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More microfinance needed in Kenya, Malawi, Tanzania & Uganda

Best practices in microfinance could increase access to and the use of basic financial services in southeast Africa.

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A country's financial-services penetration level is a good indicator of its economic development. In some African countries, the figures speak for themselves: In Kenya, just 10% of the adult population has access to basic financial services; in Uganda, just 6.7%; in Tanzania, 6.4%; while for Malawi, no reliable data exists. Furthermore, the percentage of private-sector lending in these four countries does not surpass 22.6% of GDP.

IESE professor Javier Santoma and researcher Francesc Prior have analyzed the level of access to financial services in these four countries. Their study shows there is unsatisfied demand for financial services, forcing much of the population to resort to informal services that are far more expensive and inefficient, while at the same time preventing them from reaching higher levels of economic development.

Informal finance in Africa

Why does the population turn to informal institutions instead of going to a traditional bank, which on paper offers better prices and security?

The first answer is that regulated financial services in those four countries are quite expensive, with financial margins sometimes double the average in developed countries.

The high prices are due to the relative inefficiency of their institutions. Disproportionately high operating costs eat up more than half of their revenues, and distribution networks are weak, a problem compounded by the lack of infrastructure such as bank branches.

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Those who can access a branch often encounter difficulties getting loans. Risks are calculated according to the applicant having a confirmed, stable income, i.e., a paycheck. In Africa, where informal economies are commonplace, that may not always be possible.

Credit-rating agencies rely on data from banks, which means a person's credit history from other sources will not be taken into account.

As such, formal institutions end up concentrating on people who are already in the banking system, like a dog chasing its own tail, while the rest are excluded.

When it comes to microfinance, the problem is not a lack of demand but rather supply. The scarcity of microfinance makes the few services that do exist much more expensive than they should be for such broad, low-income segments; and these service providers are not adequately regulated.

The macroeconomic context in Africa

The four countries studied by Santoma and Prior have achieved sustained economic growth. Between 1995 and 2005, their real GDPs grew at rates ranging from 2.4% (Kenya) to 5.4% (Tanzania).

Still, serious poverty persists. In 2005, Malawi's per capita income was $180, far below the sub-Saharan average of $552. Only Kenya came near that.

Interest rates are extremely high, as is public debt. This causes financial systems to gear their liquidity toward the financing of that debt. Most loans go to large, private-sector corporations. Small companies and individuals get left out.

The country with the most developed financial system and lowest public debt is Kenya. The private banking sector there is relatively unconcentrated. Although loan default rates are high, banking institutions achieved a ROE of 23.59% in 2005; in Tanzania, 33.1%. Malawi is similar, but unless these countries fix their still high default rates, they could suffer serious crises, like the one Uganda went through in 1999. That crisis forced a necessary restructuring and recapitalization of its financial sector, although this also resulted in a more concentrated market there.

An opportunity for microfinance in Africa

In Kenya, the microfinance market is marginal, served mainly by powerful co-ops. In Malawi,

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microfinance is reserved for public bodies. Unfortunately, they generate major losses. At the time of writing, only one private bank granted microcredits, representing 2% of the total, while unregulated entities had a market share of 28%.

In Tanzania, the regulated sector works only with microdeposits, with microcredits handled by the country's underdeveloped 600 co-ops. In Uganda, regulated institutions admit microdeposits, and small, specialized operators give out microcredits.

All four countries are creating legislation more favorable to microfinance. This is a first step, though many more are needed.

The region must stabilize its financial sectors and channel its liquidity into something more than just buying up public debt. States should eliminate the distortions they cause in their economies and encourage the modernization of their banks and other institutions, including more electronic payment systems.

In short, by combining best practices in microfinance with specific financial policies, these countries could extend basic financial services to more of their populations.

SOURCE: Based on the study "Acceso a servicios financieros en los países del Africa suroriental" (ST-44) by Javier Santoma and Francesc Prior (in Spanish).

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