	

Commercial banks generally insist on the “Strict” form of collateral than the “less formal” form and SMEs, especially those in the informal sector, find it difficult to meet this requirement. Although the “Strict” forms of collateral are important for commercial banks to cushion against default risk, they are prohibitive for most informal sector SMEs and are, therefore, creating a skewed allocation of credit towards formal SMEs.

Second tier banks typically employ a group-lending methodology and would usually require the “Normal” form of collateral, thus allowing SMEs currently neglected by the banking system to access credit.

3.2.4 SME Defaults, Reasons, and Recovering Methods

Figure 4 below shows the default rates for the respective regions in 2003. Overall, commercial banks experienced relatively high default rates on SMEs loans, averaging 20.31 percent. With respect to regional default rates, the second tier regions (STRs) averaged 10.41 percent, while other regions (excluding Khomas) stood at 25.37 percent.



As shown in figure 4, the default rate for STRs are:- Caprivi region 25.6 percent; Oshana 5.6 percent; and Ohangwena 0 percent. Defaults in Caprivi are relatively higher than in other regions. This does not augur well with crucial factors determining the profitability and success of STBs, such as low default rates and a good repayment culture.

Commercial banks have provided several reasons why their SME clients defaulted on their loans. They have also devised measures to recover outstanding money on the overdue loans.

Reasons for SMEs Defaults:

- Lack of mentoring support, and proper financial management
- Lack of skills, knowledge and experience, and funds
- Misconception of SBCGT
- Job losses,
- Lack of security, and
- High risk sector.

Recovery Methods:

- Contact with clients,
- Discussion of problems with customers,
- Undertake legal actions against defaulters,
- Avail financial assistance to clients,
- Embark on monthly customer visits, and
- Realize customer's security/guarantee.

3.2.5 Deposits from SMEs

Commercial banks offer several deposit products to SMEs. These include savings accounts, deposit accounts, fixed deposits, time deposits as well as unit trust accounts. While the preference for the first four products is average and good, unit trust accounts are poorly preferred by the SMEs sector. Unawareness of this product could be the reason why it is not favored.

SMEs deposit their money with commercial banks on a daily, weekly and monthly basis. This frequency of deposits if maintained for an STB would be beneficial to prospective STBs in Namibia because it will enable them to meet their day-to-day liabilities and extend much needed finances to potential borrowers.

Table 3: Total Deposits to SMEs (2003)

Regions	**Total Deposits from SMEs (N$)**	**Total # of SME Deposit Accounts**
Caprivi	-	-
Kavango	603,68	70
Otjozondjupa	24,998,910	968
Oshikoto	9,238,643	325
Oshana	59,368,163	1,239
Ohangwena	700,000	30
Omusati	820,000	80
Kunene	18,488,619	239
Erongo	73,260,670	1,468
Karas	12,279,871	624
Hardap	11,952,017	565
Omaheke	7,651,600	448
Khomas	254,727,017	6,487
Total	**474,089,194**	**12,543**

As indicated in Table 3 above, commercial banks received over N$474 million in deposits from SMEs, spread over 12,543 accounts. SMEs deposits as a percent of total core deposits of the banking sector in 2003 stood at 3 percent. This is a very low proportion, which could be ascribed to the smallness of the sector, amongst others.
The average SMEs deposit mobilization in second tier regions is 27 percent in comparison to total SMEs deposits from other regions, except Khomas.

3.2.6 Interest Rate Policies

Lending rates

Interest rates charged by commercial banks on loans to SMEs differ from one bank to the other (table 4). Two commercial banks charge prime rates (12.5 percent:2003) plus 3 percent, one bank charge prime rate plus 4 percent, while the other bank's lending rates varies depending on whether the SMEs is involved in the SBCGT and Adult Skills Development for Self Employment Trust (ASDSET).

Table 4: Interest Rates charged to SMEs and Rural Areas in General

Name of Bank	SMEs	Rural Areas
NedBank Namibia	Prime + 3% (15.5%)	Prime + 5% (17.5%)
First National Bank	SBCGT 16.5% ASDSET 14.50%	SBCGT 16.5% ASDSET 14.50%
Bank Windhoek	Prime + 3% (15.5%)	Prime + 3% (15.5%)
Standard Bank	Prime + 4% (16.5%)	Prime + 4% (16.5%)

The rates indicated above are far much lower than those prevailing at money lenders (Microlenders) in Namibia, whose rates hover around 30 percent or even more. As could be seen from the literature review, for second tier banks to succeed, their lending rates should vary between rates charged by commercial banks and those prevailing at the informal lenders.

Deposit rates

Generally, rates paid by banks on SMEs deposits vary according to the amount and type of deposits. These rates range between 6 percent and 7 percent but some banks pay on average 3.5 percent deposit rates.

3.2.7 Commercial Banks Regional Outreach

Table 5: Commercial banks branch network (2003)

Region	Branches (1)	Agencies/Service Centers (2)	Total (3) (1+2)	Population of regions (2001 Census)	# of Persons per Branch/Agency/Service Centers (Population/3)
Caprivi	2	0	2	79,826	39,913
Okavango	3	0	3	202,694	67,565
Omusati	1	2	3	228,842	76,281
Oshikoto	4	0	4	161,007	40,252
Oshana	7	3	10	161,916	16,192

Ohangwena	1	4	5	228,384	45,677
Kunene	4	1	5	68,735	13,747
Erongo	9	3	12	107,663	8,972
Khomas	18	13	31	250,262	8,073
Karas	13	3	16	69,329	4,333
Hardap	4	1	5	68,249	13,650
Omaheke	3	0	3	68,039	22,680
Otjozondjupa	10	1	11	135,384	12,308
Total	**79**	**31**	**110**	**1,830,330**	**369,641**

Commercial banks are generally based in the town centers of the regions. As shown in table 5 above, rural regions, such as Caprivi, Ohangwena, Omusati, Kavango etc have the least number of bank branches and highest number of persons per branch than urban regions like Khomas, Erongo, Karas, and Otjozondjupa. The urban region of Khomas, for instance, has the highest branch network of 31 branches and agencies and the second lowest number of persons per branch, 8,073. By contrast, the second tier regions with a combined population of 470,127, 17 branch network, and 27,654 persons per branch, lags behind the Khomas region in terms of the number of bank branches.

The low branch representation of banks in STRs supports the argument that existing FTBs are reluctant to enter rural areas due to low profitability prospects (E. Kaakunga et al, 2003). The corollary is that there is no demand for banking in these areas. While this presumption could be true, the flipside could be that banks' products and services are not compatible with the poors' needs.

3.2.8 Commercial banks' strategies to improve access to financial services to the currently unbanked / underbanked areas

Commercial banks reported various approaches they plan to undertake as means to improve access to banking services. Banks mainly plan to use marketing and promotion tools for market education, banking services and products awareness campaigns, and delivering services through existing branch network. A few banks plan to open up new branches in rural regions.

Since none of the banks are proposing to design products and services customized to meet the needs of informal SMEs and the poor, it is questionable whether the additional availability of bank branches in rural regions, would address the needs of SMEs that are currently failing to meet the stringent lending requirements of banks.

3.2.9 Commercial banks cost of doing business in rural areas

In this section of the questionnaire, commercial banks were asked to indicate the average cost per credit customer (SMEs & rural areas in general) and the average cost per deposit customer they incurred in 2003. This information is crucial in determining how much, on average, it costs to provide banking services to SMEs and to run a profitable bank branch in rural areas. Unfortunately, none of the commercial banks provided responses to this question, the reason being given that this data is not available.

Nonetheless, E. Kaakunga et al (2003) states that banks find it costly to establish fully-fledged bank branches in rural/under-banked areas. Typically, these costs are associated with erecting physical infrastructure and buildings, staffing and training, security, lack of support services, and languages. Commercial banks consider these areas as not profitable due to few transactions that would take place at the end of the day. Moreover, it takes about three years for a branch in these areas to break-even. High operating costs and non-profitability are regarded as the main factors preventing commercial banks from penetrating rural areas.

3.2.10 Commercial banks diversification strategies

This section covers the diversification strategies of commercial banks with respect to areas where new branches and products are planned.

Only two banks have indicated plans to open up new branches in the north-western regions of Namibia i.e. Omustai, Kunene, and Ohangwena regions. Of these two banks, one also proposed to introduce, without being specific, new products at this branches. The other two remaining banks envisage neither opening up new branches nor introducing new products.

As noted earlier, the establishment of new branches in the currently un/under-banked areas, without the parallel introduction of products compatible with the poor and SMEs, may not necessarily alleviate the plight of the rural communities and SMEs presently neglected by banks.

Conclusion

The existing banks are more active in urban and peri-urban areas of Namibia. These areas also received the highest number of bank loans extended to SMEs during the past 3 years. Banks impose strict lending requirements on prospective SMEs borrowers. As a result SMEs that could not meet these criteria, particularly SMEs in the informal sector, failed to receive loans from banks. Lack of proper collateral and “bankable” business plans were cited as the some of the reasons many SMEs failed to qualify for bank loans.

In an effort to encourage bank lending to SMEs, the government introduced the SBCGT scheme, which aimed at providing security/collateral to qualifying SMEs wishing to access bank loans. While many SMEs benefited from this scheme, many more could not meet the SBCGT requirements.

Generally, commercial banks are making inroads into the currently un/under-banked areas of Namibia by opening-up new branches in these areas. However, the majority of banks have not indicated any plans to introduce new products and services tailored to cater for the unique needs of SMEs, specifically those in the informal sector and the rural poor. It is therefore doubtful whether the availability of bank branches in rural areas, without provision of the right product mix, customized to suit the needs of the poor, would adequately improve the status quo.

Further, banks are seemingly reluctant to get involved with any venture beyond their usual traditional credit evaluation process (Genesis Analytics, 2003:6). The reason for this is that transaction costs associated with the screening of loan applications and business proposals, recovering NPLs as well as the risks inherent in the low segment of the market are too high. These disincentives are preventing banks from providing financial services to SMEs and the poor, and hence leaving them neglected.

The gap left by commercial banks could potentially be filled by adopting non-traditional banking techniques. This, according to Genesis Analytics, 2003:6, includes the use of the group-lending methodology, which has not been widely used in Namibia, or co-operative models. However, considering the reluctance of banks to renounce their traditional banking techniques, we examine now whether the solution lays in the introduction of a different type of banks in the form of STBs, specializing in servicing the rural poor and informal SMEs.

CHAPTER 4

LITERATURE REVIEW

In the first half of 2004, the Bank of Namibia project team carried out a literature review, which covered the following issues:

- various models of banking with the poor (e.g. Grameen Bank, village/rural/community banks);
- factors affecting the success of such banks;
- studies compiled on access to financial services in Namibia (NEPRU), microfinance institutions in Namibia (Bank of Namibia Research Department), and Rural Bank Branches in Namibia (Bank of Namibia Research Department); and
- survey on operations of SMEs (Ministry of Trade and Industry).

The review paid close attention to the structure, operations, supervision and regulation of banking-with-the-poor models. It also, and most importantly, identified certain preconditions for the successful introduction and development of tier two banks. These benchmark factors include: ***macro-economic situation***, ***political stability***, ***profitable investment opportunities***, ***population density,*** and ***savings clubs***. The viability of second tier banks in Namibia was then contextualized by comparing these success factors to other countries, namely Bangladesh, Ghana, and Uganda. The three countries were chosen in view of the successful introduction of banking-with-the-poor banks. Microfinance institutions in the respective countries had impacted positively on lending to low-income households, micro-enterprises and SMEs.

Macro-economic stability: According to the literature reviewed, a stable micro-economic environment, with relatively low inflation rates, is important for the emergence and success of microfinance industry. This has been achieved to some extent in all the countries considered by the task force. However, most important for the MFIs is the level of economic growth (in the examined countries GDP in 2004 averaged around 5.3 percent). In this particularly case, Namibia has a lower average growth rate (averaging 3.5 percent for the last decade) than the other four countries reviewed. This implies that low economic growth in Namibia is likely to have a constraining impact on the emerging businesses and thus on microfinance institutions for which they form the basis of lending.

Political stability: Whereas political stability is considered important and present in Namibia, microfinance institutions have prospered in other sample countries that have been considered less politically stable than Namibia.

Developed Infrastructure: under-developed banking infrastructure makes money transfer and the overall liquidity management difficult. The alternative is physical transfer of money across the countryside, which causes other security risks and insurance costs. Bangladesh, Ghana and Uganda have far less developed physical infrastructure (roads), commercial infrastructure (retailers, companies) and financial infrastructure (bank assets per capita, ATMs and payment system) than Namibia. Developed financial infrastructure in Namibia is likely to play a positive role in the creation of business opportunities for SMEs and thus for microfinance.

On the other hand, some degree of under-development in infrastructure may be a blessing. Research by the FinMark Trust has highlighted that modern electronic payment systems may result in lower cost of financial services, which can reach more people, while significantly increasing the cost of joining the market. In addition, it is normally easy for SMEs to prosper in the absence of large traders. In Uganda, for example, many small traders suffered when Shoprite opened the first supermarket in Kampala.

Profitable Investment Opportunities: The question here is whether or not MFIs can find profitable lending opportunities in order to expand the capital base, operations and thus have an impact on poverty. Unlike in Namibia, the micro-conditions in the three comparator countries were opportune for the development of microfinance. In Uganda and Ghana, for example, the macroeconomic collapse of the 1970s and 1980s destroyed much of the formal economy and banking sector. The result was that the vast majority of employment and economic activity now conducted by micro-enterprises, representing a significant market for micro-financing. In addition, in Uganda thousands of small farmers are involved in the production of crops (tea and coffee) for export.

The picture is quite different in Namibia, where subsistence farmers produce very little marketable surplus.

Population Size and Density: To have a sustainable microfinance operation, a critical mass of clients needs to be achieved in order to achieve economies of scale and keep operating costs low. All the comparator countries in the study have both populations and population densities at least five times higher than Namibia.

Savings Clubs: the presence of culture of savings clubs is a good indication of the savings culture in a particular country in a particular country and is an important base on which to develop STBs. Based on the high level of take up and variety of savings accounts at banks and NSB, Namibia appears to have a well developed savings culture. A sound savings culture would be beneficial to the prospective STBs, enabling them to meet their liquidity needs and extend credit to prospective borrowers.

Demand for Financial Services

Findings from the literature review revealed that there is excess demand of financial services in the lower end of the market, especially the informal sector, that is not provided for by the formal banking system. The baseline surveys on SMEs conducted by the MTI in 1998 found that the majority of SMEs have no access to bank credit and therefore use their own savings for business start-ups. The study also found that many SMEs had never applied for bank loans because of the complicated loan application procedures employed by banks, high interest rates, and failure or inability to draw up business plans.

The results indicate that many SMEs do not apply for bank loans is also attributed to the fact that most entrepreneurs in the informal sector are not familiar with banking procedures and lack the necessary skills to present their business ideas to banks. For this reason, the low level of education coupled with the lack of business management skills could be a major contributing factor to the lack of access to bank services by SMEs and the poor. In support of these arguments, the Namibian Informal Economy Survey, (2001) suggests that the lack of access to credit is the main reason the informal sector uses simple technology and remains operating on a small scale.

Further, the MTI survey showed that SMEs typically require small loans, ranging between N$1,000 to N$5,000 and operate on a small scale. Extending loans of these sizes normally involves a high level of administrative costs. These costs are even higher for banks and other financial institutions in Namibia that do not use appropriate financial methodologies, in terms of appraisal and monitoring techniques, required to efficiently operate micro lending activities.

The Finscope survey 2003 conducted by NEPRU also confirmed the limited access to financial services by the poor and rural communities. The survey found that there is still a large untapped market in the financial sector, which reflects opportunities for growth. The survey also suggested that there is a need to use different interface with clients and design appropriate products. In this regard, there is a need to lower transaction costs by using technology or group-lending mechanisms, address bank requirements and accessibility, and educate clients.

The situation discussed above demonstrates that there exists a gap in the lower end of the financial services market. Therefore, there is a need to formulate appropriate techniques that could effectively bridge this gap.

CHAPTER 5

STUDY OF SUPPLY: SURVEY FINDINGS

The survey teams visited candidate institutions in the North-Eastern and North-Western regions of Namibia. In Oshana and Ohangwena regions, one team visited four Micro-lenders, five Co-operatives (Co-ops), and two NGOs. At the same time, another team visited five Micro-lenders and two Co-ops in the Caprivi region. In Windhoek, information was collected from NSB, and Commercial Banks.

The face-to-face interviews were conducted with standardized questionnaires. The following sections outline the findings of the survey.

5.1 MICRO-LENDERS

All the interviewed microlenders (Cash Loans[4]) were based in town centers of Ongwediva, Ondangwa, Eenhana, and Katima Mulilo. The purpose of soliciting responses from Micro-lenders (Cash Loans) was to assess the existence of profitable lending opportunities, constraints to growth, and efficiency of operations. The ultimate aim is to determine the viability of STBs in Namibia. The following paragraphs will review the information collected and attempt at its interpretation.

Though operating in different localities, Cash Loans have common operational features. For instance, the majority operate from small offices, without computers, and, in some cases, without electricity. One Cash Loan at Ongwediva even operates from the owner's house. Record keeping at Cash Loans is very poor and done manually.

Cash Loans have lending procedures that, compared to commercial banks, are simple and less cumbersome. Loan funds are disbursed on the same day of loan application. Cash Loan clients view this as an advantage over commercial banks.

Most Cash Loans have very flat ownership structures. They are owned by sole owners who in most instances are full-time employed elsewhere and only

[4] In terms of the Usury Act, no 73 of 1968 exemption notices no. 189 & 196 of August 2004, microlenders are institutions that are registered to extend micro credits not exceeding N$ 50, 000, payable within a period of 60 months, and not paid in terms of a credit card scheme or withdrawn from a cheque account with a bank so as to leave that cheque account with a debit balance.

manage these businesses on a part-time basis. Cash Loans usually employ an average of two loan officers who work under the direct supervision of the owners.

Cash Loans only give loans to employed individuals with monthly salaries and bank accounts. This group is not the target clientele for STBs. Loan recovery in Oshana and Ohangwena is good and defaults are very few, averaging 4 percent. This is attributed to the stringent lending practice employed by Cash Loans in these regions. Most Cash Loans require borrowers to surrender their bank ATM cards, pin numbers, and national ID cards. Hence, allowing the manager to withdraw repayment amounts from borrowers' bank accounts when salaries are paid in.

The retention of the ID card serves to prevent borrowers from opening new accounts with other banks where the manager would not enjoy access to their salaries. The Cash Loan manager, as the principal custodian, keeps the customer documents in a handbag that he/she carries around with him/her. There is, therefore, a high risk of loss of these items, should something happen to the manager. In addition, there is also a risk of fraud if the manager is dishonest.

Default rates are higher in Caprivi, averaging 24 percent and ranging from 2 percent to 64 percent. This complete departure from the performance in other two regions is attributable to the fact that, in Caprivi, Cash Loan operators do not take possession of borrower ATM cards, pin numbers or national ID cards. As a result, Cash Loans in Caprivi are not reported to be profitable as their counterparts in Oshana and Ohanguena. The higher default rates in Caprivi also signal a weak credit culture or poor debt enforcement practices.

Most respondent Cash Loans have portrayed a positive picture of their business. The latter is reportedly profitable, although shortage of loanable funds deprives them of optimum profits. Loan demand is so high that many times prospective borrowers are turned away for lack of sufficient funds.

Cash Loans fund their lending operations from three main sources: owner's start-up capital; owner's savings; and interest income. All respondents indicated that limited sources of funding constitute their major constraint to growth and expansion. In many cases they turndown loan applications for lack of loanable funds.

The dearth of business management skills was also stated several times as a major constraint to growth and expansion of Cash Loans. Inability to extend loans to micro-enterprises and SMEs is another factor limiting the growth and expansion of Cash Loans.

Financial statements collected from Cash Loans are largely incomplete and, as a result, very unreliable. Record keeping at Cash Loans is poor or nonexistent.

However, verbal disclosures by the Cash Loans indicated that, except for lack of loanable funds, their lending operations are profitable.

Conclusion

Cash Loans only extend credit to salaried individuals with bank accounts. This category of borrowers is not considered to be the target group for STBs. Lending to this category eliminated the need for collateral since borrowers have a stable income that is accessible to the Cash Loan for loan repayments. There is very little lending to micro-enterprises and SMEs, except for cases where an employed individual owns such a business. One main reason offered for not lending to SMEs and micro-businesses is the inability to provide acceptable collateral. However, by not lending to micro-enterprises and SMEs, Cash Loans might have forgone profitable lending opportunities.

Cash Loans do not have sufficient capacity at this stage to transform into STBs. Transformation into STBs status would only be viable once, inter alia, the abovementioned problems that Cash Loans are experiencing at the moment has been remedied. In addition, it would be disastrous to give regulatory approval to institutions with very poor record keeping and inadequate capacity to take public deposits.

5.2 CO-OPERATIVES

Unlike Cash Loans, the interviewed Co-ops were mainly based in rural villages but also operated on a small scale. The majorities are hit by hard times and are on the verge of collapse. The fact that many Co-ops are mainly involved in agricultural activities suggests that they are not actively operating throughout the year but only during rainy seasons. As a result Co-ops are rather stagnant, and therefore remain financially distressed.

Most Co-ops do not offer savings and credit services to their members, despite the fact that their by-laws make provision for such services. Out of seven Co-ops visited, only three were offering savings and credit services. Many Co-ops are involved in providing agricultural services and selling of farm produces for the members. A few that had implemented a SACCO ceased operating it because of financial constrains. Many Co-ops have indicated willingness to start a SACCO if funds were available.

One major challenge hindering Co-ops' growth is poor membership base. The composition of membership is also a cause for concern because it is made up of mainly old people, aged between 40 and 60. Young people (18-30 years) have not shown sufficient interest in joining Co-ops.

Another obstacle restricting the development of Co-ops is the lack of proper corporate governance. Co-ops are normally managed by a board of directors, working part-time and on voluntary basis. Although the board members are usually elected from the membership, academic qualifications are not part of the selection criteria. As a result, Co-ops are managed by people without proper knowledge and skill to ensure success. There are many instances where a treasurer, for instances, who looks after the finances of the Co-op, lacks basic financial and bookkeeping skills.

All co-ops interviewed indicated that their members have productive/profitable activities that could be funded if funds were available. These activities include: funding tractors, working capital, start-up capital, buying livestock. As of 2004, three out of four SACCOs extended 157 loans worth N$57, 349 (average of N$ 365 per loan) to their members.

Lack of funds was given as the major obstacle to provision of loans to co-operative members. Co-ops depend on donor grants. Most of these funds have dried out in recent years. Many members have overtime become disillusioned and left their co-operatives. At the same time, it has become difficult to attract new members.

Out of seven Co-op visited, only two once received a loan from a formal financial institution, in both cases to finance a tractor. Banks normally require collateral and other loan securities, requirements which Co-ops usually find hard to satisfy. Lack of business management skills also constrains expansion.

Only two Co-ops could provide their annual financial statements. Judging from those figures and from verbal conversations with the principal officers, Co-ops are not profitable.

Conclusion

Co-ops have a low outreach in terms of membership and the majorities of Co-ops are on the verge of collapse. Most Co-ops are stagnant due to the seasonal nature of their agricultural activities. Given the lack of funds, existing Co-ops are also not actively involved in the provision of financial services to their members, although their By-laws allow them to offer such services. Most Co-ops depended on donor funds but since this funds dried out, Co-ops had no other source of funding to turn to and could not get loans from Commercial banks because they lack the required collateral. The current status of Co-ops makes them unfit to graduate to STBs level. Therefore, the obstacles facing Co-ops need to be addressed before they are considered for conversion to STBs.

5.3 NGOs

The NGOs interviewed have their head offices in Oshakati but serve a number of northern Regions. NGOs typically provide technical assistance, information on training for capacity building, and consultancy services to community groups and clubs. Some NGOs write business proposals for clients, connect projects to savings clubs, and assist in opening group accounts at commercial banks. They rarely have sufficient resources to offer financial assistance. Those that did it were in form of small loans to fund community projects. One NGO has, at one point, provided a surety for a loan through a commercial bank.

NGOs are heavily dependent on donor funds. Their inability to mobilize savings severely handicaps their ability to provide any meaningful financial services.

Conclusion

At the moment, NGOs do not provide any meaningful financial services to rural areas. They are heavily dependent on donor funding and rarely have sufficient funds to offer financial assistance. NGOs typically provide technical support and consultancy services to community groups and clubs. Allowing NGOs to mobilize deposits would perhaps enable them to provide adequate funding to their clients. However, before they are considered for conversion to STBs position, NGOs would need to reorganize their current operational structures to accommodate STB operations.

5.4 NAMPOST SAVINGS BANK

Nampost, a public postal services company, has a large number of branch outlets in all rural and urban town centers of Namibia. In 2004, Nampost had 115 branches and a full-time staff compliment of over 500 countrywide (16 branches and about 53 staff are located in second tier regions i.e. Oshana, Ohangwena, and Caprivi regions). Nampost also runs a savings bank, which provides financial services to currently under/unbanked rural areas, through its widespread branch network.

The NSB offers an array of savings and investment products to low and medium income earners. Because of its advanced infrastructure and extensive branch network NSB has also been used as a service delivery channel by commercial banks and other companies seeking to access remote and under/unbanked areas. These services include:

1. Money transfer
2. Payment services (insurance; pension settlements etc)
3. Account payments services (telephone; municipal bills etc)
4. Salary/wage services
5. Collection services (FINED; NHE loans etc)
6. Deposits/withdrawals
7. Premium collection (Legal Shield; MNet; Old Mutual etc)

During 2004, NSB had about 230 000 savings accounts and over N$ 300 million in deposits, of which about N$ 90 million is mobilized from the second tier regions. This represents over 100 000 transactions per month. NSB offers affordable banking services to its clients, however, its transaction delivery costs substantially exceeds its income. Attributable to this is NSB’s use of savings books which are costly to maintain and administer.

NSB's legislation does not allow it to offer credit but NSB's vastness allows it to play the role of loan agent for a commercial bank. The whole loan application process is handled by the commercial bank itself. In this case, the arrangement is limited to loan disbursement and collection services without NSB assuming any associated credit risks. Lately, NSB has also been in talks with a microlender to provide loan agency services.

In an effort to reduce transaction costs and provide an effective alternative to traditional banking to the currently under/un-banked people, NSB in partnership with a local commercial bank and a South African technology company is planning to install a new IT system which will allow NSB to offer a wide range of products and services both to its clients and on behalf of third parties. The system enables the use of stored value cards with biometric fingerprint identification capabilities.

NSB's wide capacity and well established infrastructure makes it suitable for conversion to a second tier bank. However, NSB indicated that it would not consider acquiring a banking license under current conditions since this would impose a cost structure on it and might remove the tax benefits that NSB currently enjoys. Nonetheless, NSB could apply for a banking license if the following conditions are in place:

1. The existing tax advantages
2. No liquid asset requirements
3. Limited banking license
4. Provision to utilize smart cards
5. Provision to use technology as banking facility vehicle
6. Provision to provide banking and financial services to the current clientele
7. NSB does not have to carry the credit risks

Some of the aforementioned conditions, such as item 3 and 6, are the typical features distinguishing the proposed STBs from conventional FTBs and therefore, will be accommodated by the STBs' framework. Since NSB is already conducting one arm of banking business (mobilizing public deposits), adopting the lending arm would not be much of a problem to NSB. However, in other countries where post banks have engaged in credit extension it has often ended in tears. Either poor risk selection resulted in large loses or the commercial banks complained that the strategy was in competition to them and was unfair as the post bank did not face the same operational constraints (required rate of return on capital, or level of capitalization).

Conclusion

In contrast to the aforementioned, NSB appears to be well positioned to transform into a second tier bank status. NSB's wide capacity and well established infrastructure will allow it to take up the lending business in addition to its current savings mobilization activities. However, NSB seems not to be keen with the idea of conducting fully-fledged banking business. It reported that it would only consider acquiring a banking license provided certain incentives are in place. NSB would apply for a banking license if there is assurance that its existing tax advantages will remain intact, it would not carry credit risks, no liquid assets requirements, and that the banking license would be of a limited scope.

CHAPTER 6

FACT-FINDING MISSIONS TO KENYA AND UGANDA

During May 2005, a team from the BoN, Banking Supervision Department went on a study tour to Kenya and Uganda. The purpose of the missions was to acquire insight into the planning, implementation and operation of STBs, in countries with comparable characteristics to Namibia.

The study tours were aimed at increasing the knowledge of the BoN's project team as to the benefits, risks, costs and challenges associated with the implementation of a second tier banking system and regulatory regime. The delegation visited and interviewed experts from various organizations, such as the central banks; existing STBs; and donor agencies in these two countries. Key findings from the respective institutions are presented in **Appendix I** of this report.

6.1 Microfinance Environment, Operational Conditions, and Regulation

- **Microfinance Environment**

The Microfinance environment in Kenya and Uganda differs from Namibia in that the micro-finance industry in the two countries grew rapidly in an environment characterized by a large number of micro-entrepreneurs and small scale farmers who were already involved in existing micro-businesses. Many of these activities are concentrated in highly productive farming / semi-urban areas in which population densities are very high. Most of the Micro-finance players interviewed do not fund start – up businesses as these were considered too risky.

- **Operational Conditions**

Most MFIs in Kenya and Uganda benefited from donor funds during their early stages of operation. The funds were used to provide lending capital and to cover operational costs. It is estimated that an individual microfinance institution required an average of US$5 million to succeed.

A typical MFI required between 50,000 and 80,000 customer accounts to break-even. Staff costs were between US$150 and US$350 per loan/field officer. For the institution to break-even, each loan officer needed to manage around 400 loans. There is an abundance of educated labor force in the two countries, which acts as a reservoir of cheap labor for the MFIS.
Lending was either group-based or individual based. The latter methodology applied where household assets could be used as partial collateral.

Non-performing loans (NPLs) averaged between 5 percent and 10 percent of the loans portfolio. MFI's in Uganda indicated that there was a high willingness to repay to avoid the stigma of not honoring debt obligations. Loans carried average interest charges of between 1 percent and 5 percent per month. Deposit rates were between 3 percent and 8 percent per annum and commercial loans cost 15-18 percent per annum.

Most of the MFI's that had achieved partial sustainability still fund asset growth from equity and had capital funds of between US$2 million & US$5 million. Although larger MFI's were covering operating costs, they were not profitable in the normal sense of earning return on equity of more than 20 percent. Thus, their future survival depended on further non-commercial injections of funds. Centenary Bank and Equity Bank were profitable, in the normal sense, because both have strong marketing capabilities and extend salaried loans as a significant portion of their business. They also have relatively larger loan sizes and lower operating costs. On the other hand, SACCOs did not operate with fully paid staff (volunteers) and have a different cost structure.

- **Regulatory framework**

In Uganda and Kenya, Tier I comprises commercial banks and Tier II consists of credit institutions (finance companies). These institutions are well capitalized and allowed to do micro-financing business.

In both countries the focus is on developing regulatory frameworks for Tier III and Tier IV institutions. Tier III will include micro-deposit taking institutions (MDIs) and Tier IV will comprise all those that do not qualify as MDIs. In Uganda and Kenya the central banks regulates Tier I – III while Tier IV would be regulated by an umbrella body and a different supervisory authority respectively.

Micro Deposit Taking Institutions –The major concern of regulators in this regard is the sustainability of the microfinance sector and the protection of the public deposits. MDIs will be regulated, supervised and allowed to take deposits. A minimum required (reduced) capital is defined such that it is sufficient for deposit taking and intermediation. Since Tier III institutions are more vulnerable to economic crises, their legislation should provide for more strict capital adequacy requirements, more conservative liquidity requirements, and more strict provisioning policies than for standard financial institutions.

In Uganda, two institutions have already complied with the MDI legislation and after Sept 2005 all deposit takers will need to be licensed, compliant and registered. In Kenya, the MFIs bill will soon be debated in parliament but will likely follow the same trends as in Uganda.

Meeting the regulatory requirements has required substantial investment on behalf of the microfinance institutions, including expenditure on: training; upgrading systems and equipment; MIS and data reporting; branch upgrading;

and additional staffing (1-3 people). One MFI felt that the cost of compliance would be greater than the benefit of being able to mobilize savings.

In both countries, all the MFIs that are likely to be licensed as MDIs already have operations of sufficient scale and exceed the current capitalization requirements (US$2 million or US$1.5 million) for commercial banks in Namibia.

Governments have been concerned over weak corporate governance in member-based organizations, NGO's and donor supported entities. Weak corporate governance has lead to the collapse of several of these institutions.

What stands out in both countries is the huge amount of donor involvement and funds to either capitalize or support institutions and MFI's and to assist the Governments in policy formulation. This is quite different from the situation in Namibia.

6.2 Insights for Namibia

- MFI's built on existing micro-enterprise culture. This is far less developed in Namibia. Lending to start ups is likely to be far more risky. So, MFI's in Namibia would need to support existing micro-businesses.

- Low population densities in Namibia will present an additional challenge and will probably drive up operating costs relative to Kenya and Uganda. MFI's and Government would need to find ways of overcoming the costs of operating in less densely settled areas.

- The MFI industry, in both countries, has developed due to a high level of co-ordination and co-operation between the Government, the central bank, donors and co-operatives. The donors have provided funds to drive the industry and support its development. **This works out at around US$5 million per successful MFI.**

- The MFI industry is very labor intensive and relied on low cost skilled staff (graduates at US$250 per month). In Namibia, shortages of skilled staff, willing to work at low wages, would have a constraining impact on overall sustainability.

- Collateral shortages have been overcome through group-based lending methodologies or through chattel mortgages.

- The industry was only able to prosper due to the absence of interest rate caps of any kind, but even then high NPL's kept profitable at a minimum.

- MFI's that qualified as MDIs had sufficient capital to be registered as banks in Namibia without a reduction in the minimum capital requirement.

- Costs of regulating MFI's were high as they often needed onsite assistance due to weak systems and poor reporting capacity.
- The cost of compliance with MDI legislation was high than the cost of capitalization of the MFI's.

1. Regulation should focus on deposit taking not lending activities.

- Lending activities are probably best regulated through voluntary regulatory environments, but with input from the central bank.

- The governments of Kenya and Uganda recognize the important role SACCOs play in micro-financing (see Appendix I, paragraphs 1.4 and 2.5). For this reason, the Central Banks and Ministry of Finances of both countries identified the need to work closely with relevant stakeholders to improve the effectiveness and sustainability of SACCOs. This involves distinguishing between financial and non-financial co-operatives and providing support to them to improve governance and capacity.

- Substantial government involvement and donor support were key to the emergence of this industry in both Kenya and Uganda.

- Ensure adequate corporate governance (and registration under companies act etc) to prevent problems as institutions grow.

- MicroFinance cannot help in certain instances: poor and vulnerable groups with very low levels of assets (human capital, land, property, micro-business cash flows); SME's need large amounts of funding than is available and more difficult to monitor; and risks inherent to emerging agricultural businesses.

CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

Low economic growth in Namibia is likely to slow the emergence of micro-enterprises. This in turn will affect the sustainability of micro-lenders for which micro-enterprises form the basis for lending. Political stability, though important, is not critical to the prosperity of micro-finance institutions.

Developed banking (financial) infrastructure (by lowering the cost of financial services) makes money transfers and overall liquidity management, by MFIs, less risky and less costly. A well developed financial infrastructure in Namibia is also likely to play a positive role in the creation of business opportunities for SMEs and thus for MFIs. Developed commercial infrastructure, on the other hand, is likely to stymie the emergence of micro-businesses. It can, thus, be concluded that the impact of the state of infrastructure (physical, commercial, financial) in Namibia on SMEs (e.g. small traders) and MFIs is ambiguous.

The microfinance environment in Kenya and Uganda differs from Namibia in that the micro-finance industry in the two countries grew rapidly in an environment characterized by a large number of micro-entrepreneurs and small scale farmers who were already involved in existing micro-businesses. Many of these activities are concentrated in highly productive farming / semi-urban areas in which population densities are very high. There is no such proliferation of micro-enterprises in Namibia.

One of the key conditions for a thriving MFI industry is the high population size and density, which allows MFIs to attain a critical mass of clients and achieve economies of scale. This condition is lacking in Namibia, therefore, ways and means need to be devised to make up for that deficiency. A telling lesson from Kenya and Uganda is that low population densities in Namibia are a challenge to the sustainable development of MFIs because they are likely to result in high operating costs. MFIs in Namibia need (perhaps with government assistance) to find ways to overcome this handicap in less densely settled areas.

The results of the survey show that Micro-lenders or Cash Loans only lend to salaried individuals with bank accounts. Current operations are profitable. However, limited sources of loanable funds limit the prospects for more profits. There is a general lack of ability to develop new products and services and most Cash Loans have no clear vision. Almost in all cases, lack of funds and poor business management skills present a major challenge to growth and expansion.

Co-operatives don’t play a significant role in terms of provision of financial services. They suffer from lack of funds and are plagued by poor management and dwindling membership. NGOs don’t extend any credit. They depend on donor funding.

The following conclusions are based on the visits to Kenya and Uganda. It is very risky to lend to start-ups. MFIs in Namibia would need to support existing micro-businesses and micro-enterprise culture is conducive to MFI development.

MFIs need donor funds and grants to develop into sound and mature institutions that can be licensed to take deposits. Co-ordination among Government, donors and co-operatives is also critical.

The availability of cheap, but skilled, labor will advance the sustainability of MFI operations.

MFIs in Kenya and Uganda were able to overcome the issue of collateral by employing group-based lending methodologies.

Interest rate ceilings can limit the growth of micro-lenders, by preventing them from charging rates that cover their costs. In addition, NPLs should be kept at a minimum.

The cost of regulatory compliance must not suffocate MFIs. Moreover, regulations should not aim to cover every MFI. It is advisable to focus regulation on depositor protection, leaving lending activities less regulated. MFIs that do not quality as MDIs could be regulated by an umbrella (apex) body.

SACCOs have played an important role in micro-finance in countries like Kenya. Government and donor support for SACCOs is critical. It is not clear whether this form of assistance is available in Namibia.

Micro-finance is not a cure-all. This limitation needs to be appreciated and alternative solutions be found.

7.1 CONCLUSIONS

The report concludes that STBs are not at this point viable in Namibia as an approach to expand access to financial services/ improve credit for the poor and SMEs. There are a number of reasons for this, as set out in the following argument:

1. The two key conditions to establishing successful STBs are missing in Namibia's case. Firstly, Namibia is almost unique in the world for its very low population density (2.2/kmsq). This results in very low-volume business, which is not high enough to support mass micro entrepreneurs and SMEs. Secondly, while some entrepreneurs and small farmers might complain about lack of credit with good reason, there is, simply, not enough business volume density to support the operations of STBs.

2. Consequently, potential demand of second tier banking is low. There is a an implied lack of profitable banking opportunities in the lower end of the

market, and private sector players are unlikely to be drawn into this market.

3. It will be challenging to turn a profit in this market for a number of reasons:
    - Good communications infrastructure exists in rural areas and mainstream banks do operate there already – albeit not in low-income and SME lending. However, the presence of banks with advanced infrastructure would make it difficult for STBs to establish a foothold in these areas.
    - The cost of banking staff is high in Namibia and most people would be reluctant to work in remote areas. This is in contrast to Uganda and Kenya, where there is a wide pool of educated, cheap labour available.

4. Even if there were profitable banking opportunities it appears that there is a lack of capacity in potential STB entrants surveyed. The MFIs surveyed had very small operations exhibiting poor record keeping and business management skills.

5. Likewise co-ops are in a weak position, many surveyed were on the verge of collapse, and less than half interviewed offered deposit/savings facilities to their members. They also suffer from a poor membership base with membership mostly made up of older people (who are not a strongly entrepreneurial demographic group). They also displayed weak corporate governance and depend on donor grants in order to sustain business. It is unlikely that co-ops would be profitable STBs.

6. Similarly, the survey encountered no obvious NGOs who would be likely STB candidates.

7. Based on the survey findings, it is unlikely that NGOs, microlenders or Co-ops would be able to reach the costs of capital requirements or to comply with, even relaxed, regulatory compliance burdens. In order to be sustainable this businesses would need to use grant funding to such a level that capital requirements would be easily met anyway. **In other words, regulatory capital requirements are not the issue preventing suppliers entering the banking market**.

8. There are other valid reasons why there is a low diversity of supply of banking services to the poor and informal SMEs, but prohibitive regulatory requirements is not a major blockage. It is not likely that lowering the capital requirements would encourage entrants – in fact by regional standards Namibian entry capital requirement of N$10 million[5] is already

[5] The entry capital requirement in South Africa is about N$ 250 million.

low. The fact is that few profitable opportunities, high default rates, and low levels of collateral are preventing banks from entering lower income, higher risk lending markets.

9. There are also the costs and risk involved in the implementation of the regulatory structure that should be considered. These have not been studied closely but there would certainly be legislative costs and regulatory costs incurred in setting up a new regulatory regime for STBs, ongoing supervision and monitoring costs, and possibly even direct subsidy costs. STBs would also face compliance costs. There is also the risk to the stability of the first tier banking system and national payments system (assuming STBs would have access to that system).

10. In summary, **STBs are not a viable route in Namibia, and are unlikely to be in the near future without substantial state intervention and support.** The value of this support would have to be assessed relative to other demands on government resources.

7.2 RECOMMENDATIONS

This report has considered two closely related public policy challenges:

- **Firstly,** how to expand the distribution of core banking services to regions and clients who are not adequately serviced by the commercial banks.
- **Secondly,** how to provide access to credit for SMME's and emerging but informal business.

We deal with these in turn.

7.2.1 Expanding Access to Banking Services

As the report concludes that STBs are not the appropriate solution to Namibia's level of access to financial services, the following alternatives need to be further explored:

a) While banks in Namibia might not operate in an overly competitive environment, they are undoubtedly well-capitalised, well-governed and profitable. At the same time, the emerging non-bank MFI's and co-operatives are too small, unsustainable and fragmented to constitute even the basis of an alternative network. Given this situation, BoN should look at ways of working within the **current banking system** and explore ways to build on existing capacity either within commercial banks and/or Nampost rather than looking at introducing new regulatory categories.

b) Regulators in other countries have tried to encourage banks to create **branch infrastructure** in remote parts of the country through:

   i. Direct branch operating subsidies - this tends to be politically unpopular when banks are already perceived as making super profits;

   ii. Reduced regulatory requirements regarding branch specifications;

   iii. Political pressure – In South Africa the Financial Sector Charter has been used to establish a social contract with the banks to improve financial access through providing lower cost products;

   iv. Alternatively the award of key public sector payment contracts can be tied to infrastructure provision commitments;

   v. Channeling government payments through the banks or requiring every recipient of a government salary or payment to open a bank account can create additional revenue in currently under serviced areas.

   vi. Increased central bank depositories to reduce the cost to the banks of moving cash around the country.

c) The BON should also explore with the Commercial Banks the constraints to reducing the price of entry-level banking products.

   i. Exploration of the degree to which there is price competition for banking products and what regulatory action can improve the level of competition.

   ii. Political pressure – In South Africa the Financial Sector Charter has been used to establish a social contract with the banks to improve financial access through providing lower cost products.

d) Given their network the NSB can play an important role in expanding access to banking. However, at present it appears that the NSB is exploring a card solution that would not be inter-operable with the rest of the payments network. If they persist with this strategy their contribution will be severely reduced.

7.2.2 Expanding Access to Credit

STB does not increase the supply of credit to SMME and informal business unless there are thriving MFIs that have exhausted their funding opportunities.

This was not found to be the case in Namibia. In fact the MFI's are so underdeveloped that a meaningful increase in SME credit is again most likely to come from the commercial banking sector.

1. What can be done to incentivise these commercial banks to increase the supply of credit to SMME's and informal busineses? This requires a closer analysis of the commercial drivers of SME lending and how blockages may be removed. This was not the focus of this study. A further investigation is required on how SMEs can be assisted to become more creditworthy. This would need to address issues such as:

    a. the importance of land reform to increase access to title;

    b. support to SME's to improve their ability to provide the information that the banks require in order to complete credit assessment;

    c. although improving transaction banking opportunities may not in itself solve the problem of lack of credit, it can help indirectly: transaction banking leads to better opportunities for behaviourally-scored rating and credit-extension.

    d. NSB is currently involved in a joint venture with a commercial bank that would see credit facilities extended to rural areas. Although this arrangement will not necessarily change the sponsoring banks risk acceptance criteria, it may improve distribution of the existing credit product and as such should be welcomed.

2. There is a growing body of knowledge on best practice in SME lending and the Bank of Namibia should play an active role in promoting research that highlights the constraints and best practice solutions. For example a recent study by Genesis Analytics for the Banking Council of South Africa found that:

    a. Given the legacy of apartheid, there was a key role for government to support business practices in SME's with respect to book keeping, credit applications etc.

    b. That increasingly banks internationally apply credit scoring to SME loans. If there is insufficient information in any one bank to support the development of a credit scoring model then it may be appropriate for the regulators to facilitate the creation of a central credit information repository.

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APPENDIX I

FACT-FINDING MISSIONS TO KENYA AND UGANDA

1. UGANDA

1.1 Financial Sector Deepening Project: (DFID)

The project is focused on supporting MFIs to qualify for Tier III and improving Tier II. It also wishes to focus on Domestic Transfer projects and Insurance projects (medical insurance).

The presenters give an outline of the tiered-approach to regulation of micro-finance sector: Tier I comprising Commercial Banks (offering Cheque clearing, among others); Tier II includes Credit Institutions (offering everything other than current account); Tier III will include Micro Deposit Taking Institutions; and Tier IV will consist of non-deposit taking institutions and initiatives (NGOs, etc.); and all other very small member-based organizations mobilizing membership subscriptions.

Tier I-III institutions are providing loans to the top 20 percent of the population. The rest of the population is served by the Tier IV institutions. The Bank of Uganda will regulate micro-finance business under tier 1, 2 and 3, while organizations under tier 4, which are currently unregulated and probably cannot afford to meet the costs of regulation, will be regulated by an umbrella body. There is no transparency or consumer protection in this tier. Bank of Uganda has until now shown no interest in the regulation thereof. This is currently being debated in Government.

1.2 FINCA

The team visited FINCA's head office in Kampala and met with head of sales and marketing. FINCA Uganda (FU) was found in December 1992 as an NGO and company limited by guarantee with a local Board of Directors. FU is an affiliate of FINCA International Inc., a non-profit organization operating out of the USA and which partly funds the institution. In November 2004, FU has become the country's first-ever MDI (microfinance deposit-taking institution) to obtain a license authorizing it to mobilize savings from the public and thus allowing a much bigger outreach than could otherwise be achieved. FU is providing micro-finance services through group-based lending methodology (75 percent of the book) to predominantly economically active poor women in Uganda. They focus on group lending due to the lack of a functioning legal environment in the rural areas or collateral of any sort.

Through 7 Regional Offices, FU now serves more than 47,000 clients and boasts a balance sheet of around $7.5 million. Its operations are funded by a combination of savings (25 percent), commercial loans (50 percent), and equity (25 percent). The institution continues to receive a subsidy of about $2 million. Because they have a social mandate, they are not required to generate a commercial rate of return. They are, however, aiming to break-even soon.

FU is currently focusing on meeting the compliance requirements for the Tier III license. This has involved ensuring that 4 of the 7 branches are upgraded to meet deposit taking level of security (systems, safes, security services).

FU's main program product has traditionally been village banking lending and include the following products and services: village group loans (max $2.K); salary guaranteed loans (($6K); working capital loans ($12K); open access account; limited access accounts; group access saving accounts; fixed deposit saving account; and Western Union money transfers. No single exposure can exceed 15 percent of the capital or $45K.

Through an international insurance company, FU has offered a disability and accident life insurance policy at no extra cost to all its clients. This policy covers the outstanding loan balance in case of death from causes other than AIDS. FU is also giving loans to clients to enroll on a health insurance scheme operated by an allied organization.

The institution has a total of 1900 groups and 137 loan officers. A loan officer oversees 14 groups of 25 persons each. FU currently pays 3 percent on deposits, 18 percent for commercial funding, and zero for equity. Lending is at 67 percent effective interest rate and the NPL ratio stands at 5.6 percent.

Main threats come from insecurity in the North and from fluctuations in agricultural prices. The insecurity has led to the displacement of some clients which eventually leads to delinquency. Business has also slumped in insecured areas leading to less demand for credit. The increase in the number of branches, necessary for effective deposit mobilization, is likely to result in rising costs.

1.3 Commercial Micro-Finance (CMF)

CMF is one of the Tier II institutions. It is, thus, regulated in a similar fashion as the Tier I banks but has a lower capital requirement ($600K) and does not offer current accounts.

It grew out of a purchase and acquisition of the assets of a failed Co-operative Bank, and now has a balance sheet of $7 million and 6 branches. CMF, which is owned by private investors, raises both retail and commercial deposits and lends to individuals and groups with loans of less than $6k. Lending is focused on businesses lending and does not lend for consumption purposes. The Institution initially had a group loan approach but now focuses on individual lending to small businesses with collateral (land title, household title or guarantor). CMF does not lend to start-ups.

Its key constraint is funding, which is partially relieved by long term funds administered by the Bank of Uganda at a cost of 17 percent. CMF has just implemented an Equinox system and is networking all the branches. It uses Stanbic as its clearing bank and its next focus will be on debit cards.

The institution operates on commercial terms - mandate to attain a RoE of 30 percent - and has a loan to deposit ratio of 85 percent. It has no problems with the regulatory environment but would like to have an exemption on the liquid asset requirement because their loan size is low and feel this requirement penalizes them unduly. CMF pays 5 percent for savings account and charges a rate of 30 percent per annum for loans. The latter are protected by a credit life cover. CMF currently has around 30,000 customers. The balance sheet and deposits grew by 80 percent and 100 percent, respectively, last year. The cost of funds, at 5-16 percent, is CMF’s main challenge.

1.4 Uganda Co-operative Savings and Credit Unions Limited (UCSCU)

UCSCU is the national apex organization for all Savings and Credit Cooperative Societies (SACCOs) in Uganda registered under the Uganda Cooperative Societies Statute of 1991. It has an active membership of about 230 SACCOs, the largest of which has around 6000 customers and $400K in assets. The principal UCSCU membership requirement is 30 members. In addition, an institution must first register with the Registrar of cooperatives as a SACCO. In future, submission of a business plan will also be a requirement for registration as a member. Members pay an entrance fee, subscribe to shares and also pay for services provided by the umbrella body.

The UCSCU receives funds from the Ministry of Finance and in turn extends these funds to the SACCOs for on-lending. As a condition for receiving funds, SACCOs are required to report on the uses of such funds. UCSCU and the Registrar examine the books of the SACCOs and monitor their operations.

There has been a move in Uganda to distinguish between financial co-operatives that mobilize savings and extend credit and other forms of co-operatives. In the past, without this distinction, it was felt that the co-operatives tended to use savings to invest in single asset and suffer from portfolio concentration problems.

UCSCU was funded by donors but this was felt to create perverse incentives. So they currently focus on getting the SACCOS to pay for services that are only moderately subsidized. They try to provide support and training (stationary, software, accounting & auditing training etc) and are experimenting with insurance products.

Governance problems have plagued member institutions. There have been a number of instances where SACCOS failed, and depositors lost their money, due to poor governance, mismanagement, fraud and insufficient accounting records. Currently UCSCU does not have any enforcement capability. Government is thus changing the regulatory framework and is likely to only allow very limited deposit mobilization by Tier IV institutions where group discipline can prevail. The rest will be required to register as Tier III and comply with the regulation.

UCSCU believes strongly that people need to save before they access credit and thus the SACCOS system should be preserved in some way.

1.5 Uganda Microfinance Union (UMU)

The UMU, established in 1997, has grown with donor funds and grants into a business with a loan portfolio of $11 million and savings of $3.4 million. It now has achieved operational sustainability and is funded with a combination of deposits ($3.4), commercial borrowings ($3) and equity ($7). Equity is held by the founders who initially received a small loan of $40K from Bank of Uganda and three donor funding institutions (Oruis, Norfund, Accion Invest).

UMU currently has 21 branches with a staff complement of 310 people, of which 120 are loan officers, with university degrees, earning $250-$350 a month. A branch has up to 15 workers, including field officers. UMU has a wide range of products covering groups and larger individual enterprises. Its major product though is working capital loans. In addition, UMU provides credit life insurance products and use a range of security for personnel loans. The majority of clients is in groups of 5-10 people, and guarantees each other’s loan. Interest rate charges are between 2-5 percent per month, with a performance ratio of around 93 percent.

UMU acts as a sub-agent for Western Union and also offers local money transfer services. They seem more flexible and experimental in their product approach than their competitors. Most loan products have a 20 percent savings component, and pay 3 percent interest on savings and 8-10 percent for term deposits.

The Bank of Uganda has given all deposit taking institutions until Sept 2005 to register as MDI. UMU is about to apply for an MDI license.

1.6 Micro Finance Outreach Program: MFEP

The Micrefinance Deposit Taking Institutions (MDI) bill for Tier II mircrofinance institutions was enacted in 2003 and published an official gazette in 2004. The project is currently developing a regulatory framework for Tier IV, with the bill anticipated in two months. The framework will cover member-based organizations, non-deposit taking institutions such as credit-only NGOs, or any other non-deposit taking initiatives. However, a series of conflicting issues (companies act, consumer protection act, accountancy rules etc) need to be addressed.

There are concerns over depositor and consumer protection issues for users of money lenders services. The program also wants to subject financial co-operatives (SACCOs which mobilizes huge amounts of deposits) to prudential requirements and to develop models of savings and credit institutions (to register as SACCOs). Training and support programs are used as a carrot to support behavior change in model ROSCAs.

The project, funded by UNDP at the tune of $6 million per year, comprises the following components: policy development and implementation; training and support programs; and transformation support grants to institutions that need to comply with regulations.

1.7 Centenary Rural Development Bank

CERUDEB started off as a Catholic church co-operative and struggled for many years. It nearly collapsed in the early 1990’s but was rescued and resuscitated with funds from DFI’s private equity wings. Since then it has grow to have almost 400,000 savings accounts and 40,000 lending accounts. CERUDEB is a Tier I bank and have a sustained profit record with RoE’s of around 30 percent for 4 years. According to the bank’s risk manager, the key to their success was that they enjoyed a “halo” of safety due to the backing of the Catholic Church and its status in the community. This support enabled them to rapidly grow the deposit base at low cost.

CERUDEB now has the second largest branch network in the country and also serve as an agent of Western Union. The Central Bank has requested the bank to implement new systems and it has invested in an Equinox system which is currently being rolled out.

In 2003, the bank had a balance sheet of $80 million of which $12 million was equity. It had a loan book of $40 million, fixed assets of $5 million, and a profit of $3.5 million. By 2004, profits have risen to $5.5 million.

1.8 GTZ: Financial Sector Development Program

FSDP started in 1998 and aimed to convince BOU of the importance of micro-finance and the need for a regulatory response and framework. The program started with a policy paper (1999), and worked closely with the Association for Microfinance Institutions in Uganda (AMFIU) that became an important lobby group.

The project has the following main components:

- Regulatory response to microfinance
- Payment systems development (mainly back-end)
- Capital markets development (mainly handled by the Capital markets authority)
- Supporting training and best practice communication via courses at Uganda Martyrs University
- Next phase will help institutional development and transformation support
- Credit bureaus policy (has been developed and will shortly be implemented)
- Working on policy rense to SACCO's

The program was also keen to emphasis what Micro-Finance cannot achieve, namely: that support to the poor and vulnerable (results in a debt trap); SME's need more funds than are available; and that agricultural finance was inherently risky.

1.9 Bank of Uganda Micro-Finance Division

BOU has established a unit to develop the policy and legislation for the regulation of the micro-finance in the country. The development process went through three stages: the policy development; the execution of the Act; and the regulation according to the Act.

The unit's strategy is:

- Not to regulate what cannot be supervised
- Not to impose costs of regulation that are greater than an institution can bear

- It is, in their experience, more costly to regulate micro-finance institutions than formal banks as the microfinance institutions lack the ability to generate proper reports and need to be micro-inspected.

The BOU indicated that the initial cost of compliance for a Tier III institution averaged $350K. Thus, it is imperative that an institution is large enough to absorb these costs. The figure is also an important indication of the size of cash flow that an institution should attain before it can be regulated.

Tier I and Tier II institutions are allowed to conduct micro-finance activities subject to MDI-style regulations. The latter specify that an institution cannot lend more than 1 percent, 5 percent, or 15 percent of its core capital to an individual, a group, or a single obligor, respectively.

There is no deposit insurance for non-regulated entities, but the law makes provision for institutions that can contribute to dealing with failed entities. Deposit-taking microfinance institutions not registered as MDIs by September 5, 2005, will be wound up.

2. KENYA

2.1 Equity Bank

Equity Bank arose from a failed mortgage bank and was successfully re-invented as a micro-finance and micro-lender bank that combined good management, clear vision, strong marketing and focus. In addition, a careful articulation of donor support helped the institution to grow into a bank with a balance sheet of $80 million, equity of $19 million, profits of $4million and an ROE of 18 percent. At the same time, NPL's are 9 percent.

Business is split between 42 percent salaried loans and 35 percent micro-loans to individuals. 60 percent of loans are not collateralized. Equity Bank has 24 branches, 600 staff, and 46 mobile branches. 62 percent of branches are in rural areas. Customers using mobile branches are charged a fee of $0.75. Currently, the bank has a deposit-customer base of 400,000 and a lending base of 80,000. The bank aims for flexibility in product design and covers living crisis loans, working capital and SME finance. The bank also serves as a Western Union agent.

Depositors' value of money is preserved and there are no ledger or admin fees. However, the bank requires a maintenance balance of $6. Interest charges on loans range from 1 to 2 percent per month. Customers are issued with an ID card and the bank is currently investigating computerization options.

The institution was originally registered as a building society in 1984 and made extensive "arbitrage" of a weak regulatory framework. It has now registered as a bank in order to meet the needs and expectations of the clients. In addition, unlike the banking Act, building society Act was ambiguous and created uncertainty for customers and impediment to growth. The bank raised capital through a private placement to customers and focused strongly on human capital development as well as judicious use of donor funds to grow. Next for the bank is to list on the local stock exchange.

Future challenges include managing rapid growth and meeting client expectations and facing growing competition from banks.

2.2 Kenya Women Finance Trust (KWFT)

KWFT is the largest Micro-finance NGO in Kenya and has over 60 branches across the country. They use group and individual lending methodologies and only lend to women as they are often the neediest. The institution applies a maximum effective interest rate of 30 percent. KWFT takes cash security of 10 percent against the loan. The amount, which is maintained in a bank account but which KWFT does not use for lending or earn interest from, cannot be withdrawn before the loan is repaid. KWFT nonetheless uses the deposits to obtain better deals on loans from banks.

After 15 years of hard work and around $5 million of investment in grant donor funds, the institution has achieved operational sustainability, but not overall profitability. Currently they fund the business with about 40 percent bank loans and the balance from retained earnings.

KWFT Managing Director was very much of the view that micro-lending, because of its labor intensive nature, is not a very profitable business and needs substantial grant contribution to stay in business. KWFT has a staff of 300 and uses a ratio of 400 borrowers per loan officer who costs $300 per month. They currently have 120 000 clients, at an average loan of $373, and a portfolio of $18 million.

They no longer rely on donor grants and believe that donor conflicting agenda complicates the management of the business. They do, however, make judicial use of donor support for training and transformation, MIS, etc.

Although it already has sufficient capital to qualify as a full scale bank, KWFT is reluctant to register and transform to a MDI as it believes that the cost of compliance will be too high. It does, however, need to reduce the cost of funding and plans to take savings in the future.

The Managing Director noted the key challenges in a micro-finance environment as: need for regulatory framework and good corporate governance; dearth of a national policy on the development of the microfinance industry; lack of strategic vision coupled with donor interference; establishing solid systems and management information systems (MIS) and securing a reliable source of funds.

KWFT has a board of 11 non-executive directors, comprised of senior women in the community, elected by the members. The board formulates policies, approves budgets, and monitors performance. Management reports to the board on quarterly basis through board committees.

2.3 Department for International Development (DIFD)

DIFD supports two programs: Financial Sector Development Trust (to support the private sector) and Financial Sector Legal & Technical Assistance Program (to assist the Kenyan Government)

The FSDT focuses on four areas:

1. Consolidation of capacity for pro-poor financial service providers (this is mainly transformation and Technical Assistance to support entities like Equity Bank)
2. Extend the access frontier – into rural areas through decentralized micro business models
3. Agricultural finance – need to review the situation and explore options, but hampered by the incomplete liberalization of the sector
4. SME finance for growth. The micro-finance revolution has forgotten the SME (larger enterprises). Focus is moving away from guarantee programs to technical support to banks
5. Product development and innovation

The FSLTAP program has 7 components:

1. Strategy development – focus on access, privatization, rural, term finance, regulations (single regulator)
2. Resolution
3. NPS – RTGS
4. Regulation – single regulators and regulation of microfinance, resolution of building society act
5. Access issues – focused on company registration and title issues
6. Debt markets – improved domestic debt management
7. Legal – support in drafting etc.

The program focuses on a systems approach, NBFI regulation, and developing appropriate regulation, including a microfinance audit kit. The representative noted that the new MDI act, apart from the level of capital, is not different from the banks act. In addition, the representative emphasized the need to reduce the cost of regulation, compliance and reporting. Before an organization is allowed to operate as a licensed microfinance, he remarked, the regulator should ensure that their systems are sufficient to provide the supervisor with accurate data and have strong management.

2.4 K-Rep Bank

K-Rep is a micro-finance institution of long standing (20 yrs) that has converted from an NGO to a bank in 1999. The transformation was aimed at gaining self-sufficiency by tapping into the financial business. Their investors include IFC and Shore bank. K-Rep Bank is part of the K-Rep Group that includes K-Rep Development Agency (KDA) that acts as an incubator of new product ideas that when commercialized can be implemented by the Bank, and K-Rep Advisory Services KAS) a micro-finance consulting services.

K-Rep Bank has portfolio quality with all ratios growing around 30 percent per annum and an NPL ratio of less than 5 percent. The institution does group (55 percent) and individual lending as well as wholesale lending (13 percent) to co-operatives and small business. 60 percent of revenue comes from group lending and ROE is between 8 percent and 15 percent, while the loan-deposit ratio stands at 90 percent.

At the time of conversion, the bank had enough qualifying capital but later found branch compliance issues to be very costly. The bank also felt that there was need for a special regulation for microfinance and that MFI's needed more rigorous inspection as they have rapidly maturing portfolios. Currently the bank has 6 conventional branches and 28 field offices that they wish to convert to small branches. The bank sees the definition of "microfinance" in the microfinance bill as likely to be the main challenge.

2.5 Central bank of Kenya (CBK)

There are many SACCO's, micro-finance institutions and development finance institutions in Kenya. MFIs in Kenya are well developed. The importance of MFIs is primarily in transactional and payments then in savings and credit. Four out of 49 banks (Equity, K-Rep, Kenya Commercial, and Co-operative) specialize in micro-finance, in addition to a further 120 MFIs of which 15 are significant players. However, it has not always been like this.

In the late sixties and early seventies, there was a lot of Government involvement in the Kenyan economy. At independence, for instance, Government policy promoted SACCOs. There are about 4200 such institutions in Kenya, some are bigger than the MFIs and they provide more micro-loans than any other micro-lenders .Unfortunately, Government involvement became a disincentive to repay and negatively affected the MFIs.

In the 1980s-90s, liberalization and reforms, backed by the IMF and World Bank, introduced universal banking, removed credit and interest rate ceiling, and sectoral quotas. Many banks left the rural areas and moved to the urban areas. SACCOs filled the gap left by banks. Rural SACCOs were producer based and membership came from various societies, such as tea and coffee societies. Urban SACCOs, on the other hand, were employer based.

Some SACCOs started taking deposits and offering ATM services. The Kenyan Government also recognized them as pay points. They have become banks illegally. NGOs were the biggest players, but when donor funds became unsustainable, they also started to take deposits. Eventually, the Government got concerned over the safety of depositors and, hence, the need for a regulatory framework. A unit was established in the central bank to develop microfinance legislation. The microfinance bill, providing a framework for deposit taking, will be discussed by parliament in its May 2005 session.

The bill provides for lower capital requirement of US$700K for deposit taking microfinance institutions and of US$230K for microfinance institutions in a particular place, for example a market place. Every enterprise will be required to register and make basic disclosures. The development of the regulations has been highly consultative including the CBN, Treasury, and Microfinance institutions. There is separate legislation for SACCOs and a new authority will be created to supervise them. MFIs are supervised by the Central Bank of Kenya.

SACCOs typically lend at 1 percent per month. They will, however, suffer if the agricultural markets in which the members operate are not well organized. Governance has been a problem in SACCOs and has led to several failures.

2.6 Association of MicroFinance Institutions (AMFI)

The AMFI is a not-for-profit umbrella organization established in 1999 and is involved in lobbying for the microfinance institutions bill. The association has also been actively involved in the development of the new bill. It provides training, capacity building, and establishes codes of conduct for its members and co-ordinate donor assistance. AMFI funding comes from membership subscription (US$250 per year), initial registration (US$800) and donors (USAID grant). Judging by its rundown office building and small staff compliment (5), the association appears to be poorly funded.

The AMFI lobbied for the bill due to the lack of standards and client abuse environment that was undermining the credibility of the industry. Of the 30 AMFI members, about 5 will qualify as MDIs. For those that would qualify, AMFI calls for some non-prudential supervision to be in place to streamline their operations. Such regulatory framework should include:

- disclosure requirements

- consumer protection issues
- establishment of credit reference bureau
- prevention of abuse of MFIs by borrowers

AMFI could also act as a voluntary regulatory mechanism and overseer of the above.

APPENDIX II

List of interviewees on surveys and Study tours to Kenya and Uganda

LOCAL SURVEYS	**JOB POSITION**	**ORGANIZATION**
A.P. Engelbrecht	Senior commercial manager	FNB Namibia
Mr Derek Kimber	Retail Head	Standard Bank Namibia
Mrs V. Beukes	Branch manager	Nedbank Namibia
Ms Gida Sekandi		Bank Windhoek
Ms Eva Emvula	Chairperson	Ongushu Regional Farmers Co-operative
Mr Joseph Halweendo	Former Treasurer	Mandume Regional Co-operative
Mr Thomas Nambambi	Chairperson	Ompundja Farmers Co-operative
Ms Frieda Haufiku	Chairperson	Eudafano Women Co-operative
Mr Joseph Ndakalako	Chairperson	Mandavisu Community Co-operative
Mr James Walubita	Treasurer	Katima Sacco
Ms Clara Musweu	Chairperson	Caprivi Women Sacco
Mr A Kalumelume	Principal Officer	Namibia Fiancial Multi-Purpose Cash Loan
Mr Paulus Elago	Owner/Manager	Yours Cash Loan
Ms Hambeleleni Sam Nekoto	Manager	Janeel Financial Services
Mr Hango Salom Sailoh	Principal Officer/Owner	Zinzimba Cash Loan
Mr Busani Maphumo	Manager	Shimwe Buiswalelo Cash Loan
Mr R M Nkando	Managing Director	Kuomboka Cash Loans
Dr N H Paike	Owner	Katima Micro Loan

Mr Likanyi Vister	Assistant Manager	Katima Cash Loan
Ms Royce Silengela	Clerk	Njangula Cash Loan
Ms Veronica De Klerk	Executive Director	Women's Action for Development (WAD)
Ms Gerson Hiskia Tuneeko	Director	Community Management and Resource Centre
Mr Johan L. Claasen	Acting CEO	Nampost
Mr Patrick Gardiner	General Manager	Nampost Savings Bank
KENYA		
Mr George Omino	Senior Manager	Central Bank of Kenya (Bank Supervision Department)
Mr Daniel K.A. Tallam	Manager	Central Bank of Kenya (Research Department)
Ms Beatrice Sabana	Chief Executive	Association of Microfinance Institutions (AMFI)
Mr David Ferrand	Financial Sector Specialist	DFID Kenya
Mr Kimanthi Mutua	Manager Director	K-Rep Bank
Mr Alex Muhia	Personal Assistant to the CEO	Equity Bank
Ms Susan Wakonyo	Customer Service Manager	Equity Bank
Mrs Mary Wangari Wamae	Legal Services Manager	Equity Bank
Ms Winnie Kathurima Imanyara	Head of Human Resources & marketing	Equity Bank
Mr Aleke Dondo	Managing Director	K-Rep Development Agency
Mr Ken K. Kariuki	Head of Marketing	Equity Bank
Mr James N. Mwangi	Chief Executive	Equity Bank
Dr Jennifer Riria	CEO	Kenya Women's Fiancne Trust
Dr Ayako		Central Bank of Kenya (Banking Supervision Department: Rural Finance)
UGANDA		
David .L. Kalyango	Supervision Function	Bank of Uganda (Microfinance Division)
Ms Robinah Nakato	Senior Principal Examiner	Bank of Uganda (Microfinance Division, NBFI)
Mr Paul K. Nyakairu	CEO	Commercial Micro-Finance Ltd.
Jayachandran K.V	General Manager: BR Supervision	Commercial Micro-Finance Ltd.
Mr Paul Rippley		DFID
Fabian Kasi	MD	FINCA Uganda
Kashugyera Lance	Coordinator	Ministry of Finance & Economic Development (Microfinance Outreach Plan)
Ms Karen Losse	Programme Advisor	Financial System Development Programme
Mr Patrick Mbonye	MSE/MFI Component	Ministry of Finance, Planning

	Manager	& Economic Development (Aid Liaison Dept.)
Mr Wilson M. Kabanda	General Manager	Uganda Co-operative Savings & Credit Union Limited