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ADRESSING AN SME FINANCING GAP: DEVELOPMENT FINANCE INSTITUTIONS IN SUB-SAHARAN AFRICA

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There is, thus, little more important for poverty reduction than the development of financial institutions that make sound decisions.

World Bank- *Private Sector in Development*

[An] entrepreneurs' stated need for credit is increasingly questioned by those who think carefully about microcredit ... some enterprises themselves are perceiving that this is not all they need, and may not right now be something they need at all.

UNDP – MicroStart Program Feasibility Study
Uganda

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Quotations above drawn from:
Klein (2003) and Dichter & Kamuntu (1997), respectively.

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DFI – Development Finance Institutions
FMO – Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (The Netherlands Development Finance Company)
IFC – The International Finance Corporation
IMF – The International Monetary Fund
MF – Microfinance
MFI – Microfinance Institutions
NBFI – Non Bank Financial Institution
NGO – Non-governmental Organization
SME – Small and Medium Enterprise
SSA – Sub-Saharan Africa
UNCDF – The United Nations Capital Development Fund
UNDP – The United Nations Development Programme
WB – The World Bank

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Chapter 1 Introduction

1.1 The Problem: A Financing Gap Stagnates SME Growth

Sub-Saharan Africa, for the most part, has been unable to match global rates of economic growth, and is commonly viewed as being sub-industrialized, under-diversified and disadvantaged by deteriorating terms of trade in primary products pricing. Even though international investment in developing countries has been growing, during the first half of the 1990s Africa only attracted 1.6% of private capital flows [Madavo & Sarbib, 1997]. While other regions have seen sustained positive growth rates, sub-Saharan Africa (SSA) is being left behind, with some countries seeing negative growth rates over the last decade, growing inequality within their borders and between other nations [UNDP, 2003].

In order to achieve significant poverty reduction, estimates state that investment within SSA must double from their current rate, a figure far beyond current levels including national government investment, foreign aid, and foreign equity / direct investment flows. It is argued that the only way to achieve these levels of investment is to involve the resources already present in most developing countries, that of the private sector. Some believe that private sector investment results in faster growth and more efficient allocation of the resulting benefits to citizens [UNDP, 2004].

One of the key players in private sector economies is the small and medium enterprise (SME) group, which is argued to be more innovative, create jobs faster and adapt to changing conditions better than larger enterprises. Support to this sector, therefore, is critical to the growth of the whole economy [UNDP 2004, WB 2002, 2005]. Another key component to private sector growth is availability of financing, which can act as an accelerator to investment. Many small businesses face a credit constraint when looking to expand their businesses[1]. SMEs find it difficult to qualify for loans from banks and other financial institutions, due to their general lack of collateral and documented track record. Banks tend to perceive SME lending as high risk and with high transaction costs, and therefore unappealing [Cook & Nixson, 2000].

[1] See for example: Ortero, Africap, UNDP, UNCDF, WB, IFC.

In the last 20 years, a new form of financing has rapidly taken hold in developing countries, namely microfinance (MF). Pioneered in Bangladesh, and later spreading to Latin America, Africa and most other regions, microcredit growth has rocketed in terms of the number loans, portfolio size, and especially its value in demonstrating that the poor are indeed bankable [CGAP]. Lessons learned over the past two decades point towards the need to formalize microbanks into legal, viable institutions in order to ensure sustainability, and broaden their potential reach, by attracting commercial capital [UNCDF]. While much focus is being placed on supporting microfinance institutions (MFIs) to increase their coverage or achieve operating self-sufficiency and legal status, many MFIs are unable to grow with their clients who graduate beyond their small-scale lending models.

The result is that in many economic and geographical sectors in Africa, SMEs are caught in a financing gap. An SME financing gap can be defined as a situation where a small enterprise is unable to receive appropriate financing for its growth needs, due to a lack of financial intermediaries willing to offer them credit and/or services. Their perceived higher risk brings with it barriers, such as collateral requirements, higher cost of interest and terms available from lenders[2]. MFIs are not able to fill the need, as the loan size or term requirement is either too large, or the group model is uncomfortable lending to an enterprise outside of their knowledge area. Banks will also not provide the financing, as their credit evaluation is typically based on rigid models demanding collateral, a proven track record and often, legal status.

This financing gap is argued to have a significantly detrimental impact on the growth potential of the SME segment, thereby limiting development in SSA [Mutesasira et al., 2001]. Attempts by African states to solve this gap, either through development bank-directed credit, interest rate caps, or segment-targeting projects, has for many countries run into serious failures [Nissanke & Aryeetey, 1999], and complications from macroeconomic shocks has led to bank failures and stock market underdevelopment, therefore exacerbating the problem [Daumont et al.,2004]. A cruel irony on top of this is the fact that Africa is a net exporter of capital.

[2] See for example, [UNCTAD, 2001:2].

The resultant domestic market failure to provide private sector lending creates the niche for foreign development finance. Development finance can be defined as financing and complementary initiatives targeted to strengthen a financial sector, in order to achieve an accelerated impact of economic development and improved well-being; development finance institutions (DFIs) are typically based in the OECD countries.

It is argued that while domestic resources eventually need to address a financing gap, foreign intervention is critical in the mean time, to build bridges between entrepreneurs and investors, and to accelerate growth. It is also argued private sector financing achieves more impact as a development tool than 'aid distribution', and many Northern countries are channelling donor funds through DFIs to Africa. This phenomenon is seated within the broader current focus that the market is more efficient than the state in leading development.

1.2 Objectives of the Study

This research seeks to gain an understanding of the applicability of development finance interventions to the SME operating requirements in sub-Saharan Africa. In order to navigate through this myriad of perspectives on the root of a financing problem, it is crucial to first to understand the financing needs that SMEs have. Is a lack of suitable finance a key bottleneck to SME growth? If so, why are local financial markets failing to fill this need? Are foreign development finance institutions more appropriate for filling this niche?

Looking beyond whether or not financing options exist, this research also examines the issue of absorptive capacity of sub-Saharan economies. Microcredit's success in proving that the poor are bankable has led many development practitioners to claim that it is a key tool in local economic development (to be led by SME growth, much of which in the informal sector). When considering the size of the informal sector in Africa, many feel excitement about the possibilities microfinance brings. The proceedings of a leading microfinance strategy meeting in Africa records: "on the demand side, its almost universally held by DFIs that the current structure of developing world economies offer basically unlimited demand for micro financing" [Africap, 2003:9].

This gives one pause for thought: does sub-Sahara Africa represent a region with unlimited demand for SME financing? Should focus on creating stronger financial sectors be the priority for local government and international donors that want to achieve meaningful poverty reduction and sustainable economic growth in the region?

1.3 Research Questions

Based on the above issues, the study seeks to address two main questions:

To what degree do foreign development finance interventions address SME financing requirements in sub-Saharan Africa?

Does the performance of DFIs and partner financial intermediaries support the argument that SSA economies represent a case of unlimited demand for development finance?

1.4 Methodology

This study involves an analysis of both primary and secondary data. In order to gather perspectives of the 'reality in the field', primary data was collected through personal and telephone interviews with development finance practitioners, most of whom were located in the Netherlands. Five organizations specializing in development finance were included in the practitioner group (FMO, Novib, Oikocredit, Triodos Bank, Africap), and two more were included as organizations involved in support of 'structural issues' and the bigger picture of the field (UNCDF, IFC).

Secondary data consists of a review of relevant studies in the field of financial markets, SME growth and sociological perspectives on economic development and microfinance. Sources used include annual reports and publications of DFIs, the World Bank and financial statistical databases.

1.5 Limitations

This study attempts to take a 'survey of development finance' from the perspective of Dutch DFIs, and complement this with points of view from other support institutions. The author recognizes that great variety exists amongst the financial sectors in sub-Saharan Africa, within sub-regions such as West, Southern and East Africa, and within individual countries; therefore any attempt to extrapolate specific findings as applicable across the region would not hold much credence.

This study does not set out to categorically judge what kind of impact DFI practices are having on SME growth in any particular African country, but rather attempts to look at the field in a bigger frame, drawing out intended results of interventions and seeing how closely they match with the development realities of SMEs in Africa.

1.6 Organization of the Study

The study is divided into five parts: Chapter One introduces the problem of an SME financing gap in Africa, and the claim of unlimited demand. Chapter Two brings in the theoretical perspectives behind private sector versus state-led development; the importance and challenges of SMEs leading economic growth; and the historical failure of markets in Africa, leading to a financing gap. Chapter Three examines the proposed solutions of development finance, including specific interventions that DFIs use, while Chapter Four analyses the reality of how these interventions take place in Africa. Finally, Chapter Five summarizes the key issues and reflects on some conclusions that can be taken from the analysis.

Chapter 2 Role of Private Sector in Development in Africa

2.1 State or Market-Led Development

One of the key debates in development during the last forty years has been regarding whom best to lead development, the state or market. In mainstream economics, the flavour of Keynesian state involvement, popular after the founding of the Bretton Woods system of financial reconstruction and planning in the post-war period, became less appealing after being tested by the energy and debt crises of the 1970's. The downward swing of the long-term business cycle accelerated a shift in political thinking towards free market ideology, and the ascendancy of influential neo-liberal governments (led by Reagan and Thatcher) had an impact on not only structure and role, but on the atmosphere of academic thought surrounding economists and social scientists studying development theory.

The production of the Berg report in 1981, the World Bank's strategic plan for Sub-Saharan Africa, reflected a shift in ideology within mainstream practitioners' development thinking. The report integrated an analysis of government performance using rational choice theory, which takes the assumption that individuals acting as rational beings can be predicted to always act in a manner of maximizing their own welfare, and therefore this behaviour can be accurately predicted in neoclassical economic models. The report was used to justify a significant reduction of the state's role, while relying on market forces to accelerate development, combined with implementation of structural adjustment policies [Berger & Beeson, 1998:490].

However, structural adjustment and unfettered market-led development did not achieve the results hoped for in Africa. The World Bank itself admits that the performance of adjustment policies was disappointing, effective in less than 20% of projects [Weeks et al. 1995: 1461]. Observers who watched the apparent havoc that the neoliberal development model of extreme state reduction, macroeconomic shock treatment and uncontrolled liberalization was having on many developing countries' economies (and social welfare of their citizens) came to a realization that market forces alone could not be entrusted to ensure development – and so modification of the *modus operandus* was sought.

2.1.1 New Institutional Economics as a Solution to Neoclassical Faults

A school of economic thought termed *New Institutionalism* gained popularity among mainstream development practitioners. An influential member of this school and father of rational choice theory, Nobel Prize economist Douglas North, had his focus on pure rationality, to include the conceptual importance of 'institutions' in economics. Defined as instruments that help reduce uncertainties in human exchange, North argued that institutions introduce critical concepts of transaction costs and political influence into the functioning of markets, something that pure neo-classical economics was lacking [North, 1995:18].

The theory stresses that central to an efficient economy are institutions that permit individuals to benefit personally, while at the same time serving the broader interests of society [Leys, 1996:37]. The assumption is that this can be applied to all transactions, such as taxation, government, education, banking, etc; North particularly stressed property rights. Since institutions help to define the 'rules of the game' (both formal and informal), focussing on the ones that govern transactions in society would allow the maximization of welfare for individuals and society as a whole; and all problems that emerge in development can be chalked up to market distortions caused by weak institutions (such as corruption, state capture, prohibitive access to finance, etc.).

In a challenge to new institutional economics, Colin Leys argues that North's theory suffers from ideological, reductionist and determinative factors. As much as the theory attempts to link economic impartiality with historical fact, there is no denying that ideology is involved when attempting to generalize social behaviour. The theory falters in explaining collective action that supersedes individual free riding, and long-term social change [p39]. Human behaviour, both collective and individual, does not often conform to strictly 'rational' choices, and hence institutions alone cannot address all concerns in society. In other words, how did major societal upheavals take place when the leadership could not have benefited in the short run – reflecting an irrational decision.

While structural economists agree with new institutionalist thinking that capitalism is inherently unstable and susceptible to crises and unemployment, they differ in their opinion on a solution. Structuralists view the adjustment of economies to be a difficult task, due to uneasily-adaptable production systems, labour and natural resource factor characteristics, and structural and technological limitations. This inflexibility can result in slow growth, high inflation, under utilization and chronic unemployment [Forstater, 2001]. Where new institutionalists believe installing or enabling the right institution to facilitate these adjustments is adequate, structuralists see the direct role of the state in being more critical to achieve change. For instance, rather than simple stimulus of the market, the state has a direct responsibility to ensure full employment and price stability [ibid].

In a sociological critique of the role of institutions in microfinance, Hospes and Prose address the claim that institutions are a response to market failures and can help overcome information gaps that hamper their efficiency. They argue that 'information' is too often viewed "as a product and commodity, omitting social relations, structures and people" [2004:241], and that institutional economics has little to say about the legitimisation of institutions. The authors caution that a simplistic reduction of the purpose and function of an institution, such as a rotating savings and credit association, into a vehicle for development can result in ignoring important realities in terms of conflicting norms, goals and characteristics of a supposedly 'homogenous membership' [p242].

2.1.2 Financial Markets and Institutions

New institutional economists argue that financial markets play a critical role in the growth and prosperity of economies. Financial markets connect firms with outside investors who are willing to lend money to the venture, share some of the risk, in exchange for some payment (return) on their investment. It is a common belief that when firms rely only on reinvesting their own profits, it can take much longer to grow than if they receive injections of capital from investors outside the firm[3].

[3] See for example, [UNECA, 2000:16].

One challenge capitalists face is the risk of investing in a venture that is not their own. Obtaining information on investment decisions is a costly matter, and since investors will be more hesitant to invest in higher-risk areas without proper information, this prevents capital from flowing to a higher-value use [Levine, 1997:695]. This creates a demand for financial intermediaries: institutions capable of gathering and evaluating information on investment options. Because these intermediaries can share information with many interested investors, they lower the costs of obtaining the information if each individual had done it on their own. Financial intermediaries are banks, stock markets investors, venture capitalists and supporting institutions, such as credit rating agencies and bureaus.

Due to the fact that they specialize in understanding their clients and select the projects most likely to offer higher returns, financial intermediaries are argued to be able to obtain the best possible return for the capital available. It is argued that this efficient allocation of capital is what equates to higher levels of economic growth [p695]. It is also argued that because financial system can better mobilize savings (through offering attractive returns), this leads to faster capital accumulation and higher technological innovation [p700]. In other words, effective institutions allow the market to allocate capital necessary for growth, in a more efficient manner than the state can achieve.

Throughout the 1990s the World Bank clarified its ideological shift towards the importance of institutions combined with minimal government interference. However, it found itself at pains to explain the East Asian miracle and obvious state intervention leading to spectacular growth by the so-called Asian Tigers[4]. The conclusions arrived at in the Bank's *East Asian Miracle* report were challenged by many scholars. While the authors argued that success came from Asian states' adoption of 'market-friendly approaches' and the important link between real interest rates and savings, no mention was made of studies to the contrary, nor the fact that banks in Taiwan and South Korea during the growth heydays were entirely publicly owned [Amsden, 1994:631].

[4] Hong Kong, Taiwan, South Korea and Singapore.

The release of the 1997 World Development report *The State in a Changing World*, popularised the term 'good governance, and reflected another shift in thinking for market theorists that recognized an important role for the state to play in development[5], however remaining in a strong but supervisory role. This line of thought carries on today, where the (2002) "Building Institutions for Markets" and (2005) "A Better Investment Climate for Everyone" WD Reports stress the importance of well-functioning institutions to facilitate efficient markets, and the state's critical role as watchdog of these institutions. The argument remains that if these criteria can all be aligned, private sector growth will take off and lead the way to development.

2.2 Importance of the Private Sector for Economic Growth

It is argued that countries that experience faster economic growth, receive the majority of investment from the private sector, versus the state [UNDP, 2004]. According to the UNDP Report *Unleashing Entrepreneurship*, the private sector can alleviate poverty through economic growth leading to employment, and through empowering people by offering them lower prices and more choices [ibid, 8]. In terms of resources, it is argued that domestic private investment in developing countries (10-12% of GDP) is much larger than state investment (7%) and foreign direct investment flows (2-5%) [p9].

While all actors in the economy are important, many feel that the small and medium enterprise segment represents the key to change, a veritable 'hotbed of entrepreneurship and innovation', creating jobs and driving economic growth [p9]. According to the International Labour Organization, SME start-ups are critical in acting as a cushion to absorb the unemployed. For example, new entrants into the workforce yearly amount to: Kenya (100,000), Tanzania (300,000) and Uganda (250,000); yet because the formal sector can only absorb 10%, the rest need to invent their own jobs [ILO, 2003:15]. SME support is a major focus of many governments and international donors, and is one of the central target groups for development finance.

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[5] Some say is a model that is based on "predominantly Anglo-American political thought and the essentially liberal notion of state neutrality" [Berger, pg.497].

2.3 Characteristics, Operating Environment and Requirements of SMEs

In order to analyze SME financing, it is first important to more closely examine the concept of an SME. There are many definitions of SMEs, focussing on number of employees, sales or value of assets – the former being the most common criteria due to availability of information. A typical definition proposes: small-scale (2-5 employees) and medium-scale (6-50); this definition excludes the micro enterprise (one person, household-based), and enterprises with anything beyond 50 employees, considered to be a large-scale enterprise. For the purpose of this study, the focus will be primarily on the small and medium scale; however since it is not always easy to draw a clear distinction between micro and small-scale enterprises (as labour levels can fluctuate eg. casual/seasonal or familial help), micro enterprises will be included in the discussion when their realities apply to the subject at hand.

SMEs are often categorized by business type, such as: trader, manufacturer, agricultural and retail/resale. It is unwise, however to treat the SME segment as one homogenous group, as there are often very distinct characteristics that distinguish them, across regions, countries and sectors [Helmsing & Kolstee, 1993]. SMEs typically start off as small ventures with limited resources, often financed through owner savings and contributions from family and/or close friends. Constraints identified in studies usually include access to technology, training and finance; high input costs; lack of viable markets and limited managerial skills [ibid: 7]. SMEs often remain in the informal sector, due to prohibitive regulations or cost requirements in order to legalize.

When examining the evolution of an SME from an enterprise life-cycle perspective, one can see distinct stages of growth, with different financing requirements at each stage. In the start-up phase, a sole owner typically needs working capital to purchase inputs, and will add whatever personal resources they have themselves or from family/friends. However, financing can become available in the form of credit extended by either customers awaiting the final product (down payment), or from suppliers (in Africa it tends to be the former[6]). At this stage most micro entrepreneurs are not ready for long-term loans nor large capital investments, such as machinery or

[6] See Helmsing [1993].

a workspace / stall. As sales grow, the business begins to reach full capacity and the owner has confidence in its viability, they may seek formalized financing in order to invest in additional equipment/inventory [Otero, 1989:14].

Passing to the growth stage is argued to be the point where a micro enterprise makes the jump to a viable small-scale business, expanding beyond the limited scope of a household sole-proprietorship. This is the important stage, as expansion results in the hiring of workers, therefore resulting in two critical impacts towards poverty reduction – employment and higher income generation. However, the net result of studies examining key constraints preventing firms from taking this step have been ambivalent towards the degree to which access to finance is significant[7] [Cook & Nixson, 2000:8].

The operating reality in many Sub-Saharan African nations is affected by macroeconomic shocks (currency fluctuation, import/export rationing); political instability and policy inconsistencies; limited rule of law and foreign direct and short-term investment swings[8]. Many sectors have high barriers to entry, while those with minimal barriers are plagued by fierce competition and saturation. A lack of viable market in which to sell, combined with the above-mentioned influences, reflects a volatile operating environment full of risks to entrepreneurs, big and small.

While the claim that access to finance is the primary problem may not always be true, the frequency in which it is cited as a major constraint to small business development warrants further analysis of its roots. The next section examines the recent historical failure of financial markets in Africa, from the viewpoint of various institutions, and attempts to show how this has influenced the operating environment for African SMEs.

[7] The authors point out that many studies focus only on existing enterprises, and critically omit the cases of failures – something difficult to track when most operate in the informal sector.
[8] See for example, Aryeetey [1993], Drame [1996], Hermes et al. [2004].

2.4 Why Financial Markets Have Failed in Africa

2.4.1 State Interference in Banking Sector

As part of a grand scheme of national development in an era of new independence, many African countries used interest rate controls as a tool in state-led development; the rationale being that cheap credit was necessary to promote investment. However, "the interest structure typically did not account for loan maturity or risk, and in fact, created perverse lending incentives for banks, with riskier sectors such as agriculture being given a preferential rate" [Daumont, 2004:24]. Lending rates were often set too low to cover risks and overhead. Credit allocation controls were also used in varying degrees in these countries, often to the manipulation of political interests. Strong banks, constrained by credit ceilings and forced to lend to general money markets, were affected by imprudent borrowing and lending of weaker banks [p26].

Table 1: Real Interest Rates (%), 5-Year Intervals, Select Countries

Country	1985	1990	1995
Cameroon	3	17	-1
Uganda	-44	-4	10
Zambia	-16	-35	5

Source: World Bank Development Indicators 2005

Table 1 shows the degree of real interest rate fluctuation from the dual impact of high inflation and state credit rationing. Uganda and Zambia show extremely low levels from the 1985-1990 periods, with effective rate levels well below zero. All three reflect high levels of fluctuation.

As a callback to Colonial times, foreign banks continued to dominate the banking systems in most of SSA and were criticized for favouring short-term trade and working capital for foreign companies. Governments responded to fill financing gaps by either forming commercial banks or nationalizing foreign ones. Nigeria had some success, but most other countries experienced poor performance, due to a lack of separation between government management and ownership. Managers had little leeway in running competitive banks and often succumbed to pressure from politically connected enterprises or the government itself to make questionable loans [p28]. This financial repression resulted in the failure of banks to develop a capacity for risk assessment, portfolio monitoring and mobilization of savings, while removing incentives to strive towards efficiency [Nissanke & Aryeetey, 1999:5].

Development banks - state majority-owned institutions with a mandate to support certain sectors either through subsidized or directed credit - did not fare much better. Many suffered from unprofessional management and a lack of diversification, leaving them exposed to market shocks. Political interests led to interference in credit extension and recovery practices, where often the demand for credit would override concerns of sustainable management [Daumont et al.: 30].

2.4.2 Macroeconomic Shocks and Bank Failures

A series of external shocks hit sub-Saharan Africa in the mid-1980s, including a sharp rise in international interest rates and a decline in world prices of primary export commodities (oil, cocoa, coffee, cotton, oil). The banking crises took on systemic proportions, and in many countries, non-performing loans reached 50% of banks portfolios. "Financial distress was especially acute among government-owned commercial banks and development banks" [Daumount et al.,2004:8].

In a study examining the impact of these banking failures in 10 SSA countries[9] from 1985-95, the IMF identified major trends and themes common to banking crises. The study found that failures were commonly linked to three factors:

- Operating environment – state of financial markets, susceptibility to external shocks, macroeconomic factors, institutional strength
- Market structure – bank ownership and concentration, sources of funding, market features that affect decision making behaviour
- Bank Conduct – internal governance and lending practices, such as public and insider lending, competitive behaviour [p4]

These shocks served to expose the weaknesses inherent to many banking systems in SSA, to both outside events and inside manipulation. The costs, however were enormous:

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9 Benin, Cameroon, Côte d'Ivoire, Ghana, Guinea, Kenya, Nigeria, Senegal, Tanzania, and Uganda

Table 2: Impact of Banking Sector Crises, Select Countries

Country	Time Period	Impact	Losses Incurred (as % GDP)
Benin	1988-90	78% loans non-performing; failure of 3 national banks	17%
Ghana	1982-89	40% loans non-performing; 7 of 11 banks insolvent	6%
Senegal	1988-91	50% loans non-performing	17%
Tanzania	1987-1990	60-80% loans non-performing, 95% banking assets with insolvent institutions	10%

Source: Daumount et al, 2004

Beyond retardation of GDP growth, the losses represented the tragedy of financial ruin for people who invested in the banks, and the end result was a severe undermining of citizen trust in financial institutions.

Table 3: Financial Intermediation Indicators, 5-Year Intervals, Select Countries

Indicator	Country	1985	1990	1995
Loan to Deposit Ratio	Cameroon	1.4	1.4	0.7
	Ghana	0.8	0.5	0.4
	Tanzania	0.6	0.3	0.3
	Uganda	0.8	0.9	0.6
Credit to Private Sector*	Cameroon	9.0	0.8	0.5
	Ghana	78.4	14.3	43.9
	Tanzania	73.6	29.6	-9.8
	Uganda	174.1	n.a.	28.2

Source: Daumont et al. 2004 *annual change

Table 3 shows the impact of banking crises on private sector credit in four sub-Saharan nations. The loan to deposit ratio, a proxy for measuring bank willingness to on-lend deposits (conservative benchmark = 0.5), shows a decrease in all cases and a conservative stance. Credit available to the private sector shows significant fluctuation, reflecting an unstable operating environment for private business.

2.4.3 Impact of Structural Adjustment Policies

During the 1960's and 1970's, most African nations set out on ambitious industrialization plans, following the import substitution model made popular by Latin American economies. With the exception of a few success stories, the majority of SSA nations in the late 1970's produced struggling indicators of economic transformation, such as labour and capital under-utilization, inefficiencies and low rates of growth [Wangwe & Semboja 2002]. Compounded by the oil crises and interest rate shocks, most African nations found themselves in spiraling debt crises, and forced to turn to the IMF.

Structural adjustment was the strategy employed by the IMF / WB as conditionally-linked to financial bailouts. The theory underlying structural adjustment policies (SAPs) was to affect macroeconomic stability through fundamental restructuring of the economy, including reducing government deficits through layoffs and budget cutbacks, and improving the allocation of investment capital [Griffin, 1996:9]. The policy recommendation to achieve the latter was to increase interest rates, based on the assumption that this would attract private savings and foreign capital seeking higher returns; hence allowing banks to mobilize this capital into the most profitable investments. IMF policy resulted in Central Bank rate increases across the region.

Table 4: Country Sample of Nominal Interest Rates – Pre/Post Adjustment

Country	Pre-SAP Period			Post-SAP Period			% Change in Spreads (post SAP)
	Deposit	Loaned	Interest Rate Spreads (L-D)	Deposit	Loaned	Interest Rate Spreads (L-D)	
The Gambia	8	18	10	13	27	14	40
Ghana	12	18	6	25	38	13	117
Zimbabwe	8	13	5	24	34	10	100
Nigeria	9	10	1	22	30	7	600
Average	9	15	**6**	21	32	**11**	**200**[10]

Source: Naude 1996

Table 4 shows that while there were increases in both deposit and lending rates, some SSA nations experienced higher relative lending rates, resulting in widening spreads. This, combined with decreases in credit to private sector (Table 3 previous) shows a credit crunch to the private sector as a result of structural adjustment.

The IMF doctrinal belief in raising interest rates, however, neglects two important caveats. One is that in sub-Saharan Africa, savings levels are not very sensitive to interest rates[11]; the second is that structural adjustment through economic contraction cannot realize quick and efficient reallocation of human and physical capital [Griffin, p6,12]. Rather, massive layoffs as part of government cost downsizing, resulted in significant increases in new enterprise formations[12], increasing competition for existing SMEs.

[10] Excluding Nigeria (which had minimal spreads pre-SAP), the average equals 85%.
[11] Indeed, many economists argue that the majority of investment comes from reinvested corporate profits, rather than individual savings.
[12] For example in Mali, Tanzania and Ghana.

2.4.4 Liberalization of the Financial Sector

Economic reformists proposed to liberate repressive African systems through: deregulation and opening to foreign competition; free-float of interest and exchange rates; removal of credit ceilings; development of equity markets and the privatization of state banks [Senbet & Otchere, 2005:20].

The economic argument for liberalization is that in restricted markets (either national or cross-border), banks are limited in their ability to attract depositors to finance their lending, and the presence of other non-bank institutions to act as competitors is also limited. Gaps in financing develop, while international capital is prevented from flowing in to fill these gaps. It is argued that financial liberalization allows interest rates to once again take on a decision-making role [Blundell-Wignall & Browne, 1991:8].

Rather than solving the problem, experiences of many African nations show that liberalization had negative consequences, especially when taking place before other conditions were in place. For example, without the presence of viable competition in Kenya, liberalization gave existing banks the opportunity to abuse their near-monopolistic position and increase spreads, resulting in higher profit margins and less credit going to the intended private sector [Pill & Pradhan, IMF, 1997:8]. Similarly, without well-developed equity markets yet in place, governments in some countries availed themselves of non-regulated credit in order to finance larger deficits [p9].

Reflecting blatant abuse of liberalization policies, an example from the Zambian financial sector proves illuminating. Liberalized standards meant entrepreneurs could found a bank on as little as US$20,000 capitalization. Inadequate oversight and economic shocks resulted in a series of banking failures beginning in the early 1990's, the most noteworthy being the 4th largest (and highest regarded) Meridien Bank [Zambia News Service, 1997]. Formerly the flagship of a network of banks across Africa, huge debt levels caused the closure of foreign branches and eventually, the headquarters. Concerned Central Bank officials attempted to allay public fears by sending in experts to take over the management of Meridien, and pumped US$90 million into the venture, which was promptly spirited away to the Bahamas in a colluded affair between senior bank and government officials. The bank finally closed its doors in 1995, with depositors losing everything and no officials (yet to be) held responsible for the missing funds [Chanda, 2003:10].

2.5 The End Result – Shallow Markets and Fragmented Institutions

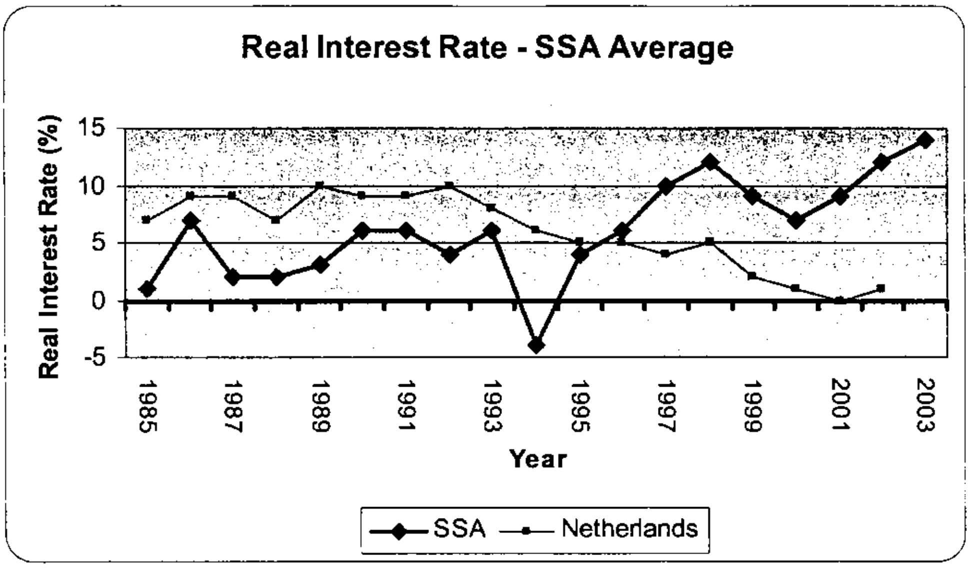
The past decade has seen a recovery of sorts for the financial sectors in Africa, with increased stability, investment and improved governance [Madavo & Sarbib, 1997]. However, on a global scale, the SSA financial sectors (excluding South Africa) have less capitalization and number of institutions than other comparable 'emerging markets.' One area that is particularly underdeveloped is financial markets (equity, bond, futures, etc.). Due to space limitations this topic cannot be examined in detail; however it can perhaps serve as a partial explanation for the absence in many African sectors of a key form of SME finance – namely venture capital[13].

A new institutionalist review of these market failures would be one of institutional inadequacy in governing the changes (state interference in bank operations, inconsistency in policy reforms, etc.). For example, liberalization itself was not flawed, only that the timing was unfortunate, in that markets were freed before the presence of either adequate competition or supervision. Structural adjustment policies were economically sound, but weak institutions allowed a perpetuation of government meddling.

Financial sectors in most of sub-Saharan Africa over the last four decades have not been SME-friendly in any consistent way. Figure 1 shows, there has been an upward trend in real borrowing costs in the region over the past 18 years. Whether through state-induced credit rationing, bank instability, macro economic shocks, donor-driven 'solution packages' and liberalization, the operating environment has shown for the most part enough volatility to undermine the confidence of even the most risk-inviting entrepreneur. Liberalization and adjustment has resulted in the creation of formal systems on top of still functioning and critical informal systems, resulting in what Nissanke and Aryeetey call extreme fragmentation [1999].

[13] Playing a significant role in OECD countries, venture capital is categorized by investors willing to accept higher risk in exchange for higher potential payoffs and the ability to oversee the management of an SME. However, this type of financing has been much less active in Africa, perhaps due to a lack of viable 'exit options' due to the absence of equity markets. A counter argument could be the degree of comfort many African entrepreneurs have in giving up managerial control to strangers, an unusual concept in the business culture of many countries.

Figure 1: Interest Rate Trends



(Netherlands Included for Illustration) Source: World Bank Development Indicators 2005

The proposed answer to this fragmentation, by foreign donors and development practitioners, is development finance. What this is and the forms it can take are the focus of the next chapter.

Chapter 3 Different Models of Development Finance

3.1 Functions

While development finance institutions (DFIs) can take a variety of forms and follow diverse operational models, they typically share the common view and purpose of filling a financing gap that exists in developing country economies. In markets where a financing gap exists, the two most common affected sectors tend to be long-term, large-scale infrastructure projects, and small-scale lending to the SME low-income market.

According to a recent INSEAD study, development finance institutions (DFIs) serve three main functions:

- Offer long-term debt instruments otherwise not available in local financial markets
- Provide risk mitigation, either implicitly through involvement, or explicitly through guarantees or credit enhancement instruments
- Offer services to optimise the development impact of projects [Landrey et al., 2002:19]

The first two services reflect the institutions' willingness to accept both commercial and country risk, while the third is an add-on attempt to ensure socially-responsible outcomes. Adding to this list of functions, it is argued that DFIs (should) serve two other valuable functions. The first is to act as a counter-cyclical buffer to the often-whimsical flows of international financial markets. As Griffith-Jones states: "international financial markets tend to overestimate risk in difficult times and underestimate it in good times. This supports the case for official development-focussed finance that acts counter-cyclically to the market" [2004:84].

The second function is to help demonstrate to commercial financiers the viability of banking projects available in their countries. With the implied stability of an equity investment or loan to a local financial institution, DFIs try to catalyse other sources of local funding, thereby achieving a 'multiplier effect'. The end goal of most DFIs is to graduate as many institutions, borrowers and savers into the formal banking sector as possible; and maximize the participation of local capital in project financing.

3.2 Development Finance Organizations

DFIs can be classified into three broad categories: development banks, private non-governmental organizations, and ethical banks / investment funds. For the purpose of this study, I have researched Dutch institutions in each of these different categories, in order to examine how they specifically address the issue of a financing gap. I have also included the perspectives of institutions that offer general support to the field, namely the United Nations Capital Development Fund (UNCDF) and IFC[14]. Table 5 gives a brief summary of the organizations studied:

Table 5: Development Finance Institutions – Key Characteristics

Category	Name	Structure / Mission	Capitalization (For Credit Programs)	Location / Geographical Focus
Development Bank	FMO (Netherlands Development Finance Company)	Majority government-controlled (51%); Supports private sector in developing countries	1.9 billion Euros	The Hague, Netherlands. Focus: Worldwide
Private NGO	Novib (Oxfam Netherlands)	Private Foundation; Support basic rights to life for poor people.	20.2 million Euros[15]	The Hague, Netherlands Focus: Worldwide
Private NGO	Oikocredit	Private Cooperative Society; Supports development of poor communities through credit.	214 million Euros	Amersfoort, Netherlands Focus: Worldwide
Ethical Bank / Investment Fund	Triodos Bank	Private Bank; Supports socially responsible and innovative companies in a sustainable manner.	1 billion Euros	Zeist, Netherlands Focus: Worldwide
Ethical Bank / Investment Fund	Africap Microfinance Fund	Private Investment Fund; Supports microfinance industry in Africa.	12.5 million Euros	Dakar, Senegal Focus: Africa
Support Organization	UNCDF (United Nations Capital Development Fund)	UN body; Eradicate poverty through local development programs and microfinance operations.	40.2 million Euros (Microstart Program)	New York, USA Focus: Primarily Africa and Asia
Support Organization (& Development Bank)	IFC (International Finance Corporation)	World Bank member; multilateral. Supports private sector investment in developing countries.	2 billion Euros	Washington, D.C., USA Focus: Worldwide

[14] Although the IFC is a very active DFI in terms of financing provision, it also focuses on strengthening the industry as a whole, and produces research and best practices. For the purpose of this study, the focus on IFC will be regarding the general supportive role it serves.

[15] Including funds from the Dutch Central Bank ASN fund

DFIs typically manage their resources through revolving capital funds, originally financed through government overseas development assistance and/or investment from the general public. The capital funds are managed for growth and to earn returns on investments; often they are supplemented by donor funds for targeted lending projects or specific technical assistance.

There are two ways that DFIs can assist SMEs, through providing passive assistance (strengthening of the financial sector and overall business environment), or active assistance (direct loans which affect operations of an SME). Where historically many DFIs directly funded projects, in recent times most have taken the position that the best impact can be made by acting as a catalyst to stimulate further private investment. Any direct support is limited to providing technical and advisory services, and strengthening the overall sector. [Landrey et al., pg 17]. The following is a brief description of the various institutions that participated in this study and the justification they give for their programming[16]:

FMO (Netherlands Development Finance Company)

Founded in 1970 as a joint venture between the Dutch government and private business sector, FMO targets private sector strengthening in developing countries. It began by supporting Dutch business investments but soon broadened out to include other investors. After some unprofitable years focussing on 'soft lending', FMO was restructured in the 1990s to gain more distance from government, focussing on operations to restore profitability. The government still underwrites a large portion of the portfolio, maintains a majority (51%) stake, and contracts FMO to manage various other state development funds, related to export promotion, infrastructure, Dutch business joint ventures and SME support. FMO uses the 150 million euro *Massif* SME fund (managed on behalf of the Dutch government) to invest in local banks and MFIs, focussing on three key areas: local currency loans, savings mobilizations and institution building, in order to increase financial outreach to SMEs.

Argument for SME support –FMO argues that the SME sector is important for local economies, as they provide a key source of employment, help to educate and train

[16] Information sourced from websites, annual reports and promotional literature.

personnel and therefore contribute to economic growth and poverty reduction. The assistance that financing can play is to help local financiers "keep services and products up-to-date, provide capital and savings/payments services", stressing that SMEs rely on a functioning and reliable local financial sector.

Novib (Oxfam Netherlands)

Founded in 1956 by a variety of civic organizations and political parties, Novib's goal had been to engage the Dutch public in issues of international development and global concern. In 1994 they joined the Oxfam network, and currently employ a rights-based approach to managing projects, lobbying and campaigning for issues of poverty and justice. Their microfinance program, based on the right to sustainable livelihood, subdivides the field into *poverty finance* (rural, vulnerable poor, group-lending for basic income generation) and *micro banking* (urban, enterprising poor, individual lending for SME growth). Novib's vision is that microfinance can "profoundly contribute to improving income and overcoming injustice"; to this end they provide loans and guarantees to help institutions leverage more support.

<u>Argument for SME support</u> – Novib does not make a specific case for what impact supporting SMEs in particular will make, but rather argue from a rights-based perspective that support for the poor 'ought to be given'. Their strategy is to target start-up and young expanding financial institutions (NGO's, microfinance institutions, savings and credit co-operatives) that provide credit to small-scale entrepreneurs who traditionally lack access to financial services. They do not enforce self-sufficiency as a hard and fast rule, recognizing that the informal sector is "volatile and often offers low margins", but they do argue that high quality service and client responsiveness is critical.

Oikocredit

30 years ago Oikocredit was founded in response to members of the World Council of Churches seeking ethical and socially responsible alternatives for investing their money. The international office was located in Amersfoort, Netherlands, while support associations formed in various countries – 37 to-date. A privately owned cooperative, Oikocredit claims to be "one of the largest financiers of the microfinance sector worldwide", with a current portfolio of 214 million euros. 50% of the portfolio

is in the form of micro finance institutional loans, while the other 50% is in the form of direct lending to cooperatives (with SME members) and select larger-sized exporting enterprises. Lending is managed through a network of 17 regional offices. All monies have been privately raised and exclude government funds.

Argument for SME support – Oikocredit states that "being at the grassroots of society makes it hard to obtain credit from a 'normal' bank in many countries around the globe"; although they have productive enterprises, they lack collateral. Oikocredit focuses not only on well-developed MFIs, but also riskier start-ups in rural areas. Loans are directed not only to MFIs, but also directly to groups of entrepreneurs, such as small-producer cooperatives and alternative/fair trade organizations.

Triodos Bank

Triodos, meaning "three-way approach" in Greek, seeks a positive return from the planet, people and profits in their role as an ethical banking institution. It formed as fully licensed operating bank in the Netherlands in 1980, and has now expanded operations into Belgium, Spain and Great Britain, and globally manages 1.02 billion euros in assets. It manages different funds targeting: microfinance and fair trade; renewable energy; and environmental business innovations. Three funds: (Triodos-Doen Foundation, Hivos-Triodos Fund Foundation, Triodos Fair Share Fund[17]) provide debt and equity finance to microfinance institutions in the developing world.

Argument for SME support – Microfinance is an important tool in combating poverty for those that do not have access to financial services from local commercial banks. "With these loans they can, for example, start their own business, or buy materials or machines for their existing business, or extend their market stall." Triodos states that: "professional provision of financial services in developing countries, in particular to micro entrepreneurs, is crucial for the development of a local economy [...] enabling businesses to grow, to generate income and to create jobs." Professionally managed microfinance has a significant impact on the reduction of poverty.

[17] Only the first two funds are included in this study, due to their longer track record.

Africap

Formed in 2001 by various development finance institutions (including FMO, Triodos, IFC and UNCDF), Africap is touted as the first microfinance investment fund dedicated to Africa, which is actually headquartered in the continent and managed by Africans. Africap takes a "venture capital" approach, bringing management expertise through an active governance role to each of their investments. It is based on a 10-year lifespan, where at the end of the period, the investments will be sold off and capital plus profits will be returned to the original investors. They also manage a US$3 million technical assistance supplied by donor DFIs, used to help participating investees on a cost-sharing basis.

Argument for SME support – MFIs that seek Africap's support must demonstrate commitment to either microfinance or small-business lending to low-income communities historically excluded from the formal banking system. Africap focuses on selecting institutions with high potential growth, to serve as demonstration models for the viability of African commercial investment in the sector. It is argued that commercial capital is needed to ensure long-term growth to match the potential market demand.

3.3 Why Are Foreign DFIs Necessary?

These DFIs argue that there is a need for specialized financiers to be present in developing countries. The general assertion is that national financiers serve only big business, foreign investors and elite society, thereby neglecting the poor and potential SME markets, which drastically impede economic development and growth. Some institutions also mention that African economies suffer from macroeconomic instability and potential shocks, which limits financiers appetites, and therefore a hole needs to be filled by outside (partially donor) funds that are more willing to accept the risks in this volatile market. An end goal is to use the interventions as a demonstrator effect, proving to local financiers that the lower end of the market is indeed bankable, and thereby encouraging local investment, thus resulting in multiplied impacts.

As an example, FMO states that developing country banks are inappropriate for funding long-term investments, due to potential instability through short-notice withdrawals, while insurance and pension companies are risk sensitive and prefer to invest in safe government vehicles, thereby leaving the majority of the business sector with limited access to finance [FMO website]. According to Gerrit van Kampen, Senior Portfolio manager for Africa, FMO's role is to complement local (or international) short-term market funds: "there is a shortage of long-term funding available in the developing world and therefore a necessary niche for FMO to fill a gap that the market is unwilling to." The next sections highlight the most commonly referred gaps that DFIs seek to fill.

3.3.1 The Attempt to Reduce Risk

Country Risk

Infrastructure[18] is one sector particularly exposed to country risks. For FMO's African operations, it is a strategic focus, comprising the majority of their portfolio (55%) in the continent by year-end. According to van Kampen, poor infrastructure acts as a bottleneck constraining economic growth, but projects are often complicated and involve long time frames. Infrastructure lending is typically done in dollars, but repayment plans are calculated in local currencies. Projects carry heavy political risks – in the event of currency devaluation, local governments are averse to increasing user fees/rates, and so projects typically have to absorb the losses - thus requiring a DFI-type lender willing to accept those risks.

Currency fluctuation affects not only infrastructure projects, but also applies to local financiers. Banks may be willing to serve the SME segment, but often face a shortage of local currency funds. A strategy that DFIs use in order to overcome this is to offer local currency loans to national institutions.

All the institutions offer loans to MFIs in local currency when appropriate, with many of them hedging risk through 'local currency hedge funds'. As Els Boerhof, SME Fund Manager for FMO notes, the provision of funds in local currency allows FMO

[18] Due to space limitations infrastructure cannot be integrated into this study, however it is worth a brief mention in respect of the argument that improvements in this sector improve the operating environment of SMEs.

to transfer currency risk to their balance sheet, thus freeing the local bank to focus on managing the client risk.

Both Africap and FMO recognize the stabilizing role that long-term foreign funds can play in a region characterized by fragile economies susceptible to crisis, contagion and temperamental foreign capital flows. Stefan Harpe, former Investment Manager of Africap, stresses the symbolic importance of an African institution willing to operate and ride-out the conditions on the continent; to build faith in African investments by showing success examples. Boerhof of FMO has seen how volatile foreign capital is (East Asian and Argentine crises), and that when viable businesses and projects are abandoned by foreign capital flight during times of crisis, DFIs can play a crucial role in maintaining stability and hope.

Project Risk

Some DFIs follow a model of having a local presence in order to better evaluate the risks unique to each project. Oikocredit for example, relies heavily on its network of local offices that evaluate all loan proposals and closely examine the business potential in the local context.

Africap, FMO and Triodos will take equity positions in banks/MFIs. This is done either as a precondition to investment (Africap), or if the DFI feels they can bring added management value to the investee. It also reflects an attitude that even though investing in MFIs is more stable than individual enterprises, it still carries with it inherent risk that needs close supervision. As Harpe of Africap states: "equity investments in Africa can be volatile and therefore you need to be an active partner, in order to understand the culture and context, read warning signals and intervene successfully. It is about building trust." Oikocredit is now moving into equity positions in MFIs, while Novib is the only institution that does not, for ideological reasons.

3.3.2 Aversion of Banks to Downlend

One of the main focuses of the larger-scale DFIs (FMO, IFC) is to stimulate national banks to focus more attention on the small-scale market, especially the SME segment. According to Boerhof, banks can purchase safe government T-bills and get a decent return at minimal risk. Both FMO and Africap point to the need to liberalize interest rates and the banking system in general, as they have seen that increased competition invariably pushes down interest rates and makes banks 'hungrier', and therefore more open to serving riskier markets.

Boerhof of FMO expands the analysis of banks hesitance, to include three other factors besides risk appetite:

Evaluation Methodology – most African banks rely on traditional credit methodology to evaluate loan applications, such as available collateral (and respective legal titling). They lack modern tools such as credit scoring, that allows banks to rate SMEs based on other criteria, such as past track record, cash flow analysis, managerial capability, business potential, etc.

Financial Industry Requirements – New requirements, such as the 'Basel 2 Accord'[19] demand that banks have higher reserve requirements when electing to work in riskier sectors. These types of constraints act as a disincentive for banks to serve markets such as the SME sector.

Image / Organizational Culture – All banks want to be seen as prosperous, however some perceive that being seen serving poor clients will tarnish their image as a bank for 'successful people." Some managers do not see the SME and/or informal sector as being bankable, and their conservative attitudes limit any effort to gain a better understanding of the lending potential of this market.

In order to improve credit scoring, FMO has a technical assistance fund to hire consultants (local or international) to offer custom training on innovative appraisal techniques to bank staff. To help guide banks through the international banking legislation, FMO focuses on building information systems. "There are ways around the constraints", Boerhof states, "for example with a good track record, a bank can justify holding less reserves for an asset class than initially dictated by the Basel requirements, thus making the microcredit sector more capital appealing."

[19] The label 'Basel 2 Accord' is given to the new banking requirements being brought into effect as part of the so-called New Financial Architecture.

In addressing corporate culture constraints, FMO believes that one of the best ways to achieve a change in lending culture is through illustration – introducing managers to other banks that have successfully made the shift to 'pro-poor banking'. Once management begin to see the possibilities and want to change, technical assistance grants can help offset the costs of training in order to implement changes in methodologies. For example, FMO hopes to organize a conference in the Netherlands this year, to allow bank CEOs from developing countries the chance to share experiences with one another.

3.3.3 Lack of Competition and Other Constraints

According to DFIs, one of the key roots to bank hesitancy is a lack of competition. Shallow markets with a limited number of competitors often have high interest margins (difference between lending and savings rates) and low loan/deposit ratios. Hany Assad, Program Manager at the IFC argues that gloabalized financial markets have resulted in increased competition for banks, which no longer have a monopoly serving clients at the top of the 'financing pyramid'. "Clients at the top of the pyramid are being fought over like never before, [...] commercial bank margins are narrowing and fees are dropping [Africap, 2003:30]. He finishes with a confident assertion that "banks will move down market. They'll move first into the SME market and then into microfinance" [ibid:33].

Peter Kooi, Director of the Microfinance Unit, UNCDF in New York, explains that their focus has shifted from supporting microfinance, to helping move the retail-banking sector to the lower segment of the market. He has seen that almost universally, banks have a minimum loan size of around US$30,000, which appears to indicate their profitability threshold for the small-scale market. UNCDF attempts to sit all players of the financial sector down at the same table, to identify the constraints that are preventing banks from downlending. "It can be more complex issues, like transaction costs (time and effort to process a loan) to simpler barriers, such as a (bank or national law) requirement that the applicant produce a National Identity card." What Kooi does see is that often the cost of interest is not the key constraint.

Mark Ampah, of the SME Project Development Facility, IFC (Johannesburg office), adds other pieces to the puzzle regarding banks' lack of interest. He says that banks serving the SME market typically have high default rates and correspondingly high recovery costs. Legal systems in many countries favour borrowers over lenders, and "even when a bank is able to recover an asset (for example, a house), the lack of a viable re-sale market can often render the asset basically valueless." The IFC spends a lot of time looking at building credit bureaus and addressing legal frameworks within countries, in trying to remove constraints to banks.

Table 6: Availability of Credit Information and Legal Creditor Rights

Region	Legal Rights Index Range (0-10)	Credit Information Index Range (0-6)	Public Registry Coverage (% adults)	Private Bureau Coverage (% adults)
Sub-Saharan Africa	4.4	1.5	0.8	3.5
East Asia & Pacific	5.3	2	1.7	12.7
Latin America & Caribbean	3.8	4.5	11.5	31.2
OECD Countries (High Income)	6.3	5	7.8	58

(Regional Comparison) Source: Doing Business Database – WB/IFC

Table 6 shows that SSA lags other regions in terms of credit information available (Credit Information Index tests the depth, quality and access to available credit information, while the Public and Private Registry Indices measure coverage of the population). The region has a relatively high Legal Rights Index (protection of borrowers and creditors), ranking higher than Latin America, but lower than other regions.

3.3.4 Difficulty for MFIs to Move Upmarket

While FMO is the organization within this study that mostly focuses on bank downlending, the rest of the organizations primarily focus on working with microfinance institutions. Microlending has undergone significant changes in the last 20 years, and is nowadays readily accepted as part of 'mainstream development'; however an analysis of failures and successes is beginning to lead practitioners to reflect on the underlying theories.

One of the main assertions is that microfinance helps the poor by supporting income generation activities (starting or expanding a business). MFIs and their supporting donors stress the proven success of banking with the poor, showing low default rates, growth of loan portfolios and repeat customers. However, looking at MFIs and their ability to lend to SMEs, it is apparent that many institutions are not able to respond to their specific needs.

The microfinance field has built itself upon the Grameen-model of group lending; where lending circles of closely associated neighbours would use solidarity and resource pooling in order to achieve 'credit-worthiness.' This system works better in poorer, rural settings, where clients have fewer tangible assets to use as collateral, and rather rely on existing networks of trust.

Over time, however, the group model has not been as successful in some urban settings, and often excludes potential SME clients. According to Resi Janssen, African Senior Investment Officer for Novib, many clients see group meetings as a time waster. If an entrepreneur wants to take their business beyond the immediate survival stage, they need bigger loans. Lending circles view these requests as being outside their comfort and knowledge zone, due to the size and complexity of the business model. Potential micro-enterprises find that they cannot grow beyond the small-scale individual loan size.

This leads to a second main assertion of microfinance practitioners today – that MFIs who offer individual-based lending are better able to serve entrepreneurs. Koert Jansen, Investment Officer for West Africa Triodos Bank, says "its hard watching profitable clients graduate and leave lending circles." Triodos, Novib and FMO all encourage MFIs to attempt to keep their clients as long as possible.

As Janssen from Novib observes: "it is the graduates from the lending circles that are the best clients." Boerhof agrees, stating that "SMEs want to stay with their lending institution, so that they can continue growing their track record and build a relationship." This relationship is especially critical in the absence of formalized credit bureaus. The irony is, some MFIs have an inherent resistance to move upmarket, as they opportunistically view a huge untapped market of microloan clients, often representing lucrative margins (70%). Many do not see the need to grow and change, as serving the SME segment brings with it higher risk, lower margins and less loyalty.

A third major assertion of microfinance practitioners is the importance of striving for MFI self-sustainability. Experience has shown that MFIs that continue to rely heavily on donor support and make little effort to become sustainable, have less likelihood of profitability, offer lower quality service, and have a higher chance of failure. Harpe of Africap believes strongly in self-sustainability:

> Non-viable NGO-based microfinance programs take advantage of their 'pro-poor' approach to justify continued donor funding, perpetuating dependency. These non-viable institutions 'screw-up' the market by undercutting (with subsidized interest rates) and resist professionalism and formalization. And worst of all, when the donor money runs out, what happens to the clients and their assets?

The argument for sustainability is linked to the concept of formalization. Most DFIs now stress the importance of 'graduating' as many MFIs (and their clients) to the formal financial sector as possible. According to Africap, long-term sustainability and large-scale impact depends on the ability to convince commercial capital that the lower market segment is indeed bankable, profitably.

The argument for attracting commercial capital is that it allows scaling-up to achieve more coverage and lower costs [Africap:10]. When development finance is injected, it attracts private investment, thereby producing a multiplier effect. For example, FMO finds that for every 1 euro invested, they can achieve 4 times the amount of investment through other parties. DFIs can also use their government backing to allow them to accept higher risks. As the demand for financial services increases along with the complexity of proposals from SMEs, MFIs need more resources and technical skills to continue serving this sector. Being able to attract further capitalization beyond donor funds will not happen unless the MFI becomes a legally recognized financial institution in the country.

3.4 View of Unlimited Demand

The majority of DFIs view that the enormous informal sectors typical to developing economies represent huge untapped demand for microfinancial services. James Mwangi, Chief Operating Officer of Equity Building Society Kenya (one of Africap's investments), voices a common view:

> [...]Africa offers the opportunity – it's an open market – yet there are no major players. In Africa, when we talk about success stories, we talk, for instance, about KREP in Kenya. But KREP has twenty or thirty thousand borrowers in a market of about 11 million potential customers. So you find in Africa even the surface has not been scratched." [Africap: 9]

Similar numbers came up in various interviews: "Nigeria -100,000 clients in a country of 100 million; in Africa only the bottom and top 5% are banked, the rest is wide open," etc. The view is that there is a huge market waiting to be served, which for the most part can be done profitably. DFIs claim that for-profit financiers (either local or international) cannot see beyond the numerous lending risks and therefore stay out of the market, leaving the majority of Africans (estimates around 85-90%) unbanked. The irony is that Africa has surplus capital, but instead of being invested locally, the continent is a net exporter of finance [Melamed, 2005]. DFIs argue that one of their key roles is therefore demonstrating to local financiers that the poor are indeed bankable.

3.5 The Predicted Outcome

Surprisingly enough, the actual predicted outcome of interventions undertaken by these DFIs is not expressly stated, beyond 'better service and coverage.' There is an inherent confidence that *extending* micro credit is sufficient; the basic assumption is that beyond household loans, many of the applicants that access credit will be SMEs, and they will know best how to reap the maximum benefit from it, and their businesses will be improved.

The DFIs in this study also acknowledge a role for 'business development' type services; to assist entrepreneurs improve their management skills and achieve enterprise growth. There is less agreement on how it should be offered: some feel it should be part of the lending package, others stress that it should be separated from lending operations, and offered by third party specialists. Generally however, the 'trickle-down' approach implemented through the power of markets is relied upon to achieve development impact. Most practitioners interviewed stress that this type of support is superior to aid – helping to reduce dependency and achieves a more sustainable impact for the long run.

The DFI perspective fits within the new institutionalist view that the market is the best implementer of development change, and that existing institutions need to be strengthened in order to achieve this. Due to historical factors, banks in sub-Saharan Africa have underdeveloped abilities of risk assessment and biased corporate culture, resulting in a view of high transaction cost (and therefore unprofitable) SME segment. Microfinance is a response to market distortions, and these institutions can be effective in reaching the SME market, if only shown how to adapt their model. Macro level risks still persist (currency fluctuation and capital flight) and until they are better regulated, donor-funded institutions play a role in mitigating this risk.

The predominant attitude of DFIs is that with the right interventions, the financing gap faced by small African businesses can be filled, thereby spurring local economic growth and improved well being for citizens. The degree to which these endeavours match the financing prospective of African SMEs will be the focus of the next chapter.

Chapter 4 Analysis of SME Financing Reality in Sub-Saharan Africa

The purpose of this chapter is two-fold: first to examine how well DFI planned interventions address the financing requirements of SMEs, assuming that a financing gap exists; secondly to test whether the performance of DFIs and partner financial intermediaries supports the argument that SSA economies represent a case of unlimited demand for development finance.

The following examination of DFI programs has been kept general, as it is difficult to attribute individual interventions to changes in specific variables that are under the influence of many different factors. The intention of the exercise is limited to examining how well the various interventions seem to match criteria that are significant to SME access and demand for credit.

The DFIs in this study all have the same approximate range of investment sizes in African financial intermediaries, and all have seen rapid growth of activity in the region during the past decade.

Table 7: Average Equity / Loan Investment by DFI in SSA

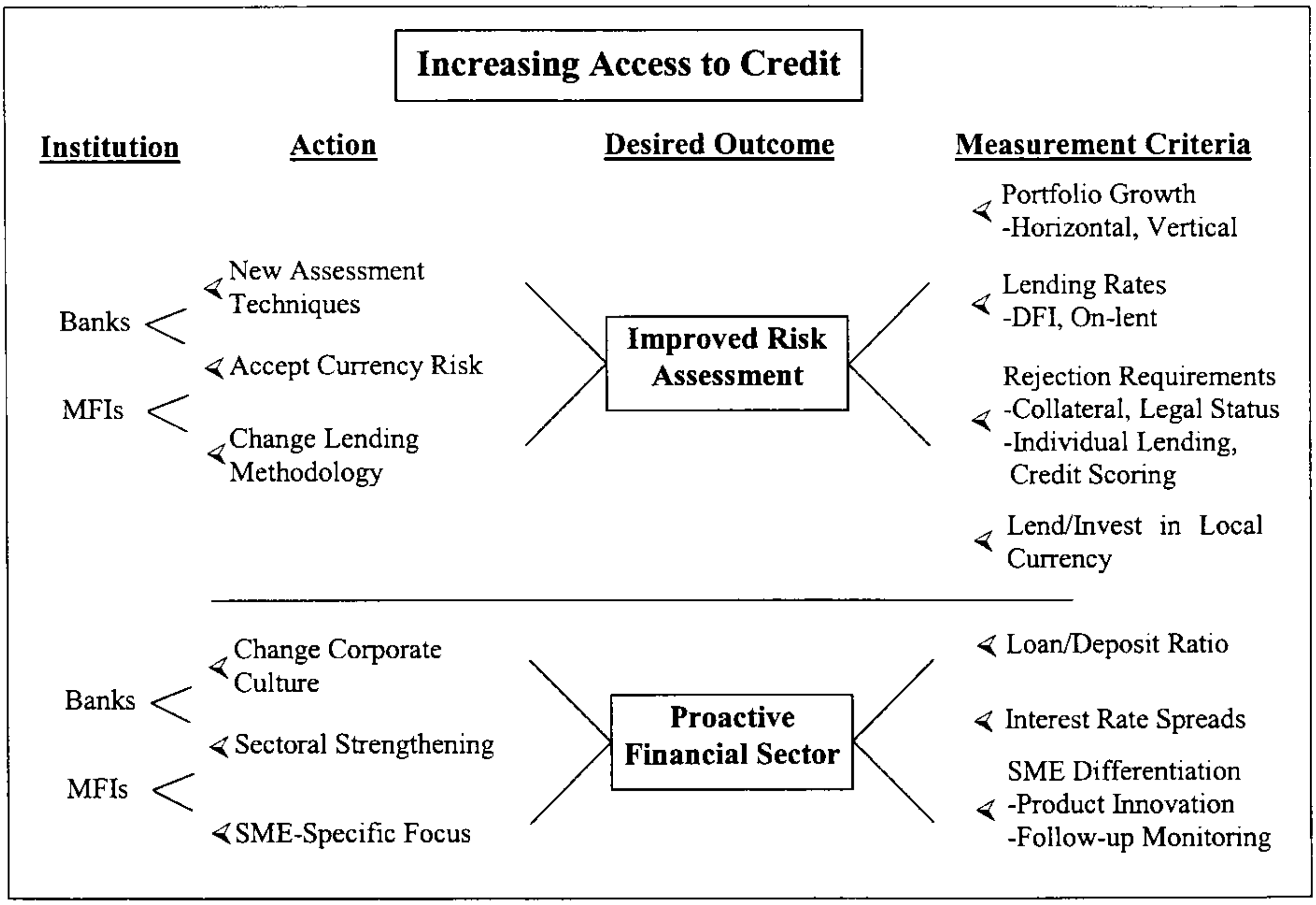
Institution	Average Loan Size and/or Equity Investment in MFI / Bank 2005 (USD)
FMO	1,700,000
Novib	408,000
Oikocredit	50,000 – 2 Million
Triodos	568,780
Africap	850,000

4.1 Analyzing DFI Interventions Within A Financing Gap

As was shown in Chapter Two, the influence of structural adjustment, premature liberalization, systemic banking failures and macroeconomic shocks have resulted in credit shortages to the private sector. This has resulted in a financing gap for SMEs in many market sectors in sub-Sahara Africa.

In analysing the interventions DFIs use to influence the local financial sector to extend more credit to SMEs, two common themes emerged, which I call 'risk assessment' and 'creating a proactive financial sector.' Figure 2 summarizes the perceived relationships between institutions, actions and criteria for measuring change.

Figure 2: Average Equity / Loan Investment by DFI in SSA



4.1.1 Risk Assessment

Interventions of DFIs attempt to target the methodologies that financial intermediaries use to evaluate risk, and other important conditions in their lending models that may influence their ability to extend credit to the SME sector. In order to test the degree in which interventions are influencing risk assessment capabilities, the following criteria will be analysed: Portfolio growth; Lending rates; Credit application rejection; Currency risk reduction.

Portfolio Growth

While growth in the portfolios of financial intermediaries does not directly show how risk assessment is being altered, it can serve as an indirect indicator of how well intermediaries are overcoming barriers to extending higher levels of credit. Portfolio growth is a proxy for measuring the outreach of development finance, and can be measured in two ways, by overall volume, and by individual loan size.

Table 8: Changes in Institutions and Portfolio Volume, SSA

Institution	Number of Institutions Supported in Region 2000	Number of Institutions Supported in Region 2005	% Change	Total MF / SME Financing 2000 ('000 USD)	Total MF / SME Financing 2005 ('000 USD)	% Change
FMO	35	43	23 %	7,489	72,628	870 %
Novib	2	11	550 %	652	4,490	588 %
Oikocredit	N/a	91*	-	N/a	10,500	-
Triodos	15†	25	67 %	4,225†	12,508	196 %
Africap[20]	2	5	250 %	2,628	5,302	102 %
Average Change			**223 %**			**439 %**

*# Loans † 2001 Data

Development finance flows to Africa have seen a dramatic growth in the past five years, with an average increase of 240% in the number of institutions supported, and the total amount of equity and loan financing invested increasing by 520%. Novib has seen the largest growth in number of institutions supported; FMO has not significantly increased institutions, but has managed to increase investing nearly ten-fold. There is no doubt that more development finance is being made available to the region as a whole.

It is more difficult to measure individual on-lent loan sizes, as this data is not as readily available - many of the DFIs do not track the outreach of the institutions they support. Novib and Triodos have outreach data, while the other organizations stated they are beginning to track this information as of this year. Table 9 examines a sample of supported MFIs, in order to see if there is a pattern of change in their portfolios over time.

Table 9: Changes in On-lending and Client Base

Institution	Average # Clients 2000	Average # Clients 2005	% Change	Average Loan Size On-lent 2000 (USD)	Average Loan Size On-lent 2005 (USD)	% Change
Total Portfolio						
Novib	17,858	18,367	3 %	84	231	174 %
Triodos	10,656	30,407	185 %	644	505	-22 %
Constant Institutions						
Novib	17,858	17,395	- 2%	84	268	219 %
Triodos	11,481	31,601	175 %	681	768	13 %

[20] Historical data for Africap goes back as far as 2003, when it made its first equity investment.

In examining Total Portfolio (all MFIs supported over both periods), Novib shows little horizontal growth (in other words, the number of people receiving loans), but does show vertical growth, in terms of increasing sizes of loans. Triodos is the opposite, with more horizontal growth, and a reduction in average loan size. However, this pattern alone does not show the whole picture, as DFI portfolios change: for example Triodos took on a number of MFIs offering smaller loans during this period, thus lowering their average loan size.

By examining Constant Institutions only (organizations supported by the DFI during the whole period), the influence of newly supported MFIs can be removed. For Novib, horizontal coverage shrank slightly, while individual loan sizes increased by 174%. Triodos-supported MFIs nearly doubled their coverage, but saw modest growth of individual loan sizes. However, their average loan size is nearly three times larger than that of Novib.

Analyzing MFI changes over time reflects high levels of fluctuation, which impacts the data and makes it difficult to draw any firm conclusions. For example, the Triodos supported MFIs in the constant group had average loan sizes fluctuating from –23% to +118%. The former relates to Akiba Bank, which had the highest average loan size of US$1,715 in 2000, but reduced to $1,315 in 2005, at the same time its clientele base grew by 458%. Therefore, there does not appear to be more stability in MFIs with higher average loan sizes. One can say that DFI support over time tends to increase average loan sizes in MFIs, more so in cases where the clientele base does not significantly change. For those MFIs with higher average loan sizes, DFI support does not seem to significantly increase loan size further, but does appear to influence coverage.

Lending Rate

The cost of credit is one of the forefront considerations for an SME, as it has a direct impact on their operations and appetite for credit. Not all DFIs track on-lending rates of supported financial intermediaries, and credit costs vary widely depending on the circumstances in each country. Table 10 provides an indication of the cost of financing for MFIs/Banks and the range of charges they levy when on-lending.

Table 10: Average Annual Interest Rates, DFI to MFI/Bank & Subsequent On-Lending

Institution	Average Interest Rates, DFI to Financial Intermediaries (on the Euro)	Average Interest Rates, Financial Intermediaries On-Lending
FMO	8%	15-30%[21]
Novib	8%	30-80%
Oikocredit	8-12%	40-80%
Triodos	8%	30-80%
Africap	N/a (Equity Only)	40-80%

While rates were quoted on the Euro, most DFIs lend in either local currency (at higher rates) or in USD (at similar rates). FMO's SME portfolio is predominantly comprised of banks (75%), which appear to be able to charge lower rates due to larger operational sizes and perhaps from higher competition. The rest of the DFIs support MFIs, all of who have similar rates, ranging from 2.5 – 6.5% monthly.

In comparing these rates to the average commercial rates in SSA, all DFIs state they monitor the local rates available, and charge similar levels with a slight premium added for risk in each particular country. FMO sets their rate 1-2% above the average deposit rate, so as not to create a disincentive for banks to attract savings. Triodos does not undercut the local commercial rate; Novib will not undercut if an MFI is able to attract commercial capital.

It appears from this simple interest rate comparison that banks are able to offer lower interest rates than MFIs. This is not a revelation, as the whole argument for microfinance is that because it is banking the 'unbankable', it has higher costs. MFIs typically have higher operating costs per client, especially when starting out, thus dictating higher interest charges. As they grow in size and expertise, MFIs should be able to lower their rates. However, one can conclude that if an SME has potential access to both MFI and bank lending programs, it would be better off investing its energy in trying to prove to a bank that they are bankable, rather than an MFI.

Credit Application Rejections

In this study, it is not possible to correlate the rejection rates of SME applications to financial intermediaries with the involvement of DFIs. Therefore the analysis will be

[21] This relates specifically to SME targeted lending by banks, as opposed to lending from MFIs.

limited to an examination of some typical interventions to overcome traditional lender hesitance in extending credit.

While criteria that financial intermediaries use in evaluating loan requests can vary widely between institutions and countries, two common barriers to SME application success are conditions of having collateral/reserves and legal business status. Table 11 examines the lending requirements of MFIs/banks supported by DFIs.

Table 11: Collateral and Legal Business Requirements

Institution	Fund Financial Intermediaries That Do Not Have Collateral / Reserve Conditions	Fund Financial Intermediaries That Do Not Have Legal Status Requirements
FMO	Yes	Yes
Novib	Yes	Yes
Oikocredit	Yes	Yes
Triodos	No	Yes
Africap	Yes	Yes

Almost all DFIs support MFIs and banks that lend without collateral requirements, however most of these programs are typical group solidarity models; Triodos for example, has not seen any non-group models that have avoided collateral requirements. However, others feel that some financial intermediaries are looking at creative ways to avoid strict collateral-based lending – leasing, for example is gaining in popularity, where the actual equipment acts as the collateral.

A more important indicator of a barrier to credit for SMEs is whether or not an applicant must meet the condition of being a legally registered company. All DFIs in this study support at least some organizations that waive this requirement; banks included in the case of FMO. This reflects an understanding by financial intermediaries that SMEs, just like microfinance clients in general, often operate in an informal environment, but are still bankable.

Credit scoring training is claimed to be a methodology that permits a more sophisticated analysis of business potential, to thus remove the strict requirement of physical collateral to secure a loan. Credit scoring saw a sharp rise in OECD countries in the 1980's with the development of statistical models capable of processing high amounts of information. The challenge of implementing the models in developing countries however is the limited amount of historical performance information available on SMEs, particularly those in the informal sector.

FMO states that although it has not implemented credit scoring training with local banks in the region as of yet, they plan on doing so, using grants to partially-finance the introduction of scoring software and/or training through consultants. They cannot say what kind of impact it will have in terms of increased loan approvals, but some banks have expressed interest in using it.

Another style of lending that can affect SME rejection rates is the group solidarity model. All DFIs confirmed that rejection rates for SMEs is higher if an MFI only offers a group-based lending model.

Table 12: Trends in Individual Lending Models

Institution	Has a Change Been Noticed Over the Last 5 Years?	% MFIs Funded that Offer Individual Lending Models (2005)
FMO	Significant change	90
Novib	Significant change	82
Oikocredit	Some change	Unsure, but group still significant
Triodos	Significant change	90
Africap	Some change	100

Table 12 confirms an often-quoted trend that individual lending models are gaining popularity, with most MFIs now offering options for individual lending. Oikocredit started off by funding cooperatives, but as Erik Heinen, Director of Credit Operations states: "we have found that in Africa, the cooperative savings model does not work very well – it is often hijacked or abused by local politicians and others." Oikocredit focuses on individual lending in many African countries (for example, Ghana and South Africa), recognizing that family enterprises are the building blocks of local economies.

According to Koert Jansen of Triodos, MFIs with individual lending models have an easier time sustaining themselves than group models. Kooi has seen that the Grameen and Brac banks have not legalized, and have not grown with an SME market, but have rather continued with small-scale loans, serving the household market. However, almost all practitioners have cautioned that SME lending is different than small-scale group lending, and any organization that wants to grow with their client should be careful to understand the new business model. But in general, the move to individual lending should prove beneficial for SME applications to credit.

Currency Risk Reduction

As was shown in the last chapter, the provision of local currency loans is argued to stimulate financial intermediaries to move into riskier lending, as the DFI accepts the currency risk. Table 13 examines the degree to which local currency loans are made.

Table 13: % Loans / Equity Investments Offered in Local Currency

Institution	% Loans
FMO	80
Novib	82
Oikocredit	20
Triodos	100
Africap	100

Local currency loans are particularly important in Africa, as many banks operate in local currency, as opposed to MFI lending in Latin America, which is predominantly dollarized. There was however, disagreement amongst the DFIs as to the importance of local currency. Triodos feels that it is not a risk-reducing measure *per se*, but rather a reality that MFIs in Africa can only accept local currency. FMO claims banks in some countries face a shortage of local currency, as people prefer to hold dollars – however it was recognized that this might be more indicative of lending in East Asia than in many African countries.

In general, providing loans in local currency should permit MFIs to avoid currency fluctuation. In receiving this protection for their margins, financial intermediaries should in turn be more motivated to enter into the riskier SME segment.

4.1.2 Creating a Proactive Financial Sector

Although risk assessment capability is central to the question of a financing gap, it is also arguable that the general attitude of financiers towards potential clients plays a crucial role as well. As was discussed in Chapter Three, many DFIs feel that SSA financial sectors present an unfriendly environment in which SMEs must seek support.

In order to gauge how well DFI interventions seem to create a proactive financial sector, the following variables will be examined: Loan/deposit ratio; Interest rate spread; Existence of SME-specific considerations; Follow-up monitoring.

Loan / Deposit Ratio

As explained earlier in the study, the loan to deposit ratio acts as a proxy for the lending appetite a bank has, where a low ratio (~50%) indicates a conservative institution. Table 14 examines the loan/deposit behaviour of FMO supported banks.

Table 14: Trends in Loan / Deposit Ratios – Select FMO-Supported Institutions

Institution	Country	Ratio (Pre Support)	Ratio (Post Support)
The Trust Bank	Ghana	33 %	69 %
Bank of Africa	Madagascar	38 %	53 %
Novobanco	Mozambique	2552 %	129 %

In the first two cases, DFI support resulted in increasing ratios. The example of Novobanco is an exception, as it reflects a typical path that an MFIs can take during start-up. It was founded in 2000 through donor support and limited local savings, hence the high first ratio. Over the next four years however, savings levels rose rapidly (7000%), thus lowering the ratio, which is still at a non-conservative level.

Interest Rate Spread

It can be argued that a decrease in interest rate spreads reflects a more proactive sector, as financial intermediaries are willing to lower their margins in order to gain more business. The cause for this however is varied – it could be from a DFI intervention, such as a 'spread cap', or as an indication of increased competition.

Table 15: Spread Caps and Other Means of Control Used By DFIs

Institution	Strict Spread Cap	Other Way of Controlling?
FMO	No	Encourage overall sector deepening, competition
Novib	No	Monitoring, will encourage MFIs to lower rates if appear excessive for market conditions / sustainability
Oikocredit	No	Review by credit committee, will reject if appear too high
Triodos	No	Influence of future negotiations for further loans should prevent gouging
Africap	No	-

Triodos emphatically stressed the importance of allowing the market to determine the rates, and that rate caps (from either the government or donor) create distortions and do not benefit the sector. According to Femke Bos, Senior Investment Officer, they like to see a higher spread, as it allows an institution to be profitable and work towards sustainability. In terms of SME lending, Triodos feels that margins are lower, due to the higher value of loans (relative to microloans).

Rather than investing in only one institution, FMO endeavours to target a country's financial sector as a whole, supporting various institutions in an attempt to increase liquidity, competition and transparency. They see sector evolution as having more influence on spreads than individual financiers; rates usually will not increase, but they may not decrease without adequate competition. Oikocredit does have a concern for excessive spreads, as it could result in a distortion of supporting an inefficient MFI. All DFIs in this study feel that increasing competition is the best way to lower rates.

Existence of SME-Specific Considerations

In the understanding that SME financing requirements are often not the same as bigger business or micro-entrepreneurs, it is arguable that a more proactive financial sector would have certain criteria or focus on SME-specific requirements. This could take the form of differentiation of SME-lending programs based on various criteria, such as sector, business type (manufacturer versus trader), stage of development (growth, export), etc. Table 16 examines whether or not SME-specific financing needs are acknowledged by the DFIs themselves and also at the MFI/bank level.

Table 16: SME-Specific Considerations Present in DFI Models

Institution	Differentiation of SME-Specific Needs at DFI Level	Differentiation of SME-Specific Needs at Bank / MFI Level	Instruments / Programming Used
FMO	Yes	Yes, particularly in banks	Longer tenures (for capital equip.), machinery as collateral, LOC, seasonal, overdrafts, payment systems
Novib	Yes	Some awareness	Limited
Oikocredit	Yes	Some awareness	Limited
Triodos	Yes	Awareness, but lacking products, more comfortable with group model	Seasonal repayment, longer-term, leasing, working capital, overdraft
Africap	Yes	Some awareness	Limited

As FMO states, being supportive to SMEs is more than just providing credit – it is providing financial services in general, such as payment services, insurance, chequing, etc. One of the priorities that Novib places on MFI selection is their ability to develop new products, such as SME-directed instruments. Triodos and Africap however both see awareness of SME needs slow in coming; MFIs tend to be more comfortable with the group-lending model and may not have the technical expertise to handle loan appraisals in diverse sectors. Letters of Credit (LOC) are hard to implement due to fluctuations; it is easier for the MFI to stay with fixed loans. Harpe of Africap sees SME targeting as mostly talk right now in many MFIs, with little implementation of new products.

Follow-Up Monitoring

An important indication of a proactive financial sector is the commitment to undertake monitoring and evaluation of programming, in order to see how well it is meeting its objectives. While all DFIs undertake regular monitoring of portfolio performance, it is less certain how much attention is paid to the impact that credit has on SMEs specifically. Table 17 examines the degree of monitoring undertaken by DFIs in this study.

Table 17: Monitoring and Evaluation of DFI Intervention Impacts

Institution	Portfolio Monitoring	Formal Evaluations of Financial Intermediaries	Impact Assessment of General Client Livelihood	Impact Assessment of SME Clients Specifically
FMO	Yes	Yes, selected institutions evaluated by independent evaluation department annually	Starting in 2005, this will be analyzed annually	-MASSIF fund evaluated every 5 years by external evaluator, includes section on SME clients
Novib	Yes	Indirectly, through evaluations sponsored by others, or independent rating agencies	Not directly, but will contract a study on behalf of MFIs if requested. Also through membership in Microfinance Platform	No
Oikocredit	Yes	Yes, regional office visits	Yes, now tracking 'social performance indicators' in general database	No
Triodos	Yes	Yes, when equity investing, due diligence investigation, seat on Board Yearly reviews and visit for all.	Indirectly, through HIVOS Foundation	No
Africap	Yes	Indirectly through position on Board	No	No

Triodos and Novib were the only two DFIs that could provide even limited outreach data of the supported MFIs, such as client base, average loan size and gender breakdown (in Novib's case). The rest of the institutions in this study are in the midst of implementing social indicator tracking.

4.2 Do SSA Economies Represent A Case of Unlimited Demand?

As mentioned in the introduction, the second part of the study analyzes the question of whether or not the performance of DFIs and partner financial intermediaries support the argument that SSA economies represent a case of unlimited demand for development finance?

In order to address this question, the implementation of DFI programs will be contrasted with the general argument regarding the flow of finance, in an attempt to test how well results in practice seem to match with what theory dictates. As mentioned in Chapter Two, neo-classical economics predicts that well-functioning markets will result in equilibrium between supply and demand of finance, resulting in market clearing. Investors seek the highest rate of return, and capital should therefore flow to where the risk/return ratio is higher.

The claim that sub-Saharan African countries represent unlimited demand signifies that there is no shortage of applicants on the demand side of financing, and the constraint would be in the supply side of provision[22]. Huge demand would signify a high number of applicants, resulting in a large pool of potential projects for any prospective financier to fund. This large selection affords the financier the luxury of being able to sort through the various proposals, and choose the least risky. By using selectivity, the financier can reduce risk, and maximize their potential return. Therefore the theory predicts that unlimited demand would be characterized by high numbers of applications, and low default rates.

[22] This attitude is not uncommon among supporters of initiatives such as the UN Year of Microfinance.

4.2.1 The Experience of Direct Lending

Does this appear to be the case for the DFIs in this study? The only two DFIs that are undertaking direct credit at this moment are Triodos and Oikocredit. Triodos does not lend directly to SMEs, but 20% of their loan portfolio does support larger companies wishing to export organic/fair trade products to Europe[23], in the form of pre-export or trade finance. The remaining 80% of their portfolio is invested in MFIs. Triodos 'experimented' in direct lending to smaller operations (primarily in the Netherlands and Eastern Europe), but facing high default rates they quickly moved away from that model.

Even with a network of local offices and years of experience in financing enterprises in the developing world, Oikocredit has found it difficult to lend directly to SMEs. Their portfolio at risk (measured by loans with problems in payments of principal/interest) is 30%, compared to 4% for loans to MFIs. While globally their credit operations are profitable, not all field offices have become self-sustaining - it has been achieved in Latin America and Europe, but is proving more difficult in Asia and Africa. They strive to strike a balance between direct lending and MFI support.

The experiences of these two organizations do not lend support to the unlimited demand argument. If they had an abundance of applications, they should have a high probability of selecting 'winners'. Triodos would have plenty of SME-sized projects to fund at a manageable risk, while Oikocredit would not have portfolio at risk levels 7 times higher than when funding MFIs.

This stresses the significance of the underlying trend of DFIs moving away from direct funding. The IFC does some limited direct SME financing, but is focussing more on credit bureau strengthening and other sectoral factors. UNCDF's focus is on building 'inclusive financial sectors' and promoting savings (eg. MicroStart program). Novib, FMO and Africap do not directly fund SMEs, but work through local intermediaries. The fact that little direct financing is taking place reflects a demand-side problem, not supply.

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[23] Criteria for lending is a signed export contract, past financial performance of the business, and 250,000 euro minimum loan size.

In addressing the failure of neo classical economics to explain these poor results, the new institutional economic argument would contest that market distortions are affecting these organizations' ability to evaluate risk. Political interference, a weak legal framework, cultural differences or other extraneous factors must be at play. A common sense argument could be propositioned at this point as well: that due to its small scale, the SME sector is unprofitable for international lending. This could be complemented with the argument that sustainable development requires the strengthening of local financial sectors, not direct lending from abroad, and so the best intervention for DFIs to make is to support local financiers.

This is a reasonable argument, and is worth following through. MFIs and banks are believed to be more appropriate vehicles in which to invest development finance, as they have better knowledge of the local business culture and clientele, and can therefore process clients more cost-effectively. If this were to be the case, in a high demand market, local financial intermediaries should be swamped with applications for credit, and again enjoy the same selectivity as mentioned above regarding DFIs, however this time with the added benefit of having local knowledge. The theory again would predict high demand, and due to their local presence, lower default rates.

Selectivity should allow MFIs to be profitable, which translates into no longer needing donor subsidies. DFI interventions also recommend helping MFIs to graduate as formal financial institutions, so that they can attract commercial capital and have greater outreach. How do these predictions compare with the observed realities of DFIs operations?

4.2.2 MFI Sustainability & Donor Subsidies

Microfinance has risen up from grass roots, coming a long way in two decades in terms of popularity and outreach. How have MF institutions fared in terms of achieving operational sustainability?

Table 18: Sustainability Levels of Supported MFIs/Banks

Institution	% of MFIs Operationally Sustainable	Average # Years of Support	Total Amount Grants Invested (Euros)
FMO	100%	5 yrs	1,000,000
Novib	100%	5-7 yrs	-
Triodos	100%	N/a	-
Africap	80%	2	150,000 per MFI

The four DFIs in table 18 have a prerequisite that an MFI is already operationally sustainable before they lend / invest in it, an exception being Africap's latest investment, United Microfinance of Nigeria, a new venture that has not yet achieved sustainability. FMO and Africap are the only two institutions to give grants to support training and other institutional-building projects, and in the case of this study, these grants do not reflect a significant portion of the MFIs total portfolios (3-5%). The fact that these DFIs all have choices of sustainable MFIs in which to invest seems to reflect a strong demand market at first glance.

Another way of looking at the depth of financial intermediaries is to examine DFI overlap. Overlap signifies a situation where various DFIs are supporting the same MFI/bank; high overlap could be looked at as an indication of a lack of 'fundable' institutions in the field, hence an absorptive limit to supply.

Table 19: DFI Overlap

Institution	% Institutions with At least One Overlap (estimate)
FMO	80%
Novib	36%
Triodos	High
Africap	20%

(% of institutions supported, in which at least one other DFI in this study also supports; includes UNCDF and IFC)

Africap has lower overlap of its funded MFIs, but is itself founded by various donors / investors, including FMO, Triodos, IFC and the UNCDF. Of course, overlap could be justified as a strategic decision by DFIs, either through partnerships/synergies developed with other donors, which results in more impact for the receiving institution, or a 'pooling of funds' in order to leverage more coverage/institutions. Triodos' policy dictates that when taking an equity stake in an MFI, there must be at least one other international investor. They cite that a more diversified investor base is healthier for the MFI.

Although partly explained as a strategic decision, the DFIs in this study confirmed that overlap is also due to a lack of 'investment worthy' MFIs, who are operationally sustainable. Harpe of Africap illustrates this with an example: "despite the fact that Ghana has an amazingly high number of MFIs (approximately 400), maybe 10 are professionally-run, and only 2 are 'investible' to a higher level." Investor overlap that includes donor money also runs the danger of providing risk subsidy from one government or private sector investor to another.

For example, the HIVOS-Triodos fund has lost money 9 out of the 10 years of its existence. This is a 'strategic choice', reflecting the volatile markets and unstable MFIs that the fund supports in its attempt to extend credit to the neglected developing world. "A limited loss, 10% per year at most, indicates that the development of this sector still depends on donations to a small extent. It also marks a considerable improvement on the situation in previous years, when 100% of the finance needs had to come from donations" [Hivos, 2004:16]. The fund has also suffered exchange rate losses for the past 4 years, of which HIVOS bears the cost - 90% through co-financing (government) funds, 10% through Dutch public savings through the North/South Plan [Hivos p15; Hivos Website].

Analysis of the microfinance sector has shown that in the race to inject funds and build self-sustaining institutions, donors have been competing in order to invest in the stronger MFIs, including the offer of technical assistance training, while the weaker MFIs receive little support [Novib, 2002:2]. This kind of donor competition and overlap indicates a shortage of viable demand for MFI credit operations, rather than a demand constraint for development finance.

4.2.3 Graduation Levels

The graduation of microfinance institutions into legally recognized and licensed institutions is a primary goal of the mainstream development finance field. There are different possible structures that an MFI can graduate into, ranging from 'non-bank financial institutions' (NBFI) such as a private lending company (non-deposit taking) or a lending and savings enterprise (with limited services), to a full-fledged bank (offering all services).

If one looks at the number of NGOs successfully transforming into formalized institutions, there has been limited success in Africa.

Table 20: Successful African NGO Transformations

Institution	Country	Year Formalized
BancoSol	Bolivia	1992
Finamerica	Colombia	1994
Caja Los Andes	Bolivia	1995
CARD	Philippines	1997
Mibanco	Peru	1998
FIE	Bolivia	1998
K-REP	**Kenya**	**1999**
PRODEM	Bolivia	2000
SOCREMO	**Mozambique**	**2001**
Finca Uganda	**Uganda**	**2004**
UMU	**Uganda**	**2005**
Uganda Finance Trust	**Uganda**	**N/a**

(Select MFIs Outside Region Included for Illustration)

Table 20 is an incomplete listing, intended only to show the trend of transformations. Latin America has a longer history and higher number of transformations - only by 1999 had an African NGO managed to graduate as a licensed financial intermediary, that being K-Rep in Kenya (supported by Triodos and FMO). Many MF practitioners are convinced that the Latin American model can be replicated in Africa[24]. However, due caution should be observed when attempting to do so, as the differing histories of independence, land distribution and capital accumulation must be taken into account.

The recent trend of transformations in Ugandan reflects the implementation of government legislation, namely the 'Micro-Deposit Taking Institutions Act', passed in 2003. Three institutions have managed to obtain licenses, out of only five in the whole country that meet the requirements. In the SSA region, there are approximately a dozen microfinance NGOs that have managed to transform into formally licensed intermediaries. This small number does not strongly support an argument of unlimited demand.

4.2.4 Commercial Investment

As was mentioned in Chapter Three regarding moving MFIs up-market, the final argument for MFI formalization is that it is a pre-requisite for attracting commercial capital, which is needed in order to achieve a large multiplier effect and reduce donor

[24] See for example FINCA, ACCION.

subsidies. Investment capital seeks the highest risk/return possible, and local African investors are no exception. If microfinance and the SME sector represent unlimited growth possibilities, commercial flows should likewise be significant.

Table 21: MFIs / Banks Receiving Commercial Investments

Institution	% of Supported Institutions That Have Received Commercial Investment	Value of Equity Investment as % of Total Equity (Average)
FMO (MFIs)	Low level	5%
FMO (Banks)	50%	10-15%
Novib	27%	5%
Triodos	Low level	5-10%
Africap	60%	50%

Commercial investment signifies at least one national external investor, beyond the original managers / investors / donors of a transformed NGO.

As can be seen from Table 21, many MFIs are able to attract at least one outside investor. Banks appear to have a better ability to attract commercial money than MFIs, and these investments represent a slightly higher proportion of total equity. For MFIs, Africap is an exception; they have been able to target funds with higher commercial participation, due to their specific focus on high-end institutions in order to achieve a demonstration effect.

An interesting discovery is that an MFI does not necessarily need to have a formalized status as a pre-requisite for attracting commercial capital. 17% of Novib-supported MFIs received commercial investment before graduating; Africap has also seen this trend. None of the DFIs see a specific change or jump in average loan sizes or new product development, once a financial intermediary achieves sustainability, graduates into a formal institution or attracts commercial capital. The growth is seen more as a continuum as an MFI reaches maturity, which stresses that achieving formal graduation *per se* will not necessarily result in instant increases in credit to the SME sector.

The fact that many of the MFIs and banks in the region have some commercial investment is testament to the growing confidence in microfinance, in terms of its potential growth and profitability. However the limited presence of commercial investment (~5-10% over all institutions) again does not signify a market driven by viable demand.

Chapter 5 Summary and Conclusions

The first section of this chapter will briefly summarize the findings in Chapter Four, relating to how DFI assistance in a financing gap seems to influence the credit market to match SME financing needs, and whether or not the track record of development finance supports the argument of unlimited demand for credit in SSA. The next section will then look at the larger conclusions that can be taken from the study.

5.1 Summary of Findings

In situations where financing gaps exist, DFI interventions aim to help financial intermediaries improve risk assessment capabilities and create a more pro-active financial sector, with the intended result being more credit extended to the SME sector.

DFI support tends to result in increased average loan sizes, if beginning with a low value, or an increase in clientele if the average loan size is already at a higher level. While DFIs lend at low rates, intermediary on-lending is still steep for SMEs - the best option appearing to be banks. Most MFIs / banks avoid hard and fast criteria of legal status and fixed collateral, although the latter applies mostly to solidarity-based lending. This style of lending is seeing less focus, with more MFIs expanding individual lending operations, thus providing more options for SMEs. Most DFIs accept currency risk, therefore freeing up the financial intermediary to accept riskier clientele.

In terms of creating a proactive financial sector, DFI interventions with banks appear to have a positive effect on changing conservative lending attitudes. Interest margins are allowed to free-float for the most part in the confidence that competition will bring them down. DFIs are cognizant of the special financing needs SMEs have versus microfinance clients, but this awareness is not seen to be as strong in the MFIs. Very little SME-specific monitoring and evaluation is done in order to determine outreach and impact.

In terms of how well DFI efforts to improve credit conditions match the financing needs of SMEs, the results appear mixed. On the downside: the cost of credit remains high in most countries; vertical growth of loans does not always take place, especially when average loan sizes are in the higher range (relative to microloan levels); collateral requirements are only avoidable through group lending; and MFIs face difficulty in changing lending models and creating new products for the SME sector. Positive results include: a perceived trend in moving away from group-based lending only; MFIs/banks are relieved of currency risk; and SME-targetted funds do impact credit extension in banks through increased loans versus deposits.

In order to test the concept of unlimited demand, theoretical market conditions of high profitability and low portfolio risk through selectivity was taken as a starting point in the analysis. Direct lending has proven to be challenging for DFIs, and most have changed focus to strengthening local financial sectors and investing in local financiers instead. Donor subsidies do not seem high, but most DFIs have selected their investments of MFIs based on sustainability criteria, of which only a few qualify. The apparent lack of 'investible' intermediaries is supported by the low level of transformations and the high degree of DFI overlap. Some commercial investors are present, but the overall low level suggests limited, although perhaps growing, interest.

5.2 Broader Conclusions

5.2.1 Interventions Change with the Theory in Fashion

One could argue that the development finance interventions studied are relatively recent, and that supporting MFIs towards sustainability and building inclusive financial sectors will take time to bear fruit. Once enough positive results have been shown, commercial investors will flock in to seize the lucrative opportunities. Development finance however, is not a young field, with its roots dating back to post World War II initiatives at reconstruction and economic 'catching-up'[25]. Intervention styles tend to follow the dominant paradigm in development thought throughout recent history.

The move by DFIs away from supporting large-scale state-managed projects, to invest instead in business ventures, reflected the doubts in state-led development theory and

[25] For example, the roots of the Commonwealth Development Corporation (CDC), a large and active English DFI, trace back to its founding in 1948.

bias towards the neo-liberal market-led ideology. The subsequent move away from direct lending (now limited only to large-scale commercial ventures or private infrastructure consortiums) and realignment to supporting inclusive financial sectors reflects another shift away from pure neo-liberal model, to one stressing the importance of institutional strengthening.

Western-based DFIs and supporting governments appear to have taken limited interest in the success of the East-Asian development state model, preferring to rely on free market forces to deliver financing to the most appropriate investments. African governments are not trusted to play any significant role in directing development, beyond creating a fair and level 'playing field'. Improved well-being in the livelihoods of Africans is trusted to come through trickle-down associated with economic growth.

Recent Asian successes in terms of standard of living improvements, such as Vietnam and Thailand, are heralded as proof that development finance does make a difference. This could be true, but one must be careful to assume that what works in Asia (or Latin America) will necessarily translate directly to success in Africa, keeping in mind differences in a variety of factors, such as savings trends; collective behaviour patterns; geographical size, density, and productive bases; colonial legacies, etc.

5.2.2 Different Forms of Intermediaries Can Benefit SMEs

Is there any difference in which type of financial intermediary can better serve SMEs? Stefan Harpe of Africap argues that rather than focussing too much attention on the top (banks) and bottom (MFIs) of the hierarchy, it may be more effective to focus on the institutions in the middle, such as the NFBIs, leasing companies and trade financiers. "Focus needs to be placed on the institutions that *inherently* want or need to serve the SME market."

Leasing companies as a possible solution are receiving much attention these days, although the IFC has been encouraging leasing for over 30 years, with US$850 million invested in 177 different projects. The argument for leasing is that since the asset being leased acts as the collateral for the loan, it is much easier to extend credit to SMEs that lack other collateral. The equipment can then be used as a productive asset in the business, generating funds to help pay for itself, and requires little capital upfront, thus freeing up cash flow. These flexible options and institutions could provide a positive impact on filling an SME financing gap.

5.2.3 Is Everyone An Entrepreneur?

Reflective of the theory of private sector development based on SME growth, concepts such as 'unleashing entrepreneurship' are currently in fashion. When one travels to developing countries, it is always amazing to see how 'inventive' and 'entrepreneurial' the locals can be in earning a living, from selling food and drinks at traffic jams to fixing up and modifying abandoned equipment to be used for some other purpose. It creates an almost glamorising effect that they are all entrepreneurs in spirit, only being held back by their resource limitations. Most major donors and private sector development practitioners have the opinion that there is a huge untapped potential energy just waiting to be unleashed with the right financing, and with that they can happily work themselves out of poverty.

As Janssen of Novib points out, not everyone wants to be an entrepreneur; it is a simple matter of being inventive and proactive to earn a living for survival, due to the absence of safety social nets in many developing countries. If offered the choice, most Africans would elect a stable decent wage employment over the uncertainty of running their own business – similar to attitudes all over the world. Being a successful entrepreneur takes a special mix of skills that not everyone has, and even then most small businesses need some sort of government support, and have a high failure rate anyways.

According to UNCDF, Oikocredit and Novib, the number of clients that graduate beyond the microfinance model into viable SMEs is relatively small, around 5%. There may be a financing gap for these cases, but the remaining 95% at subsistence level presents a more urgent case. This seems to show a disconnect with the other side of the argument, that SMEs are the engine of growth, and that development finance can water these little seeds and fire up the engine. The microfinance industry spends a lot of money and time focussing on ways to provide the poor with credit, but is graduation of most clients limited by a glass ceiling of low odds to business success?

5.2.4 Can Credit Overcome Other Significant Constraints?

As has been shown, SMEs in Africa face a highly volatile operating environment. How much of this volatility can institutional strengthening be expected to overcome? Great governance, denoted by limited corruption, dependable rule of law and pro-business regulations might assist SMEs to reduce some of their operating costs and emerge into the regulated sector. But will this provide them with access (and appropriate training) to advanced technology, or protect them against cheap imports from international competition benefited by huge economies of scale and research and development budgets?

Lower credit costs and improved financial services will benefit SMEs, but the cost of credit is not usually the top concern of small business. Issues such as a viable growing market, linkages with FDI production chains and technology are key for *significant* SME expansion. Some argue that a lack of absorptive capacity is the largest constraint to SME growth [Cook & Nixson:16].

As one USAID analyst summarizes:

> Most microenterprises are limited to selling their goods and services in local markets that are overly crowded, highly competitive, and characterized by low barriers to entry and correspondingly low profit margins. A common, fundamental need, therefore, is for improved access to new, more rapidly growing markets. In particular, microenterprises need to be able to identify and access market niches in larger urban or export markets, either directly or through linkages with various types of intermediaries or larger enterprises.
>
> [Barton, 1997:7]

Until other structural barriers can be removed, and a 'level playing field' is established at the global level, SMEs in sub-Saharan Africa are fighting an uphill battle in a globalized economy.

5.2.5 Micro Finance Success Should Be Taken With Caution

The success stories of micro credit have been mainly supported from the viewpoint of the supply side. The proof that the extension of credit supports development has been based on high repayment rates and sustainability of credit institutions. As one analyst critiques: "The rationale behind [the microcredit] argument is that when clients pay the full cost of the services they receive, pay back their loans on time, and come back regularly for more loans, microcredit must be having positive impacts" [Rahman, 2004:32]. Only recently have sociological critiques of microfinance come forward, citing cases of limited actual livelihood impact, high pressure by extension workers demanding repayment, and recycling of loans to meet payment schedules [ibid:33].

This burden of proof applies to the SME sector as well, since the argument for development finance led by the private sector is based on the assumption that the provision of credit will lead to improved well being, based on local economic activity and business growth. What is important to keep in mind however, is exactly what kind of growth are we talking about?

This author has seen micro credit loans assist 'entrepreneurs' looking to start a business (in which to survive on), such as acquiring a taxi license. The businessman then struggles against fierce competition to earn enough each month to make his loan payment, gas prices keep rising eating into his profits, and the city traffic is further clogged with one more taxi on the road. However, from the MFIs perspective, if the loan is being paid, impact is being achieved. But does another taxi on the road really mean long-term, sustainable growth for the productive base of the country?

5.3 Final Remarks

This study did not set out to be a critique of microfinance, nor the operations of development finance institutions. Its intention has been to gain an understanding of the nature of development finance and some of the models by which it is implemented in the reality of sub-Saharan Africa. The author is left with three conclusions.

First, in many African sectors, SMEs are caught in a financing gap, due to fragmented financial systems that have experienced a history of failure, caused by both internal and external influences. Foreign development finance initiatives can be a useful tool in order to help overcome this gap. However, an SME financing gap does not extend across the board, in all countries and sectors, and even where it does exist, providing finance is just a small piece of the puzzle for achieving SME growth.

Secondly, the perspective that SME support falls within the general model of microlending programming results in a blurred line, where one is led to believe that growth in portfolios is leading to long-term sustainable growth of viable enterprises, which is rarely the case. Development finance can have positive impact on long-term growth in developing countries, but one must give careful consideration to the underlying assumptions and criteria upon which growth theories are based, in order to design programs that can achieve significant results.

Finally, less comfort can be taken from the fact that development finance (similar to debt relief) is included under 'aid flows'; this can actually mislead the general public who is under the assumption that meeting the goal of development assistance (0.07% of GDP) is a redistribution of resources to the developing world, when actually a portion of it is loans based on market rates of return to the North.

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