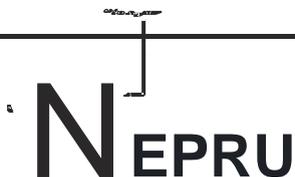


The Microfinance Gap: Selected Issues for Namibia

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Abstract

In a stable political environment and enabling macro economy, microfinance institutions are important in providing savings, credit, funds transfer and other financial intermediation facilities to low-income households, micro-enterprises and marginal small-scale enterprises. Effective, long-term provision of these facilities occurs through microfinance institutions that adhere to the key principles of microfinance endorsed by CGAP.

This report presents a synthesis of selected issues contributing to the microfinance gap in Namibia and associated solutions, in the context of the key principles of microfinance. It highlights the fact that the microfinance industry has shown significant signs of activity over the past few years.

Rather than onerous regulation, this report suggests that both regulators and practitioners should explore and promote ways that microfinance institutions can reduce costs while controlling the integrity of the loan portfolio. One key area that opportunities exist is through the sharing, for a fee, of existing distribution networks currently owned by disparate microfinance players to reduce transaction costs of loan disbursement, collection of repayments and savings mobilisation.

Other ways that cost can be reduced include the separation of financial from non-financial service provision in the auditing of microfinance performance; the incorporation of strategies to reduce risk exposure from social factors in the microfinance institutional model, such as HIV/AIDS; the embracing of technological innovations to further reduce transaction costs, including credit and risk management tools; and the development and use of cost-friendly enabling infrastructure to promote financial sustainability.

Apart from structure, ownership and control; another key criterion of good governance is public timely and full reporting of an institution's activities and results. From this perspective, the quality of objective information in Namibia's microfinance sector needs to be improved before policy intervention can be considered. Professional auditing firms can be a useful provider of financial capturing and reporting services for a fee, under their corporate social responsibility mandates. Based on reliable information, an accurate snapshot of the complete picture of microfinance in Namibia can be presented periodically, which will also enable the tracking of dynamics over time.

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List of Acronyms

BoN	Bank of Namibia
CGAP	Consultative Group to Assist the Poorest
CYCI	Commonwealth Youth Credit Initiative
DCD	Division of Co-operative Development
FIDES	International Finance for Social and Economical Development
FOS	Fund for Development Cooperation
GIPF	Government Institutions Pension Fund
GTZ	German Agency for Technical Cooperation
HIV/AIDS	Human Immuno-deficiency Virus/ Acquired Immunodeficiency Syndrome
ICT	Information and Communication Technology
MAWF	Ministry of Agriculture, Water and Forestry
MPCM	Multi-purpose Co-operatives providing Microfinance
MTISC	Ministry of Trade and Industry Steering Committee
NAD	Namibian Dollars
NAMFISA	Namibia Financial Institutions Supervisory Authority
NGO	Non-Governmental Organisation
NPC	National Planning Commission
PIN	Personal Identification Number
RISE	Rural Peoples Institute for Social Empowerment in Namibia
SACCO	Savings and Credit Co-operative
SANASA	Federation of Thrift and Credit Co-operative Societies
SBCGT	Small Business Credit Guarantee Trust
SCA	Savings and Credit Association
SME	Small and Medium-Scale Enterprises
SMS	Short Message Servicing

USD	United States Dollars
WOCCU	World Council of Credit Unions

1. INTRODUCTION

It is argued that an increase in financial services offered by formal sector microfinance institutions will contribute towards alleviating the plight of savers and borrowers in marginalised areas. Many surveys that focus on low-income households or enterprises (micro or otherwise) continue to report that access to financial services is a constraining factor inhibiting their development or growth (ICEG, 1999b). This has led to efforts to address the gap that exists between the supply and demand of microfinance in most developing countries. This perceived gap in microfinance can be due to issues arising on the supply or demand side.

On the demand side, some argue that the microfinance target group is not financially sophisticated enough to participate in the formal financial sector or cannot afford market interest rates and therefore require government or donor funded credit subsidies. On the supply side, some argue that profitable provision is not possible due to the high transaction costs and institutional risks arising from asymmetric information between borrowers and lenders; the inability of the microfinance clientele to generate sufficient volume of business to attract formal financial institutions; sparsely distributed populations or inadequate enabling infrastructure in rural areas. Whether valid or invalid, these are some of the reasons why a gap continues to exist in the provision of microfinance to low-income households, micro-enterprises and marginal, small-scale enterprises in Namibia.¹

In a stable political environment and enabling macro economy, evidence arising over several decades has supported the view that the provision of microfinance is an important component of any effort to improve the livelihoods of the poor in any society. In Namibia, there has been an interest in microfinance by both policymakers and practitioners as a valued component in policies and programs geared towards addressing inequalities arising from the country's socio-political history and improving the livelihood of the rural population.

Microfinance refers to all types of financial intermediation services (savings, credit, funds transfer, insurance, pension remittances, etc.) provided to low-income households and enterprises in both urban and rural areas, including employees in the public and private sectors and the self-employed (Robinson, 2003).²

Effective, long-term provision of microfinance facilities occurs through microfinance institutions that adhere to the key principles endorsed by the Consultative Group to Assist the Poorest (CGAP) and its 28 member donors, which were further endorsed

¹ Other reasons arise from the "operational problems and obstacles [micro-enterprises and marginal] small-scale enterprises face in both the formal and informal sector..." (Thomas, 2005).

² This definition is constantly evolving; however the essence of its evolution is that microfinance is simply finance on a smaller scale.

by the Group of Eight leaders at a Summit on June 10, 2004. These are presented in Box 1 below.

Box 1: Key Microfinance Principles

1. Poor people need a variety of financial services, not just loans;
 2. Microfinance is a powerful tool to fight poverty;
 3. Microfinance means building financial systems that serve the poor;
 4. Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people;
 5. Microfinance is about building permanent local financial institutions;
 6. Micro credit is not always the answer... and is not the best tool for everyone or every situation;
 7. Interest rate ceilings hurt poor people by making it harder for them to get credit;
 8. The role of government is to enable financial services, not to provide them directly;
 9. Donor funds should complement private capital, not compete with it;
 10. The key bottleneck is the shortage of strong institutions and managers;
 11. Microfinance works best when it measures—and discloses—its performance.
- Source: www.cgap.org Date accessed: October 25, 2005

This report presents a synthesis of the issues contributing to the microfinance gap in Namibia and associated solutions, in the context of the key principles of microfinance. It is hoped that the issues discussed will inform practitioners as they design institutional models and regulations in their efforts to boost the effectiveness of microfinance provision in Namibia.

The scope of the formal sector microfinance institutions covered in this study included those governed by the Division of Co-operative Development (DCD) in the Ministry of Agriculture, Water and Forestry (MAWF), the Namibia Financial Institutions Supervisory Authority (NAMFISA) and the Ministry of Trade and Industry Steering Committee (MTISC).³ This included:

³ MTI is involved to the extent that microfinance is a key component of its SME program.

- Savings and credit co-operatives (SACCOs) and multi-purpose co-operatives providing microfinance (MPCM).⁴ These are supported by the Rural Peoples Institute for Social Empowerment in Namibia (RISE), which is backed by funding from the Fund for Development Cooperation (FOS), a Belgian donor agency;⁵
- Savings and credit associations (SCAs) supported by the MTISC, which consists of various donor and development project financing agencies; financial institutions and regulatory bodies;⁶
- Micro-lenders, commercial bank branches involved in the provision of microfinance and non-governmental organisations (NGOs) that are registered with NAMFISA

Although the authors fully recognise the importance of the NGOs directly involved in the provision of microfinance, those that are not registered by either the DCD or NAMFISA are not included in this study because they are governed by their own donor agencies and fall outside the scope of direct government policy.⁷

Following this introduction, which serves as Section one, the remainder of the report is organised in the following manner: Section two presents a synthesis of selected supply side issues contributing to the microfinance gap in Namibia and associated solutions, in the context of the key principles of microfinance. This is followed by Section three which presents selected demand side issue contributing to the microfinance gap in Namibia in a similar context. Other selected issues that do not clearly fall on either the demand or supply side are presented in Section four. Finally, Section five presents the conclusions.

⁴ In this report MPCM is defined as a co-operative supported by RISE that is providing both financial and non-financial services in Northern Namibia. This category does not include NGOs registered under NAMFISA such as Michelle McLean Trust.

⁵ Although, the multi-purpose co-operatives providing microfinance in Namibia are termed as SCAs; the acronym MPCM was adopted in this report to avoid confusion with the SCAs supported by FIDES.

⁶ Although these SCAs are currently not registered by any formal authority, reports from practitioners and comments from the focus group discussion on the draft version of this report, indicate their intent to apply for a banking license under the Bank of Namibia.

⁷ The experience of some of these organisations was captured in a study by Roth (2002).

2. SUPPLY SIDE

Issues arising on the supply side include, but are not limited to, financial sustainability, affinity towards lending to the public sector, transaction costs, information, ability to assess credit applications, perceptions, independence, institutional factors and standards and regulations.

2.1. Financial Sustainability

Due to the features of the microfinance environment the operating costs of microfinance institutions are high. This results in their inability to easily achieve profitability and even if they do, their margins are relatively lower than other formal financial institutions that do not cater to this segment.

While recognising this obstacle, the key argument of the microfinance revolution is that only independently financially sustainable, commercially-oriented microfinance institutions in the formal sector can handle the rapid safe expansion of the loan and savings portfolios that is required to achieve large-scale outreach to the desired target group and improve livelihoods to the largest extent possible (Robinson, 2003). This school of thought argues that independent, financial sustainability is the base level condition that needs to be the focus of sequenced, microfinance institutional development.

The attainment of financial sustainability is a key component of institutional financial viability, as identified in a case study of the Federation of Thrift and Credit Co-operative Societies (SANASA) in Sri Lanka (Hulme & Mosley, 1996b). Attainment of financial sustainability will allow the microfinance institution to graduate towards providing larger and more complex loans to a more sophisticated clientele, e.g. Banco Solidario in Bolivia, which is different from encouraging micro-enterprises to shift from the informal to the formal sector (transformation lending) or to graduate to being commercial banks (Graham Bannock & Partners, 1997).

Financial sustainability is defined as the provision of microfinance services [to the microfinance target group] at interest rates that enables the microfinance institution to cover all non-financial and financial costs without subsidy and risk, and still generate a profit (Robinson, 2003).

The most popular way advocated to achieve financial sustainability is to increase the interest rates charged on loans, such that the spread between interest rates received on loans and that paid on savings, is enough to cover costs. This involves a shift away from subsidised interest rates.

The focus of financial sustainability is essentially the break-even interest rate. This rate needs to be high enough such that the income of a financial institution is at least enough to cover total expenditure (Hulme and Mosley, 1996a). In fact, the

break even interest rate is usually much higher than the market rate, which is defined as a rate that arises from the interplay of supply and demand in some defined range of transactions, and usually refers to the rate which commercial banks and their conventional customers conduct deposit and loan transactions.⁸

In Namibia, the break-even rates for SACCOs, SCAs and micro lending institutions are usually much higher than the market rate.⁹ This is illustrated for each category in Figure 1 below. This figure shows that the interest rate required for MPCMs as a category to break-even was the highest while that required by term micro-lenders as a category to break-even was the lowest. However, the high break-even interest rates required for MPCMs can be attributed to the fact that they are currently the only microfinance institutions included in this report for which data was available, that provide both financial and non-financial services and the costs of providing these were not separated in their reporting.

Calls for the raising of the interest rate ceilings to ensure financial sustainability is the seventh key principle of microfinance (See Box 1). However, this principle highlights the conflict between the protection of borrowers and access to financial services paradigms. Since banks in Namibia are currently under heavy criticism for charging too much in terms of service fees, this criticism could easily filter to the higher interest rates required to ensure financial sustainability of a microfinance institution subjecting them to claims of being discriminatory against the poor. However, microfinance practitioners argue that there is a need to make the case to politicians and the public that the social benefits of increased access to finance provided by financially sustainable microfinance institutions in the formal sector, may outweigh the private costs to the clients of higher interest rates. This requires political skill (Robinson, 2003).

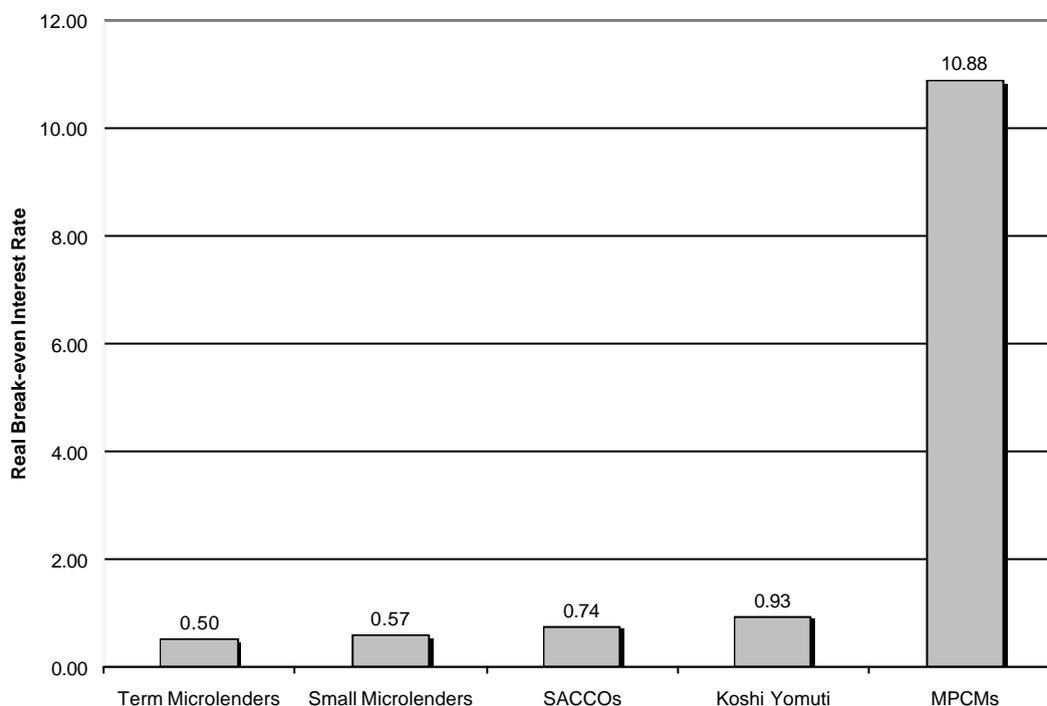
To boost their position, microfinance practitioners argue that the higher interest rates required for financial sustainability should not put off their clients. This is because microfinance institutions are in competition with informal moneylenders (as opposed to the commercial banks) who typically charge higher interest rates.

Despite their higher costs, informal moneylenders typically have high repayment rates and low-income borrowers frequently report that their transaction costs in borrowing from informal moneylenders are quite low (Robinson, 2003). Since little or no documentation of microfinance programs reports that increasing rates has significantly altered client demand for loan products (Rhyne, 1998), it is argued that microfinance institutions can set higher interest rates up to the level required for

⁸ Loan interest rates are subsidised or unsubsidised depending on whether they cover the full cost of providing the loan. Since per unit costs of microfinance are higher than that of commercial banks, the market rate is thus likely to be a “subsidised rate” if it is applied to microfinance (Christen, 1997a and Rosenberg, 1996 in Robinson, 2003).

⁹ The method used to calculate the break-even interest rate is described in Appendix A.

institutional profitability on a declining month-end balance (to provide a more attractive product than informal moneylenders who typically charge interest rates on a flat basis, i.e. on the original loan balance).



Note: Operating costs for RISE were calculated based on information in NASSP (2005a). Micro-lenders charge 30% interest (or 2 x prime interest rate) on a flat basis, and if the loan is in default (30 days overdue) an additional 5% is charged.

Source: Own calculation from microfinance institution annual returns using method in Appendix A.

Figure 1: Break-Even Interest Rates for Microfinance Institutions in Namibia by Category for 2004.

Different methods of computing and collecting instalments can produce large differences in the effective cost of the loan to the borrower. Micro-lenders typically expect that the loan should be paid in full within 90 days while the larger micro-lenders rely on a 6-month to three-year repayment period. SACCOs in the southern parts of Namibia rely on a monthly instalment collection period, while the MPCMs and SCAs in northern Namibia rely on a weekly instalment collection period (NASSP, 2005a).

To avoid complete reliance on raising nominal interest to achieve financial sustainability, microfinance institutions in some instances use practices that raise the effective interest rate above the quoted rate by more frequent compounding. These include collecting interest at the beginning of the loan i.e. upon disbursement, charging a loan fee and requiring daily repayment (Robinson, 2003).

Another short-term measure to promote financial sustainability is the subsidisation by donors and governments of recurrent costs (Hulme & Mosley, 1996b). In Namibia, RISE subsidises the costs of promoters that support the MPCMs while the MTISC subsidises operating costs of the Koshi Yomuti ('under the tree') head office (NASSP, 2005a).

However, this is not sustainable over the long-term due to the high demand for the limited resources of these entities by other instruments in the poverty alleviation toolkit, such as education and health service provision and other components of NASSP.¹⁰ In addition, donor and government resources are not enough to cover the costs necessary to meet the desired scale of outreach necessary to have the largest effect on improving livelihoods. Even the roughest calculation of potential market size reveals a need for microfinance assets far in excess of donor funding available for the purpose (Rosenberg, 1996).

Table 1: Percentage of Portfolio at Risk of Default for Selected Microfinance Institutions in Namibia as at 2001

Organisation	Portfolio at Risk (%)
Adult Skills Development for Self-Employment	56
Community Small Enterprise Development Agency	100
Co-operation for Development	> 50
Lisikamena	100
Morukutu Co-operative Union	57
Namibia Housing Action Group – Shack Dwellers Federation of Namibia	30
Namibia National Women in Business	77
Okatumbatumba Hawkers Association	10
SACCOs founded by RISE	>70 (North) >56 (South)

Source: Roth (2002)

In addition, the provision of subsidies by donors and governments may enable microfinance institutions to continue to cover the losses of subsidised credit programs and support inefficient operations. This could result in a state of dependency that becomes an excuse for microfinance institutions to avoid difficult improvement and make the necessary adjustments in their practices, especially those pertaining to repayment enforcement and interest rates (Rhyne, 1998). The

¹⁰ The other components of NASSP include institutional support, livestock development, crop diversification and mahangu (pearl millet) cultivation.

dangers of subsidisation are captured in the study by Roth (2002), who focused on microfinance institutions supported by donors as at 2001. His main finding is summarised in Table 1 above.

Following Roth’s study, donor agencies in Namibia shifted their mode of support to microfinance from direct financing of the loan portfolio to supporting the creation of independent, community-based microfinance institutions. However, in some cases there is still continued subsidisation of operational costs and provision of loan capital, technical assistance and grants (NASSP, 2005a).¹¹

Based on reports from NAMFISA, annual returns submitted to the DCD, RISE (2005) and NASSP (2005a), the default rates of the selected microfinance institutions in this report are presented in Table 2 below. With better provision of objective information these default rates can be calculated for each institution. This report expects these figures to change if the quality of information provision is addressed.

Table 2: Estimated Percentage of Portfolio at Risk of Default for Microfinance Institutions in Namibia as at 2004

SUPPORTING BODY	INSTITUTION	Portfolio at Risk of Default (%) in 2005^a
NAMFISA	Micro-lenders	5
MTI Steering Committee ^a	Koshi Yomuti	0.55
RISE ^b	MPCM	67
RISE ^c	SACCOs	50

Note: ^a Only RISE provided disaggregated data for calculation of default rates. NAMFISA cited 5% as a general indicator, and NASSP (2005a) cited 0.55 as a general aggregate indicator. Provision of disaggregated data would allow a clearer picture of the actual default rates for each category.

^b RISE default rates are for 2003.

^c The SACCO estimation of portfolio at risk of default for RISE supported microfinance institutions was not provided in their annual returns. Although, Roth (2002) gave an estimate of >56 (South), this report assumes a 50% default rate [(0.5 x 100) + (0.5 x 0)] because no robust documented information is currently available.

Source: NAMFISA database, DCD database, NASSP (2005a) and RISE (2005)

An option that can be pursued to reduce default rates can be through adopting credit and risk management systems. In addition, the separation of financial and non-financial services in auditing would allow regulators and practitioners to understand the relative sources of operational costs and revenue at the institutional level.

¹¹ MPCMs supported by RISE access refinancing from support institutions such as the National Federation of Microfinance Institutions in Namibia (RISE, 2005).

Donors and government may be convinced to focus on supporting the non-financial services of microfinance institutions where these fit in with human development goals, and leave microfinance institutions to find ways to cover the cost of all financial services through interest income.

Reliance on donor funding could be a source of vulnerability for community-based microfinance institutions because they are susceptible to 'donor fatigue'. To avoid this danger as well as reducing the level of government cost subsidisation, microfinance institutions in some countries have turned to financial markets and issue debt or equity to finance their microfinance loan portfolios, in combination with mobilised savings. Turning to the financial markets is expected to have the additional benefit of enabling microfinance institutions to conduct market research and pilot projects to determine the correct level of interest rates to set, without constraining the growth of the loan portfolio in line with prudential regulation. In Namibia, microfinance institutions that mobilise wholesale deposits by issuing securities on the financial market do not exist yet.

In addition to limiting their ability to reduce costs, the inability to use alternative sources of financing is a constraint where growing micro-enterprises have a preference for fixed rate long-term debt and rely on savings alone because they may find it difficult to acquire matching deposit liabilities (Graham Bannock & Partners, 1997).

Microfinance institutions that are weaned off donor and government funding and profitably provide microfinance will stick with it even when it is not in fashion (Rhyne, 1998). This will allow donors' and government funds to limit their support to microfinance institutions by focusing on supporting the implementation of much needed [auditing] and data management systems and skills development training (Robinson, 2003 and Mukama, Volschenk and Fish, 2005).

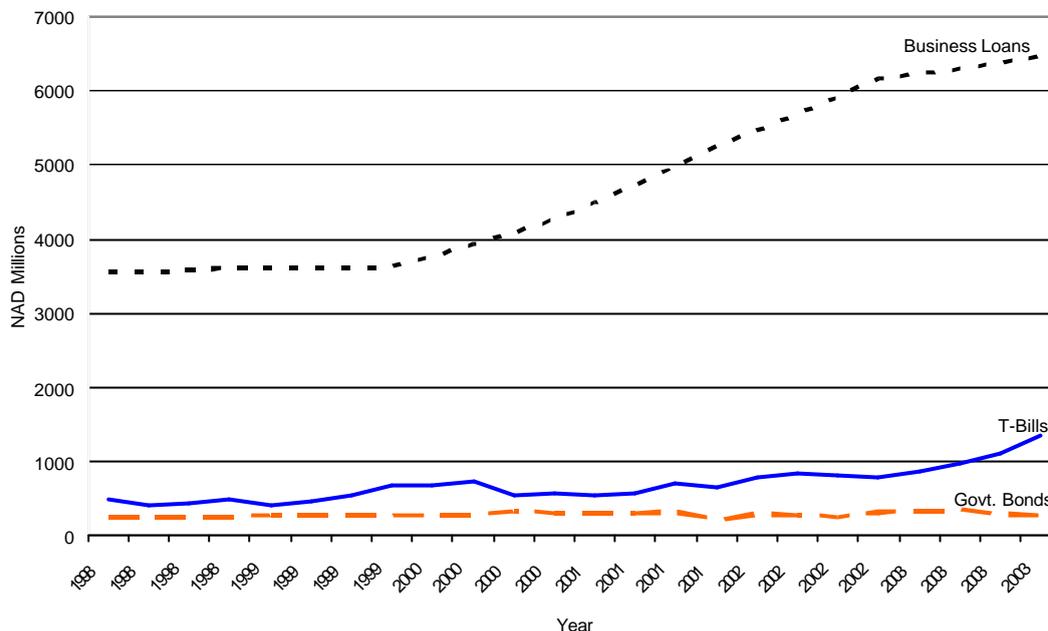
2.2. Affinity towards Lending to the Public Sector

One potential barrier to lending by commercial banks to the microfinance target group could be their affinity towards lending to the public sector. Governments issue treasury bills, notes and bonds to meet their public expenditure needs. Treasury bills are typically categorised as risk-free and may provide a safer option for bank investments than the option represented by lending to the microfinance target group.

The Namibian experience of commercial bank lending to the public sector is illustrated in Figure 2 below. This figure shows that the portion of funds commercial banks allocated to government treasury bills rose gradually from 1998 to 2003, and the portion allocated to longer term government securities remained constant.

Figure 2 illustrates that the portion of funds allocated to business loans is way above that allocated to both treasury bills or government bonds throughout the period, and has risen steadily. Therefore, the claim that an increase in treasury bill purchases

by commercial banks adversely affects microfinance in Namibia is not supported by the figure below.



Source: Bank of Namibia Annual Reports

Figure 2: Amount of Credit Portfolio Allocated by Commercial Banks to Government Paper versus Business Loans in NAD Millions

2.3. Transaction Costs

The relative opacity of the microfinance target group results in relatively higher transaction costs when lending to the sector (Aryeetey, et al. 1996 and Mukama, Fish & Volschenk, 2005). This is because the costs of assessing and processing loan applications are identical for large and smaller loans, and micro-enterprises require relatively smaller loans than larger enterprises to start or expand their businesses. In Namibia, this is illustrated in Box 2 below.

Box 2: The Potential of Microfinance

In a sample of 333 SMEs in Namibia, only 12% used start-up capital of over 100,000 Namibian dollars (NAD) in 2004, and these were mostly in the medium-scale segment. 10% of this sample used start-up capital of between NAD 5,001 to NAD 10,000. 45% of SMEs used start-up capital of less than NAD 5,000. Although this sample does not claim to be representative, it suggests that microfinance institutions could play an important role in assisting micro-enterprises and marginal small-scale enterprises seeking financial services, because most of these only require small amounts for start-up.

Source: Grossman, Mwatotele, Stork & Tobias (2005).

Similarly, the costs of administering small and large savings accounts are identical. Therefore, the per unit transaction costs are higher for institutions that provide

financial services to the microfinance target group, because it is more costly to process many small loans and savings accounts than a smaller number of larger ones (Robinson, 2003).

Furthermore, in sparsely populated areas with a low concentration of clients, where climatic conditions are harsh, transaction costs are higher (ICEG, 1999b). Namibia, which is characterised by dry desert conditions, has an overall population of 1.8 million, of which 1.2 million live in the rural areas (Central Bureau of Statistics, 2003). Outside of the rural towns, geographic remoteness and isolation results in a very sparsely distributed population. This is illustrated in Figure 3 below.

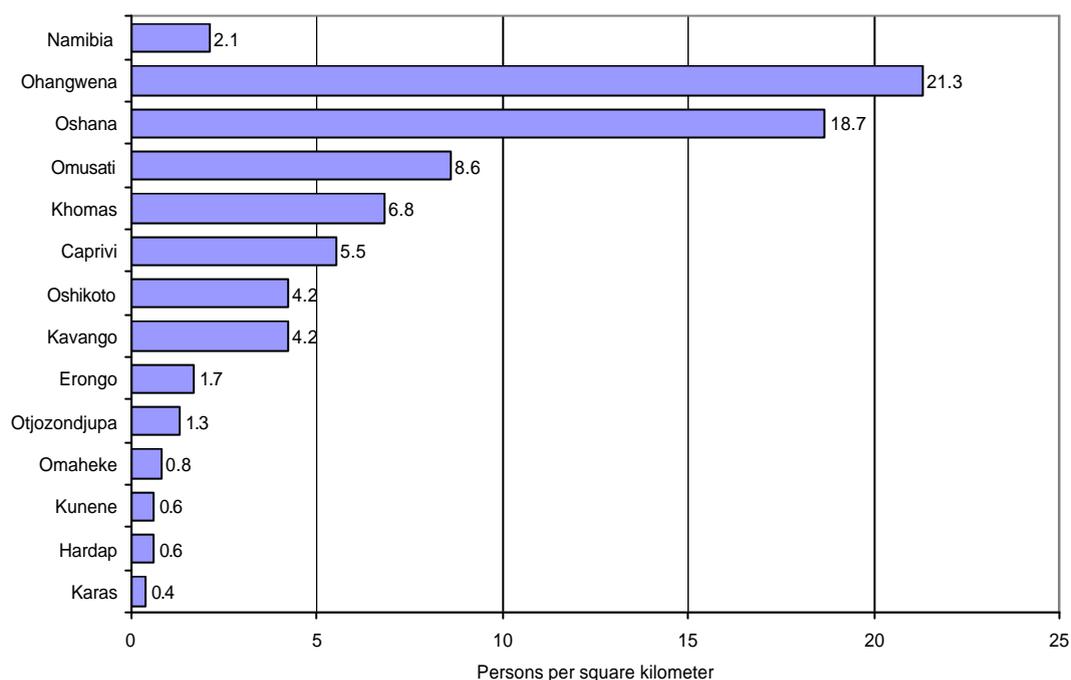


Figure 3: Population Density in Namibia by Region

Source: Central Bureau of Statistics (2003)

In addition, the relatively long distances between rural villages and urban centres, where most branch offices are located, is a contributing factor to the persistence of the microfinance gap. The challenge here is to find microfinance delivery methodologies that can cater to microfinance target groups residing in sparsely populated areas who are mostly involved in agribusiness, which is characterised by low yields and long gestation periods (ICEG, 1999b).

To reduce the barrier created by high transaction costs, microfinance institutions have introduced several innovations that should allow them to reduce the costs of staff maintenance in small widely dispersed outlets.

Microfinance institutions are shifting from being providers of solely credit or savings, to a financial intermediation model that involves the provision of both savings and credit. This is in recognition that the microfinance target group are not only

borrowers but also savers (Robinson, 2003). In Namibia, although micro-lenders do not mobilise savings, the SACCOs, MPCMs, SCAs and NamPost do. To the extent that information of clients' savings habits can be used in evaluating their loan applications, transaction costs arising from the fixed cost element in credit assessment will be reduced.

To further reduce the fixed cost element arising from loan assessment, tiered interest rates are used. This involves charging higher nominal interest rates on smaller loans i.e. loans offered to the microfinance target group. Although this could be a source of criticism because the interest rates on micro loans are higher than those charged by commercial banks, which could be exacerbated by the fact that the microfinance target group does not have the same buyer-power as larger customers, microfinance institutions almost always find that demand for the credit products that they offer far outstrips their ability to supply.

In fact most microfinance customers are able to repay their loans and return repeatedly for new loans, displaying that the social benefit of microfinance loan outweighs the private costs of the higher interest rates charged (Rosenberg 1996). This phenomenon could be occurring because informal moneylenders charge higher nominal or real interest rates for small loans than microfinance institutions. Therefore, when microfinance institutions begin to offer credit facilities, they are a preferred alternative because they provide access to credit at a lower cost than moneylenders.

However, higher interest rates on smaller loans could be a source of adverse selection, where more risky projects are selected and bad borrowers benefit at the expense of good borrowers. This could result in a higher rate of defaults resulting in loan loss provisions that cannot be covered by the interest income of the microfinance institution (Graham Bannock & Partners, 1997).

In Namibia, despite nominal interest rates ranging from 24% to 35% per annum (NASSP, 2005a and NAMFISA database, 2005), the amount of loans mobilised by the selected microfinance institution in this report was approximately NAD 341.5 million in 2004. Even when the term micro-lenders were excluded, the amount of credit issued was still quite substantial.

This huge demand for microfinance credit exists either because of its preference over that offered by informal moneylenders or a lack of other alternatives. In 2003, information from a representative sample consisting of 800 people was collected to assess the usage of financial services in Namibia, and only 12% of respondents used informal financial services. From this portion only 1% of this category used informal moneylenders with the rest using burial societies (FinMark Trust, 2003). This suggests that when the microfinance target group seeks external financing the microfinance institutions may offer a better alternative to the informal credit market.

As the commercial banks begin to provide microfinance, current microfinance institutions may face similar displacement effects as the informal moneylender,

unless they find ways to further reduce their costs. One way this can be done is through the use of the small business credit tools to reduce credit assessment costs. The reduction in the time and labour intensity spent assessing microfinance loan applications that the adoption of these tools represent may translate into lower staff costs – a major cost item for microfinance institutions in Namibia (Roth, 2002).

Tiered interest rates are also used on savings products provided by microfinance institutions. This involves paying lower rates on smaller accounts than on larger ones, reflecting the higher cost of mobilising and administering the smaller accounts. Some microfinance institutions pay no interest on very small accounts.

Lower interest rates on savings accounts, or none at all could be another source of criticism. However, the alternative to the secure storage facilities offered by microfinance institutions at no cost (besides opportunity cost) is to resort to the informal savings market. This involves paying savings collectors for providing savings facilities or storing savings 'under the mattress' (the use of the former results in negative returns, while the use of the latter is neither safe for the saver nor secure for her/his savings).

Microfinance savings products are easily accessible to their target group and evidence exists that the social benefit of the convenience they offer outweighs the private cost of loss in returns. Small savers in Indonesia interviewed over a 10 year period rated convenience to be far more important than returns (Schmidt & Zeitinger, 1994).

To reduce the transaction costs of distances between the microfinance target group and branch offices in urban areas, or the expense of maintaining widely dispersed branch outlets in areas with low population densities, some microfinance institutions have taken up the challenge to implement innovative ways created by the collaboration between technology and microfinance experts (Robinson, 2003).

To alleviate the costs of funds transfer, some financial institutions such as First National Bank Namibia have begun to take advantage of the cellular phone delivery channel to allow client-driven, electronic funds transfer using short message servicing (SMS) technology as they downstream into microfinance provision. This allows the microfinance target group to make small payments locally and nationally at a lower cost than they do now. As financial and information and communication technology (ICT) markets become more liberalised and secure, this product can potentially facilitate international financial transactions.

In addition, NamPost in collaboration with Net 1 Universal Electronic Payment System Technologies Incorporated (Net 1) has introduced a debit card that utilises biometric-based security technology (Katswara, September 2005). Individuals can use these cards to conduct point of sale transactions, which alleviates shoe-leather costs for the microfinance target group. A potential additional value of these cards is that credit lines approved by commercial banks or other financial service providers

to micro-enterprises can be accessed through these smart cards, if NamPost allows these institutions to access this distribution channel for a fee.

To reduce branch costs, the microfinance revolution advocates that microfinance institutions should target a broader client base by scaling up to a size that will enable economies of scale to reduce per unit costs. Capturing of a larger client base can be accelerated at a lower cost by combining small business credit tools with the cellular phone delivery channel. The combination of these instruments should allow microfinance institutions to leverage marketing strategies that solicit potential borrowers by promoting their eligibility for unsecured loans that have been evaluated using small business credit scoring tools (Financial Standard, 2005).

To further reduce the transaction costs of distances between the microfinance target group and branch offices some institutions have set up automated teller machines and mobile agencies at the village level and use group collection by microfinance staff at focused delivery points, such as markets on market day, to collect savings and disburse loans so that clients do not have to visit a branch office. This is based on the Grameen bank model (Hulme & Mosley, 1996b).

In densely populated, low-income neighbourhoods in urban areas, collections by loan officers occur daily as in the case of SAFESAVE in Bangladesh (CGAP, 2000b). This microfinance institution goes to the extent of visiting clients in their homes or workplace so that clients do not have to attend meetings. In sparsely populated rural areas the frequency of the loan officers visits can be reduced to weekly or in some cases monthly, and should be scheduled for convenience.

In Namibia, micro-lenders have very strong loan delinquency control systems. They determine loan eligibility by proof of employment and a bank account. In some cases, borrowers provide the micro-lender with a bank card and a personal identification number (PIN), who then withdraws payments according to the loan contract after each wage or salary deposit is made by the employer into the borrower's bank account. Some of the large micro-lenders have direct access to government employees' payroll so enforcement costs of loan repayment is low (unless the borrower resigns from government, which then makes them difficult to locate).

To reduce the costs of group collection strategies, microfinance institutions utilise maximum delegation with all the main activities relating to the collection of savings and issuing and collecting loans being done in the field by junior staff. They also utilise maximum standardisation with junior staff using electronic disbursement and collection systems where they cannot apply any discretionary powers in decision-making. It is argued that this prevents rent-seeking behaviour (Robinson, 2003).

To enhance the maximum delegation and standardisation principles in loan disbursement and savings collection, microfinance institutions in Namibia could explore the outsourcing of disbursement and collection services to the Government Institutions Pension Fund (GIPF) for a fee. The embedding of disbursement and

collection services in existing processes used by the GIPF to disburse pension remittances would enable microfinance institutions to benefit from the GIPF's outreach, which is wider than any other existing financial institution in Namibia, including NamPost. This can be achieved by utilising the pension distributor's electronic disbursement machines to disburse loans and collect mobilised savings. Sharing of the distribution network in this instance, will require the remittance disbursement equipment to be redesigned and can be done at the expense of the microfinance institutions, donors or the government.

Some microfinance models utilise NGOs as intermediaries between microfinance institutions and their target group to reduce branch operating costs and their target groups' transaction costs by collecting loans from the microfinance target group on behalf of microfinance institutions.

The Commonwealth Youth Credit Initiative (CYCI) has an institutional model conforming to this design. It envisions NGO delivery where the loan fund is managed, loans are distributed and training is provided by an NGO (Directorate of Youth Development, 2005). However, it is cited that MPCMs will conduct the function that was envisioned for NGOs in field implementation (NASSP, 2005a).

Other models advocate that NGOs have a role to play in mediating contacts with commercial banks, depositing savings of microfinance institutions with commercial banks, negotiating bank loans for microfinance institutions for on lending, entering into loan contracts with banks as the legal borrower and on lending to microfinance institutions e.g. Seibel in Indonesia. These methods were applicable before the microfinance revolution, which views the role of NGOs in microfinance as transitional and aimed at developing sustainable institutions that are able to address potential barriers by combining training, technology and innovation (Robinson, 2003). However, where intermediating NGOs are still operational, it is important that they respect the autonomy of existing institutions and try to work through them.

2.4. Information

The microfinance target group is characterised by informational opacity. This can be attributed to the fact that they are typically new entrants to the formal sector and lack any credit history or formal records. Even where they keep records these are mostly incomplete or inaccurate (Stork, Tatalife & Adongo, 2005).

This opacity results in information asymmetry between the providers and beneficiaries of microfinance. Asymmetric information results in adverse selection and moral hazard, which are two factors that contribute to credit rationing. This is well-documented and evidenced in monetary economic literature (Diamond & Dybvig, 1983).¹²

¹² The imperfect information paradigm is explored in Herath (1996) and Aryeety & Urdu (1994).

To reduce imperfect information in the microfinance sector, the public sector has implemented various tools to combat what is viewed as market failure. One of the main instruments used is a credit guarantee scheme. The aim of such a scheme is to reduce the net losses incurred by banks from defaulting small business borrowers, through the assumption of a share of this loss by the guarantee organisation, normally in return for a guarantee premium. The existence of such a scheme should increase the supply of credit to small firms, if accompanied by reduced target group risk and lower institutional costs (Graham Bannock & Partners, 1997).

In Namibia, the guarantee organisation is the Small Business Credit Guarantee Trust (SBCGT), which is governed by the MTI and guarantees up to 80% of the loan amount disbursed by commercial banks to the microfinance target group. The use of guarantee mechanisms as an indirect support for funding NGOs and other institutions on-lending to micro-enterprises (Graham Bannock & Partners, 1997) is not common in Namibia.

Although the aim of the SBCGT is to mitigate risks for banks lending to the microfinance target group, it essentially subsidises loans, which contributes to credit rationing. Due to this, the design and implementation of such a scheme is important. Evidence shows that well-designed and managed schemes that match incentives and costs to responsibilities are crucial for success (Graham Bannock & Partners, 1997).

Some argue that the current design of the SBCGT promotes low loan repayment (DCD, 2004). This could be because it creates a disincentive for financial institutions to adequately screen and utilise loan delinquency control systems. In addition, credit guarantee schemes may increase the cost of the credit assessment and monitoring, if the risk and/or cost of lenders do not decline because they are an additional administrative burden to the lending process (Graham Bannock & Partners, 1997).

Furthermore, if those outside of the microfinance target group are allowed access to the SBCGT, it prevents them from having widespread access to available loans. This can be viewed as a case of the public sector crowding out the private sector in the credit market. To avoid this, the SBCGT should be limited to those who are ineligible for loans from the formal financial sector, as a transitional development tool to make them eligible for such loans at a later stage. This is because these schemes use scarce donor and government funds that would be better spent on other instruments in the poverty alleviation toolkit (Robinson, 2003).

Recently reports have indicated that the SBCGT intends to expand its product base to include the direct provision of savings and loans products to the microfinance target group, in addition to the credit guarantee scheme (Tjaronda, 2005). This is similar to the Khula Equity Fund in South Africa, which is under its Department of Trade and Industry (www.khula.org.za). The SBCGT should be careful that in

providing savings and loan facilities to the microfinance target group they do not crowd out private microfinance initiatives (DFID, 2004).

Furthermore, the assessment procedures to establish that a case of default is not due to negligence of the financial institution before guarantee claims are settled by the SBCGT may take a long time and create delays before the loan loss provision of commercial banks are covered. This could result in reluctance by financial institutions to lend to the microfinance target group.

Another instrument that the public sector uses to reduce the adverse effects of the perceived market failure arising from information opacity is that of directed credit requirement policy. This can be in the form of explicit policy directives or implicit pressure on financial institutions to allocate a portion of their credit portfolio to the microfinance target group. Despite the vast amount of evidence showing that most institutions providing subsidised credit fail (Robinson, 2003), it is not uncommon for a case to be made that the benefit of credit quotas and lending targets outweigh the costs when they are targeted towards sustainable micro-enterprises. Although this is important from a development policy perspective, the overall funds are not invested in the most profitable way and increase the probability of overall portfolio losses.

2.5. Ability to Assess Credit Applications

The provision of financial services in general and microfinance in particular involves an assessment of the probability that borrowers will keep their promises to repay the principal and interest on time, and, in the case of micro-enterprises, have the experience to run a particular operation. This function is performed by credit officers.

Unfortunately, a constant finding in many surveys aimed at assessing the quality of microfinance staff is that they have limited if any previous experience in credit analysis (Hulme & Mosley, 1996b and Mukama, Fish & Volschenk, 2005). This situation is exacerbated by the fact that the microfinance target group typically lacks any credit history or complete records, as highlighted in earlier paragraphs. Therefore, even where loan officers have experience in credit analysis they usually cannot apply this knowledge to analyse non-existent or unrealistic cash-flow statements.

The two chief innovations of microfinance that are designed to overcome this barrier i.e. loans to groups, whose members use their social capital to screen out bad risks and loans to individuals, whose loan officers get to know them well enough to screen out bad risks rely fundamentally on qualitative information kept in the heads of group members or loan officers (Robinson, 2003). However, the inherent subjectivity of this leads to criticisms that financial institutions do not use appropriate financial technologies necessary for appraising and monitoring microfinance credit applications (Ministry of Trade and Industry, 1998).

To improve the ability of microfinance institutions to adequately assess microfinance credit applications, various methods are advocated.

The first focuses on skills development. Bookkeeping training is provided by commercial training providers or NGOs to micro-enterprise owners. This is accompanied by mentorship support aimed at promoting the practice of keeping proper and accurate records, e.g. the SME Mentorship Initiative provided by Bank Windhoek to those who qualify for their Emerging Small and Medium Enterprise Loans. In addition, training on financial statement analysis is usually provided to loan officers to improve their skills in analysing cash-flow statements.

The second focuses on shifting towards more objective methods of assessing credit applications. This is represented by the adoption of small business credit scoring tools by microfinance institutions. These tools utilise the information on the performance and characteristics of past loans, stored in electronic databases, to derive a statistical model that creates a formula. This formula puts weights on different quantitative and qualitative characteristics of borrowers, lenders and loans and produces an estimate of the probability or risk of default on current loan applications with similar characteristics (Latimer, 1995).

Evidence from Bolivia and Colombia suggests that the adoption of small business credit scoring tools for microfinance improves the judgement of risk by complementing existing microfinance credit assessment technologies (Schreiner, 2000). The replication of similar benefits is dependent on addressing the obstacle arising from inadequate data collection and management among microfinance institutions (Hulme & Mosley, 1996b and NASSP, 2005a). This is because the robustness of the small business credit scoring tool relies on the availability and accuracy of the collected information that is used to develop the statistical model.

In addition, the small business credit scoring tool needs to be incorporated into the current credit assessment process. This may require an organisational adjustment to accept a technique so fundamentally different from what is currently being used to assess credit applications (Schreiner, 2000). Currently micro-lenders in Namibia use an off-the-shelf product known as Compuscan Credit Check to assist them in their credit assessment processes (www.compuscan.co.za).

2.6. Perceptions

There is an inaccurate perception that the microfinance target group do not save because monetisation in their environment is low. However, evidence collected over more than 30 years shows that savings are extensive in low-income economies. Microfinance institutions frequently find that there is a huge demand for the savings facilities that they provide (Robinson, 2003). In Namibia the SACCOs and MPCMs supported by RISE mobilised NAD 568,618 in 2003 (DCD Database), while Koshi Yomuti mobilised NAD 25,708 in 2004 (NASSP, 2005a).

These savings are originally in the form of cash, agricultural commodities and domestic animals due to the lack of access to facilities to store their savings.¹³ The provision of savings facilities by microfinance institutions increases the probability that these assets are monetised (Robinson, 2003).

There is also the inaccurate perception that the microfinance target group prefer to save in the informal financial market. However, in Namibia, the use of informal financial services in a representative sample of 800 people was limited to 12% (FinMark Trust, 2003).

Another perception is that only specialised financial institutions can cater suitably to the microfinance segment. However, evidence shows that access to financial services at suitable cost and convenience is the overriding factor in the choice of where the microfinance target group chooses to save. Informal alternatives such as rotating savings and credit associations, savings collector, etc., are viable alternatives only where formal savings, credit and insurance services (microfinance) are still at a low level of development. Evidence exists indicating that the provision of savings facilities by microfinance institutions attracts savings out of the informal sector. In fact, moneylenders also use the facilities provided by microfinance institutions to store their surplus funds as in the case of SAFESAVE.

The microfinance target group typically have small, irregular cash-flows and spend a large proportion of their income on basic necessities (Robinson, 2003 and Mukama, Fish & Volschenk, 2005). This leads to an inaccurate perception that they are not a viable credit market because the volume of loans they generate is not adequate for the cost incurred to provide it. This is attributed to the view that “penny economies” do not generate enough business volume to be attractive to banks (Bouman, 1988). However, in 2004 the microfinance institutions included in this report disbursed a total of NAD 341.5 million, as mentioned earlier. The SACCOs and MPCMs supported by RISE contributed approximately NAD 443,000 of this total. Koshi Yomuti accounted for NAD 345,550 of this total. The rest was attributed to micro-lenders. This is illustrated in Table 3 below.

Despite the substantial amount of credit disbursed by micro-lenders in Table 3, Legiovini’s (2002) study for Nicaragua shows that cash loans although effective for strengthening growth prospects in the overall economy are not good policy instruments for reducing poverty (Honohan, 2004).

Another perception is that credit provided to the microfinance target group will not be used for productive purposes but rather for consumption to meet basic necessities. Although this may be true below a certain threshold, evidence shows that even above this threshold, external factors such as lack of access to land or water are

¹³ Monetary economic theory covers the various financial forms that are found in the microfinance target group in the context of discussions that focus on the introduction of money (Mishkin, 2001 and Ghatak, 1995).

constraining factors. If these are addressed loans can be used for productive purposes (Rosengard, 2001). Dysfunctional land ownership structures in the context of commercial versus communal land ownership rights in Namibia, is a relevant issue here. On a positive note, the Married Persons Equality Act of 1996 partly addresses the inequality issues arising in the context of property ownership at the household level (Department of Women Affairs, 1997).

Table 3: Nominal Amounts of Loans Mobilised by Microfinance Institutions by Category

Category	Total Loans in NAD	Share (%)
Micro-lenders	340,191,734	99.7752
SACCOs and MPCMs supported by RISE*	420,961.90	0.001235
Koshi Yomuti	576,900	0.001013
TOTAL	340,958,246	100

Note: *as at end of 2003

Source: RISE (2005), NASSP (2005a), DCD and NAMFISA databases,

Furthermore, there is the inaccurate perception that the microfinance target group cannot afford higher interest rates. This has led to the subsidisation of interest rates or the establishment of credit quotas and lending targets to the target group. Besides their distortional effect on the microfinance market mechanism, subsidised interest rates result in inaccurate budget plans resulting in the inability of microfinance institutions to cover their costs. This increases their insolvency risk in high inflation environments and makes the desired level of microfinance outreach unattainable. Subsidising interest rates should be a last resort especially when evidence exists that loans to micro-enterprises can generate more deposits and be more profitable than to larger enterprises (Churchill & Lewis, 1985 in Barber, Metcalfe & Porteous, 1989).

In Namibia, SACCOs and MPCMs charge an annual nominal interest rate of 35% on loans under six months while all other loans are disbursed at an annual nominal interest rate of 30%. Koshi Yomuti, charges 34% on micro loans taken over four to five months while micro loans taken over one year are charged an interest rate of 26% (NASSP 2005a). Therefore, subsidised interest rates do not seem to be an issue for this category of microfinance institutions.

Finally, there is the institutional bias among financial institutions that view other areas such as corporate or international banking as more prestigious than microfinance. This leads to a lower priority being given to the development of microfinance products by financial innovators (Robinson, 2003).

Fortunately, microfinance has not been forgotten and various innovations have allowed the debunking of the myths described above. The focus of these

innovations has been on increasing access and convenience while reducing the costs of microfinance products.

Microfinance institutions focus on providing loan schemes that are compatible with the cash-flow generation of the microfinance target group. Prior to eligibility for loans some microfinance institutions require potential borrowers to be members for at least two months. This is necessary to reduce information opacity and to circumvent the unsuitability of collateral obstacles described in earlier paragraphs. During such time it might be beneficial for the microfinance institution to provide life and entrepreneurial skills training and then provide access to loans as a reward for completion. This should reduce the possibility of the pre-loan time period being viewed as a penalty.

Once eligibility for loans is attained some microfinance institutions allow withdrawal up to a certain limit as a form of prudential supervision. These include withdrawal up to the limit of the savings balance of an individual (1:1 ratio), or multiple savings to loans ratios such as 1:4. Other proposed prudential measures in Namibia include limiting each member's eligible loan amount to not more than 10% of the loan portfolio and limiting loans of a group's board members to not more than 20% of the savings portfolio (DCD, 2004).

In addition, loan sizes typically start small and graduation is determined by loan repayment history and savings balance. However, it is reported that in some cases that graduation is determined by factors such as land tenure rights and the economic activity in the area, rather than proof of no moral hazard (Hulme & Mosley, 1996b).

In some cases there has been a realisation among microfinance institutions that the majority of loans requested usually exceed the current value of the savings balance for most low-income households and micro-enterprise owners, that a portion of loans issued for productive purposes are used for consumption and that most of the microfinance target group may go to great lengths (including borrowing from informal moneylenders) to ensure repayments, when confronted with a crisis or shock (CGAP, 2000a).

This has led to a push towards more voluntary flexible loan products to enable the microfinance target group to have access to the loans that they prefer at any time, and prevent them from reverting back to informal moneylenders to adhere to the rules of microfinance institutions (or other informal sources because the use of informal moneylenders is not widespread in Namibia). In Namibia, microfinance institutions allow their clients, who are eligible, to take loans on demand and use them for whatever purpose they choose.

Flexibility in the loan product can also refer to the flexibility in repayment schedules. MPCMs and SCAs have weekly loan repayment schedules while SACCOs in Southern Namibia have monthly repayment schedule. In the case of micro-lenders the flexibility of the repayment schedule term ranges from one to six months or even

three years. For SANASA in Sri Lanka, which pursued a more long-term repayment schedule, the only requirement was that borrower's pay the interest portion on the due instalment date as opposed to the full amount - principal and interest (Hulme & Mosley, 1996b).

Finally, to increase the amount of loanable funds to the microfinance target group, institutions such as SAFESAVE allowed multiple loan accounts from the same low-income households.

There has also been a realisation that the microfinance target group requires savings products that are secure, convenient, and confidential and are provided promptly by friendly staff (Robinson, 2003). Microfinance institutions have embraced this challenge by shifting from inflexible 'forced savings' that deduct a portion of the disbursed loan (which increases the effective rate of interest on the loan) and not allowing savings to be withdrawn while a loan is outstanding unless it is to repay the loan in full or keep savings as equity (DCD, 2004); to voluntary savings schemes that allow individuals to open accounts (even if they are not organised into groups), which are easily accessible, allow the microfinance target group to deposit and withdraw whenever they want, and save in whatever amounts and without borrowing, at a low cost.

In Namibia, the MPCMs supported by RISE encourage savings for an initial period before group members are eligible for loans. Koshi Yomuti on the other hand has a weekly and fixed deposit savings product that members are encouraged to use from the onset of joining the group (NASSP, 2005a).

Despite evidence from Indonesia showing that savers prefer convenience and safety to returns as indicated in earlier paragraphs, some microfinance institutions use tiered interest rates on savings to account for high transaction costs. The payment of interest prevents criticism of paying interest to rich savers and not to poor ones. Others provide a package of two or three products that provide different ratios of liquidity and returns so that savers can customise their use of the products according to their needs.

Other microfinance institutions such as SAFESAVE and Bank Rakyat Unit Desa, in Indonesia, have allowed savings accounts to be held in the name of a group, organisation or institution, which does not apply to individual savings deposited in a group account. This has helped to improve the security, accountability and management of group funds and has greatly decreased opportunities for rent seeking, allowed groups to earn a return on their idle funds and strengthened the audit function. Group savings accounts will be introduced by the SBCGT in Namibia and should have the same effect (Tjaronda, 2005).

As part of the microfinance revolution, other microfinance institutions have begun to increase their target group beyond microfinance to the general public as opposed to collecting savings only or mainly from their members. Although Koshi Yomuti aims to move in this direction, currently such microfinance institutions do not exist in

Namibia. The pursuit of this strategy should result in larger average savings account sizes, which will reduce per unit administrative costs and increase the volume of funds for small loans.

To increase the probability that microfinance institutions will overcome the obstacle created by their relatively higher operating costs, microfinance institutions have begun to implement models that relate to financial intermediation - linking savings and credit within a single institution by mobilising deposits and lending these out to creditworthy borrowers in a profitable way, e.g. Seibel. This allows them to take advantage of the economies of scope and synergies that exist between savings and loans (Hannig & Wisniwski, 1999).

In the absence of preventive regulation, some microfinance institutions begin with savings services, some start with savings and loans together and others add savings services to existing credit services. Assuming that the microfinance institution is registered and there is appropriate regulation and enforcement capacity to ensure adherence to prudential regulation aimed at depositor protection, products should be introduced gradually and carefully if they are to be as successful as desired, otherwise the institution will not have the capacity to provide the promised services to clients, and stands to lose the trust of its clients and eventually its own viability.

More importantly, before being allowed to mobilise savings, a microfinance institution should have reliable well-trained owners and managers, who have demonstrated reliable, effective governance and consistently good financial management, moreover the institution should be financially solvent with a high rate of loan recovery, regularly earning good returns (Robinson, 2003). This will ensure that the savings of the microfinance clientele are not put at risk.

If innovative microfinance products and delivery systems are to be successful, they should be designed in such a manner that they reduce cost while increasing access, flexibility and safety. This should result in their potential to be more responsive to demand and to serve a wider target group on a larger scale in the different environments where the microfinance target groups reside. Examples are flexible savings and insurance, housing, education and emergency loans (Robinson, 2003). Commercial banking literature and practice has a wealth of information that would greatly assist the microfinance field in identifying and adapting products that can suit clients that conduct transactions on a smaller scale.

If microfinance products and delivery systems are successfully designed they can allow microfinance institutions to capture market share from informal financial providers, NGOs and commercial banks in the microfinance segment.

The microfinance target group requires products that provide security, convenience, liquidity, confidentiality, access to credit, good service and returns (Robinson, 2003). Informal providers do not normally provide a combination of these characteristics, e.g. moneylenders provide easy access to credit but at high cost. In fact the

informal market may actually make use of microfinance products such as in the case of SAFESAVE, where their savings product provided a small informal moneylender with a much easier way of handling her lending business (CGAP, 2000b).

In addition, the flexibility provided by microfinance products can also displace group-based NGO microfinance schemes that may have procedures which, although justified, are inherently rigid.

Finally, the microfinance target group conducts transactions on a small-scale. Therefore they are generally ineligible for commercial banking products that require higher opening balances than they can amass, which even if they can, are below the minimum for interest payments. In addition, banks in Namibia are frequently criticised for high retail banking charges by consumers (Adongo & Stork, 2005). The effect of these charges will be exacerbated for the microfinance target group, which typically requires the option of frequent withdrawals at low cost. Credit unions (MPCMs and SACCOs) and village banks (SCAs) are microfinance institutions that provide a cheaper, alternative savings option, even in developed countries (Curry, 1999).

2.7. Independence

One of the key components of successful microfinance institutions is their independence. In addition, to allowing them to stand on their own, it is important that microfinance institutions run their affairs without influence from donors, government or large-scale enterprises. This is quite a challenging task because of the high priority given to improving the livelihoods of the microfinance target group by both donors and government and their dominance in microfinance development in Namibia.

Donors are criticised for being prone to fads (Robinson, 2003). This can be destabilising for long-term country programs to improve livelihoods. Therefore, microfinance institutions need to balance donor demands with the long-term strategies of improving livelihoods [that may already be in the process of being implemented] (Hulme & Mosley, 1996b). One of the ways that has been proposed to resolve this issue in Namibia is utilising a development fund manager, to act as an interfacing agent between donors and their microfinance beneficiaries, to handle disbursement of development finance to NGO intermediaries or directly to [microfinance institutions] (Cloete, 2004). According to the microfinance charter for good practice, the National Planning Commission (NPC) was envisioned as the body that would potentially manage donor funding and relations for the microfinance sector (RMFTT, 2004).

In some cases, links of directorship, joint ownership or other common financial or political dealings could cause institutional bias on the part of microfinance institutions towards lending to the corporate sector or firms with ties to politicians.

In a case study of SANASA in Sri Lanka two characteristics identified that could contribute to independence are (Hulme & Mosley, 1996b):

- Grouping of donors into a consortium and creating long-term relationships with key donors;
- Effective internal management arising from distance from government ... and the management of external relationships including avoidance of contacts with politicians and politically active officials.

Independence from external influences can be strengthened by adopting sound, transparent portfolio management practices. This can be achieved by the extensive use of robust loan assessment and tracking information systems to prevent contamination of the loan portfolio (Levitsky, 1993).

2.8. Institutional Factors

In addition to the factors discussed above, many microfinance institutions are plagued by system related problems such as fraud, lack of appropriate staff incentive schemes, inability by staff to interpret product rules as intended, unclear ownership structures, lack of enough capital to lend to clients and inadequate donor funding, i.e. for those that still rely on donors to subsidise costs of their loan portfolio (Mukama, Fish & Volschenk, 2005).

In the case of SACCOs and MPCMs, although savings are the entry point for members, the savings policies and practices have not been focused on and are distorted to support low-interest loan policies. This practice is not unique to co-operatives in Namibia and leads them to suffer from liquidity problems that are exhibited by their inability to generate capital rapidly enough to meet member demands. This can result in credit rationing which can be in the form of queuing, where loan applications are processed as funds become available or limiting the member's loan to a relatively low multiple of the amount of saving (low savings to loan ratios). This constraint can be lifted by co-operatives providing better designed savings products (Magill, 1994).

In addition, microfinance institutions may be plagued by poor loan delinquency control and weak portfolio management systems, thereby hindering their ability to assume the risk involved in large-scale provision of microfinance. This is exacerbated in an unclear regulatory environment where it is more complicated to provide more advanced microfinance services (notably checking) that more sophisticated clients need.

Furthermore, SACCOs and MPCMs are associated with conservatism and highly traditional organisations that do not have a modern growth and service-oriented philosophy (Magill, 1994). As a result they are associated with a lack of progressive product design capabilities and marketing strategies that can allow them to design

attractive microfinance products that meet their members' needs as well as identify and target their clientele.

2.9. Standards and Regulation

The benefits of microfinance are dependent on the standards of microfinance provision. This requires that the institutions are registered and qualified and that microfinance industry regulation exists and is appropriate - or is not enforced if inappropriate (Robinson, 2003).

In Namibia, the microfinance practice has seen the widespread adoption of industry standards advocated by CGAP. Practitioners advocate the use of Generally Accepted Accounting Principles to maintain accounting standards (DCD, 2004). In addition, co-operatives involved in microfinance are required to adhere to a set of internationally accepted rules concerning regulation and supervision at the institutional level. This includes performance and monitoring systems such as the prudential standards for excellence developed by the World Council of Credit Unions (WOCCU). These focus on **Protection**, **Effective financial structure**, **Asset quality**, **Rates of return and cost**, **Liquidity** and **Signs of growth** – PEARLS (WOCCU, 2002) .

Microfinance in Namibia is governed by a myriad of institutions that either fall under government control or are independent. These governing bodies ensure compliance with regulation that focus on issues related to interest rates, capital requirements for opening an institution, requirements for opening branches or setting up groups, capital adequacy ratios, liquidity ratios, accounting standards, auditing standards and reporting requirements (Robinson, 2003). This regulation affects NGOs, commercial banks, state-owned microfinance institutions, micro-lenders, MPCMs, SACCOs and SCAs.

In Namibia there is no specific NGO Act. NGOs that are involved in the direct provision of microfinance are regulated under Section 21 of the Companies Act of 2004, which permits the formation of associations that are not for gain, under the Namibia Trust Monies Protection Act of 1934, or under the Friendly Societies Act. Governance is normally left to their funding agencies. The only extent to which government policy affects NGOs in Namibia is through limiting conventions such as prohibitions from mobilising saving, and whether or not they obtain tax exemption from the Receiver of Revenues.

Currently, the government is in the process of consulting with civil society organisations to develop a partnership policy, which calls for a review of the current laws and regulations affecting NGOs. This review will be undertaken by an Advisory Committee composed of government representatives and NGOs under the National Planning Commission Act of 1994. The goal is to formulate a Registration Act that will harmonise and consolidate existing laws regulating NGOs and establish a transparent registration process under the control of a single agency. This future statute aims to establish minimum criteria for competence and governance, enhance

transparency and accountability, and improve coordination within the NGO sector. Its design will respect the independence and autonomy of “genuine” organisations. It also proposes voluntary registration, based on the premise that registration and a legal status will enable NGOs to attract more donor funds.

The review will decide on the extent to which registration of NGOs may be decentralised, it will also decide on the extent that NGOs, through voluntary codes and a representative body such as the Namibia NGOs’ Forum, may be permitted to participate in self-regulation (Human Rights Watch, 2004).

The Bank of Namibia (BoN) regulates the activities of commercial banks involved in microfinance provision through the Banking Institutions Act No. 2 of 1998. This Act creates a framework for the regulation and supervision of businesses accepting savings from the general public in order to protect depositors and the integrity of the banking system. It ensures that banks do not put depositors’ savings at risk as they pursue microfinance lending opportunities. The Banking Institutions Act recognises co-operatives as institutions that are allowed to mobilise savings.

State-owned institutions involved in microfinance are regulated by their own independent statutes. AgriBank’s microfinance activities are regulated by AgriBank Act No. 5 of 2003. NamPost is regulated under the Post and Telecom Act No. 19 of 1992.

NAMFISA governs micro-lenders in Namibia by mainly ensuring compliance with the interest rate ceilings stipulated in the Usury Act of 1968 as amended by the Government Gazette dated August, 6 2002. Even though they are registered and governed by NAMFISA, micro-lenders in Namibia are still prohibited from mobilising savings.

In many countries, the regulation that affects financial sustainability the most is the Usury Act. The interest rate caps set by this Act are to protect borrowers. However, interest rates required for a microfinance institution to be financially sustainable are quite high in nominal or real terms, and are way beyond the ceiling imposed by Usury Acts.

In the short-term, Usury Acts are necessary. As the microfinance industry becomes more developed and competitive, laws that encourage self-regulation based on transparent information that borrowers can then use to choose the microfinance institution whose services they would like to use, can be introduced to complement the Usury Act. This will ensure that regulation promotes practices that work with the grain of the market, and not against it, in both a static and dynamic sense (Graham Bannock & Partners, 1997).

The DCD which falls under the MAWF and the Registrar of Co-operatives regulate SACCOs and MPCMs based on the Co-operative Act of 1996. This Act stipulates that each co-operative cannot have less than 7 members. In addition, co-operatives have management structures consisting of a chair, secretary and treasurer. A

constitution articulates the member's shared vision and guides member practices (RMFTT, 2004).

The SACCOs and MPCMs are governed by Regional Farmer's Co-operatives, which are responsible for actively monitoring performance, setting targets and deciding interest rates (NASSP, 2005a). These apex bodies obtain 70% of each MPCM and SACCOs interest income to cover the costs of providing these activities. This income is deposited with AgriBank.

Below these governing organs, a Training and Monitoring Unit has been specially created. Its promoters are funded by RISE. Its objective is to monitor adherence to loan policies, provide computerised monthly reports, assist MPCMs and SACCOs to determine repayment rates, allocate interest income for various uses and co-ordinate their operations in three regions in northern Namibia.

The MTISC governs Koshi Yomuti under the SME promotion program of the MTL. Current plans are to register it under the BoN as a bank where it will be regulated under the Banking Institutions Act. As opposed to the apex body governing MPCMs and SACCOs, which is supported by co-operative interest income, the apex body governing Koshi Yomuti is supported by donors. Based on best practice, Koshi Yomuti may revert to the model used by MPCMs and SACCOs to free up donor and government resources for other purposes in the long-term.

The reason why Koshi Yomuti has to register as a full-fledged bank is because there is currently no recognised legal status for microfinance institutions that would like to scale-up and provide microfinance to a wide clientele, yet does not wish to become conventional, full-service commercial banks. The existing legislation requires that no other organisation, except commercial banks can collect savings if they consist of more than 20 members. This restriction leaves MPCMs, SACCOs and SCAs with more than 20 members and less than N\$ 10 million (the current minimum to register as a commercial bank) in legal limbo. To overcome this barrier, SACCOs, MPCMs and SCAs are exempted on condition that they are registered by the Registrar of Societies and are governed by the DCD.

Also, the Ministry of Youth, National Youth Service, Sports and Culture, through a Management Advisory Board, governs the CYCI by providing strategic advise, coordinating its activities and ensuring compliance with the Co-operatives Act.

As microfinance institutions move towards a large-scale financial intermediation model, their registration, the quality of their regulation and the capacity of the regulatory body, must be addressed.

A first attempt to establish a unified, legislation for the microfinance sector is represented by the Microfinance Charter for Good Practice. The creation of this charter was driven by the DCD and was signed by the MTI, Ministry of Finance, MAWF, BoN and NPC. It supports the financial systems approach and institutions advocated by the proponents of the microfinance revolution. In addition, the Charter

supports the need for adherence to the common guidelines set by CGAP and the pursuit of a co-ordinated approach in efforts to boost the effectiveness by all stakeholders involved in the provision of rural microfinance (RMFTT, 2004). To cater to demands for prudential regulation, it endorses a required reserves level of 20% (DCD, 2004).

The microfinance charter proposes an inter-ministerial steering committee to govern the microfinance sector, comprising of the various signatories, except the NPC, which it recommends should be responsible for co-ordinating donor support. In addition, a technical committee has been proposed to promote the model advocated by the microfinance revolution (RMFTT, 2004).

As more entities begin to provide microfinance services to the microfinance target group and boundaries become blurred, regulation will become more and more important to prevent fraud. It will be important to create awareness among individuals who want to conduct transactions with microfinance institutions, that they should only do so with a regulated one. Currently NAMFISA is actively putting notices in the daily newspapers warning members of society that they should only conduct transactions with micro-lenders registered with them. The DCD should also begin to create awareness among SACCO and MPCM members, that they should only join registered co-operatives. This will ensure that they do not become victims of fraud (Big Issue Team & National Centre for Research on White Collar Crime, 2005).

This regulation should be flexible and not too cumbersome and prohibitive, so that informal microfinance institutions can find it easy to legitimise their status and be attractive to remain in the formal sector (Levitsky, 1993).

In countries such as Greece, regulation of the microfinance industry falls under the central bank. This regulation includes setting the operational and supervisory framework concerning village banks, which encourages the commercialisation of microfinance and strengthens the outreach capacity of existing institutions (ICEG, 1999a and Kamberoglou, Liapis, Simigiannis & Tzamourani, 2002). Replication of this regulatory structure in Namibia could require a review of the Banking Act to add additional clauses that cater to the difference between microfinance and commercial banking service provision. This will ensure that the rules for microfinance institutions are suitable for their activities and that the supervisory body is able to monitor these institutions effectively. Examples of this include the adaptation of prudential criteria to suit microfinance operations by classifying loans with group guarantees as secured, placing microfinance institutions in a lower risk category for capital provisioning, and streamlining staffing and reporting requirements (ICEG, 1999). This is an option in efforts to create a regulatory framework that allows the scaling up of microfinance institutions as envisioned by Robinson (2003).

3. DEMAND SIDE

Issues arising on the demand side include, but are not limited to the level of formal sector knowledge, legal status, collateral, risk, ability to meet basic necessities and the pecking order hypothesis.

3.1. Level of Formal Sector Knowledge

The microfinance target group has strong survival skills, shrewd business sense and long experience of hard work, knowledge of their markets, extensive informal support and communication networks and a fundamental understanding of flexibility as the key to survival (Robinson, 2003). Although these features are crucial to operating in the informal sector, an additional set of skills are required to access financial services and run enterprises in the formal sector.

Due to the nature of the formal sector, accusations arise that its procedures and regulations are a factor contributing to the persistence of the microfinance gap. This is exhibited in many surveys that find that one of the main constraints cited for not receiving credit from formal financial institutions, is that of complicated loan application procedures (Ministry of Trade and Industry, 1998).¹⁴

In Namibia, the submission of business plans is a requirement of all microfinance credit applications to commercial banks. This requirement is identified as a constraining factor in survey findings. Financial institutions accuse these business plans of lacking clarity, being unfeasible or lacking adequate market research. These weaknesses, when coupled with the absence of a verifiable track record in business success, result in the inability of micro-enterprise owners to convince financiers of their potential (Reid, 1993). In addition to these factors, many micro entrepreneurs are overoptimistic and underestimate the amount of capital they need, which could be an additional source of under financing (Rhodes, 1984 in Barber, Metcalfe & Porteous, 1989).

Although various attempts have been made to overcome these obstacles such as simplifying loan application procedures, as well as other administrative formalities that have a high opportunity cost for the borrower and using additional criteria besides business plans to assess credit applications, the microfinance gap continues to persist. Although, the literacy level (the ability to read and write) of the microfinance target group is high when compared to the national average (Premier Consult, 2005), this persistence can be attributed to the inadequate business

¹⁴ Other impediments to conducting business are measured in the Doing Business Surveys conducted by the World Bank.

education in the microfinance target group or lack of business skills (Mukama, Fish & Volschenk, 2005). It could also be simply due to the lack of knowledge of the diversity of options available to the microfinance target group that offer the financing they need.

The obstacle created by lack of knowledge on financing options and how to overcome the requirements of complicated credit application procedures can be reduced by the provision of ancillary devices in the form of entrepreneurial skills training. This should improve the competence of the microfinance target group to deal with formal sector loan criteria and increase their chances of convincing financial providers of their potential. In Namibia, this is being addressed by incorporating entrepreneurial skills training in the schools curriculum at an early age by promoting the courses offered by NGOs such as Junior Achievement Namibia (GRN, 1997).

3.2. Legal Status

Informal micro-enterprises are typically unregistered and operate from unauthorised business locations where financiers and investors cannot see them (Robinson, 2003). The lack of legal status hinders contract enforcement due to the inability to collect debts through the legal systems (which reduces the assurance that investments in micro-enterprises will not suddenly disappear). This could be a reason why the size of individual loans offered by microfinance institutions are small relative to those offered by other formal sector financial institutions such as commercial banks. It could also be a reason why the nature of transactions in the microfinance segment is limited to narrow local circles where people know and trust each other.

In a non-representative sample of 337 businesses in Namibia, 24% were sole proprietorships, as illustrated in Table 4 below. This implies that a large number of the businesses registered may be sole proprietorships.

Table 4: Number of Full –Time Employees for 337 SMEs in Namibia in 2004

Employment Size	No. of Businesses	Share (%)
0 (only business owner)	80	23.74
1	74	21.96
2 to 5	166	49.26
6 to 10	15	4.45
11 to 15	2	0.59
Total	337	100

Source: Grossman, Mwatotele, Stork & Tobias (2005)

To the extent that sole proprietorships are unincorporated, the owners of these micro-enterprises cannot sell shares in their businesses, cannot attract investment due to their undefined liability and cannot benefit from tax incentives offered to corporations (De Soto, 2000).

Reducing obstacles to registration, educating micro-enterprise owners on the benefits of incorporating and training on corporation tax management should contribute to reducing the microfinance gap.

3.3. Collateral

Financial institutions require security when providing credit. For large financial institutions, this is usually requested in various forms including personal guarantees, life insurance policies, floating charges e.g. notarial bonds on movable assets such as plant, equipment and stocks, heritable securities such as fixed property, land or financial market assets (Reid, 1993).

However, the microfinance target group typically lacks marketable assets that are suitable to be used as collateral to access credit from these institutions. Their assets consist of houses, farms, businesses, which lack legal title and cannot be used as collateral to access credit.¹⁵ In Namibia, this is exacerbated by the existence of communal land rights in Northern Namibia, where the majority of the microfinance target group resides.

The lack of suitable collateral is one reason why policies aimed at providing microfinance to low-income households and micro-enterprises end up benefiting the non-marginal, small and medium-scale segments of the enterprise spectrum that have the form of collateral desired by financial institutions.

Even where the microfinance target group has substantial marketable assets on which notarial bonds can be issued, there is no mechanism in place to guarantee that the value of the bond is retained if the underlying collateralised asset is sold by the credit beneficiary (Stork, Tatalife & Adongo, 2005).

Through best practices shared over the years, microfinance institutions have engineered several innovative ways to overcome the obstacle created by a lack of suitable collateral.

Firstly, microfinance institutions have reduced the barrier by requiring that a certain portion of an approved loan is retained in a fund.¹⁶ Although, various critics argue that this 'forced savings' practice generates a social cost to the borrower by raising

¹⁵ Hernando de Soto coined the term 'dead capital' to refer to these assets (De Soto, 2000)

¹⁶ In Namibia, SACCOs and MPCMs issue loans based on the amount of savings that members can mobilise during the pre-eligibility period. However 'forced savings' can allow the mobilisation of credit in an environment where the target group has no capacity to save at all.

the effective rate of interest, and goes against the democratic principle of freedom of choice, the benefit it creates works in the opposite direction.

Secondly, based on the Grameen Bank model, microfinance institutions have also created borrowing groups that provide joint collateral (Hulme & Mosley, 1996b). Group members use their joint savings as collateral for their individual credit needs. In other countries the group's savings fund, generated through 'forced savings', is not immediately accessible to group members and performs a prudential function that is similar to that of required reserves in the commercial banking system.

In Namibia, membership eligibility in SACCOs, MPCMs and SCAs, is restricted to a group of people who have some natural affiliation to one another. This is defined either as a closed or open common bond. Closed common bonds limit membership to a clearly defined group of people, e.g. employees of a given company, teachers, small employers, etc. In Namibia, examples of these closed common bonds are the street vendors and teachers co-operatives. Open common bonds are drawn from members from a geographical area rather than a specific group (Magill, 1994).

Thirdly, microfinance institutions, in addition to assessing loan applications based on the ability to pay criterion, advocate the disbursement of loans based on the reliability of a borrower assessed by her/his reputation in the community (RMFTT, 2004). This represents a shift towards the use of relationship lending credit assessment strategies used by commercial banks. The adoption of relationship lending strategies requires a mechanism to screen the potential borrower at the community level. The members in a co-operative can be selected by an external party or by the community itself. Although, a community-based screening mechanism is created when borrowing groups are formed independently, some organisations such as Seibel uphold the use of an NGO to fulfil this function.

The unavoidable existence of screening mechanisms provides a challenge to development practitioners to avoid accusations of discrimination by addressing the needs of those left out of independently formed borrowing groups, who are essentially the poorest of the poor that the microfinance programs do not reach.

Discrimination on the basis of gender is not a criticism that can be levelled on co-operatives in Namibia. Although, most of the members of co-operatives in Namibia tend to be older, and mostly women, none of these institutions are involved in any explicit gender or age targeting

This report views community-based screening mechanisms as an improvement on target group identification, with those excluded from independently formed groups as being the most marginal of the poor, as established by their community. Development practitioners should focus on developing suitable programs for this 'excluded group', which may involve the provision of ancillary devices that meet health and education needs.

All these solutions to overcoming the obstacle created by the lack of suitable collateral assist in the process of creating legally recognised assets among the microfinance target group, which may later be used to meet the demands for collateral by large financial institutions such as commercial banks.

3.4. Risk

The financial profession is conservative by nature and design, while the microfinance target group they aim to serve is riskier relative to other entities that do not fall into this category (Akingunola & Onayemi, 2005). This creates a source of conflict that results in a persistence of the microfinance gap.

Due to the relatively higher possibility that borrowers will not repay as promised because of moral hazard or reliance on products that have low yield and long gestation periods, as in the case of agribusinesses, formal financial institutions are less willing to enter into long-term commitments with the microfinance target group and prefer to limit their activities to financing working capital. This involves short, distant, relationships that are monitored through bank statements and involve a minimum amount of money.

Financial institutions protect themselves against the inherent risk of the microfinance target group by relying on collateral. However, due to the inappropriate forms of collateral held by the microfinance target group, as described in earlier paragraphs, additional ways of reducing the risk barrier have been devised.

First, microfinance institutions incorporate the inherently higher risk of lending to their target group by charging higher interest rates than those on similar products offered to clients that do not fall in the high risk category. Although, this is a source of criticism, the higher interest rates are justified due to the greater probability of loan default. In addition, although these interest rates are higher than the standard market rates offered by larger financial institutions, they are still attractive to the microfinance target group because they are typically lower than those charged by moneylenders operating in the informal sector, with which microfinance institutions compete.

Second, microfinance institutions use an incremental approach to loan disbursement, where borrowers start with small loans and increase the size of their loans gradually as their track record improves (Robinson, 2003). In Namibia, loan amounts typically start at 100 NAD and peak at 3500 NAD (NASSP, 2005a). An advantage of this is that smaller loan amounts ensure that a limited amount of funds can be spread wider to help more of the microfinance target group. In addition, when borrowers with good repayment records have reached the loan ceiling of a microfinance institution, they are often eligible for standard loans from commercial banks. This enables microfinance institutions to play a transitional role in moving

their target group to the more formal and larger sources of finance provided by commercial banks.¹⁷

Third, risk is mitigated by establishing incentives that reward prompt repayment. This strategy involves reducing the repayable amount by a certain percentage if payments are made before the due date. An alternative way used by SAFESAVE, which is a microfinance institution in Bangladesh, is to charge a small 'renewal fee' if loans are held over the due date (CGAP, 2000b). In Namibia, micro-lenders charge a flat, nominal interest rate of 30% on their loans, which are expected to be paid in one month. If the loan remains unpaid for 90 days a 5% penalty is charged. The use of incentives has been resisted in some instances, for instance in Malawi it was argued that the use of incentives drained the capital base for loans (Hulme & Mosley, 1996b).

Another incentive used, particularly by NGOs, is to disburse funds as loans and then transform them into grants if the project is successful. However, this strategy is reported to be ineffective as the borrowers view it as a grant anyway, which leads to high probabilities of loan default (DCD, 2004).

Fourth, based on the Grameen Bank model, shared risk methodologies are used by forming joint liability groups. This relies on the use of social collateral where group members apply pressure on each other to meet repayment deadlines for the mutual benefit of the group. In addition, independently formed groups apply an implicit mechanism that helps to reduce risk, where community members screen those they admit to these groups based on their own perceptions of reliability.

Despite its widespread promotion as a best-practice, not all microfinance institutions use the group lending methodology. Group success rests on self-formation and strong leadership, a relatively narrow and tangible range of services and motivation to maintain cohesion and organisation.

However, in some countries there is no historical or cultural basis for strong associations and donors' attempts to induce them to play an enhanced role in the market have often been unsuccessful. In some cases, groups have been plagued by difficulties such as externally founded groups, lack of cohesion and focus and proneness to capture. This leads to their frequent collapse through failure to retain members (Hitchins, Elliot & Gibson, 2005), such as in the case of the Likwama Women's Group in Caprivi (NASSP, 2005b).

For these institutions risk is mitigated by implementing a preliminary period before loan eligibility is granted. This is usually because the members of the microfinance target group are entering the formal financial sector for the first time and lack a

¹⁷ The provision of graduated loans offered out of necessity to account for the inherent risk in the target group is a hindrance to micro-enterprises that want to grow substantially, since the process may take too long. In addition, for larger enterprises that typically have large capital requirements, their needs are better met by commercial banks (Graham Bannock & Partners, 1997).

verifiable credit history, which if it exists, is usually poor due to the irregularity of income streams. This grace period allows loan officers to get to know the future credit beneficiaries and screen out bad risks, which could lead to adverse selection. Such a strategy is used by SACCOs and MPCMs in Namibia.

Fifth, microfinance institutions reduce risk by establishing a savings component in their institutional model, which leads to high repayment morale (Levitsky, 1993). It is frequently cited that borrowers are more inclined to adhere to repayment deadlines if loans are leveraged out of their own savings. This is based on the notion that individuals are more likely to pay if they feel that they are using their neighbour's savings (RMFTT, 2004). An opposing view to this is that leverage of own savings for loans could result in risk averseness on the part of the borrower, which has negative implications for micro-enterprises.

Sixth, frequent instalment collection by microfinance loan officers is used to mitigate risk. These loan collection visits are usually weekly (or monthly in some cases) and are criticised as a source of rigidity in the credit product offered by microfinance institutions.¹⁸ Although the use of this method has the additional benefit of reducing 'shoe leather' costs for borrowers, who may have to travel long distances to make loan payments or deposit savings, it also reduces the potential risk arising from moral hazard. This can occur if the loan beneficiary is tempted to skip instalment payments to cover other urgent, unforeseen expenses.

Finally, micro insurance can be provided to reduce the inherent risk in the microfinance target group.¹⁹ Group cover reduces per unit costs of servicing insurance (Matin et al. 2002). The most common micro insurance product that can be provided to the microfinance target group is life insurance because of its known risks and possibility of controlling moral hazard, adverse selection and fraud. In Namibia, term micro-lenders use insurance products offered by Credit Life Insurance to cover the risk of default on their loans.

Although, health and property insurance are less easy to establish in low-income environments, weather-based farm insurance is emerging as a viable product to protect against natural disasters through national and international reinsurance. This can be useful for the provision of loans to target-groups that reside in flood-prone regions such as the Caprivi. Insuring the unpaid portion of a loan against death and other specific risks is also a viable business, that could assist in controlling against the risks arising from the unpredictable life spans in target groups affected by the HIV/AIDS pandemic (Honohan, 2004).

¹⁸ In the case of SAFESAVE loan collection is done on a daily basis.

¹⁹ See Brown and Churchill (2000) and Morduch (2003) for a discussion on micro insurance. Also, see Wright et al. (1999) for a discussion on microfinance insurance schemes in Uganda.

Efforts to manage the inherent risk in the microfinance target group can be strengthened by applying some of the solutions discussed in this report, within the Namibian context.

3.5. Ability to Meet Basic Necessities

Low-income households can be categorised as economically active or the poorest of the poor. It is argued that microfinance provided to the economically active who participate in at least a partial cash economy can be a powerful tool for improving livelihoods, if used effectively.

Below a certain threshold, represented by the poorest of the poor, who are typically engaged in pre-entrepreneurial activities, the sole provision of microfinance will not be effective because this segment has a lower ability to use microfinance because financial assistance is firstly focused on covering basic necessities, which are not considered productive (RMFTT, 2004).

For this segment, provision of the ancillary devices advocated by micro creditors in tandem with microfinance will enable the microfinance target group to acquire adequate food, shelter, clothing, medicine, life and enterprise skills training and to pay their children's school fees. This is necessary before they are able to obtain the desired gains advocated by microfinance (Robinson, 2003).²⁰ Such services can be provided by MPCMs as opposed to SACCOs or SCAs.

3.6. Pecking Order Hypothesis

The pecking order hypothesis in corporate finance literature postulates that enterprises will be more inclined to rely on internal financing before they consider external options. This is a common finding in many surveys in developed and developing countries alike. The Wilson Committee in the United Kingdom found that the majority of capital in small firms was internally generated either from personal resources or from friends and relatives (Barber, Metcalfe & Porteous, 1989). Using a different sample, not weighted by value, another study found small business owners raised funds from their own resources in the United Kingdom (Binks and Vale, 1984 in Barber, Metcalfe & Porteous). Similar findings are found in baseline surveys conducted in Namibia (Ministry of Trade and Industry, 1998). Grossman et al. (2005), in a non-representative sample of 365 SMEs in Namibia, also found that 87% sourced working capital from internal sources This is illustrated in Table 5 below.

However, these surveys do not test whether this finding arises because of personal preference or lack of alternatives. If it is due to the latter then the provision of

²⁰ The burden of paying school fees is reduced in countries where basic education is free or subsidised.

microfinance would be a welcome solution. Even where alternatives exist, Khandker (2003) finds that many households borrow from multiple lenders.

Table 5: Financial sources used to fund shortfalls in working capital for 365 SMEs in Namibia in 2004

Sources of funding for Shortfalls in Working Capital Needs	No. of Businesses	Share (%)
Bank loan	13	3.56
Bank overdraft	34	9.32
Family and friends contributions	9	2.47
Personal Contribution	148	40.55
Retained earnings	161	44.1
Total	365	100

Source: Grossman, Mwatotele, Tobias & Stork (2005)

Despite this finding Reid (1993) found that sources of finance in the United Kingdom, in order of importance were bank finance, family and friends, hire purchase, leasing and equity finance (probably due to the reluctance of owners to give up ownership).²¹ This suggests that that credit provided by microfinance institutions may in some instances be preferred over internal financing options.

²¹ The local and regional government were the most important in the residual category (Reid, 1993).

4. OTHER FACTORS

In addition, to the selected supply and demand issues affecting microfinance in Namibia, other selected issues that contribute to the microfinance gap include competition, infrastructure and unique local factors.

4.1. Competition

Currently, the various formal microfinance institutions have relatively little interaction with each other and the prices of each category have little or no bearing on the operations of others. As commercial banks begin to downstream into the microfinance arena and SCAs begin to provide large-scale financial services to a wider clientele, the boundaries will become blurred (Harper & Arora, 2005). This could result in significant competition in the microfinance sector and the impact of this is yet to be seen.

In addition, there is still competition from informal sources. There are anecdotal reports that the microfinance target group resorts to moneylenders to meet the repayment schedules of microfinance institutions. For Namibia, although only a small percentage of the population use the financial services offered by informal moneylenders, the use of facilities offered by burial societies is common (FinMark Trust, 2003). As microfinance institutions introduce more flexibility, this may be eliminated.

4.2. Infrastructure

Most areas where the microfinance target group reside are characterised by infrastructure that is rudimentary at best, if it exists at all. This inadequate physical infrastructure contributes to insufficient access to basic services such as health, education, electricity and ICT networks (Hitchins, Elliot & Gibson, 2005). The level of access to infrastructure in Namibia is reflected in Table 6 below.

When compared to the rest of sub-Saharan Africa, access to ICT infrastructure in Namibia is quite competitive. However, this competitiveness does not extend into its comparison with other lower, middle-income countries, of which it is one. This may hinder the provision of microfinance because of the lower access relative to the category of countries that it is compared against.

To resolve these problems the only alternative is to increase access to infrastructure. The public sector is the best institution to tackle this and would play a valuable role in reducing the microfinance gap by focusing on providing adequate power, transport and ICT networks.

Table 6: Access to Infrastructure in Namibia: A comparison

	Namibia	Lower Middle Income	Low Income	Sub-Saharan Africa	Period
Transport Services					
Total road network in km	42,237	n/a	n/a	n/a	1997-2002 ^a
Paved Roads (%)	12.8	53	13.3	13.3	1997-2002 ^a
Rail lines total route in km	2382	332569	n/a	n/a	2000-2003 ^a
Power and Communications					
Electric power consumption per capita in kwh	n/a	1289	312	457	2002
Telephone main lines per 1000 people ^b	66	175	32	11	2003
Mobile phones per 1000 people ^b	116	207	24	52	2003
Information Technology^b					
Personal Computers per 1000 people	99.3	35.6	6.9	11.9	2003
Internet Users per 1000 people	34	63	16	20	2003

Note: a. Data is for the latest year available in the period shown.

b. Data from International Telecommunication Union's World Telecommunication Development Report database.

c. n/a indicates that data is not available.

Source: World Bank (2005)

Another component of the infrastructure issue is cost. A comparison of ICT costs in Namibia to the cost based on regional category is illustrated in Table 7 below. Reducing the burden of cost that microfinance providers face by lowering the cost of infrastructure where it is already available, would promote access to microfinance (Thomas, 2005).

Table 7: Cost of Infrastructure in Namibia: A Comparison

	Namibia	Lower Middle Income	Low Income	Sub-Saharan Africa	Period
Communications					
Cost of local telephone call per 3 minutes in USD	0.04	0.03	0.07	0.09	2003
Information Technology					
Total monthly price for 20 hours of internet use in USD	33	30	58	64	2003

Note: Data is from the International Telecommunication Union's World Telecommunication Development Report database

Source: World Bank (2005)

Currently, public-private partnerships are being recommended to reduce the burden on the public sector to provide adequate infrastructure. If this is successfully addressed the impact possibility frontier for microfinance is likely to increase (Hulme & Mosley, 1996a).

4.3. Unique Local Factors

The location of the microfinance institution determines the socio-economic conditions of the area where the microfinance institution is located. The distribution of microfinance institutions by location is illustrated in Figure 4 below.

In Namibia, the southern regions, central and coastal and northern regions are very different in terms of communities, cultures and the impact of socio-political factors rooted in Namibia's history. In addition, they have very different population densities with the northern regions being the most concentrated – see Figure 3.

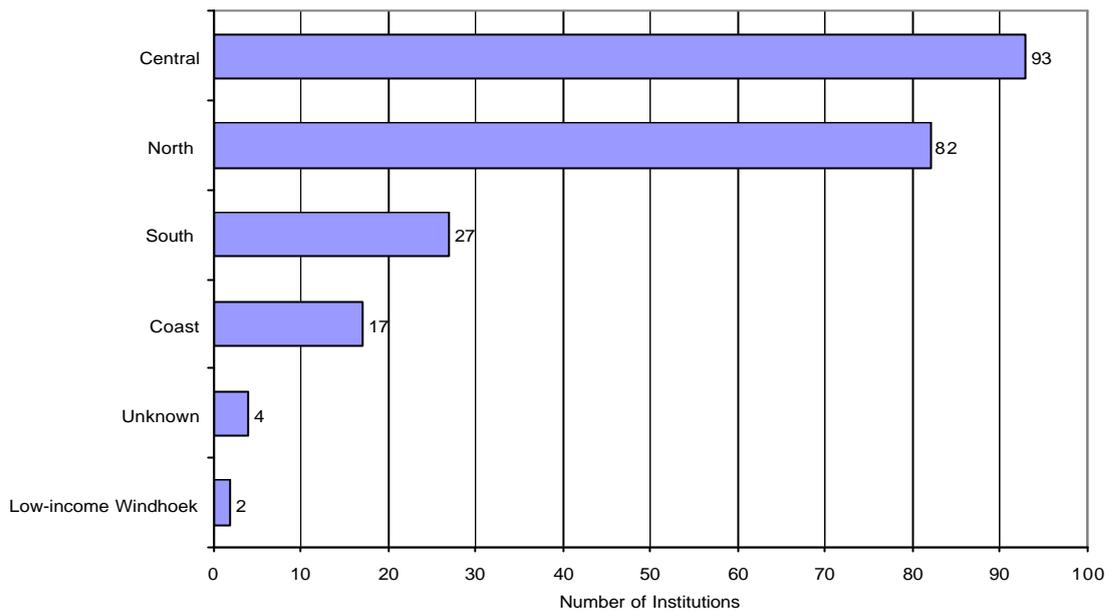
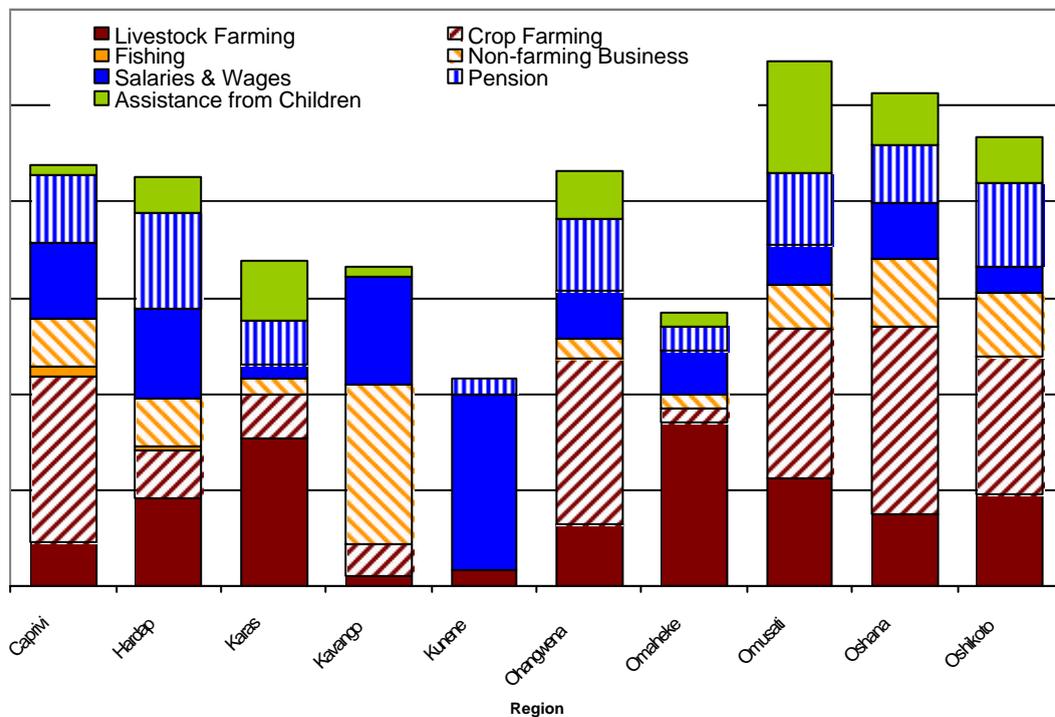


Figure 4: Distribution of Microfinance Institutions in Namibia by Region

Source: DCD and NAMFISA databases and NASSP 2005a and Premier Consult (2005)

Also, climatic, socio-economic and cultural factors determine whether the microfinance target group are micro-enterprises, farmers, labourers or low-income salaried employees. The case of Namibia is illustrated in Figure 5 below.



Source: Premier Consult (2005)

Figure 5: Source of Income by Region in Namibia (%)

In addition, the microfinance target group are a very vulnerable group. In the rural areas, health issues result in weak social capital, particularly due to the devastating impact of the HIV/AIDS epidemic on rural households in Namibia (Fuller & Van Zyl, 2005).

It is crucial for the microfinance practitioners to begin to take unique local factors into account when designing their institutional models (DCD, 2004). The differences in target group profiles result in differences in per capita incomes, which could potentially translate into differing demand for microfinance services. This needs to be considered when rolling out products to the microfinance target group, and could make the difference between success and failure (Reinprecht, 2005). Vulnerability to health and other risks that could adversely affect the probability of loan recovery presents a key opportunity for the micro insurance industry to design risk management products for microfinance institutions.

5. CONCLUSION

This report presents a synthesis of selected issues contributing to the microfinance gap in Namibia and associated solutions, in the context of the key principles of microfinance. It highlights the fact that the microfinance industry has shown significant signs of activity over the past few years.

Rather than onerous regulation, this report suggests that both regulators and practitioners should explore and promote ways that microfinance institutions can reduce costs while controlling the integrity of the loan portfolio. One key area that opportunities exist is through the sharing, for a fee, of existing distribution networks currently owned by disparate microfinance players to reduce transaction costs of loan disbursement and collection of repayments and savings.

Other ways that cost can be reduced include the separation of financial from non-financial service provision in the auditing of microfinance performance; the incorporation of strategies to reduce risk exposure from social factors, such as HIV/AIDS in the microfinance institutional model; the embracing of technological innovations to further reduce transaction costs, including credit and risk management systems; and the development and use of cost-friendly enabling infrastructure to promote financial sustainability.

Policy intervention should only be attempted with a proper understanding of its effect on the welfare of society. Apart from structure, ownership and control, another key criterion of good governance is public timely and full reporting of an institution's activities and results. Before policy intervention is considered the quality of operational information in Namibia's microfinance sector needs to be improved. Professional auditing firms can be a useful provider of financial capturing and reporting services for a fee, under their corporate social responsibility mandates.

Based on objective reliable information, an accurate snapshot of the complete picture of microfinance in Namibia can be presented periodically, which will also enable the tracking of dynamics over time.

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Appendix A: Break-even Interest Rate

Hulme & Mosley (1996a) demonstrate the break even condition for a financial institution over a period of time, which they define as a state where [total] income is at least equal to total expenditure. The formula, the authors use to calculate the break-even condition in the form of an interest rate is:

$$r^* = \frac{(b - a) + i + a + ap + (Z - Y)}{1 - p}$$

Equation 1: Definition of the Break-even Interest Rate

Where:

r^* represents the break-even, loan interest rate

b represents the share of the principal of each loan that has to be paid back per time period by the lender.

a represents the share of the principal of each loan that has to be paid back per time period by the borrower.

i represents the effective interest rate paid per unit of principal on borrowing and savings deposit.²²

a represents administrative cost per unit of principal.

p represents the expected default rate on loan, i.e. expected losses due to non-repayment of principal and interest on a loan.

Z represents non-loan expenditure attributed to training, outreach work, etc.

Y represents non-loan income attributed to training, outreach work, etc.

By assuming that the share of principal that has to be paid back by the borrower and lender each period is the same ($b = a$) and that non-loan income is equal to expenditure ($Z = Y$) equation (1) reduces to:

$$r^* = \frac{i + a + ap}{1 - p}$$

Equation 2: Formula for Break-Even Interest Rate

²² $i = \left(1 + \frac{i^*}{m}\right)^{m/t} - 1$

This reduced form equation does not incorporate slow-burning returns, gradual build-up of amount borrowed and the use of borrowed resources for risk reduction or other non-measurable benefits (Honohan, 2004). In addition, it assumes that the return on the amount borrowed (excess over interest costs) is fully reinvested every month by the microfinance institution during the months of the program participation and also that there is no borrowing by non-members. Finally, it does not differentiate the provision of financial from non-financial services by microfinance institutions.

An Example:

If a microfinance institution charges 34% on micro loans taken over six months, the effective interest rate (*i*) on these loans will be:

$$\begin{aligned}
 i &= \left[1 + \left(\frac{i^*}{m} \right) \right]^{mt} - 1 \\
 &= \left[1 + \left(\frac{0.34}{2} \right) \right]^{2 \times 1} - 1 \\
 &= 0.3689 \\
 i &= \underline{\underline{36.89\%}}
 \end{aligned}$$

If *i* = 36.89 %; *a* = 0.694262; *a* = 100% and *p* = 5%. Then the break-even interest rate for this microfinance institution derived from the Equation (2) above is:

$$\begin{aligned}
 r^* &= \frac{0.3689 + 0.694262 + (1 \times 0.05)}{1 - 0.05} \\
 r^* &= 1.236847 \\
 r^* &= 124\%
 \end{aligned}$$

Therefore even if the microfinance institution above charged a 30% effective interest rate it would still need to raise interest rates by an additional 84% to break-even.