Expanding Access to Financial Services in Malawi

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Acronyms

APIP	Agricultural Productivity Investment Programme
ASCA	Accumulated Savings and Credit Associations
BRI-UD	Bank Rakyat Indonesia Unit Desas
CCF	Central Finance Facility
COMSIC	Community Savings and Investment Club
COMSIG	Community Savings and Investment Group
CUMO	Concern Universal Microfinance Organization
DFI	Development Finance Institution
ECLOF	Ecumenical Church Loan Fund
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
IMF	International Monetary Fund
MALSWITCH	Malawi Switch Center
MARDEF	Malawi Rural Development Fund
MoCI	Ministry of Commerce and Industry
MFI	Microfinance Institution
MMN	Malawi Microfinance Network
MPC	Malawi Post Corporation
MPRSP	Malawi Poverty Reduction Strategy Paper
MPOSB	Malawi Post Office Savings Bank
MRFC	Malawi Rural Finance Corporation
MSE	Micro and Small Enterprise
MUSCCO	Malawi Union of Savings and Credit Cooperatives
MSB	Malawi Savings Bank
MWK	Malawi Kwacha
NABW	National Association of Business Women
NAG	National Action Group
NASFAM	National Association of Small Farmers of Malawi
NBFI	Non-banking Financial Institution
NGO	Non-governmental Organization
OIBM	Opportunity International Bank of Malawi
PDA	Personal Digital Assistant
POS	Point of Sale
PRGF	Poverty Reduction and Growth Facility
PURP	Privatization and Utility Reform Project
RBM	Reserve Bank of Malawi
SACA	Smallholder Agricultural Credit Association
SACCO	Savings and Credit Cooperative
SEDOM	Small Enterprise Development Organization of Malawi
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
USAID	US Agency for International Development

Foreword

This book has been a work in process for some time. Initial versions of *Expanding Access to Financial Services in Malawi* were generated about two years ago when UNDP, UNCDF and USAID jointly developed a terms of reference that would result in consultations with stakeholders and studies to understand the state-of-the-art in microfinance in Malawi and industry challenges. USAID, UNDP and UNCDF carried out independent exercises to fulfill the terms of reference. USAID produced *Microfinance Sector Assessment* in Malawi. With an interest in broader policy issues and challenges for rural finance, UNDP and UNCDF drew on USAID's work, and with the strong encouragement of UNDP's Resident Representative at the time, Zahra Nuru, Daphne Casey, Deputy Representative and UNCDF programme officer, Bill Chanza, focused on additional issues including increasing access to finance for rural and agricultural households and understanding the impact of policies across sectors (agriculture, economic development, social, etc.) on overall financial systems development. While this report brings together information and analysis in rural finance and policy issues, there remain significant gaps in knowledge, not just in Malawi, but globally. We hope that this report stimulates discussions around and potential solutions for these challenges in Malawi.

UNCDF and UNDP have been involved in microfinance in Malawi through two separate initiatives in microfinance. In the mid-90s, UNDP and UNCDF supported the DEMAT project which attempted to increase access to financial services by providing lines of credit and partial guarantees to banks interested in providing loans to microentrepreneurs and small businesses. While the project enjoyed some success, it did not result in significant expansion of services to the targeted segment. From 2000, in partnership with the Ministry of Trade and Private Sector Development (formerly Ministry of Industry and Commerce), UNDP and UNCDF financed the establishment of a greenfield microfinance institution, Pride Malawi, dedicated exclusively to the delivery of financial services through a national network to low-income households. While Pride Malawi experienced a number of growing pains during its development, including a major portfolio crisis in 2002, it is now profitable due to the efforts of a disciplined management team and strong Board and is seeking to transform into a shareholding company over time. Many of the conclusions contained in this report draw from UNDP and UNCDF's experience managing its investments in microfinance in Malawi.

In addition much of the information and analysis draws on ideas generated by

Roberto Cater during a visit to Malawi in 2002 with the support of Ephraim Chirwa to assist UNDP and UNCDF in scoping out potential opportunities to support the microfinance industry. It also draws very generously on the *Microfinance Sector Assessment in Malawi*, researched and written by the USAID AMAP Microfinance Chemonics Consortium (including Victor Luboyeski, Debjani Bachi, and Muwoso Chawinga) as well as ongoing consultation with the USAID supported DMS (Developing the Microfinance Sector) project. Richard Kimball and Autman Tembo from USAID read initial drafts of this report and also provided valuable inputs to its ongoing development.

This report also draws on the ideas and inputs of key stakeholders in many sectors in Malawi that influence access to finance including the Ministry of Agriculture, the Ministry of Trade and Private Sector Development, the Reserve Bank of Malawi, the Malawi Microfinance Network, the National Association of Small Farmers of Malawi (NASFAM), the Privatization and Utility Reform Project (PURP), microfinance institutions, commercial banks, non-banking financial institutions, the Malawi Union of Savings and Credit Cooperatives (MUSCCO), bilateral and multilateral agencies supporting Malawi's plans for economic and social development, NGOs and other civil society organizations promoting finance as well as the integration of markets.

USAID, UNCDF and UNDP are jointly presenting this report to the stakeholder community in advance of the upcoming planned National Microfinance Conference. It is certain that no one party will agree with all the report's conclusions. And while the conclusions draw widely on different sources, the author is responsible for the report's content and any inaccuracies (or breakthroughs!) contained herein. We hope however that it provides some orientation to stakeholders, both public and private sector, supporting the objective of increasing access to finance to a massive number of Malawians. The report also contains links to various resources on issues raised to facilitate more in-depth reading and consultation.

Kiendel Burrit was the principal author of this report, supported by her colleagues in UNCDF Microfinance and at UNDP Malawi.

Richard Weingarten
Executive Secretary, UNCDF
March 2006

Executive Summary

The primary financial service needs of people are shared across income groups. They include accessing liquidity, having a safe place to store money, transferring money electronically to and from family members and creditors, and finding ways to decrease risk.[1] Correspondingly, microfinance includes the provisioning of a broad range of financial services including loans, deposit services, insurance, payment services and money transfers. While governments have long pursued the goal of financial sector deepening[2] to support economic growth, the microfinance industry, focused on markets that have been excluded from formal financial systems, has emphasized the dual and mutually reinforcing objective of financial *inclusion*, or financial sector broadening. Financial inclusion means making available at an affordable price a wide range of financial services to meet people's diverse financial service needs, particularly poor, low-income and vulnerable households and micro and small enterprises, including "household firms" [3]. In Malawi, 65% of the population lives below the poverty line, with the rural poor being particularly vulnerable. Malawians seek safe savings facilities, payment services, and access to credit and insurance to build assets, increase income, reduce vulnerability, and maintain consumption for food and other services during lean periods.

Many potential markets have been excluded from formal financial sectors for a variety of reasons. Reasons range from legitimate ones, including high transaction costs for both clients and institutions and inadequate technologies in financial markets to manage client and institutional risk, to illegitimate ones, including irrational biases against certain market segments and government policies and donor programmes that undermine financial sector development. Addressing market exclusion in rural areas and agricultural markets has heightened challenges, particularly in Malawi where the economy is highly dependent on a narrow productive base.

Most agricultural markets, often defined by different segments of the agricultural value chain (input suppliers, producers, traders, processors, exporters) lack access to needed financial services, not just the least affluent. In Malawi, as in many countries, formal financial institutions concentrate services in urban areas and town centers. Services concentrate in these areas despite that 86% of the population lives in rural areas, and that agriculture directly employs more than 80% of the labor force, accounts for 54% of GDP (including agricultural distribution) and 90% of exports. Developing financial products and technologies to serve agricultural and rural markets, including

[1] *Footnotes are at the end of the book, beginning on page 166.*

smallholder producers and small traders, also requires the development of more complex financial technologies, for example, insurance and derivative products, that can potentially serve *all* segments of the agricultural value chain from farmer to exporter to reduce risk.

This report assesses the achievements and challenges for microfinance service delivery in Malawi, with particular attention to rural and agricultural markets. It identifies key elements that influence the development of Malawi's financial system, and provides some recommendations and opportunities for investors, donors, government and private sector entities to support the development of an inclusive financial system. Recommendations focus on getting key policies right, promoting innovation in financial markets, supporting the integration of fragmented markets along the agricultural value chain, promoting transparency and accuracy in institutional performance reporting, and most critically providing financial and technical support to financial institutions that have the appropriate operating and governance structures to intermediate savings in rural areas, where the most challenging but greatest potential markets exist. This report also defines basic microfinance concepts and refers the reader to internet links and other resources to deepen their understanding of microfinance and relevant issues. The reader is invited to use these resources as a basis to challenge and/or deepen some of the conclusions presented in this report and advance the dialogue on inclusive financial systems in Malawi.

Once isolated from the wider financial system, microfinance initiatives in many countries have shifted from shallow programmes designed to win political favour or implement development policies (for example in agriculture) to the development of commercially viable institutions that comprise an important element of the financial system. Globally, microfinance services are provided by a range of institutions including (but not limited to) NGOs, mainstream commercial banks, specialized microfinance banks, non-banking financial institutions and credit unions. To serve massive unmet demand, institutions that provide micro financial services must be integrated with capital and financial markets to tap the financing required to serve growing numbers of clients.

The broader policy and macroeconomic environment enables or hinders the development of microfinance services. Evidence from successfully transformed economies (from centrally-planned to market-oriented) demonstrates that macroeconomic and sector reforms must precede efforts to build financial systems, particularly rural financial systems. Financial sector deepening in Malawi will depend on the Government of Malawi adhering to policies of fiscal and monetary stability, meaning reductions in government spending to further reduce inflation, stabilize the Malawi kwacha and reduce real rates of interest. The Government of Malawi appears to have made advances towards meeting fiscal objectives, having met key budgetary targets under the Staff Monitored Programme in 2004, and having proposed a 2004/5 budget that should reduce government domestic borrowing.

High real rates of interest and an uncertain future remain a major impediment to economic growth in Malawi. These conditions create disincentives for bank lending to the private sector (in June 2003 net lending to the government was more than double that to the private sector; in 2004 net lending to government was projected at nearly three times lending to the private sector), discourages the entrance of new financial service suppliers (particularly those seeking foreign finance), the entrance of new players in the agricultural value chain (traders, input suppliers, etc.) and makes it difficult, if not impossible, for smallholder producers and other players in the agricultural value chain to generate adequate margins. This creates a vicious cycle in which the high cost of inputs, including credit, hinders improvements in the quality and efficiency of production and trade, depressing margins even more.

While the government recognizes that sustainable access to affordable finance is a critical pillar in the Malawi Poverty Reduction Strategy, the absence of broad-based market solutions to supply products and services including inputs, credit, transport, etc. has resulted in donor and government-affiliated projects that provide "credit" with limited expectation of repayment to transfer cash and inputs to households to meet non-financial, welfare objectives (e.g., food security). This approach threatens the development of long-term market-based solutions that have the potential to create sustainable access to finance. It is continual access to services, not one-time injections, that allow people to grow their asset base and reap the poverty alleviation-related benefits that access to finance provides. Careful coordination and sequencing of grant and credit programmes is important to preserve a strong credit culture and to ensure that the greatest number of people can be reached with public resources. Dialogue across sectors that generates coordinated policies and programmes that complement each other to meet financial sector, agricultural development, social policy, and economic growth objectives is critical. Some effective examples of cross-sectoral and multi-donor collaboration, for example the National Action Group (NAG) and the Health SWAP, may offer lessons on how to support an effective cross-sectoral dialogue and coordinated action.

Innovation in products and delivery channels creates value for both suppliers and clients, driving the finance frontier outwards[4]. Significant disincentives however exist for companies to invest resources required for research and development (R&D) since innovations can be easily adopted by competitors who benefit from new technologies without having to absorb the R&D costs, including the costs of failed attempts to innovate. Donors and/or governments may have a role to play in supporting R&D investments in financial markets.

The Reserve Bank of Malawi, has installed a state-of-the-art switching network (MALSWITCH) to support the national payments systems and smart card technologies. With a reliable communications infrastructure and the presence of Point of Sale (POS) or Automatic Teller Machines (ATMs), the switching system may offer a promising platform for electronic banking services that enables new delivery channels and product development opportunities. The opportunities for electronic banking to deepen and broaden financial sectors however will depend on the development of cost effective business models that support electronic banking applications.

In Malawi, few instruments exist that enable producers, financial institutions, traders, marketing boards, and exporters to manage the price and production risk associated with agriculture. Growing the financial system – thus people's ability to save, take on loans, make payments, hedge risk and transfer money – will depend on the development of financial instruments that enable risk sharing and pooling at *all* levels of the agricultural value chain. In Malawi, however, there are limited incentives for speculators to take on heightened risk with the potential for high returns given the relatively consistent trend of declining tobacco prices. The development of insurance and other products that enable Malawi to pool and transfer risks in national and international markets is another area where donors and governments may have a role to play supporting innovation, particularly for agricultural markets.

Estimating demand for financial services is an imprecise exercise. This study estimates demand for microfinance loans in Malawi at between 300,000 and 760,000 clients. Generally, the method for estimating demand assumes a fixed proportion of the population that can repay credit. Wary of this method, one industry expert likens this method to a magic trick – " [the estimator] figures out a reasonable average loan size, estimates the number of borrowers, multiplies by the magic percentage, and presto!" Recognizing the limitations of this method, estimates provided are merely meant to demonstrate that even assuming very limited debt capacity, the potential market is still sizable. Higher end estimates peg loan demand at more than four times the current supply of microcredit. Meeting even limited "effective" demand would nearly double the size of private sector credit in the economy. A more useful way of understanding demand and supply for financial services however is to consider the "frontier of finance" approach, explored below.

The supply of *microcredit* as of end 2004 is estimated at approximately 230,000 loans. While a range of institutional types exist with the potential to reach different market niches, government owned institutions and government affiliated programmes remain the dominant suppliers, accounting for more than 63% of estimated borrowers and 80% of savings services. Supply and demand estimates indicate a relatively high proportion of met demand, but may be misleading. Given that few microfinance operations demonstrate potential for financial viability now, it is unlikely that a significant percentage of loans will be available on a sustainable basis. From the demand side, given the high level of client exits[5] in Malawi (probably more than 50%), a significant percentage of those currently receiving loans do not represent sustained demand.

A more useful way of understanding demand for and supply of financial services is to consider the dynamic aspect of markets. Through innovation, new financial technologies, ways of structuring deals, means of creating confidence, and appropriate incentives, suppliers can engage new clients and market segments, and create both debt and savings capacity. Debt and savings capacity is also enhanced by improvements in productivity in the agricultural sector, improvements in legal frameworks that enable titling of assets and more efficient arbitration, and macroeconomic improvements. A change in any of these variables changes the number of potential clients that are drawn into the financial system. Considering demand for services beyond debt including savings, payment services, money transfers and insurance, demand for financial services seems infinite, and supply limited. Only 3% of the population accesses deposit services now.

Developing an inclusive financial system will require strengthening current players and potentially, supporting the entrance of new players. Currently there are no microfinance operations in Malawi that are fully financially viable (though institutions that have microfinance lines of business may be profitable due to heavy investments in government treasuries.) The absence of retailers that can provide liquid savings accounts, efficiently intermediate savings and provide "one-stop" shops for clients is a glaring absence in Malawi's financial landscape, particularly in rural areas. Parastatals with their relatively large branch networks and significant knowledge of rural markets, may provide the only potential platform for rural financial service delivery for the majority. However, they will require extensive operational and financial restructuring to realize potential. Malawi Rural Finance Corporation and Malawi Savings Bank are currently receiving support under the World Bank Privatization and Utility Reform Project (PURP) to restructure their operations to prepare for eventual private sector participation in their ownership. Absent significant changes in governance, operational and financial restructuring and capacity upgrades from this process, donors and investors may consider supporting a *new,* scalable financial institution that can effectively serve rural markets. Seeking results over relatively short-term periods, reluctant to affiliate with government-linked institutions, or simply fed-up with investment in non-performing institutions, some donors and development finance institutions (DFIs) with deep pockets have chosen to walk away from the complex and time-consuming task of transforming parastatals or supporting new, formal financial institutions. Instead, large sums of money have been earmarked to develop community managed savings and credit groups. While these can add a valuable element to a country's financial system, especially where no financial infrastructure exits, there utility is limited. Informal systems cannot provide the range and depth of services nor the consistency of services required by rural populations. While the task of establishing a formal intermediary in rural areas seems daunting, donors and DFIs with deep pockets should consider investments anew.

Microfinance institutions have made notable achievements in recent years. Many institutions have recovered from the portfolio crises of the early 2000s; operators have attempted to reprice services to eliminate overt subsidies; suppliers have worked to reduce transaction costs by linking with producer and farmer associations and supporting group based lending technologies. However despite these achievements, operators have identified important challenges that remain, and that for the most part are shared across the industry. Operators continue to seek ways to reduce transaction costs for both suppliers and clients, including innovative means to move service points closer to clients. Non-bank operators seek ways to make their success less dependent on the use of commercial banks infrastructure by seeking alternative channels through which to process transactions. Operators seek ways to meet the challenges that HIV/AIDS poses to both clients and staff. With start-up capital exhausted, operators seek access to financing to implement ambitious growth strategies necessary to realize financial viability.

While operators have attempted to support new markets with new products, with some notable exceptions, they have achieved product imitation not innovation, often cannibalizing markets served by other suppliers resulting in limited value creation for either suppliers or clients. While portfolio management has improved, portfolio quality remains vulnerable. The implementation of information systems that can better support management's quest to ensure portfolio quality, customer satisfaction, and profitability objectives remains an oft-expressed need. Many institutions suffer from weak governance and ownership structures. Companies Ltd by Guarantee seek transformation to shareholding companies with clear ownership structures and incentives for success. Parastatals require a governance overhaul to create effective checks and balances between management and Boards, and to force accountability.

Meeting capacity building needs will require technical support from a range of players including technical service providers with global knowledge and experience in key areas identified by financial institutions. Some successful strategies for accessing global knowledge and expertise have included temporary management contracts (for example, for turn-arounds), technical assistance contracts focused on specific issues or for general strategic support, exchange visits to institutions in other countries with similar operating environments or challenges, and training courses or programmes geared specifically to microfinance or regulation. The cost of international technical assistance can be high; institutions and their supporters should budget appropriately to access this technical support. In Malawi as in many countries, local markets for technical assistance for microfinance are thin. Developing industry infrastructure is required that builds local expertise in financial systems development including not only broad based technical assistance but also specialized firms like audit firms and rating agencies.

An efficient and functioning financial system requires long and short-term debt markets, sources of equity finance, and specialized institutions that can manage institutions' associated financial risk. Financial institutions in Malawi have limited access to short-term debt markets (though interbank lending has increased in recent months), and almost no access to capital markets (long-term debt finance) and equity finance to develop stable and effective financial structures. There are few institutions that can provide insurance to underwrite portfolios, to manage price and production risks for agricultural markets, including derivatives, or even to provide micro insurance for clients (e.g., death, health, etc.). Developing the microfinance sector will require the emergence of new companies in Malawi or links to foreign companies that serve international markets to meet current deficiencies in the financial landscape.

Though the world of high finance may seems worlds away from the world of microloans, in fact, the development of more complex financial instruments will provide a foundation for the delivery of many kinds of microfinance services. For example, absent instruments that can manage and pool risk of agricultural markets, supply and demand for services for smallholders will remain limited. In some countries, where market failures mean key sectors remain underdeveloped, government has created Funds with appropriately designed incentives to stimulate sector development. Venture capital funds seeded with public funding may stimulate the establishment of new financial service companies, partnerships between financial institutions and technology companies, or the establishment of venture capital financing required to provide equity where stock markets remain inactive. In addition, brokers (public or private sector initiated) can play a useful role bridging information gaps (a key reason for market failure) that match institutions with potential sources of national and international equity and debt financing.

Generating client, donor and investor confidence requires transparency in financial reporting and the establishment of common performance benchmarks that enable comparisons across the industry. Confidence is a prerequisite to accessing new sources of financing, maintaining a stable client base, and achieving high levels of repayment. Non-repayment often results from client assumptions that programmes or institutions are short-lived; sustainable access to services remains the primary reason for high levels of repayment. Transparency also encourages competition that almost universally results in benefits to end users in terms of lower prices and better service. The Malawi Microfinance Network has begun collecting performance data, but the network and its members require support to generate accurate reporting compliant with international standards and to disseminate reporting information widely. Developing a common set of indicators requires the participation of a broad range of stakeholders. Stakeholders include government and lawmakers whose knowledge of the industry and its players will influence policies and legal and regulatory frameworks, and donors and investors responsible for enforcing standards and using information to make investment decisions.

A preliminary assessment of the legal and regulatory framework identifies no serious barriers to entry in the market for new financial service providers in Malawi or the establishment of microfinance operations. While there appears to be no pressing need to open a new regulatory space, several issues relevant to the legal and regulatory environment do require attention now:

- Operating under different legal frameworks, institutions do not have consistent oversight across the industry or are subject to different regulations that may provide competitive advantages to one class of institution over another. Consistent oversight, including required performance reporting under the industry's various legal frameworks, or under one supervisory entity will encourage stronger client, member and investor confidence;
- Weak oversight of cooperatives that mobilize members' savings, but fall outside of banking law, presents risks to the safety of members' savings;
- Widely varying tax laws for different institutional types potentially creates an unlevel playing field; *and*
- Secondary legislation should be reviewed to ensure that there are no serious regulatory disincentives to establishing microfinance lines of business and that it enables supervisors to adequately monitor microfinance operators that mobilize deposits.

In 2005, the Reserve Bank of Malawi will review the legal and regulatory framework with an eye towards ensuring its conduciveness to supporting a stable and growing microfinance industry as it evolves. The Reserve Bank is also reviewing various aspects of the legal and regulatory framework for other parts of the financial sector (for example, for non-banking financial institutions). A review which looks at the impact of legal and regulatory frameworks on the development of the financial sector as a whole (including for example, the influence of reserve requirements on financial sector development) as opposed to separate industries within the sector, may be a logical next step.

While there may be no compelling reason to create a new legal and regulatory space for microfinance now, the sector *will* evolve requiring ongoing review of the framework over time. Driving the need for an evolving framework will be:

- the corporate and financial restructuring of parastatals and Companies Ltd. by Guarantee;
- the need for scalable institutions that can effectively intermediate savings;
- the emergence of new kinds of financial institutions to serve market gaps;
- the changing structure of the financial sector with the emergence of new players;
- the potential participation of new kinds of suppliers (for example, retailers) that use technology to offer financial services or that substitute new products for traditional financial services (e.g., stored value cards that operate like savings or lines of credit); *and*
- an expressed desire on the part of microfinance service suppliers to be recognized as legitimate players in the financial sector.

Supporting the ongoing acquisition of knowledge by regulators and lawmakers to evolve the legal and regulatory framework and to ensure a level playing field will be critical to promote microfinance industry development. In other countries, for example, in Tanzania and Uganda, the success of evolving legal and regulatory frameworks has been attributed to a high degree of information exchange among stakeholders within a specially created forum, not hastily developed laws.

The development and approval of the Malawi Microfinance Policy and Action Plan in 2002 as well as the prominent role that access to financial services plays in the MPRS are evidence of government's interest in expanding access to financial services. The hard work of government and stakeholders to support policies and initiatives that promote an inclusive financial system however is just beginning. This year, the Government of Malawi established the MWK 5* Billion Malawi Rural Development Fund (MARDEF). Attention to the way the Fund is structured to create incentives for suppliers to effectively manage resources and borrowers to repay funds on time will be critical to its success. The visibility and size of the Fund (nearly 50% of total estimated microfinance loans now) creates significant opportunity to demonstrate sound practices to increase access to financial services, or conversely further weaken the sector and destroy any real opportunities for inclusive financial system development.

** At the time of publication, US$1 = Malawi Kwacha 107.*

Recommendations to support the development of an inclusive financial system that serves a wide range of market segments including the poor, vulnerable and unbanked populations with diverse products are explored in the report. Key recommendations include:

- Providing appropriately structured incentives to support innovative products (e.g., insurance, savings, remittances, derivatives) and delivery channels (e.g., electronic card-based, physical, input suppliers) and institutions that can provide them is required. While the world of capital markets, equity finance and derivatives seems unrelated to microfinance, development at various levels in the financial system is required to support financial markets at the grass roots.
- The industry has realized important achievements in recent years, but capacity building needs remain. Key capacity building needs include corporate restructuring of parastatals, institutional transformation of Companies Ltd. by Guarantee to shareholding companies, development of state-of-the-art management information systems to support financial management for profitability and high portfolio quality, and product development, particularly for rural and agricultural markets.
- Reaching markets in rural areas requires the development of a *scalable financial institution that can effectively intermediate savings*. Government with their investors must decide whether the political and institutional potential exists to support radical transformation of parastatals or whether it requires building a new intermediary with an inventive business model that can serve rural markets.
- Radical changes to the legal and regulatory framework appear not to be required now, but supporting the acquisition of knowledge of the Reserve Bank of Malawi, the Ministries of Industry and Commerce, Agriculture and Finance will support the evolution of policies and frameworks over time.
- Supporting dialogue among stakeholders across sectors to meet the challenges of the industry as it evolves, and through an *organized forum,* is critical.
- An industry infrastructure (auditors, technical service providers, raters, practitioners network (Malawi Microfinance Network), etc.) that can support regulators as well as financial service providers will support professionalization and transparency in the sector and its ongoing development.

Chapter 1: An Introduction to Microfinance[6]

1.1 What is Microfinance?

Millions of poor, vulnerable non-poor, and unbanked households want financial services. They seek a diverse range of services including loans, savings, insurance, remittances for funds transfer, and payment services. Households use financial services to build incomes, mitigate risk, and protect against vulnerability often exacerbated by economic crises, illness, and natural disaster. They invest in micro and small businesses, purchase assets, improve their homes, and access health and education services. Yet formal financial intermediaries like commercial banks generally do not serve these households. Conventional banks have failed to serve this market for a variety of reasons. First, their business models are generally unsuitable for managing a microfinance business, characterized by high-volume, low-value transactions. Secondly, they employ traditional lending technologies based on collateral requirements (to which the unbanked generally don't have access). And in many cases conventional banks believe, unjustly, that the unbanked are unwilling and unable to repay loans and save money.

In general terms, microfinance is the provision of a broad range of financial services to those excluded from the formal financial system. Systems of exclusion are not just based on lack of wealth but also on social, cultural, and gender barriers (*Microfinance Distance Learning Course*, UNCDF). Microfinance lending technologies are developed primarily around an analysis of clients' character, cash flows, and commitment to repay a loan, rather than on collateral requirements characteristic of asset-based lending technologies of traditional banks. A variety of institutional models have emerged globally to serve microfinance markets including specialized microfinance banks, non-governmental organizations (NGOs), credit unions, credit cooperatives, non-banking financial institutions, and commercial banks that develop new lines of business or specialized subsidiaries that focus on microfinance market segments. The spectrum of potential microfinance clients is broad. In Malawi it may include a woman in the informal sector working at home to produce prepared foods to sell outside the home; it may include a vender selling vegetables or fish in an open-air market. It may include a farming household that seeks access to credit to buy fertilizers to produce tobacco, and savings services to bank post-harvest profits that can be drawn on during lean seasons. It may include a farming family that establishes a contract with a buyer before the harvest that enables it to lock in a price for the sale of surplus production of maize. It may include family members dispersed across towns in Malawi or in the region (for example, to take on short-term work) seeking to transfer money to family members who need to supplement their cash flow during lean times.

1.2. Where does Microfinance Fit within the Financial Sector?

Globally, early efforts to provide financial services to the unbanked were overwhelmingly driven by economic and agricultural development policies and programmes. Governments supported subsidized credit programmes “targeted” at specific groups and tied to specific productive activities. While these programmes were intended to increase agricultural production or mitigate income disparity among groups, they have generally failed to reach the “target” groups or achieve intended objectives, and have not resulted in widespread and permanent access to finance. Efforts to reach the poor with financial services then shifted to the delivery of small loans to micro and small enterprises. This movement was largely driven by NGOs with social goals experimenting with new technologies to reach poor households with both financial and non-financial services. In many countries credit unions developed that mobilize savings deposits and provide lending services; often these institutions are not regulated under financial sector legal and regulatory frameworks.[7] Microfinance was seen as a “development tool” and its activities were often isolated from the wider financial system.

Over time, in many countries, with the success of credit-led NGOs, their transformation into licensed banking institutions, and the entry of mainstream and specialized commercial banks into the business of microlending and savings collection, microfinance industries have evolved into powerful subsectors of the financial services industry. Successful microfinance institutions (MFIs) have shifted away from donor and subsidized funding to become commercially viable, profitable institutions – covering their costs and generating surpluses to fund growth and expansion of services to a growing number of clients. The institutional forms of suppliers of microfinance services have diversified to include NGOs, companies, nonbanking financial institutions (NBFIs), specialized microfinance banks, commercial banks, subsidiaries of mainstream commercial banks, credit unions, leasing companies, and insurance companies. As communication technologies evolve, non-traditional players including retailers are poised to enter the market for payment and transaction services. Many high-performing institutions have managed to successfully source commercial capital (bank loans, savings, equity investments from both private and public sources) to expand their growth. In fact, absent commercial sources of funding, their ability to reach a growing number of clients would have been seriously curtailed.

It has become evident that demand for financial services by the unbanked is significant, if not massive. In the early stages of microfinance industry development, NGOs, government aid agencies, and multilateral and bilateral donors and investment companies tend to be the dominant investors in the sector. Meeting significant demand, however, requires the engagement of commercial sources of capital, including the savings of many of these unbanked households. Engaging commercial capital requires consistently high performance on the part of institutions operating in the microfinance sector. Globally, many of the most successful MFIs have outperformed mainstream commercial banks with returns on equity exceeding 30% in some cases. In the early days of the industry it was thought that profitable institutions would be unable to serve the poor – that there was an inevitable trade off between depth of outreach (reaching poor clients) and profitability. In fact, research indicates that there is no significant relationship between depth of outreach and profitability. Well-performing institutions serving a wide range of client groups from the poor to the vulnerable non-poor in a variety of contexts (urban and rural) can and have become profitable. At the same time however, it should be noted that not all institutions have achieved commercial success, and that the industry is relatively young globally. Of the 147 leading institutions reporting to the *MicroBanking Bulletin*, 62 are financially self-sufficient.[8]

Now that "microfinance" has proven itself in many contexts and it has become evident that satisfying massive demand requires access to capital markets, governments, multilateral and bilateral organizations, and other public sector agencies are developing microfinance support strategies that situate microfinance institutions and their clients within the overall financial system. Microfinance is no longer seen as an isolated industry or development "strategy." Support for the development of a microfinance in-

Box 1: Average Performance of Financially Self-Sufficient MFIs

The following table shows averages for some key indicators for the 62 financially self-sufficient institutions. However, it should be noted that there are significant differences among regions and institutional types.

Key indicators: "average" financially self-sufficient MFI:

- Total Assets: $19.9 million (banks ($60 million) and NGOs ($10 million))
- Total number of borrowers with loans outstanding: 81,510
- Average outstanding loan size as % of GNP per capita: 83%
- Average outstanding loan: $752 (Africa ($350), Eastern Europe ($1,101))
- Adjusted return on assets (after tax and accounting for the cost of inflation): 5.5%
- Adjusted return on equity: 14.1%
- Portfolio at risk > 90 days: 2.3%
- Number of active borrowers per loan officer: 408
- Yield on Gross Portfolio: 40.6% (approximately equal to interest rates)

Source: The MicroBanking Bulletin, Issue No. 8, November 2002, MIX (Microfinance Information Exchange), www.mixmbb.org dustry is driven by the aim to deepen the financial sector, including enhancing access to and gathering savings and enabling their efficient allocation in markets for goods and services. Financial deepening gives households and businesses more choices for investing their savings and raising capital and promotes a more efficient allocation of capital and risk. Beyond deepening, financial sector development strategies aim to develop "inclusive" financial sectors that respond to the diverse financial service needs of many market segments including low-income, poor, vulnerable and vulnerable non-poor populations. Deepening the financial sector and promoting financial inclusion requires a competitive financial services industry and extending the frontiers of finance[9] to develop products and financial instruments that reach those that have been excluded from formal finance, and that enable suppliers to adequately manage their costs and risks.

Boxes 2, 3, and 4 at the end of this chapter provide three examples of successful microfinance operations. One is a licensed, regulated Bank in Peru, MiBanco. The other is a unit of a restructured, state-owned development Bank, Bank Rakyat Indonesia Unit Desas (BRI-UD). The third example is a microfinance subsidiary of a commercial bank.

Box 5 describes the Bolivian microfinance market, a "mature" market, and some of its challenges. A mature microfinance sector requires an industry infrastructure to support the development of microfinance institutions and their integration with capital markets. Box 6 describes the players that comprise this infrastructure.

1.3. How does Microfinance Fit within the Broad Policy Environment?

Extending the frontier of finance contributes to a range of policy imperatives including support for poverty alleviation and the reduction of vulnerability, and broad-based economic growth. Effective macroeconomic policies, legal and regulatory frameworks, and financial and agricultural sector policies influence the enabling environment that support the emergence of deeper and more inclusive financial systems. In fact, sound macroeconomic management, and supportive agricultural and financial sector policies, are critical elements for financial sector deepening.

65.3%, or more than six million people, live below the poverty line, with the rural poor being particular vulnerable (1997-8 Malawi Integrated Household Survey). The three month period before the maize harvest, "the hungry season", is particularly difficult for many households. Safe savings facilities, payment services[10], access to credit, and reliable insurance mechanisms enable poor households to reduce vulnerability by smoothing consumption and mitigating risks. It allows them to build assets upon which they can draw during periods of economic downturn or crisis to smooth out dips in income, and maintain consumption levels for food and other services, like education and health care. A temporary loss of income for vulnerable households can drop them deeper into poverty, and make it difficult, even impossible, to work their way out of poverty.

While poor and low income people depend on access to financial services, financial sector development (and its accompanying economic benefits) rely on the existence of potential clients with saving capacity as well as the ability to borrow and pay back loans. This depends in large part on the availability of economic opportunities to generate revenues and profits. Broad macroeconomic and sectoral policies influence *access to productive assets* (for example, land and inputs), *profitability of producers* (by influencing input and output prices, interest rates, and access to markets) and the *capacity of financial intermediaries to develop sustainable businesses* (by influencing inflation, and their management of systemic and other risks).

1.4. Where does Agricultural Finance Fit within the Microfinance Subsector?

For the most part, the microfinance industry globally has focused on trade and industry in urban, peri-urban and densely populated rural areas. However, microfinance services are also critical to businesses and households in the agricultural sector and rural areas. In Malawi, the agricultural sector employs 87% of the labor force, creates 36% of GDP (54% including distribution), and 90% of exports. Smallholders dominate agricultural production and their share of total production relative to estate farms is growing. Despite agriculture's prominence in the economy, commercial bank advances in the sector totaled only 11% of total loans. Agriculture contributes 90% to the foreign exchange earnings in Malawi, with tobacco alone accounting for 70% of earnings. Within this context, and given the predominance of small holder farmers in the agricultural sector (80% of production) focus on financial sector deepening in rural and agricultural markets is critical to support economic growth and poverty reduction goals.

Special challenges exist however in supplying rural and agricultural financial services. Additional challenges faced by rural lenders include greater exposure to systemic risk (such as droughts and floods), lower density of population, higher transactions costs, weak physical infrastructure, and greater seasonality of activities. Expanding the formal financial frontier to effectively serve these markets requires significant innovation in product and financial technology development. Innovations are required that enable producers to deal with significant price and production risk, and financial service providers to deal with risks associated with clients willingness or capacity to repay. In Malawi, rural areas are characterized by the highest incidence and depth of poverty in the country, and therefore limited capacity to bear risk, for example taking on debt. Subsequently, demand for microinsurance, money transfer services and savings services, and loans for consumption smoothing may be more important than the demand for loans for production.

1.5. What are Some Characteristics of Successful Microfinance Institutions?

Microfinance is not conventional banking. Although MFIs employ general banking principles, successful MFIs have developed new, cost-effective business models and innovative lending technologies. Lending technology covers the range of activities carried out by an institution relating to developing products that respond to clients' needs, marketing

Box 2: A Successful Transformation from NGO to licensed institution

Accion Communitaria del Peru (ACP) began operations as a non-profit NGO focused on community development. In the early 1980s, ACP focused its activities on the provisioning of credit to microentrepreneurs in the capital city of Lima. As early as 1985, ACP began to consider transformation into a regulated, for-profit financial institution since its institutional form limited its ability to access capital and expand its services. While limited donor capital was available to NGOs, like ACP, a wholesale, second-tier institution in Peru had funding from a multilateral development bank, Intra-American Development Bank (IDB) for onlending to regulated financial institutions operating in the microfinance sector. As an unregulated NGO, ACP was not eligible to access this funding. In the 1980s however, Peru was hit by a financial crisis and ACP decided to delay its transformation plans. In the 1990s with the return of economic stability, ACP considered again transformation into a regulated financial entity. Several potential legal forms existed into which ACP could transform: 1) a full-service bank, regulated under mainstream banking law, 2) a *financiera* that required lower minimum capital ($3 million) than a full-service bank, but was limited in its product range, particularly for savings and current account services, and 3) Small and Microenterprise Development Entities (EDPYME), having very low minimum capital requirements ($250,000) but not allowed to offer any savings services. At the time ACP was considering transformation, a new legal form emerged allowing for the creation of a specialized microfinance bank with few restrictions on product offerings. This latter form was adopted by ACP, and the NGO was transformed into MiBanco, the first for-profit fully licensed and regulated bank dedicated to microfinance in Peru. Its mission was and continues to be promoting the economic development of Peru's low-income majority population through the provisioning of financial services. Mibanco operates in Lima, Callao, Chincha, Chiclayo, and Huancayo.

MiBanco is owned by a range of investors from the private and public sector. The majority of MiBanco's shares are owned by ACP (the founding NGO). Other investors include ProFund (an MFI equity investment fund owned by private foundations, multilateral investment funds, and individual private investors), Accion's Gateway Fund, Banco de Credito (commercial Bank), Banco Wiese (commercial Bank), and Andean Development Corporation. Banco de Credito and Banco Wiese are the two largest private banks in Peru. As a regulated institution, MiBanco has access to a range of sources of loan capital. MiBanco received significant amounts of financing from a second-tier financial institution, COFIDE, as well as private commercial banks.

Following transformation, MiBanco began offering savings services. MiBanco has also significantly diversified its product offerings in both urban and rural areas to include working capital loans, housing loans, credit lines, passbook savings, term deposits, remittances, fixed asset loans, and foreign exchange services. MiBanco uses a range of lending technologies including both traditional asset-based lending as well as non-traditional guarantees. MiBanco has a long-standing technical relationship with Accion International, an international technical service provider, that provides MiBanco with technical support services. MiBanco also participates in a Women's World Banking network, Global Network for Banking Innovation in Microfinance.

As of the end of 2002, MiBanco had 99,121 active clients, accessing both credit and savings services. More than 50% of its clients are women. Loan sizes range from $100 to $100,000, and loan terms range from 3 months to five years. About 19% of MiBanco's loans are group loans and 81% are individual loans. 71% of individual loans are not guaranteed. In 2002, its outstanding portfolio was approximately $92 million with average loan balances of $931. The first loans ranged from $300 to $700. With a portfolio at risk of 3.1 % in 2002, MiBanco is one of the soundest banks in the Peruvian financial system, and is fully profitable.

MiBanco uses technology to improve performance. MiBanco has 35 branches in its network and ATM machines at many locations. Given the large number of clients per credit officer (characteristic of microfinance operations), credit officers use handheld computers to cut down on loan processing time and errors.

Sources: *The Transformation of Microfinance NGOs into Regulated Financial Institutions*, Anita Campion and Victoria White; Accion International Website (www.accion.org)

products, developing delivery channels, minimizing risk to the institution, and enforcing repayment of loans. Successful microfinance institutions share these practices:

- They develop innovative lending technologies that balance the needs of low-income borrowers and minimize risk to the institution. Loan evaluation is often based on cash flow of a household or business, and a client's character. Asset-based collateral is secondary, though often required; and non-traditional collateral like jewelry and household appliances may be used.
- They are located close to borrowers and loan disbursement and collection often happens on the borrower's premise rather than at the Bank.
- They price products to ensure that revenue covers the full cost of operations to enable profitability within a reasonable period of time, usually within 5-10 years, but variable depending on context. The relatively small transactions of poor and low-income clients may result in costs per loan that require prices (interest rates) that are significantly higher than commercial bank rates (though generally lower than moneylender rates).
- They manage highly efficient operations to reach very large number of people. Each bank officer serves a significant number of loan clients (generally between 200 and 500, depending on the lending technology), and operating costs as a percentage of the outstanding loan portfolio are minimized. Global benchmarks for sustainable institutions peg operating costs at 15% to 25% of the outstanding portfolio. In Africa, operating costs as the percentage of outstanding portfolio on average is far above global norms making cost control a particularly challenging area for MFIs in Africa.

- They attract rather than "target" clients. They design products that draw from a broad population (the poor, vulnerable non-poor, low-income unbanked populations), rather than narrowly targeting a particular group.
- They provide financial services exclusively. As a general rule, successful MFIs do not provide both financial and non-financial services.
- To support long-term growth, they are able to access commercial sources of funds including savings from the public, bank loans, and other debt markets, for example by issuing bonds or other forms of commercial paper.

1.6. What is the Role of the Informal Sector versus Formal Sector?

The majority of households in Malawi lack access to finance from either formal (Banks, NGOs, etc.) or informal sector sources (money lenders, family and friends, Rotating Savings and Credit Associations, etc.). In many economies households rely on a combination of formal and informal sector suppliers of finance, often making trade-offs in terms of convenience (informal sector players tend to be better positioned) and depth of services offered (formal sector players tend to offer a wider variety and more stable source of finance). While informal transactions take on a greater or lesser role in different financial systems, informal markets tend to be shallow, meaning they are inefficient (and therefore often expensive); they tend to offer a limited array of services, operate in limited geographic areas, and provide inconsistent access. As a long-term solution, development of formal financial systems will be necessary to serve massive numbers of people with a range of services. In the absence of formal intermediaries, however informal suppliers provide deposit, credit and transfer services that provide value to clients for which clients are often willing to pay dearly to access.

Box 3: A Microfinance Lending Operation of a State-owned Bank, BRI, Indonesia

Bank Rakyat Indonesia (BRI) is a state-owned commercial bank that began as an agricultural development bank. While it now maintains a commercial focus, it is still largely focused on rural banking services, particularly to the agricultural markets.

In 1996, BRI total assets were more than $12 billion. BRI has 320 branches located at the district or municipal levels and 3,600 retail outlets at the subdistrict level known as BRI Village Units (or unit desas). Microfinance services are offered through the unit desas (UD) for rural and urban clients and operates as an independent profit center. BRI-UD operates on a fully commercial basis, accounting for 25% of BRI's total assets and 70% of its total savings deposits.

BRI Unit Desas (BRI-UD) was initially established in the early 1970s to channel credit to farmers through a programme intended to promote national rice production (BIMAS). Interest rates were fixed at subsidized levels and losses were covered by Indonesia's Ministry of Finance. By the 1980s lending volumes were very low and default rates were greater than 50%. With the closure of BIMAS, the government decided to convert BRI-

UD into a rural banking network that would offer a wide range of financial services to low-income clients. In 1984, the entire BRI-UD system was restructured and a single loan product was offered for general rural credit (KUPEDES). KUPEDES is neither targeted to specific client groups nor subsidized and is available for both working capital and investment capital. The *maximum* loan size for KUPEDES loans has been raised from $1,000 at product launch to more than $10,000 today.

After decades of focusing on cheap, subsidized credit, BRI recognized the huge demand for *savings* services among clients and developed appropriate services to meet that demand. With the success of this product and indications that BRI-UD could be financially viable, BRI-UD launched a savings products called SIMPEDES (rural savings). The popularity of the savings product was enhanced by a complete overhaul of BRI's public relations and marketing strategy. Savings deposits skyrocketed as money kept in people's homes and non-financial assets converted to money were deposited in the Bank. The unit desa itself is centrally located in a sub-district town, occupies one room serving 16-18 villages, and averages 4,500 savers and 700 borrowers.

As of the end of 2002, BRI-UD had total assets of $3.2 billion including a loan portfolio of $1.3 billion, and savings deposits of $2.6 billion. Its portfolio at risk > 30 days was 4.37%. It had a 6.58 % return on assets and 111% return on equity. BRI-UD accounts for the lion's share of BRI's total profit. BRI was one of the few banking institutions to have weathered the Indonesian financial crisis, largely due to the success of BRI-UD, and to have even expanded its operations at that time.

Sources: *Bank Rakyat Indonesia (BRI) Case Study,* Klaus Maurer; MIX Market statistics (www.themix.org)

Box 4: Sogesol, a Microfinance Subsidiary of a Commercial Bank

With the lifting of interest rate ceilings, Sogebank, Haiti's largest commercial bank was interested in building a client base in the informal economy, since they represent more than 75% of the working population in Haiti and an estimated 1.6 million microenterprises. Sogebank has more than 25% market share in the Haitian commercial banking market. It has more than $300 million in total assets, is highly profitable, and has stakes in a number of subsidiary operations including a credit card company, a consumer credit business, a real estate business, a mortgage company, and its microfinance business.

Sogebank received funding from the IntraAmerican Development Bank through its Multilateral Investment Fund to explore the concept of developing a microfinance business, and in 2000 established an independent subsidiary microfinance operation owned by Sogebank (35%), Accion International's Gateway Fund (19.5%), Profund (a specialized equity investment fund for microfinance (20.5%), and a local individual (25%.)

Accion (also with an ownership stake) provides Sogesol technical assistance services.

Accion works with Sogesol to develop products, train its staff in credit evaluation and risk management techniques and implement management systems that assist Sogesol to manage its microfinance business. While Sogesol and Sogebank are independent from one another, Sogesol leverages the Sogebank infrastructure for its operations, primarily its technology and human resources. Sogesol also has some dedicated staff based in bank branches to carry out functions unique to Sogesol, for example product marketing. Sogesol originates loans, but Sogesol borrowers make their loan payments at Sogebank's 24 branches. An independent information system provides Sogesol specific information it needs to manage its portfolio. Sogebank provides capital to Sogesol for onlending, enabling Sogesol to leverage its equity. However, Sogesol must maintain the minimum capital requirements imposed by the Haitian Central Bank. Sogebank also provides Sogesol other administrative services including Human Resources, Legal Affairs, Auditing, and marketing. Sogesol's monthly payments to Sogebank include interest on capital used to fund the Sogesol portfolio, payments for management services, payment for branch and teller services and payments to maintain the loan loss reserve. By outsourcing services from Sogebank, Sogesol is able to grow its operations rapidly, and minimize its fixed costs.

As of December 2002, Sogesol had 5,657 active clients and an outstanding loan portfolio of $2.7 million. Average loan balances were $421. Sogesol plans to reach 30,000 clients by 2005.

Source: Accion website (accioninternational.org); *A Commercial Bank Does Microfinance: Sogesol in Haiti*, Guy Stuart).

Box 5: Lessons from a Mature Microfinance Industry: Bolivia

The experiences of maturing microfinance markets have lessons to offer newly evolving markets. In Bolivia, commercialization has enabled dramatically greater outreach to poor and low-income clients and increased competition leading to lower interest rates and better services for clients. However, the entry of new players and consumer lenders following unsound business practices, created destabilizing conditions for the market in the late 1990s. And while the number of clients has grown dramatically in Bolivia as the market has evolved, market growth in recent years has slowed significantly despite that a significant number of people remain without access to financial services. Of the estimated 600,000 microenterprises in Bolivia, only 1/3 have access to financial services.

The microfinance market in Bolivia is considered relatively mature, with most microfinance clients now served by formal financial institutions, even though the market itself was pioneered by successful NGOs. Among the "MicroRate 29", 29 successful microfinance institutions tracked by MicroRate (an industry rating agency), the two largest microfinance institutions are based in Bolivia. Banco Sol had a loan portfolio of $81 million and 61,368 clients in 2001, and Caja Los Andes had a loan portfolio of $52.6 million with 43, 530 clients. BancoSol, focused exclusively on micro and small enterprise finance, and serves about 25% of the nation's commercial banking clients. Other notable institutions in Bolivia include Prodem, FIE, and ProMujer. Bolivia is the home of "transformed" microfinance institutions, that is, NGOs that transformed into licensed regulated banks, for example, BancoSol. In Bolivia many microfinance institutions take the form of FFPs, which are private financial funds with minimum capital requirements lower than full-service banks and that offer a stripped-back array of services, with few offering savings services. The Bolivian market has also witnessed the entry of purely commercial microfinance players. Several commercial players include Fassil, founded in 1996, focusing on both consumer lending and more traditional enterprise-based microfinance operations, and Banco Economico, a full-service bank with an independent unit for microfinance clients. Given the number and range of institutional types, competition has emerged among players. Clients have benefited as competition brings lower prices, new products and better service. In response to competitive pressures, however, some institutions have been forced to drop out of the market.

At the same time that competition was taking off in Bolivia in the late 1990s, a group of institutions that focused on consumer lending also emerged. Consumer lenders offered loan sizes similar to that of microlenders, and focusing largely on salaried workers, and the best clients of established microfinance institutions. In Bolivia, consumer lenders were reckless, not enforcing strict repayment and lending to clients who were already indebted. Subsequently, default increased dramatically among both consumer lenders and traditional microlenders, who had up to then managed very strong portfolios employing strong delinquency control measures. The poor practices of consumer lending companies weakened the financial services market. This experience has highlighted the need for credit bureaus in mature markets, and the adoption of appropriate regulation where necessary to ensure that new institutions, like the consumer lending agencies in Bolivia, do not employ "reckless" practices that threaten the stability of the microfinance subsector and the financial services industry overall. In Bolivia, despite market factors, the microfinance industry has fared better than the mainstream banking sector overall. Portfolio quality of MFIs tends to be stronger than that of the mainstream banking sector, and microfinance institutions are more profitable than commercial banks. However, the fact that portfolio growth of major institutions has slowed considerably (from 54% in 1997 to 9% in 2001) at the same time than many segments of the population remain unbanked in Bolivia, suggests that yet new models of service delivery and products are required to push the finance frontier even further out.

Sources: *The Finance of Microfinance*, MicroRate and *Commercialization and Crisis in Bolivian Microfinance,* Elizabeth Rhyne.

Box 6: The Infrastructure that Supports Microfinance Sector Development

The microfinance sector in Malawi is currently in a start-up phase with few operators on the ground. A mature microfinance industry in Malawi will comprise a variety of institutional forms likely including commercial banks, NGOs, non-banking financial institutions, and specialized microfinance banks. Over time healthy competition will develop among institutions, and MFIs will serve a variety of niche markets with a broad range of financial services including loans, savings, money transfers, and insurance. An enabling legal and regulatory environment will promote sustainability and growth of the sector. A sector infrastructure will emerge that supports microfinance institutions and their eventual integration with commercial capital markets.

Sector infrastructure will include technical service providers, industry networks, credit bureaus, funders including equity investors and lenders, and rating agencies. The following describes the kinds of institutions that comprise this supporting industry infrastructure. This report does not promote any organization listed below; these are merely indicative.

Donor and Investor Consortia

Donor and investor consortia promote industry development globally, and enable coordinated action among donors. CGAP is a global consortium of 29 bilateral and multilateral donor agencies that serves MFIs, donors, and the industry through the development of technical tools and services, delivery of training materials, strategic advice, technical assistance and action research on innovation in the industry. The CGAP website (www.cgap.org) is a strong source of information on the industry with extensive links to other microfinance-related sites, including many of the organizations listed below.

Service Providers

Technical Service Providers include both consulting firms that specialize in microfinance technical support services to microfinance institutions, as well as practitioner organizations that also provide technical services to other MFIs (generally in markets where they do not operate and therefore don't compete with those MFIs). Support services include developing appropriate business models, lending technologies, new products, MIS systems, portfolio management systems, institutional policies, financial projections, staff training, development of incentive systems, Board development, etc.

One example of a specialized microfinance technical service provider is Accion International. Accion provides technical assistance and training to microfinance institutions globally. It also manages a regional network of organizations to facilitate sharing of knowledge and learning across organizations. Other firms that have been contracted by UNDP to provide technical support services to MFIs include Calmeadow, DAI, ECI, ICC, DID, etc. Practitioner organizations that provide services include Grameen Foundation, K-REP Advisory Services, Association for Social Advancement (ASA), Alexandria Business Association (ABA), etc. The CGAP website has links to many such organizations.

Industry Networks

Microfinance networks and associations play a role in facilitating the sharing of information across institutions. Network may operate on a national, regional or global basis. Networks also play a role in channeling technical support to MFIs and establishing common performance standards in the industry.

Women's World Banking is an example of a global network that provides technical support, and monitoring and networking services to financial institutions that support women's access to financial services. It works in 32 countries globally. The Association of Ethiopian Microfinance Networks is an example of a strong national network of microfinance organizations that provides technical assistance, policy advisory services, and knowledge sharing services to its members.

Research and Development

Industry research and development is promoted by both donor supported projects and independent centers. Even "mature" markets in many countries have limited outreach to unbanked populations indicating that significant new advances are required in areas such as product development and development of new business models for microfinance service delivery.

The Microfinance Center for Central and Eastern Europe and the Newly Independent States based in Poland is a membership-based resource center that promotes the development of a microfinance sector. It has created a regional network of MFIs, and provides technical assistance, training and other advisory services to MFIs.

MicroSave-Africa, based in Kenya, carries out "action research" within microfinance institutions and trains MFIs to develop market-led (not supply-driven) microfinance products and services.

Rating Agencies

Specialized microfinance rating agencies act as third-party evaluators of MFIs. Raters carry out rigorous evaluation of MFI operations and performance, and provide information to potential investors and lender to MFIs to attract investment to the sector. By using a standardized approach they promote transparency and benchmarking in the industry. Two examples are Planet Rating (Planet Finance) and MicroRate.

Wholesalers

Wholesale microfinance institutions are often government or semi-autonomous organizations that refinance microfinance institutions. Successful wholesalers apply rigorous performance criteria to institutions that access their funding. They lend on commercial or semi-commercial terms. PKSF is a semi-autonomous wholesale financing institution in Bangladesh that provides loans to more 150 retail microfinance institutions. Interest rates to microfinance retailers (Grameen Bank, ASA, etc.) are slightly below commercial borrowing rates and funds come primarily from the World Bank. To access PKSF loans, MFIs must meet high performance standards and undergo rigorous institutional evaluations.

Debt and Equity Investors

Specialized debt and equity Funds enable MFIs to grow. These funds advance commercialization of the industry by demonstrating to commercial sources of capital (banks, private investors) the commercial and financial viability of microfinance operations. These Funds also draw in private, commercial investment by structuring their equity investment alongside national commercial bank debt.

Profund, is an example of a for-profit debt and equity investment fund that seeks commercial returns for investors and shareholders through investments in growth-oriented regulated micro finance institutions. Profund investors include private individuals, private foundations, multilateral investment banks, and development Funds. Profund has provided more than $22 million in both debt and equity in 11 institutions in Latin American and the Carribbean.

KfW is a bilateral investment Bank supported by the German government investing in 31 microfinance institutions primarily in Eastern Europe and Central Asia. Approximately $23 million is allocated to microfinance investments.

The Dexia Microfinance Fund, a private microfinance fund is based in Luxembourg. It lends to microfinance institutions including Banks, NBFIs, Rural Banks, cooperatives, an NGOs on a purely commercial, non-concessional basis. It has invested $20 million in 35 institutions globally.

Commercial Banks

In many countries, commercial banks are lending to microfinance organizations on purely commercial terms.

Sources: Policies, Regulations, and Systems that Promote Sustainable Financial Services to the Poor and Poorest (in *Pathways out of Poverty*), Women's World Banking; MixMarket (www.themix.org)

Chapter 2: The Broad Policy Environment

Microfinance services can be successfully delivered in a wide variety of policy and economic environments. Individual institutions that serve segments of the population have flourished in difficult environments (*UNCDF Strategy for Policy Impact and Replication in Local Governance and Microfinance,* 2002). However, certain factors in the policy environment enable or make difficult the development of financial sectors that respond to the majority of the populations with the range of services necessary for financial sector deepening. An inclusive and deep financial sector cannot evolve when macroeconomic performance is not strong. Weak macroeconomic performance makes it difficult for financial sectors to manage risk, efficiently intermediate deposits, and compete and attract investment required to grow. This chapter examines broad economic development, as well as macroeconomic, financial sector, agricultural, and social policies in Malawi to identify opportunities and constraints for the development of financial sectors that serve the majority of the population in Malawi.

An efficient, functioning financial sector contributes to a country's development measured by overall economic growth, income growth per capita, and decreasing income inequality. Countries with more developed financial markets that offer a range of financial services, efficient prices, and effective risk transfer mechanisms and greater financial depth (measure by the ratio of liquid liabilities to GDP) have grown faster than countries with less developed financial markets. The percentage of liquid liabilities to GDP was 18% in Malawi in 1998, compared to 122% in Japan and 65% in the United States (World Development Indicators 2000). Efficient financial sectors are populated by institutions that grow domestic savings in the formal financial sector, allocate savings to competing uses through loans and other financial instruments, and participate in a national payment systems. The efficient provision of loan, deposit, payment and insurance services enables entrepreneurship, innovation and production to develop and flourish. While financial depth does not necessarily indicate the existence of an *inclusive* financial sectors, characterized by universal or near universal access to financial services it is certainly a prerequisite.

2.1 Macroeconomic Context

This section focuses on the Government of Malawi's economic development, fiscal, and monetary policies and their influence on the performance of the economy and financial sector development.

2.1.1. Broad Economic Development Policy

Evolution of Policies and Programmes

From 1981 to 1994, the Government of Malawi implemented a series of policy interventions through World Bank and IMF backed Structural Adjustment Programmes aimed at sustainable growth. By the end of 1994, following a series of weather-related external shocks and generally weak fiscal and monetary policy management, Malawi's inflation was at 66% and its deficit more than 15% of GDP. Subsequently, the IMF has supported a series of Enhanced Structural Adjustment Facilities (ESAF). Under the ESAF, performance was uneven, with strikingly strong performance in its early phases but going off track by the end of 1999. In December 2000, a new three-year Poverty Reduction and Growth Facility (PRGF) was implemented focusing on poverty reduction, concentrating primarily on private-sector development and fiscal policy reforms. The PRGF is consistent with the Malawi Poverty Reduction Strategy Paper (MPRSP) which outlines a five-year plan for poverty reduction and growth. The PRGF lapsed in 2004 because of spending overruns, largely attributed to repeated bailouts of parastatals and the high cost of the government's growing domestic debt, high inflation and a growing current account deficit. Following the lapse and in attempts to assist the new government get the economy back on track in July 2004 a staff-monitored programme (SMP) was launched. Performance so far has been strong and the Government of Malawi has met key targets. The Government and the IMF anticipate that a new PRGF programme will be launched in the near future given that the Government continues to meet key fiscal targets. (See Chart Table 1 for a summary of key macroeconomic indicators.)

Policy reforms have led to periods of short-lived economic recovery. However, as a result of inconsistent implementation of the structural adjustment programmes and macroeconomic instability, reforms have not resulted in sustainable broad-based growth that enable Malawi to meet its poverty alleviation and growth objectives. Since the mid 1990s the economy has been characterized by high inflation coupled with sustained deprecation of the kwacha, largely driven by substantial fiscal deficits and high levels of government spending. Inflation rates however have fallen dramatically from levels approaching 50% in the late 1990s to a low of 9.6% by the end of 2003. Inflation averaged 11.5% in 2004 with rises attributed to spending before the May 2004 government election and the depreciation of the kwacha (*Malawi Country Report*, EIU, 2004). Inflation crept up to 14% in February 2005, due in part to food shortages.

While the intention of economic policy has been to reduce fiscal deficits so the government can reduce its debt in domestic markets and open up lower cost opportunities for private sector borrowing, the Government has consistently not met its fiscal targets.

Creating a vicious circle, government borrowings increased dramatically from 2000 due to the suspension of budgetary assistance from donors as result of this fiscal indiscipline. The IMF has not made any new disbursements in 2004 under the $45.1 million PRGF (only 12.9 million was actually disbursed under this programme). However, it is expected that a new programme will be initiated in 2005 contingent on the government's ability to maintain commitments to fiscal prudence.

Macroeconomic instability has undermined the intended poverty reducing impact of World Bank and IMF supported programmes – programmes' number one priority. Rather instability has exacerbated poverty levels in Malawi (*Malawi PRSP*). In addition to fiscal indiscipline, weak economic performance has resulted from external shocks (including droughts, fluctuations in international commodity prices, and the rising price of inputs) and a very narrow base of production, namely tobacco for exports, which renders Malawi especially vulnerable.

Agriculture is the key sectoral source of growth for Malawi's economy, and subsequently economic policy is largely focused on agricultural sector development and increasing incomes for farmers, particularly smallholders. Key policies have focused on market liberalization, privatization, and the reversal of earlier policies that emphasized large-scale agricultural and industrial development, and that resulted in significant income disparities among the population. Now, policies emphasize improvements for smallholder farmers. Initiatives to improve smallholder farmer production have focused on the liberalization of agricultural marketing including the removal of prices controls and restrictions on cash crop production, primarily tobacco, and initiatives to improve farmer access to inputs. Access to credit has been recognized as a key factor affecting production and income. In theory, new policies recognize the importance of access to finance, and the deepening of financial markets to support poverty alleviation and economic growth.

Results of Policies

While polices aimed at increasing access to inputs and the value of outputs by removing market distortions and allowing markets to flourish have been articulated, in practice, increased market-driven access and value has not appreciably materialized. While broad policies favour access to finance, the level of development of the financial and banking sector depends on a sound macroeconomic environment. Critical macroeconomic variables that influence the development of financial markets are the government deficit, the inflation rate, interest rates, and the exchange rate. Malawi's macroeconomic performance, specifically a high fiscal deficit, high levels of inflation (albeit dramatically lower levels in recent years), high real interest rates, and a depreciating currency, has in fact frustrated the achievement of financial sector development and increased access to finance. Volatility in the economy affects financial institutions' ability to manage risk and willingness to lend; it also affects the risks and choices of microenterprises and farming households (*UNCDF Strategy for Policy Impact and Replication in Local Governance and Microfinance,* 2002). Financial markets in rural areas tend to suffer disproportionately to macroeconomic instability.

Real GDP growth rates – both the driver and result of macroeconomic variables (including the exchange rate, inflation rate, balance of payments, etc.) – have fluctuated dramatically over the past 10 years. Fluctuations in GDP growth figures are largely attributed to the variability of agricultural output and prices of agricultural commodities. Agriculture generates 35% to 45% of GDP, and over 90% of Malawi's exports. Between 1996 and 1999, real GDP growth averaged 4.6% (EIU). From 2000 to 2002 it was only .6% reflecting drought and flood conditions that led to widespread food shortages. Weak GDP growth rates in recent years are also attributable to high real interest rates and the "crowding out" of private sector activity by high levels of government borrowing to finance the fiscal deficit.

The good news is that real positive growth is forecast for the short and medium-term future. GDP grew by 4% in 2004 (an increase from 1.7% in 2003). GDP growth is attributed to a mix of increased government spending and higher tobacco output despite that the quality of tobacco and per unit prices are falling in real terms. However with the average population growth rate at around 2% per year, economic growth rates of 6% per year must be achieved for poverty levels to fall (EIU). Real GDP per capita growth has remained flat or negative despite real GDP growth rates.

The ability for Malawi's economy to benefit from positive growth will depend on fiscal discipline on the part of Government, efficiency in the banking sector (thus more attractive lending rates), private sector investment opportunities, and the ability of public and private sector to manage the challenges presented by the falling and/or variable prices of Malawi's commodities in international markets. Some of these challenges include the rising price of inputs in the face of the depreciating kwacha, the weakness of financial markets in Malawi to deal with both agricultural production and market risk, and the significant infrastructural and financing gaps in the agricultural value chain in the areas of input supply, production, commercialization, and processing.

Table 1: Summary of Key Macroeconomic Indicators

Indicator	1998	1999	2000	2001	2002	2003	2004 (est.)	Projected (2005)
Consumer Price Inflation	29.8%	44.7%	29.6%	27.4%	14.8%	9.5%	11.4%	14%
Exchange rate (MWK/US$)	31	44	59.5	72.3	77	96	109	112
Real GDP Growth	2%	4.2%	2%	-4.1%	1.8%	4.4%	4%	4.2%
GDP/head (US$)	246	162	165	151	171	171	166	
Government Deficit as % of GDP[11]	-5.6%	-5%	-5.7%	-5.9%	-9.1%	-7.6%	-6%	
Import Cover (in months)[12]	5	5	4.7	4.4	3.3	2.9	2.9	

Source: IMF, EIU, Reserve Bank of Malawi

2.1.2. Fiscal and Monetary Policy

Monetary policy refers to the use of monetary instruments to reduce instability in financial markets. It includes open market operations that affect the money supply (for example, the sale of government Treasury Bills), the establishment of mandatory reserve requirements of Banks (and thus money available for private investment), and central Bank lending to commercial banks (the rediscount rate) to ensure sufficient liquidity in the financial sector. Monetary policy can have a profound impact on financial sector development.

Fiscal policy is controlled by the Ministry of Finance (the Treasury), responsible for taxation policies and levels of government consumption. The government's level of consumption relative to its revenues (taxes and donor inflows) determines its budget deficit, and the extent to which it must borrow money to cover its cash flow needs. Domestic debt in Malawi is currently 30% of GDP. The government can finance fiscal deficits by raising additional revenue through taxes, creating money, or by borrowing from domestic markets and international capital markets.

The Government of Malawi has followed an expansionary monetary policy, financing debt through domestic debt markets. Persistent fiscal imbalances in Malawi have resulted in high real rates of interest and the crowding out of private sector and agricultural loans in banks' portfolios. Over the past five years domestic public sector debt has risen dramatically (See Table 3), from 3% of GDP in 1999 to 20% of GDP by the end of 2003 (IMF, 2003). Government's interest payments alone on domestic debt equal 9% of GDP. While nominal interest rates have fallen with inflation since 2000, real interest rates have actually risen since 2001. Deposit rates have decreased even more than lending rates, increasing banks spreads, but not benefiting clients (see Table 4).

Despite periods of improvement since the start of ESAF and efforts to develop monitoring systems for public expenditures, poor financial controls in the public sector and overspending remain obstacles for economic and financial sector development in Malawi. In 2003, the IMF had suspended budgetary support because Malawi had not met its fiscal management targets, however support was resumed in October 2003 in efforts to avert economic collapse, potential government default on its debt and to ward off a potential crisis in the banking sector. Donor support increased following the resumption of IMF lending in 2003 and was used to pay off domestic debt. The government elected in May 2004 has promised improvements in fiscal responsibility, and appears to be delivering on that promise meeting key fiscal targets of the IMF sponsored SMP. While government expenditures rose prior to the recent election, the deficit is expected to narrow in 2004/5 to 6% of GDP, some improvement over a deficit of 7.6% of GDP in fiscal year 2003/4.

2.1.3. Impact of Inflation and Exchange Rate Stability

Very high inflation and/or unstable inflation rates can create difficulties for financial intermediaries and their clients. Inflation results in a real cost to financial institutions (and their clients) that must be covered by the interest generated on loans; thus high inflation translates into interest rate hikes. Absent price and exchange rate stability, it is difficult for both clients and financial institutions to plan for the future; thus high inflation is likely to result in stagnant financial markets – limited lending and limited savings mobilization. If returns to savers don't keep up with rises in the inflation level, then mobilizing savings in local currency becomes costly to the saver, and savings is likely to take place in non-monetary forms. (*UNCDF Strategy for Policy Impact and Replication in Local Governance and Microfinance,* 2002). High inflation rates in Malawi have been driven largely by the high levels of government borrowing, as well as food shortages.

Following very high rates of inflation, in recent years inflation has consistently fallen in and appears to be stabilizing, though recent figures indicate that it is inching up (see Table 1). The downward trend in inflation is also being reversed somewhat by the falling value of the kwacha against the US dollar (USAID AMAP Microfinance Sector Assessment of Malawi). The downward trend in the value of the kwacha is expected to continue over the next couple of years. The dollar/kwacha exchange rate was 76 to US$1 in 2002; the current exchange rate is MWK 107 to US$1, and forecast to depreciate to MWK110 to US$1 by the end of 2005. While the value of the kwacha appears stable, it remains vulnerable. The Government's foreign reserves have decreased steadily over the last five years, pushing pressure on the value of the kwacha. Debt payments as a multiple of exports remains extremely high with the potential to further deplete reserves and put pressure on the currency.

In 2004, the Reserve Bank of Malawi had planned to decrease its banking reserve requirements from 30% to 10% to free up finance for the private sector. Plans to cut reserve requirements to 10% however have been postponed due to some resurgence in inflation, and remain at 27.5%, though banks state that the way the new reserve requirement is calculated has actually increased not decreased the amount of reserves they are required to hold.

While inflation has fallen from high levels, real interest rates remain high due to uncertainties about future inflation levels (IMF, 2004) and future levels of government spending. While the new government has promised to reign in spending, and has met key fiscal targets in recent months, its ability to do so given its fragile majority in Parliament is unknown (EIU).

2.2. Implications of Macroeconomic and Fiscal Policy on Financial Sector Development in Malawi

Economic stability is conducive to the growth of the financial sector, and the expansion of financial services to an increasingly larger and more inclusive set of clients. Financial sector deepening in Malawi and the emergence of competitive financial markets depend on the Government of Malawi adhering to policies of fiscal and monetary stability. This means continued reductions in government spending to reduce real rates of interest and inflation, and support stabilization of the currency. Narrower interest rate spreads should contribute to economic growth by reducing lending rates and the cost of investment, and result in more cost efficient and desirable services for clients. Macroeconomic stability is a precondition for financial sector development. However it only provides a platform for implementation of a comprehensive strategy for growth and development. Malawi's weak economic structure creates constraints that require long-term action, beyond short-term measures to achieve macroeconomic stabilization.

- Macroeconomic stabilization, including lowering inflation and maintaining fiscal discipline must precede other reforms and is key to raising the economy's growth rate (IMF, 2004).
- Recent experience from the transformation countries demonstrates that macroeconomic and sector reforms must precede efforts to build rural financial systems (Zeller).
- High levels of domestic borrowing by the government results in high real interest rates. High rates of return to Treasury Bills creates disincentives for private sector lending thereby crowding out private investment. In June 2004, net credit to the government was nearly three times the amount to the private sector. When Treasury Bills are not competing with private sector investments, Banks have more money to lend and more incentive to innovate financial products and services that advance the finance frontier to underserved market segments.
- In addition, the high cost of servicing debt diverts budgetary expenditure from other priority investment projects making it difficult for the Government to finance development in key infrastructural areas (roads, electricity, communications) critical for financial sector and economic development, particularly in rural areas. Poor infrastructure significantly increases the cost of borrowing in rural areas.
- High government debt (and debt growing faster than exports) can result in decreases in the cache of foreign reserves, threatening the stability of the kwacha. The level of the kwacha exchange rate has an impact on the micro and small enterprise sector, influencing the performance and behavior of both financial institutions and MSEs.
  - Because of the relative loss in value of the kwacha vis-à-vis the currency of the major trading partners such as South Africa, traders dependent on imports of goods from South Africa require larger sized loans to purchase the same quantity of goods, demands that banks may not able to meet (USAID AMAP Microfinance Sector Assessment of Malawi).
  - The weakening of the kwacha makes fertilizer imports expensive, eating into farmers' potential profits and capacity to service debt and accumulate assets. Because farmers have had difficulty accessing inputs, due to increased prices and decreased availability, the export tobacco crops of smallholder farmers growing burley tobacco have diminished in quality, even though production volumes have increased. In 2003 in particular and again in 2004, price gains that may have accrued to farmers due to the fall in the value of the kwacha have been offset by lower prices that have resulted from lower quality burley crops.

  - Microcredit programmes may find it difficult however to increase loan sizes as currency devaluations and subsequent rise in inflation eats into the value of their equity (USAID AMAP Microfinance Sector Assessment of Malawi).
  - Financial institutions may be reluctant to draw on international debt and capital markets to finance growth if the value of the currency becomes unstable.
  - Financial institutions may be reluctant to make longer-term loans if the value of the currency falls and inflation increases.
- Lackluster macroeconomic performance, financial constraints at the level of micro and small entrepreneurs, and uncertainty about the future, limits effective demand for microcredit services in Malawi, measured by clients' willingness to take loans and ability to service them.
- Macroeconomic uncertainty also limits banks willingness to lend and discourages the entrance of potential new suppliers to the market. In the context of macroeconomic instability, and subsequent pressure on interest rates and inflation, investment in the financial sector may appear to be a marginal investment opportunity. While donor and private sector flows may be returning in small quantities to Malawi, flows earmarked for financial sector development may be limited, particularly for start-ups. In fact, a number of donors including the World Bank have begun investing significant resources in grassroots initiative that focus on training community groups to mobilize and disburse resources locally, rather than the development of formal financial institutions.

Chapter 3: Social and Other Sectoral Policies

3.1. Social Policy: Poverty Alleviation and Reduction of Vulnerability

Of Malawi's total population, 65% – or approximately 6.3 million – people live under the poverty line. Nearly two million people are living in extreme poverty. The per capita GNP is $190**,** one of the lowest in the world. Malawi is ranked 162 out of 175 countries on the Human Development Index[13] (*UNDP Human Development Report* [2003]). The segments of the population most affected by poverty include smallholder farmers, female-headed households, and laborers on estate farms. More than 91% of the poor and 91% of the ultrapoor poor live in rural areas (*Malawi Poverty Reduction Strategy Paper* (MPRSP)). Nearly half of poor households are self-employed, and agriculture is their predominant economic activity, especially in rural areas. Subsistence agriculture accounts for 64% of poor household's income. Cash income accounts for only an estimated 13% of household income and is derived primarily from wages, not surplus agricultural production. The limited role of sales of agricultural surplus has an impact on demand for credit in rural areas, as demand is measured in part by clients' ability to repay loans with interest. The dominance of rural, small-holding households among the impoverished population in Malawi demands that government and donor policies that address poverty and strategies for financial sector development impact this population.

Safe savings facilities, payment services, access to credit, and reliable insurance mechanisms enable poor households to reduce vulnerability by smoothing consumption and mitigating risks. It allows them to build assets upon which they can draw during periods of economic downturn or crisis to smooth out dips in income, and maintain consumption levels for food and other services, like education and health care. Reliable payments services for the transfer of funds between rural and urban areas, and affordable insurance services (e.g., crop, life, health) also provide a means to manage external shocks and cope. The availability of appropriately designed financial services is an essential component of an enabling environment for rural economic growth and poverty reduction.

While the development of financial services that enable individuals and households to manage risk is critical, equally important is the development of financial instruments that enable the financial sector to manage systemic risk. Chapter 5 (Agricultural Development Policy and Rural Finance) explores systemic risk and the kinds of products and services required to manage and mitigate this risk.

3.1.1 Microfinance in the Malawi Growth and Development Strategy (MGDS)

The Malawi Growth and Development Strategy (MGDS) is Malawi's new overarching operational strategy for the attainment of the nation's Vision 2020. Poverty reduction through economic growth and development is its overriding philosophy. The MGDS aims at creating wealth through economic growth and infrastructure development as a means of achieving poverty reduction. The MGDS is expected to guide and support Malawi's transformation from a predominantly importing and consuming nation to a predominantly manufacturing and exporting country. The Strategy is also expected to economically empower Malawians and make them competitive on services for domestic, regional and international markets. The strategy is linked to the Vision 2020 and the MDGs. In addition, the MGDS builds on the Malawi Poverty Reduction Strategy (MPRS) and Malawi Economic Growth Strategy (MEGS). In this respect, the MGDS has been aligned with existing key sectoral strategies and policies from both the public and private stakeholder institutions.

The MGDS was developed through a participatory process that included views of a broad range of stakeholders. The MGDS identifies five broad strategic themes that define the direction the country intends to take in the next five years. Priority in the medium-term will be on the achievement of sustainable economic growth, social protection of the vulnerable people, social development, infrastructure development and rehabilitation and provision of good governance. The issues of HIV/AIDS, science and technology, gender, empowerment and environment have been mainstreamed in these themes. The MDGS has also been aligned to the MDG outcomes related to poverty, hunger, education, gender, child mortality, maternal mortality, HIV/AIDS, Malaria, environmental sustainability and access to water.

The following key priorities have been identified as necessary for the implementation of the MGDS.

- Create stable macroeconomic conditions for growth to instil domestic and international confidence in the economy;
- Develop and strengthen business enterprises that create wealth and thus contribute positively to economic growth through deep-rooted private sector reforms, focusing on improvements in infrastructure;
- Enhance production of food crops to make Malawi a hunger free nation;
- Develop civil service capacity to facilitate private sector based growth and development in order to contribute effectively to the resuscitation of economic growth including moving forward the decentralization process to effectively mobilize local resources in the development process;

- Provide basic health care and industry needs driven education to ensure a productive population that will contribute to sustainable economic growth; *and*
- Promote good governance practices because it underpins the achievement of all economic growth and social development objectives.

The MGDS defines actions to address these priorities, and other means necessary to achieve the medium term outcomes of Malawi.

Most Malawians are involved in low-return, small-scale enterprises. The large-scale, high-value businesses are owned by either foreigners or a minority of Malawians. Situational analysis as part of the development of National Economic Empowerment Policy shows that disempowerment is caused by a number of factors and manifests itself in the inability by the majority of citizens to control their economic destiny. Disempowerment affects citizens depending on their race, gender, age, location and economic disposition. The rural communities are most affected by the lack of facilities and infrastructure supporting the development of businesses. With more than 85 per cent of the population living in the rural areas, there is need to specifically target the rural communities if a significant impact in empowering Malawians is to be made. This will require that private investment in these areas is fostered and the culture of handouts and political patronage to rural communities is curtailed.

The MDGS observes that women in Malawi remain marginalized compared to men, and are likely to have less access to education, credit, land, and property than men. In addition, women have less access to employment opportunities both in the public and private sectors, and may not have equal access to technology and other key market information to support their business activities. The majority of Malawians experience difficulties accessing financial services and capital, skills development programmes, and technology developments. They are also the most affected by poor infrastructure such as roads, communication, and buildings not designed to accommodate or meet their special needs.

The medium term expected outcome of the MGDS is to increase the productivity of rural communities and businesses, employment and income, increase the number of women and youth who are actively participating in public and private sectors and to ensure that the urban poor are able to contribute to the economy. However, despite the various economic empowerment initiatives that Malawi has undertaken so far, many challenges remain that hinder Malawians from exploiting their full potential to participate in wealth creation. These include weak linkages to markets and few incentives for rural communities to organize themselves for productivity enhancement, limited access to micro-credit for most Malawians and high default rates that contribute to limited supply of credit, lack of business advisory services or training opportunities, and an increasing number of people are moving into the cities. Of these, stakeholders perceive problems in accessing finance as the most important constraint to economic empowerment. Three types of problems have been identified in relation to access to finance. These are poor linkages of smallholders and rural areas into the economy, ineffective incentives and conditions in fostering productivity and investment and limited availability of funds.

Among the strategies that seek to improve the integration of rural communities, women, youth and the disabled into the economy, the MGDS includes:

- Targeting infrastructure development to ensure that rural roads link rural communities to markets;
- Developing rural cooperatives to lower transaction costs of dealing with rural entrepreneurs and helping communities increase their bargaining power. This will be through targeted programs for rural areas complemented by current programs undertaken by agro-processing companies;
- Strengthening the policy environment for micro-finance, including improved coordination of donor programs to decrease market distortions. This will focus on providing innovative credit schemes and developing a network of practitioners while enhancing mechanisms to decrease the default rate;
- Offering vocational training and other training for small businesses; and
- Targeting women and their participation in growth through business programmes.

3.1.2. Rationalizing Strategies for Income Transfers (Grants) and Access to Finance (Credit and Savings)

Where economic opportunities are lacking and financial flows uneven, condition for the success of credit products and sustainable MFIs may not exist. In these cases, alternative mechanisms that include grant-based approaches to building economic opportunity and potential debt capacity are required. Some initiatives may include investment in basic economic and social infrastructure that raises income earning potential, for example strengthening local groups and organizations, and training in business and other skills related to human development (IFAD, Rural Finance in East and Southern Africa). Other programmes may result in direct transfers to impoverished populations in the form of cash grants or other in-kind transfers to meet direct consumption needs. Microfinance should not be considered a substitute for social safety nets. It allows people to take advantage of productive opportunities, but it does not create them.

Grant programmes should be designed to avoid conflict with the development of sustainable financial institutions and markets. Careful coordination and/or sequencing of grant and credit programmes is important to preserve a strong credit culture and to ensure an efficient use of public resources. Grants may be used to help families establish a productive base that provides the means for building assets, like savings, and/or generating cash incomes that can be used to access credit in the future.

In general, use of credit as an instrument to achieve non-financial objectives has not been successful. While in-kind credit granted through Agricultural Productivity Investment Programme (APIP) may have resulted in welfare transfers to vulnerable and food insecure households, the market distortions created and pervasive non-repayment may have discouraged the development of sustainable markets for finance. For those families that cannot repay debt credit is not an appropriate “instrument”. In fact in some cases, farmers that accessed credit for inputs may have realized lower incomes as a result of the prevailing policies and macroeconomic conditions (Zeller).

Programmes which in the past aimed to provide farmers with low cost or subsidized inputs have been criticized for distorting markets for both input supply and credit. The new government's promise to provide universal fertilizer inputs has raised eyebrows anew from the development finance community, currently applying pressure to reduce the fiscal deficit and viewing universal fertilizer inputs as counter to that goal. In recent harvests, however, lower quality tobacco, attributed to the inability of farmers to access inputs due to high prices and lack of input suppliers, have drawn lower prices for tobacco on international markets with adverse economic and welfare impacts.

Government has its work cut out managing competing agendas that appear on some level to be at cross-purposes. Subsidies appear to harm markets, but limited access to inputs deteriorates the quality and volume of production, creating another set up negative impacts. Support to government and line ministries for problem solving across sectors will be critical to address issues related to the development of agricultural markets, the financial sector, and maximizing human welfare within the context of volatile markets and limited financial and physical infrastructure.

3.2. Malawi Rural Development Fund

In January 2005, the Government of Malawi launched a MWK 5 billion Malawi Rural Development Fund aimed at increasing access to finance in rural areas for low-income households. The establishment of the Fund is meant to balance development opportunities between urban and rural areas. While the Fund had just been launched when this report was written, the Ministry of Finance and other stakeholders shared information about their understanding of how the Fund would operate.

The Fund itself will be disbursed through the Malawi Savings Bank. The MSB will act as an apex organization providing funding to clients identified by other intermediary organizations. Intermediaries will identify clients and manage the collection of loans; however, the loans themselves will reside on the balance sheet of the Malawi Savings Bank. The intermediary organizations will be provided with a fee to cover the costs of identifying and managing client loans. At the time this report was written the amount of the fee had not yet been established.

Oversight of the Fund will lay in a project unit under the Minister of Finance. The project management unit appeared vested with the authority to make key operating and policy decisions for the initiative, including the final approval of loans presented to the Fund by intermediary organizations.

During interviews carried out in the sector assessment, stakeholders expressed a number of concerns about the design and management of the initiative. Concerns are summarized below.

- No organization is clearly responsible for risk assessment and management. Intermediaries are awarded a fee for client selection and identification, but the loan book is not their property. Secondly, intermediaries do not appear to have final sign off on which clients receive loans. Incentives for strong risk management on the part of intermediaries are weak. Incentives would be vastly strengthened if client loans were on intermediaries' balance sheets and if intermediaries had final say in the selection of loan clients. In general, experience demonstrates that microfinance operations should be decentralized to the greatest extent possible with key decision-making processes – who gets loans, how much and at what price – residing with financial intermediaries not the apex or the Project Management Unit. A project structure that supports lines of credit from MSB or apex institution to intermediaries, and in some cases equity building grants, would enable institutions the opportunity to build stronger balance sheets, credit history, and ultimately access fully commercial sources of capital.

- Early indications are that the Fund's project management unit will establish interest rates for loans to clients, not necessarily on the full costs of providing loans, but on what it considers to be a fair market rate. In most countries, the prices (interest rates) of microfinance loans are higher than prime lending or other types of lending because of the higher costs of providing and managing microfinance loans. In order for this initiative to be sustainable, the costs of administering the loan portfolio must be fully accounted for. Otherwise, over time the Fund itself, much like the APIP fund will diminish significantly over time. The following two links provide useful information about the costs of providing microfinance loans (*Microcredit Interest Rates*) and how to develop pricing structures, as well as the impact of late loan repayments on the fund principal (*Measuring Microcredit Delinquency,* available online at www.cgap.org).
- Underpricing due to interest rate ceilings or lax loan collection could lead to distortion and other detrimental effects in the market for rural finance.
- Rural lending is not easy in Malawi as a result of the issues identified in this report namely, higher transactions costs in rural areas, lack of risk transfer mechanisms domestically or regionally, weak links in the agricultural value chain making production and sales of goods inefficient, and limited infrastructure in rural areas. With good intentions at its base, this government led initiative may place pressure on intermediaries to expand portfolios rapidly beyond the operating capacity of intermediary institutions. Rapid expansion without adequate operational capacity could very well lead to an overall deterioration of lending portfolios, exacerbating the problems inherent in rural lending not improving them.

The recent evaluation of the government and EU sponsored Agricultural Productivity Programme concluded that it suffered from weak planning at the initial stages particularly regarding the clear definition of the roles of the Financial Service Providers (FSPs) responsible for distributing inputs, as well as lack of adequately developed systems to supervise and monitor the project.

Stakeholders caution government with the following key recommendations:

- The Government should move slowly with this initiative ensuring that appropriate institutional mechanisms and risk management incentives are in place, even if this means disbursing a very small percentage of funds over the next year.

- Devolve key decision-making process to financial intermediaries (client selection, interest rates, loan amounts, and loan tenors).
- Ensure that financial intermediaries selected for on-lending funds have the institutional capacity (e.g., MIS, rural lending experience, new product development capacity) and track record for good portfolio management.
- Enable institutions to reflect loans managed on their own balance sheets, building their capacity to strengthen and manage a capital structure that enables significant expansion over the long term.
- Do not set price ceilings for operators; rather allow them to set prices that enable full cost recovery, including a surplus.

3.3. Other Sectoral Policies

Implementation of other sectoral policies and programmes can help reduce transaction costs for rural financial intermediation and increase the profitability of producers' activities. Other sector programmes include the *development of public infrastructure like roads and communications networks,* and *strategies and policies to diversify sources of income in rural are*as, including support for the development of higher value products. Critical to financial sector deepening and inclusiveness is the *creation of linkages between players at different stages of the production and marketing cycle* including primary production, crop storage, wholesaling, processing and exporting (ICC, See Chapter 5). Farmers' ability to take advantage of finance will be limited by bottlenecks in linkages between

- Inputs procurers and international markets for input supply;
- Input procurers and input suppliers;
- Input suppliers and farmers;
- Farmers and traders with crop storage facilities;
- Farmer and trader access to the auction floor for tobacco; *and*
- Farmer and trader access to local and export markets (transport and sales channels to move production).

Land reform that allows smallholders access to title deeds that can be used as collateral may also improve smallholder access to financial services. *Telecommunications infrastructure* in both urban and rural areas may support the development of new products (e.g., money transfers and payments) and product delivery channels including remote devices like ATMs and Points of Sale (POS).

3.4. The National Policy on Microfinance

The Microfinance Policy and Action Plan is a cabinet approved policy that establishes a basic framework and supportive guidelines for the further development of microfinance in Malawi. After broad consultations the Microfinance Policy and Action Plan was approved in 2002. The Policy defines guiding principles for the support of microfinance and assigns roles and responsibilities to different stakeholders for carrying out an action plan to develop a "sustainable microfinance industry". Key objectives of the policy include:

- Creating an enabling legal and regulatory framework;

- Support for conducive economic polices;
- Developing the capacity of service providers and their clients;
- Supporting the development of an industry infrastructure including the Malawi Microfinance Network;
- Promoting best practices at the level of institutions and donors; *and*
- Increasing coordination among sectors on issues affecting financial service delivery.

The policy objectives encompass the key elements critical to broadening and deepening the financial sector. The Ministry of Commerce and Industry (MoCI) is responsible for the overall coordination of the policy.

Table 2: Budget Allocations for Microfinance and Agricultural Credit from the MPRS

	2002- 2003	2003- 2004	2004- 2005	TOTAL
Total MPRS Planned	386,282,056	410,987,664	432,426,355	1,229,696,075
Credit Activities				
Reduce the cost of credit	-	-	-	-
Strengthen the institutional framework	79,159	49,533	10,467	139,159
Expand competition and efficiency in the credit market	12,710	29,159	106,916	148,785
Diversify and expand coverage	150,280	477,383	60,561	688,224
Expand and strengthen access to agricultural inputs	408,879	817,757	1,226,636	2,453,271
Total Microfinance Activities	$651,028	$1,373,832	$1,404,579	$3,429,439
As a % of Total MPRS Budget	0.17%	0.33%	0.32%	0.28%

Reprinted from Malawi Sub-Sector Assessment of Microfinance, Roberto Cater, 2003, from the Malawi PRSP.

This Microfinance Policy and Action Plan is evidence of the intent of key players to establishing a microfinance industry in Malawi. However, its strong intentions may be undermined by the lack of clarity about government's role in supporting microfinance.

The policy states "government shall mainstream microfinance initiatives in all ministries in order to allow for proper coordination." Its intended meaning in unclear and gives rise to expectations that line Ministries or linked parastatals will be involved in direct implementation of programmes. The management of the Malawi Rural Development Fund by a project management unit in the Ministry of Finance also once again places government in a seemingly direct management role of credit programmes. Stakeholders recommend more clarity from the Government of Malawi on what it sees as its role in development of the sector apart from supporting enabling macroeconomic and legal and regulatory environment initiatives, as well as the future of numerous government initiatives and institutions (e.g., Ministry of Agriculture, APIP, MARDEF, etc.) involved in financial sector development both directly and indirectly (USAID AMAP Microfinance Sector Assessment of Malawi, 2004).

Chapter 4: The Financial Sector in Malawi

4.1. What is the Financial Sector?

The Reserve Bank of Malawi (RBM), is the core of the formal financial system responsible for ensuring the financial system's soundness. The RBM regulates and supervises the activities of financial institutions under the 1989 Banking Act, and is responsible for licensing and registering banks. The commercial banking system is the most vital component of the financial sector in most developing countries, responsible for accepting deposits and granting short-term credit to productive entities. In addition to banking institutions, the financial sector in developed markets also includes a range of other institutions including savings banks, insurance companies, pension funds, investment banks (long-term credit), and securities markets.

Financial policy refers to measures that affect the growth, efficiency, standards and diversification of the financial system. Financial policy focuses on initiatives to encourage the growth of savings, and the development of money and capital markets. Policies aim to grow the formal financial system by mobilizing savings, promoting competition and efficiency, and facilitating the allocation of resources among different uses, both productive and consumptive. In addition, policies aim to establish a well functioning and efficiency payment system that enables the clearing and transfer of funds among financial institutions. Financial sectors deepen when financial assets grow faster than a country's income growth; this is measured by the growth in liquid assets (composed primarily of currency and deposits in the central bank, demand, fixed and term deposits, and commercial paper, like bonds) as a percentage of a country's GDP. This measure provides an indication of the banking system's ability to increase lending.

A smooth functioning financial system is the glue that binds a strong performing economy. A smooth functioning financial system is characterized by:

- an efficient payment systems;
- a stable convertible currency;
- intermediation of savings and loans; *and*
- the management, spreading and transfer of risk.

A smooth functioning financial system enables an efficient allocation of resources and stable consumption that lead to higher growth rates and lower rates of poverty (Gonzalez-Vega). In Malawi, the financial sector's ability to grow and serve more markets is inhibited by key factors including high real rates of interest, uncertainty generated by macroeconomic instability, and few innovations in the financial system that enable it to pool and manage risk.

4.2. Characteristics and Performance of Malawi's Financial Sector

The Government of Malawi has taken measures to liberalize the financial sector. Reforms include the elimination of explicit agricultural subsidies, the elimination of interest rate controls, and the removal of exchange control regulations and restrictions on capital movements. The Government has stated its intention to privatize parastatal banks, and support a market-oriented legal system that facilitates the entry of new institutions in the formal financial system. (USAID AMAP Microfinance Sector Assessment of Malawi) Foreign shareholders, often a channel for innovation in the financial sector, are allowed to hold a 100% stake in a financial institution (KPMG, *Banking Survey Africa 2004*).

The government had committed to additional reforms including an agreement to lower Bank reserves from 30% (a reduction from the 35% requirement of the previous four years) to 10% to free up additional liquidity for private sector lending. Reserve requirements were lowered to 27.5% in June. In October government announced however that it would delay further reductions in the reserve requirement in 2004 due to the rising rate of inflation, spurred by government borrowing and poor 2004 harvests. The Bank has also stated its intention to review the regulatory framework.

4.2.1. Description of the Sector

The financial sector in Malawi has eight commercial banks (providing savings, lending and other investment products), two leasing companies, one discount house, a building society, a finance company, four development institutions, one savings bank and several insurance companies and pension funds (USAID AMAP Microfinance Sector Assessment of Malawi).

Private sector involvement in the financial sector, including the entry of new players, has increased with financial liberalization measures. Two banks, National Bank of Malawi and Stanbic Bank, dominate the sector with 58% of the sector's assets, and 59% of its deposits (KPMG). The first foreign shareholders entered the market in 1994 following banking sector reforms. Stanbic, formerly Commercial Bank of Malawi and formerly government controlled, is now 60% owned by Standard Bank of South Africa. Majority foreign controlled banks own over 46% of total assets in the sector, with most foreign owned investors entering the market through investments in new companies (KPMG). In recent years other private firms including New Building Society, Leasing and Finance Company and National Finance Company have expanded operations.

Despite increase in the involvement of the private sector, the National Bank of Malawi, Malawi's largest commercial bank, is dominated by owners that include companies with significant government shareholdings. Additionally, the Government remains a dominant player in the ownership structures and Boards of major financial institutions, including Malawi Rural Finance Corporation (MRFC) and Malawi Savings Bank (MSB). The strong role of government in lending operations has tended to reduce the overall efficiency and performance of institutions, has in some cases politicized lending decisions, and compromises overall sector performance. The government however has stated its intention to privatize and/or restructure parastatals.

In June 2004, the total amount of commercial banks private sector deposits was MWK 31.7 billion (or $296 million[14]); approximately 2/3 represented domestic deposits and 1/3 foreign currency deposits. Commercial banks' net credit to the government (primarily through Treasury Bill subscriptions) totaled MWK 10.3 billion in December 2004. Including credit from commercial banks and monetary authorities credit to government totaled MWK 22.3 billion. Net credit extended to the private sector totaled MWK 10.5 billion in December 2004, peak lending time for agricultural loans.

Credit to the private sector as a percentage of total domestic debt has reduced steadily over the years. At 78% of total credit, for example, in 2000, gross private sector credit was only 39% in 2004. Claims on the State and Central Bank (Treasury Bills and other advances) are far greater than private sector loans and are rising, claiming an even greater share of resources that might be otherwise available to drive sustainable economic growth. Central government debt is dangerously high at about 28% of GDP, funded primarily by private sector holdings.

Total market capitalization for the domestic stock market is MWK 8.6 billion (or $80 million), with a mere 10 companies publicly traded; the banking system has a virtual monopoly on sources of financing for businesses.

Table 3: Domestic Credit

Domestic Credit (in millions MWK)						
	1999	**2000**	**2001**	**2002**	**2003**	**2004**
Government	-719	567	5,829	15,711	18,603	22,322
Statutory Bodies	1,283	1,042	-109	-206	-352	-483
Private (gross)	3,717	5,817	6,454	7,363	9,808	13,926

Source: Reserve Bank of Malawi

The financial system also includes a range of informal mechanisms and formal institutions that are not licensed or supervised by the Central Bank. These institutions primarily provide various forms of credit and include pawnshops, money lenders, input suppliers, savings and credit cooperatives (SACCOS), Companies, and NGOs. None of these is licensed to provide savings services to the public, though some may collect savings deposits from clients and deposit them in commercial banks on their behalf. SACCOs may intermediate savings for members, though may not provide savings services to the general public. Development projects, family members, and informal savings and loans clubs may also provide credit, and or provide a safe haven for savings.

The banking sector in Malawi appears profitable, largely due to high levels of investments in Government Treasury Bills that offer high real rates of return to encourage their purchase. The 91-day treasury bill rate was 42.3% in the second quarter 2003 but had fallen to 24.8% by December 2004. While nominal and real rates of return have fallen steadily in recent years, continued high real returns on T-bills maintain incentives for high levels of investment in T-bills, and discourage lending to the private sector. Banking sector profitability is highly vulnerable to changes on the rates of Treasury Bills. For example, for the fiscal year ending September 2002, MRFC investment in Government of Malawi securities contributed about 42% (MWK 218 million) to MRFC's total revenues for the year. The loan portfolio contributed about 40% (MWK 205 million) (USAID AMAP Microfinance Sector Assessment of Malawi).

The level of non-performing assets to gross loans in the banking sector reduced considerably from 2002 to 2003 dropping from 18.6% to 8.4%; performance improvements were largely driven by the portfolio's of the two largest players (KPMG).

In addition to fiscal and monetary policies, lack of competition in the banking sector has contributed to wide spreads between lending and borrowing rates upwards of 20% for the past five years (See Table 4). Real interest rates averaged 28% between 2000 and 2002. In June of 2003, minimum and maximum nominal lending rates of the two largest banks varied from 46 to 52% while the average nominal savings rate was 26%, representing a spread of 20 to 26 points. By October 2003, while nominal lending rates had fallen to 40.5% to 46.5%, savings rates decreased to 18.5% *increasing* the spread to between 22 and 28 points. By June of 2004, rising inflation and macroeconomic uncertainty resulted in hike once again in lending rates to between 46 and 52%, with savings rate at 22%. Given inflation rates of 11.6% in June 2004, real rates of interest varied from 34% to 40%, higher than the average rates for the past five years. While new players have entered the market and created more competition in the market, a recent study indicated that given the dominance of the two main players, interest rate spreads are not likely to decline in the near future. (Chirwa and Mlachila)

Table 4: Interest Rates

	1999	2000	2001	2002	2003	2004
Commercial Bank Prime rate	47%	53%	46%	40%	36%	27%
Commercial Bank Max Rate	53%	59%	52%	46%	42%	35%
Deposit rate	30%	35%	26%	18.5%	12%	6%
Spread	17-23%	18-24%	20-26%	21.5 -27.5%	24-30%	21-29%
Interbank Rate	47%	50.2%	46.8%	40%	35%	25%
91-day T-Bill Rate	39.6%	86.6%	54.6%	36.1%	33%	33%-22%

Source: Reserve Bank of Malawi, IMF

RBM has adopted a number of policies to stimulate lending and reduce spreads including a reduction in their lending rate to commercial banks. The short-term interbank rate was cut by five points to 35% at the end of 2003, compared to an estimated average of 47.1% in 2003. The interbank rate was maintained at 25% for the majority of

2004. RBM had agreed to reduce commercial banks' reserve requirement from 30% to 10% by end 2004, but recently decided to delay reserve requirement cuts, resting now at 27.5%. RBM fears that extra liquidity in the financial system will drive inflation rates up, and absent good productive opportunities in the domestic economy will drive up imports and draw on dangerously low foreign exchange reserves.

While the government has taken some concrete steps to improve the functioning of the financial system and reduce disincentives for lending to the private sector, major constraints remain. In addition to the high real rates of interest, the legacy of frequent debt forgiveness by government institutions and programmes, as well as the continuation of effective subsidies that result from high rates of loan default and late repayments make it difficult for other financial institutions, struggling to enforce repayment and high operating costs, to promote high standards.

Government owned banks' long-term, preferential access to low-cost funds from parastatal or other government sources, also make it difficult for players to compete on commercial terms. While subsidized funding may be critical for institutional start-up, early phases of institutional development, and the promotion of innovation, its long-term deployment in financial intermediaries may distort financial markets by creating an unlevel playing field. Effective subsidies generated through high tolerance for loan default or preferential access to low cost capital may also create disincentives for efficiency, thus encouraging high prices for clients.

The banking system has some level of national coverage. A number of players, including both licensed and unlicensed operators have presence in all the primary urban areas of Malawi including the following cities and towns: Blantyre, Dedza, Karonga, Kasunga, Lilongwe, Limbe, Limbe, Mangochi, Msuzu, Mulanje, Ntcheu, Salima, and Zomba. However beyond the town centers, outreach is very limited. Competition is virtually absent in rural markets, with one provider (MRFC) providing the bulk of lending services beyond urban and peri-urban areas. Only one institution, MSB, currently provides savings services in rural areas. MRFC accepts deposits, but about 70% of deposits are used to collateralize loans and are not liquid, that is, easily withdrawn on demand.

Financial liberalization measures have had limited impact in rural areas. Few operators in rural areas are serving smallholders making up 85% of Malawi's 10.8 million residents. Some projects like CUMO operating in Dedza and non-licensed institutions including companies like Pride Malawi and FINCA Malawi, have attempted to push deeper into rural areas, but have achieved limited overall total outreach (see Table 11, *Supply of Microfinance Services*). Microfinance operators in rural areas are very dependent on the commercial banking sector for payments services, creating obstacles to efficiency and potential growth. Many commercial banks have reduced operations in rural areas for commercial and security reasons, thus availability of services from traditional sources appears to be decreasing at a faster rate that alternative operators are pushing forward.

The performance of the loan portfolios of rural operators with predominantly agricultural portfolios has been weak. An analysis of MRFC financial statements suggests that historically, losses on agricultural loans are close to 50%, and 47% of all loans issued were later expensed as losses. (However, MRFC's acquisition of the non-performing portfolio of SACA influences these figures [USAID AMAP Microfinance Sector Assessment of Malawi]). While significant investment including support for Research and Development is required to expand the financial system to rural areas, the poor performance of operators in rural areas coupled with weak macroeconomic performance weakens prospects for *new* investment in rural and agricultural finance in Malawi. More recently licensed banks including New Building Society and First Merchant may serve the larger tobacco interests in rural areas and may accept small savings deposits but as a rule are not targeting a "bottom-of-the-pyramid" client base.

4.3. Modernization of the National Payment System

The Malawi Switch Center (MALSWITCH), implemented by the Reserve Bank of Malawi in 2002, forms the basis of Malawi's National Payment System. This payment system links all the banks and allows daily electronic check clearing and "real-time" settlements between banks, and can improve banks' ability to manage liquidity. Banks know at any time how much money they have and RBM has better information on liquidity and money supply.

Apart from settlement and clearing functions, MALSWITCH may be a promising platform for a range of electronic payment, funds transfer and banking products that serve a broad client base. The use of the MALSWITCH network to support funds transfer services however has been reportedly low as only a limited number of banks have installed electronic interfaces with MALSWITCH that enable smart card users to use any ATM machine, regardless of bank branch or location. The National Payments Council is pushing for interoperability between cards and systems and hopes to have an integrated system in 2005. Access to electronic banking products may have significant, possibly profound impacts on expanding financial services to an increasing number of market segments, particularly the rural poor. However, while electronic banking holds promise, it is too early to estimate its impacts. First and foremost, electronic banking requires a reliable communications infrastructure linked to Point of Sale or ATM devices. One source notes that only 24 ATM machines exist in the country now (KPMG). While POS or ATM devices do not require constant on-line communication facilities, periodic access is required. Overall access to the cell and landline phone networks (15.2 lines per 1,000 people) and computer penetration (1.3 computers per 1,000 people) is low in Malawi (IMF).

Additional research and pilot testing is required to determine which business models and applications are affordable for card-based electronic services and other information technologies. These models must consider the full costs of systems – the cards themselves, communications links, marketing, staff and client training, and access to networks that enables payment services. The cost of an ATM for example is approximately $50,000 and MALSWITCH cards are approximately MWK 690, or between $5 and $7. Given the low margins of farmers, the cost of a Smart card is a substantial investment.

Box 7: Electronic Banking

Technology can be used to improve *microfinance operations* by enhancing loan officer productivity, reducing fraud, lowering transaction costs, assisting credit officers with decision making in the field, and enabling better data and financial management.

It can also increase *user* access to a range of financial services by linking remote locations (distant from a bank branch) into a delivery network through an ATM or POS device, by enabling electronic, not physical transfer of cash/value, and broadening the potential suppliers of services (for example retailers with POS devices).

Ebanking applications are enabled by card-based technologies.

Smart Cards

Smart Cards are a means for accessing a variety of financial services. They may be used to store value or savings, to disburse loans or manage a line of credit, or to enable money transfers. The Smart Card itself is plastic card with an embedded computer chip that can process information (with a microprocessor chip) or store data (on a memory chip). The Smart Card can function as an electronic passbook that may be used to verify client information and speed up transaction times at a branch. Or the Smart Card may be used as part of an integrated system that communicates with a "back-end" computer (on a bank premise) enabling financial service transactions at remote devices like Automatic Teller Machines (ATMs) or Point-of-Sale Devices (POS) devices. In some cases, mobile phones may be able to function as an end-user device. Currently, Opportunity International Bank of Malawi (OIBM) offers a Smart Card that allows users to withdraw cash at remote ATM terminals.

A number of institutions recognized the value of Smart cards as the basis of biometric identification systems that identify people based on a fingerprint. As lack of a national identity system has been identified by many as an impediment to expansion of financial services, smart cards may provide information that would otherwise have been provided by a national identity system.

Stored-value cards

Stored Value Cards are also known as electronic purses, in which the cash is electronic. This functions in some ways like a savings account. Stored Value Cards are loaded with a fixed sum and in some cases can be reloaded with additional value. Both banks and other kinds of retailers with ATMS or POS devices can facilitate the crediting and debiting of value/money from cards. In some cases, card holders may be able to receive deposits from a variety of organizations like governments, employers, agricultural marketing boards, etc., and make payments to cover bills or transfer money to businesses or other card holders, like family members.

Smart Card technology is however quite expensive now costing on average $7 per card, limiting the potential market base, with generally hefty user fees for each transaction. Reductions in the cost of technology however are anticipated over the long term. Cheaper card-based technologies, including magnetic stripe cards are available, but require on-line access to a central server to carry out transactions, which can in some cases be cost prohibitive.

Smart Cards linked to PDAs and Information Systems

Smart Cards may be used in connection with Personal Digital Assistants (PDAs) or Hand-held Terminals (HHTs) operated by credit officers to manage information. A borrower repays in cash and the transaction can be recorded on the credit officer's PDA and on the borrower's Smart Card. With the hand-held computer terminal the bank officer can download the loan collection and disbursement information from the terminal to a branch office and transmit it to a central server. This saves time and reduced potential for error, and enables a centralized financial manager fast access to data. Devices which are connected to a centralized computer however require access to data communications infrastructure.

PDAs may also include programmes that assist credit officers to make decisions about credit disbursements based on an analysis of household cashflows over a period of time. This may enable faster loan disbursements and better decisions regarding the likelihood of repayment resulting in a stronger loan portfolio.

Potential of card-based technologies

Card-based technologies have the potential to both reduce transaction costs by reducing credit officer and client travel and improve the quality of information generated by management information systems.

The use of PDAs are proving useful in some microfinance institutions to more efficiently manage portfolio and client information (e.g., disbursements and repayments). PDAs may also provide analytical support to credit officers making decisions about new loan disbursements. A number of institutions have seen improvements in information management and decision making as a result of use of these devices, but they too require communication with a central server to realize their full benefits.

The real promise of card-based technologies for financial sector development however appears to lay in their use as a platform for a range of services, both financial and non-financial, that enable efficient money transfers. Financial services include savings, payments services (bill paying for utilities and money transfer), credit disbursement and loan repayments from banks and input suppliers or other merchants. Cards may also be used as a receiving point for other cash payments, for example payments from agricultural buyers at harvest time, pension payments, or welfare payments. Used at retail points of sale, the cost of technology can be partially shared by retailers who can realize commissions and fees on transactions provided, or public sector agencies that use card-based systems for more efficient distribution of wages or income transfers.

In the agricultural sector, smart cards may be used to facilitate input credit and repayment of credit to tobacco companies. Smart cards may also be used as a payment system for tobacco sales at auction. Smart cards that can be uploaded with value remotely can reduce the heavy banking and transaction costs associated with receiving payments.

As a business model, the use of card-based technologies from remote access points is still being explored.

Source: CGAP IT Innovation Series (www.cgap.org/docs/IT_smart_Card.html). Other sources: *Automating Microfinance: Experiences in Latin America, Asia, and Africa*, Campion and Halpern, 2001 (www.accion.org/micro_pubs_list.asp).

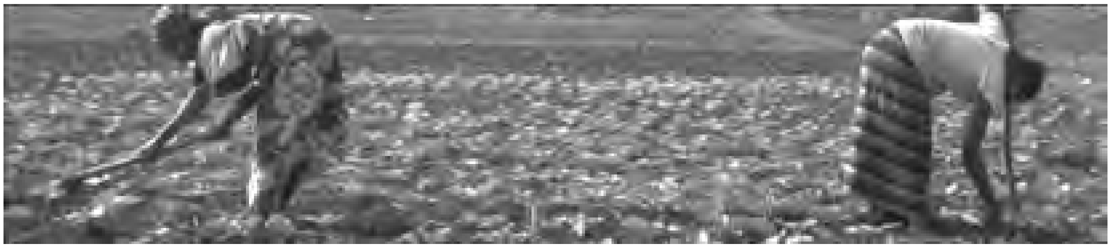
4.4. Implications for Financial Sector Policy and Development

- Formal financial institutions are biased towards urban areas and town centers. The formal financial sector remains shallow and noncompetitive in rural areas. This means that rural households depend on government or donor programmes that have proven unsustainable, limited services offered by informal systems, or self-finance. Economies that are heavily reliant on self-finance (informal mechanisms) tend to be characterized by low productivity and persistent income inequality. Given the demographics of Malawi (86 % of population live in rural areas), focused initiatives that aim to build institutions that can meet the demands of rural areas is a priority.
- The use of high levels of domestic debt to fund government deficits create disincentives for the development of the financial system. The very high rates of return to Treasury Bills discourages banks from lending to the private sector. Opportunities presented by very high real rates of return on Treasury Bills discourage banks from competing with each other to attract clients with services and competitive pricing that translates into lower real rates of interest for clients. With limited pressure to compete for market share, banks are discouraged from investing in innovations in new financial technologies that push out the finance frontier. While the government is taking measures to encourage greater private sector participation in the economy by cutting back reserve requirements and lowering the interbank rate, the success of these measures will largely depend on government's ability to manage its fiscal deficit.
- MALSWITCH, the state-of-the-art national payment system, may offer a promising platform for the use of electronic banking and payment services to deepen financial markets by supporting new delivery channels and innovations in products and services including payment services, transaction services, and credit and savings products. The extent to which MALSWITCH can deliver on its potential, particularly to rural areas, will depend on the underlying communications infrastructure

and cost-effective business models for electronic service delivery (considering for example, the price of cards and access to communication infrastructure, etc.).

- There are few institutions that are licensed and have capacity to mobilize savings in rural areas. Global experience suggest that there is even more demand for savings and payment services among poor populations than credit. Support for licensed institutions that can mobilize savings in rural areas – whether they are start-ups, or institutions currently on the ground – will be critical to meet the financial service and welfare needs of people in rural areas.
- Weak macroeconomic indicators hinder foreign direct investment (FDI) flows that can support new investments in the financial sector. The country has experienced significant withdrawal of FDI because of unstable economic performance and low profitability (UN Conference on Trade and Development, FDI Brief for Malawi). The financial sector needs inflows of FDI to 1) support the restructuring of parastatals; 2) to support the introduction of innovative financial technologies to reach new market segments; and 3) support the development of capital markets.
- A high level of production and price risk[15] in agriculture require the emergence of new financial and legal instruments that can pool and manage risk in new ways, for example, through futures or forward contracts. Specific risk management enables:
    - Growers and farmers to stabilize prices of output and currencies by pre-selling their output at current market prices.
    - Traders to manage risk by fixing the cost of commodities and currencies they will purchase in the future.
    - Bankers to manage risks associated with lending to agricultural producers and buyers.
    - Speculators to risk capital to earn profits by taking advantage of the prices fluctuations for which other parties have limited risk tolerance.

Financial instruments will depend on the development of local and regional capital markets that can interact with global markets. Absent access to markets that enable both producers and suppliers to hedge their risk speculators from national or international markets to absorb some of that risk, financial sector development in agricultural markets will remain weak. More "traditional" microfinance will not do the trick. In the context of steadily declining prices for commodities produced by Malawian farmers, however, developing risk-hedging instruments will be particularly challenging (See Chapter 5).



Chapter 5: Agriculture Development and Rural Finance

5.1. Overview of Malawi's Agricultural Sector

Malawi's economy is agricultural-based. It employs more than 80% of the labor force, and accounts for approximately 40% of Gross Domestic Product, and 90% of Malawi's exports (IMF, USAID AMAP Microfinance Sector Assessment of Malawi, 2004). Furthermore, 65% of the manufacturing sector's raw material requirements are provided by the agricultural sector. Tobacco dominates Malawi's agricultural exports, accounting for 50% to 70% of export earnings. Considering the kinds of businesses and source of employment in Malawi, burley tobacco dominates firms with 15% of total MSEs and 25% of MSE employment. The value of export earnings and foreign exchange receipts is highly dependent on world prices for tobacco. The world price of tobacco has fallen substantially in recent years and the quality of Malawi's tobacco crop has declined overall as well.

Smallholder agriculture dominates the agricultural sector. The agricultural sector can be divided into two main sub-sectors: smallholder farmers (farming 88% of Malawi's arable land) and estates (making up 12% of total arable land). Smallholder households comprise 85% of Malawi's 10.8 million resident population. 78% of households cultivate less than one hectare of land, and given that almost all arable land is under cultivation, smallholdings are decreasing in size as the population grows. 70% of land under cultivation produces maize. Smallholders generate 80% of Malawi's total agricultural output and staple foods (IMF), with commercial agriculture accounting for the balance.

A majority of Malawians depend on subsistence farming for their livelihoods (USAID AMAP Microfinance Sector Assessment of Malawi). Crop production provides on average 73% of rural household income. 70% of all full time farmers are women who carry out 63% to 71% of all agricultural work (Diagne and Zeller). According to the Malawi National Gemini MSE Baseline MSE study, income from agricultural sales was not the most important source of cash income in rural area. Rather, wage income, accounting for 13% of the rural poor income was the major source of cash income. There is limited participation in the cash economy by the poor, and most agricultural production is home consumed.

There is significant seasonality in demand for and supply of loan products to producers. October to January is the peak lending season and loans fall due between April and September. *Distribution* of agricultural output (wholesale and retail trade) particularly tobacco and sugarcane is the second largest sector in the economy accounting for 22% of GDP.

Improvements to agriculture are critical for economic growth and poverty alleviation. Because of agriculture's strong forward and backward multiplier effects for the overall economy, economic growth in agriculture and in those subsectors that benefit smallholders is a key precondition for economic growth and poverty reduction (Zeller). Improved financial markets accelerate agricultural and rural growth.

This statistical snapshot reveals critical areas of intervention in the agricultural sector.

- Smallholder production is the main source of agricultural output in Malawi's economy and the primary source of livelihood for the vast majority of Malawi's population. Prices paid at the farm gate however are so low that the majority of those involved in tobacco production generate an income below the poverty line.
- Additionally, for the most part, agricultural production is not integrated into markets, rather remains a subsistence-dominated activity. Lack of integration stems from deficiencies in the financial system and the fragmentation of markets involved in the production and commercialization process. Fragmentation results from weak linkages between input markets, farmers, traders, other intermediate buyers, processing companies, and exporters. With the collapse of the state-run marketing system, a limited number of traders exist that have facilitated marketing avenues for cotton, tea, and tobacco.
- Figure 1 provides an example of the agricultural value chain and opportunities for suppliers of financial products. Strengthening linkages between points in the value chain however also requires non-financial services interventions that create physical (e.g., road) and information links(e.g., product information) between various nodes in the chain. The Chamber of Commerce will support an initiative that aims to coordinate various players in the chain, focusing particularly on value adding opportunities for commodity crops.
- These statistics reveal the dependence of government on tobacco exports for foreign exchange, and with falling tobacco prices the extreme vulnerability of Malawi's economy. As part of a response, the Ministry of Agriculture is exploring the possibility of producing maize as a winter cash crop by irrigating farms. Diversifying export crops and improving the quality of export production is critical to improving and stabilizing the country's balance of payments position, and subsequently the value of its currency.
- The stability and strength of the Malawian economy is critically linked to the production of tobacco. Yet the inefficiencies in the value chain and inadequate market opportunities result in a gap between prices paid to growers and prices received on

> international markets to be significantly greater than in other countries. Research suggests that it is not the big tobacco exporters that benefit from price differential rather, the price difference represents wasted resources. The inefficient structure is partially supported by monopoly and oligopoly structures among exporters, manufacturers, buyers on the Auction Floor, transporters, Banks, and Auction Holdings (marketers).Inefficiencies are also attributed to lack of enforcement of rules by the Tobacco Control Commission. Banks take significant deductions off the sale of growers tobacco to process payments including high money transfer fees (Jaffee).

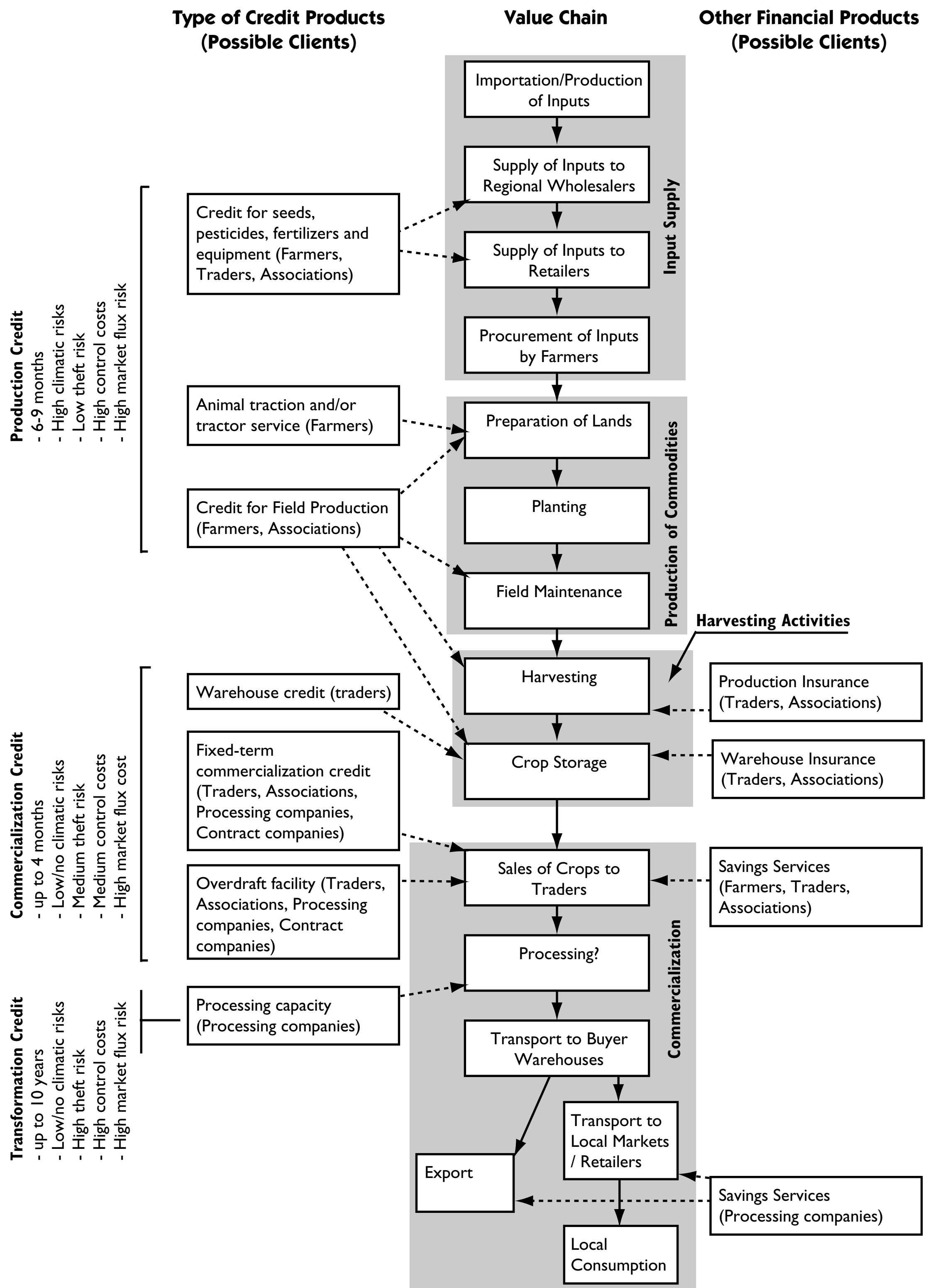
Addressing these areas – innovation in financial services for rural areas, strengthening financial and non-financial services to more efficiently integrate markets in the agricultural value chain, and diversifying export crops – requires the development of financial systems. And no one focal area identified can be developed without attention to all three. For example, developing products for rural areas requires a financial system that can handle risk management and pooling; the expansion of financial institutions to rural areas as well as the development of a broad range of financial services are critical to integrate fragmented and inefficient markets (Gonzalez-Vega). Risk management and pooling will be impossible without diversifying Malawi's narrow production base.

The attributes of rural markets in Malawi (the dominance of small holdings and limited crop diversification), however, makes the challenges of financial sector development – dependent on finding new ways of managing, sharing and pooling risk and reducing transactions costs – particularly challenging. Low levels of monetization and limited participation in markets, as well as the poor quality of infrastructure means that the expansion of service providers to rural markets must be carefully planned and implemented incrementally where the potential is greatest. The greatest potential lay where efforts are underway to improve integration of markets, support diversification, and where physical infrastructure is present.

The good news is that government policies in the agricultural sector and donor initiatives are moving in a positive direction. The current focus of agricultural and social policy described in the PRSP is improving smallholder production and crop diversification. In addition, donor initiatives support smallholders in projects that try to remove bottlenecks in vertical production chains (e.g., access to markets for inputs, access to retail markets to sell production, access to wholesalers, etc.) and encourage farmers to manage their farm activities as businesses that maximize profits instead of settling for subsistence level returns (USAID AMAP Microfinance Sector Assessment of Malawi). However, while government remains concerned about the falling prices of Malawi's key export crop, tobacco, and the country's dependence on tobacco for foreign exchange, its attempt at agricultural diversification are having limited results. With the breakdown of the state marketing system, there remain few traders and limited opportunities for marketing cotton, tea and tobacco abroad. Marketing opportunities are hampered by the falling quality of tobacco produced and uncoordinated policy announcements. For example, last year's announcement of a fertilizer subsidy, actually hampered the smooth running of markets.

In summary, improving the performance of the agricultural sector will require

Figure 1: The Agricultural Value Chain and Possible Financial Products



Reprinted from Inventory Survey of Rural Finance and Microfinance in Rural Areas of Mozambique, *International Capital Corporation (ICC), September 2004* strong complementary initiatives and policies in financial sector development, agricultural sector development, and infrastructure development. Isolated initiatives in one area or another will yield little. Initiatives must: 1) tackle the deficiencies in markets along the production and commercialization chain; 2) address pressing need to diversify agricultural production, particularly for export crops; *and* 3) expand financial service institutions as well as types of services that make it possible for both financial institutions and producers to take advantage of economic opportunities and manage risk.

5.2. Banking in Agricultural and Rural Markets

Using financial markets as an instrument for agricultural development, many countries in the 1970s and 80s developed large subsidized, directed credit programmes that channeled credit through state-owned institutions to a specific subset of the productive sector, usually large producers. In Malawi's post-independence period, resources were allocated to the development of the large-scale export-oriented estate sector. In addition, the sector had price controls for both agricultural inputs and outputs, and prices paid to smallholders were kept low. These policies generally repressed the growth of financial sectors, and resulted in credit rationing.

During the 1980s, the Malawian economy underwent a fundamental shift from a supply-led to a demand-oriented approach to the development of markets. Centrally planned agricultural policies implemented through state-owned input suppliers, credit facilities, and crop marketing structures have begun to be dismantled. Specific measures taken included the removal of fertilizer subsidies in 1995, and initiatives aimed at promoting the entry of new players in markets for input suppliers and output marketing. ADMARC is no longer the sole supplier or buyer of farm inputs and crops. Laws were repealed to liberalize pricing and marketing for all agricultural produce (except for maize), export licensing requirements for beans and groundnuts were lifted, import licensing requirements on seed and fertilizer were removed, The underperforming Small Holder Agricultural Credit Administration (SACA) run under the Ministry of Agriculture was closed in 1994 and replaced by MRFC (also 100% GOM owned) (USAID AMAP Microfinance Sector Assessment of Malawi). Policies allowing smallholders to produce and market cash crops without restrictions, including tobacco, has enabled more diversification among the small holder sector, and resulted in a dramatic increase in production levels, particularly for tobacco (Diagne and Zeller). At the same time, however, while ADMARC lost its rights to being the sole purchaser of smallholders' produce, alternative marketing and distribution channels remain thin and largely inefficient, eating into potentially higher returns to farmers and overall returns for the economy.

Similarly, while directed, agricultural credit and agricultural development banks have generally failed to produce efficient, sustainable financial intermediation they have not however been replaced by more viable mechanisms that are **widely** available to rural households or firms. The reversal of directed credit policies, while necessary to bring about long-term structural changes, has not addressed some of the more deep-rooted issues that are obstacles to financial sector deepening. In fact, new policies have resulted in the delivery of less, not more credit. 400,000 farmers received credit in 1992 (albeit not sustained access to credit); in 2004 many fewer farmers had access to credit. Malawi is not alone. In general, many countries have seen a slow response by private banks to serve rural markets with credit and other services following financial sector reforms. Rural households and firms demand a wide range of services including loans (for consumption, inputs, or fixed-asset, labor-enhancing devices), trade credit, deposit services, payment services and insurance mechanisms that allow them to manage risk and to protect against lost income and revenue uncertainty. Financial services for smallholder households in Malawi are generally limited to supplier credit, in-kind input credit delivered up to now through APIP, and some cash credit.

Despite the high levels of demand, the agricultural sector and rural markets in general remain unattractive to traditional banks (even credit to the estate sector, about which banks have some access to information to make decisions about credit risk, has virtually collapsed). Rural markets in Malawi are characterized by high levels of systemic risk and financial technologies that are inadequate to deal with those risks. Where institutions have responded to the financial service needs of smallholders, offerings tend to be quite rigid, comprising for the most part in-kind loans in the form of a pre-determined package of inputs. Loans for example to support "value-adding" opportunities though high on the government's agenda are virtually non-existent in the market. The following issues make operating in rural markets in Malawi particularly difficult.

5.2.1. Systemic Risk

Sources of systemic risk relate to production and markets. Production risks, related to crop yields, are affected by weather (for example, drought) and the availability of appropriate crop technologies and inputs. Market-induced risks relate to the cost of crop inputs and prices for outputs, often linked to international markets (Evans and Ford).

When assessing agricultural loans, banks fear low repayment rates that may result from these systemic risks particularly climatic events that influence production rates, result in severe price fluctuations in domestic and international markets, and currency devaluations and revaluations that influence the prices of inputs and the sale of commodities on international markets. In Malawi, drought has had serious adverse impacts on both staple and export products. In addition, given that prices for agricultural inputs and outputs tend to fluctuate unpredictably farmers have had difficulty accurately predicting cash flow. In many cases farmers are unable to generate sufficient margins on what they produce to repay loans.

In general, given the lack of diversification in agricultural markets and the dependence of the manufacturing sector on agricultural inputs in Malawi, systemic risk affects large proportions of a bank's lending portfolio at one time (covariant risks), and may be difficult for institutions to manage. In Malawi, smallholder plots are very small, making crop diversification for individuals very difficult. The small size of holdings may make it impossible for farmers to generate transactions sizes required to make diversification viable.

5.2.2. Underdeveloped technology in financial markets for managing risk

In addition to the impacts of external shocks, banks have incurred heavy losses in agricultural lending because of deficiencies in the *financial system* to effectively manage production and price risk. One of the main reasons why farmers don't repay loans is because of volatility in the prices of commodities. Prices often go down when large quantities of product hit the market at harvest, reducing farmers' expected income relative to their investment in inputs. In Malawi as in other places, government has attempted to manage these risks through minimum price guarantees for farmers by state owned marketing boards, as well as subsidized loans. But these initiatives have been costly and ultimately unsustainable.

Given the failure of long-term subsidy driven solutions, the government in Malawi and elsewhere seek to support private sector initiatives that attempt to develop *market-based solutions* to manage price and production risk of farmers. The expectation is that market-based solutions are more efficient, reflect the real prices, can over time reach larger numbers of people, and have a better chance at staying around for a long time. Despite this ideological shift, however, few market-based solutions have materialized.

5.2.3. Price Risk

Hedging instruments are used to eliminate as much financial risk as possible. In Malawi, simple forward contracts that enable farmers to lock in prices with buyers and manage price risk are virtually absent. More sophisticated instruments, like future and option contracts (referred to as derivatives, because they derive their underlying value from the purchase or sale of a commodity) are also for the most part non-existent. Experimenting with hedging, NASFAM negotiated forward contracts for chile farmers. Production that was covered under the forward contracts actually resulted in a higher price for farmers than production that was not covered.

Hedging instruments can be used not just by producers but also by banks and other players in agricultural markets to hedge out risk. Financial institutions themselves can hedge the exposure of their lending portfolios to seasonal price drops in commodities. This would give institutions more flexibility to restructure their portfolios in the event of a price shock. Financial institutions can hedge on behalf of their borrowers by attaching a hedge to each loan. Banks can also require that borrowers provide proof that they are price protected through hedging instruments (future or forward) through an exporter or producer organization (Bryla et al.). Forward and futures contracts may also be used by an importer or an exporter to lock in exchange rates to minimize losses that may result from a fall in the value of the kwacha.

In Malawi producers have limited access to hedging instruments. First the small size of outputs of producers means that output must be aggregated to create a transaction size attractive to suppliers. Aggregation requires sound storage facilities as well as a middleman. South Africa's futures exchange, for example, trades in quantities of 100

Box 8. What are hedging instruments?

Futures and forward contracts enables producers to hedge out risks, guarantee a source of product for traders, and enable speculators to benefit from price movements in agricultural commodities.

Forward contracts

A forward contract is a cash contract in which a seller/farmer agrees to deliver a specific commodity (like tobacco, sugar, tea, maize) to a buyer at a specific time in the future for a specific price. With a forward contract, producers are guaranteed a price and buyers (often processors or wholesalers) are guaranteed access to raw product for their business. Some contract farming relationships exist in which buyers provide in-kind credit to farmers that is repaid from proceeds of the sale of their product to buyers at harvest. Farmers may or may not however be able to lock in a price. Warehouse receipt systems are also forward contracts that not only enable farmers to manage price risk, but also may enhance access to credit. Warehouse receipt systems enable farmers to store their production in a warehouse after harvest, when prices are usually lowest. Farmers can use stored produce as collateral to access credit, and sell produce when prices are more attractive for farmers.

Futures Contracts

Futures and options contracts are financial instruments that are traded on exchanges. They allow producers (farmers) to hedge out the risk of price changes (usually for crops and livestock), and enable speculators to profit by correctly anticipating and taking advantage of prices changes in markets for these instruments. The commodity traded in a futures contract is standardized by quality, quantity and delivery time, but the price is determined on the exchange at the time of the trade. The minimum size of futures trades on financial markets, however, is generally quite large. An intermediary supplier (e.g., producer organization or exporter) would be required to aggregate the demands of farmers for futures contracts to make trades through brokers on international markets. (Agricultural Investment Sourcebook, World Bank Group)

Agricultural Derivatives in Southern Africa

In South Africa, the Agricultural Markets Division (AMD) was established in January 1995 as a division of the South African Futures Exchange (Safex) and manages the transfer of financial risk in the maize market in southern Africa. Maize is exposed to risks resulting from weather patterns, currency fluctuations and regional food shortages. Safex trades both futures and options for maize, wheat, sunflower seeds and soybeans.

In Malawi, farmers, farmers' associations, banks, and other stakeholders involved in commodity production have expressed an interest in the development of an agricultural derivatives market in Malawi. However, the development of such a system is impeded by the fact that there is no functioning system of warehouses to store produce.

and 50 metric tons depending on the commodity. Commodities traded on exchanges must also meet minimum quality standards; in Malawi the high cost of inputs has actually resulted in a lowering of quality on certain commodities, namely burley tobacco.

Additionally, the relatively steady trend of falling commodity prices is unattractive to speculators who make money from periodic price rises. With a futures contract, a farmer (or producer organization) hedges risk by locking in a price for a product (for example, tobacco); in this case a farmer foregoes benefits that may accrue if the price of the commodity rises, but by guaranteeing a price, the farmer guarantees a certain future income. In markets where prices are consistently falling, speculators are less likely to engage farmers or producers in futures contracts. In Malawi, the price of burley tobacco, 90% of 2002 production, had fallen below $1.15 by 2002, below even 1994 levels of $1.25. Additionally, like in other financial service markets, traditional players in these markets (e.g., brokerage houses) are reluctant to engage new target markets that they may have little information about (Bryla et al.).

The Commodity Risk Management Group at the World Bank works with producers, banks and other financial institutions to develop risk management strategies and overcome barriers that make it difficult for players in developing countries to access risk management instruments.

5.2.4. Production risk

Agricultural insurance is a financial tool to transfer individual farmers' production risk (potential crop losses resulting from poor weather or other hazards) to a third party through payment of an insurance premium. Insurance can also serve as a form of collateral for farmers to access credit and provides a pay out, guaranteeing an income stream to farmers in the event of a catastrophe insured against. The most commonly provided agricultural insurance protects against systemic crop losses, that is crop failures that occur with documented frequency, like a drought or flood. Those events that occur frequently (more than one in five or seven years) are not good candidates for agricultural insurance. Rather the use of credit and savings instruments for income smoothing in combination with strategies for diversification and changes in crop production are more useful. For the most part insurance initiatives that have been public sector driven have not succeeded due to distorted incentives that result in the collapse of the systems (see Agricultural Investment Sourcebook: www-esd.worldbank.org/ais).

The most promising production risk insurance products that can be implemented by private sector insurers include weather-based index insurance and area-based index insurance. Weather based index insurance allows for payouts for lower production yields due to measurable weather events (for example rainfall or temperature). Area-based insurance makes payments relative to decline in crop yields in specific areas, for example in counties or districts. *Weather-based Insurance in Southern Africa: The Case of Malawi (Hess and Syroka)* provides interesting conclusions for the potential of weather-based insurance in Malawi.

5.2.5. Inadequate Infrastructure

While laws that govern contracts are well established, enforcing contracts is difficult due to limited resources within the judicial system. Property rights are not well defined in rural areas for smallholder farmers. Many banks require property titles as collateral for loans, but few smallholders have land titles. Land titling reforms, however, have been identified as a priority policy focus.

Futures and forward contracts also require effectives systems for grading the quality of goods traded or promised. The market for hedging instruments requires contract enforcement mechanisms that protect both the buyers and sellers in the market.

Initiatives that enable farmers and producers to effectively manage risk or cyclical price swings, for example warehouse receipt systems (See Box 9), require high-grade storage facilities. Limited storage and grading facilities and contract enforcement mechanisms limit the opportunities for innovation in financial systems.

5.2.6. Mixed Agendas

In some countries, including Malawi, the culture of repayment has been damaged by the use of credit in programmes that have non-financial objectives. For example, charitable or government organizations may use credit programmes to transfer income to the poor, tolerating high rates of arrears. In some places, politicians may "forgive" debt in efforts to win political favour. Mixed agendas have resulted in confusion about payment obligations. Programmes that have used credit as a tool to effect resource transfers to the poor often result in large effective subsidies due to loan write-offs, distorted markets and the discouragement of private sector participation in markets for sustainable finance.

5.2.7. High Transaction Costs

Lower population density in rural areas and the fragmentation of markets in the agricultural sector increases lending and monitoring costs. Poor infrastructure and communications networks means that input suppliers, producers, exporters, traders, etc. have limited means to gather information and interact

It also makes difficult the delivery of complementary services (for example, access to information and training) provided by other organizations that might improve production yields or guarantee access to markets. The poor quality of rural infrastructure, for example roads and communications infrastructure, also increases costs for both borrowers and lenders.

5.3 Systemic Risks in Malawi

5.3.1. Impacts of Price Volatility

The initial impacts of agricultural reforms in Malawi led to an increase in the production of tobacco as well as private sector participation in the marketing of agricultural produce. However, the benefits of increased revenue has been offset over time by the fact that input prices have increased faster than producer prices. The lifting of price controls and the elimination of fertilizer subsidies under structural adjustment programmes has contributed to the rising cost of inputs to farmers. Even during bumper crop years, the collapse of tobacco producer prices has resulted in reduced income to farmers. Lower tobacco revenues coupled with a steadily depreciating currency make the necessary inputs even less affordable to most farmers. Prices for tobacco in 2003/4 have been even lower than in previous years. In addition, the price of maize has also fallen creating disincentives for maize surplus from smallholders.

The lack of competition and efficiency among businesses that buy and distribute inputs and farmer outputs reduces farmer's margins even more. In 2003, while international tobacco prices fell, tobacco prices in Malawi fell faster than international prices due to weaknesses in the intermediate buyers system. Lack of access to finance exacerbates the situation as it makes it difficult for farmers and producer associations to enter the market for the distribution and purchase of agricultural outputs and inputs to create competition and efficiency.

The volatility of input and output prices present serious challenges to both financial institutions and agricultural households in Malawi. The potential for financial intermediation depends on the savings capacity of clients and the ability of households to borrow and pay back loans. The opportunity to generate income to both borrow and save depends on: 1) their access to land, inputs and output markets; 2) their ability to manage production and price risk; and 3) their access to financial instruments to manage that risk as well as broad based services like savings and credit. In Malawi, high exposure to production and price risks, the absence of instruments to manage these risks, coupled with market inefficiencies, means that only certain segments of the market will have access to and the capacity to repay loans. It also means that instead there is likely significant demand for services like savings and microinsurance and loans for consumption smoothing in addition to loans structured for productive investments.

5.4 Advancing the Rural Finance Frontier in Malawi

Advancing the frontier of finance in rural areas will requires efforts in key areas:

- Developing instruments for managing clients' and institutions' risk;
- Expanding the physical network of branches or points of services for accessing financial services;
- Developing new products and services to meet clients demand, including those that reduce transaction costs; *and*
- Developing communications and transportation infrastructure to help bridge fragmented markets.

While addressing these key areas is not unique to rural finance, the rural environment presents specific challenges that make innovation and advances in these areas all the more difficult. Heightened risks demand a diverse and sometimes technically complex array of risk management products and a range of specialized suppliers that can manage these products.

In economies where family income is highly dependent on few activities, the inability of families to make up for lost income with other activities represents another risk. Common coping strategies to manage these risks include diversification of production, accumulating savings, or the purchase of credit or crop insurance. In Malawi, given the lack of diversification in agricultural production and shallowness of financial markets, there are limited opportunities for rural farmers and entrepreneurs to employ these coping strategies.

Formal financial institutions currently have a limited set of risk mitigation instruments for rural settings. These strategies are limited to traditional asset-based lending technologies using collateral and/or third party guarantees, charging a risk premium, heavy provisioning of loan loss reserves (representing additional costs and therefore higher interest rates) and portfolio diversification.

These strategies have limited effectiveness in extending the finance frontier, and increasing outreach. Loans will be limited to those willing and able to pay the risk premium. Individual loan sizes may be below borrowers' needs given collateral constraints, or loans may only be granted to those few rural households that have sufficient collateral. Assets like beds, tables, chairs and bikes are absent in 2/3 of Malawian households. Ultimately, interest rates that include a significant risk premium interest rates may only result in attracting clients with higher-risk, higher returns projects thus increasing the default risk.

The microfinance industry has realized some achievements in creating products and services that meet the requirements of both borrowers and lenders. However, in many settings including Malawi products and services still fall short in meeting both clients demands and managing institutional risk. Analysts have been particularly critical of the rigidity of products and services in Malawi and in East and Southern Africa in general. In East Africa, the rate of client dropout ranges between 25% and 60% per annum. MFIs are accused of trying to implement standardized, inflexible, low-cost credit driven systems replicated from other environments that may not be best suited for the contexts into which they are imported (Wright, *MicroSave Briefing Note #8).*

The primary reason that clients "drop out" is because products don't fully meet their needs. Deficiencies in product design or "technology" often result in excessively high transaction costs for borrowers, raising effective interest rates to high levels. Dissatisfied clients often end up "exiting" lending programmes, either willfully or by defaulting on loans. High numbers of client exits increase institutions' costs as institutions aggressively seek new clients. The high percentage of new clients, about which institutions have little information, increases MFIs' reluctance to experiment with new products to replace former clients. Often, beyond traditional solidarity group lending, MFIs introduce new products that rely on traditional asset-based lending technologies, rather than new financial technologies that actually expand the finance frontier.

Moving beyond the current barriers requires a deeper understanding of factors that influence product service delivery and design, as well as development of instruments that enable better risk management on the part of institutions and clients, particularly in rural markets where the bulk of Malawi's households and producers live. Innovations in financial service delivery are all the more challenging in rural markets as price and production risk and transactions costs are generally higher in rural economies than in urban markets. Better risk management and reducing transaction costs are preconditions for new product development.

5.4.1. Reducing Transaction Costs

Getting information that provides an accurate assessment of willingness and capacity of borrowers to repay often takes time and money. Institutions must test a variety of strategies for gathering this information in cost effective ways. Significant funding and effort has gone into organizing grass-roots farmer groups and associations in Malawi in efforts to reduce transaction costs of delivering financial services. Associations provide both information about clients and provide a convenient forum for service delivery.

Other sources of high transaction costs in rural areas include poor communication systems and physical infrastructure, as well and the cost of enforcing legal contracts. Poor infrastructure imposes high costs on *monitoring* clients where clients are dispersed.

5.5. Implications For Financial Sector Development in Malawi

5.5.1. Supporting Innovation

Serving markets in rural areas requires innovation in financial technologies that result in new products for populations that currently don't have access to financial services. Innovation requires knowing what clients want, managing institutional risk, and providing services with costs and prices that allow for sustainable, long term access. New product development requires a systematic process of market research, product development, limited pilot testing, and broad product roll out. It also requires the development of operational capacities of institutions offering new products, for example in information management, liquidity management, and marketing.

Managing Risk for producers and financial institutions

For financial service suppliers, managing risk may entail new ways of gathering information. Given that informal lenders may have better information to identify good clients, intermediaries are increasingly teaming up with informal players including supplier-traders (for example, traders that provide inputs), and community groups that have better information and can reduce transaction costs due to their proximity to potential clients, social relationships, and better ability to enforce contracts.

Box 9: Products for Rural and Agricultural Markets

Clients in rural areas seek a wide range of savings, lending and remittances services. It may be useful to understand product demand by looking at key links in the agricultural value chain. Four key stages in the chain include input supply, production of commodities, harvesting, and commercialization. (ICC, 2004) Other lending and savings products, though not unique to rural markets, must be structured to suit the needs of producers and traders in rural areas. Some examples of products for rural and agricultural markets are listed below. The different stages of the production chain and potential financial service needs are summarized in Figure 1. Table 5 outlines potential opportunities for rural markets in Malawi.

Lending against Warehouse Receipts

To access credit, a farmer delivers grain to a warehousing facility that provides the farmer with a "receipt" to document the quantity of grain delivered. The farmer pays a monthly storage fee, and can choose to sell the grain during more favourable market conditions. The price of grain can vary by 100% between the hungry season where agricultural produce is scarce and just following the harvest when prices are generally at their lowest point. The farmer may use the warehouse receipt to access credit from a bank. The commodities backed by the receipt serves as collateral for the loan.

Contract Farming

A wholesaler extends credit and in some cases technical support to a producer who has signed a contract with the wholesaler for the volume and quality of produce he will deliver at a specified period of time. The wholesaler either charges interest explicitly or charges interest indirectly through a discounted price to the producer.

Trader Credit

Intermediate buyers provide farmers with in-kind credit or cash credit that must be repaid when the producer harvests his or her goods. The trader benefits from the extension of credit because it secures a local supply of produce.

Leasing

A financial lease allows a financial institution to purchase equipment and rent the equipment to a client until the client has repaid the purchase cost of the equipment and interest on those installments. The financial institution owns the title to the equipment until its purchase costs are completely repaid with interest. Leasing can make equipment available to borrowers that do not have capital or collateral to make sizable capital investments. The lessee can then buy the equipment at the end of the lease for a small fee.

Crop Insurance

Crop insurance is purchased by farmers to protect against losses in agricultural earnings due to diminished yields from natural disasters (e.g. flood or drought) or other external events. *Index insurance* is one of the more successful production related insurance products in which a pay out is made when production is affected by easily measured weather conditions (like rainfall) and where yields are lower than normal. Whether or not a region's rainfall or production levels are abnormal can be measured against average indices for a specific region.

Derivatives: Futures and Forwards

(See Box 8, *What are Hedging Instruments*)

Long-term Agricultural Investment Loans

These loans may finance players at different parts of the production and commercialization chain: farmers, processors, retailers, traders, and exporters. With few bullet repayments at latter stages of the agricultural production cycle, long-term investment loans require careful analysis of potential risk and household cashflows.

Working Capital Loans for Farm and Non-farm activities

Working capital loans for rural family enterprises may be aimed at households with diversified income sources from agriculture and/or other rural enterprises. These loans are generally short-term and have a repayment schedule based on a household's projected cash income, rather than regular biweekly or weekly payments associated with many urban lending programmes.

Cash Smoothing Consumption Loans

Due to the cyclicality of farming households' income streams, linked to the agricultural production cycle for both on-farm and off-farm activities, households often need loans for "cash-smoothing " particularly just before harvest. This allows households to maintain food purchases and maintain a standard of living, pay school fees or respond to household emergencies.

Savings Services

Savings services may be used to accumulate financial resources that can be used to collateralize loans, finance productive investments, provide a source of income during lulls in the agricultural cycle, and even as a kind of "insurance" policy that influences the decisions of households towards higher risk, better return activities. If a household knows that it has a safety net in the event of failure it may actually invest money in activities that net higher returns in the long-term. Savings services run the gamut from fully liquid current accounts to limited withdrawal accounts or even long-term accounts whose returns provide some income. See Box 12 for more discussion on targeted savings accounts.

Source: Some examples sourced from A Technical Guide to Rural Finance: Exploring Products, WOCCU; Inventory Survey of Rural Finance and Microfinance in Rural Areas of Mozambique, (ICC), Draft/Malawi SubSector Assessment of Microfinance, Roberto Cater, December 2003)

Producers manage production and price risk in agricultural markets by accessing insurance or other products that enable risk pooling or transfer. Absent sophisticated insurance products, producers may take advantage of savings products or remittances services to stabilize income. However, there is currently limited supply for liquid savings, insurance or money transfer services. Potential areas for product development are explored in Box 9.

An important area of public support for the development of insurance products may be developing information sources such as risk maps that improve the institutional capacity of both public and private sector providers to identify and analyze risks. This information can be used for example to assist providers with pricing premiums.

5.5.2. Public Sector and Private Investment in Innovation

Institutions may be reluctant to engage in the Research and Development required to develop product innovations, especially when innovations can be easily adopted by the competition once they are introduced in the market. The public sector can contribute to overcoming bottlenecks and barriers by supporting focused initiatives that defray the costs of innovating. These initiatives may include:

- Training and technical assistance to develop the capacity of institutions to develop new technology broadly. This includes developing the capacity to carry out market research, design, market, and roll out new products.
- Support for "start-ups", potentially subsidiaries of larger institutions. Subsidiaries of larger institutions may use the significant market knowledge of their subsidiary parents, but in a smaller, more nimble environment where they may be more likely to innovate (Bonin and Abel).
- Educate stakeholders to explain the characteristics of insurance schemes and different opportunities that might work within the market challenges and constraints in Malawi. (The World Bank Group, *Agricultural Investment Sourcebook*)
- To evaluate the potential for more complex financial instrument that manage and pool risk, for example agricultural securities or insurance products, provide technical assistance to potential suppliers to assess demand from producers/traders, develop product strategy development, select brokers, etc. This may include data collection to better understand specific risk characteristics. (The World Bank Group, *Agricultural Investment Sourcebook*)
- Provide information to farmers and traders (through producer groups, trade associations, etc.) on the use of various instruments. (The World Bank Group, *Agricultural Investment Sourcebook*)

5.5.3. Strengthening Current Players and Supporting New Market Entrants

Meeting the demands and challenges of financial sector development in rural areas will require building the capacity of current players and supporting new market entrants.

- Investors and donors must support initiatives to strengthen the capacity of current market leaders that have potential for significant expansion in outreach to rural areas, including both technical assistance and capital injections. Attention has been diverted from institutional support programmes in favour of "trendy" and less expensive policy initiatives, as well as a certain stigma attached to support for institutions with state involvement.
- Limited supply of financial services in rural areas calls for investors and government to pay serious attention to support the process of restructuring the parastatals. Finding the support of foreign direct investment may be key as this is traditionally the vector of innovation in many emerging markets. A number of parastatals agricultural banks, notably Mongolia and Thailand, have successfully transformed from inefficient to highly efficient enterprises. A couple of options where state-owned banks have been engaged with good results (Pearce et al., *Rural Financial Services Through State Banks*) may have potential for the Malawi context. These two options include:

  - A management-led turnaround of the bank

  - The creation of a specialized microfinance unit that uses branches and systems[16]

  It has been noted however that getting a state bank on firm financial footing is the first order of business. Moving too quickly into agricultural lending or new products for agriculture may be too risky initially, and should be approached with caution and systematically.
- If restructuring does not make sense, donors should consider supporting the establishment of a new rural financial institution with the capacity for significant outreach and the capacity to engage in full financial intermediation – both savings and lending services.

5.5.4. Leveraging Technology

There may be opportunities to use information technology and electronic banking technologies to expand supply of services in rural markets. Electronic-based services may be enabled by Malawi's new payment system (Malswitch). Handheld PCs for example can increase a credit officer's ability to accurately assess household cash flows and repayment capacity of rural households within the context of global price frameworks. The use of ATMs at banks or Point of Sale Devices at retail outlets that have access to Malswitch networking technology *may* reduce transaction costs and dramatically expand the kinds of products that may be offered, like payment services.

Box 10: Some Options for Engaging State-Owned Banks

Management Led-Turnaround

Governments contract consulting firms to provide management and technical assistance over a period of time. The purpose of the contracts is to ensure that the bank becomes solvent and financially sound and can add new financial services tailored to new market segments among the unbanked. These contracts generally include temporary foreign senior management. Two examples of successful management-led turnarounds are the Agricultural Bank in Mongolia and the National Microfinance Bank in Tanzania, spun off from the National Bank of Commerce.

Source: Pearce et al., Rural Financial Services Through State Banks

Specialized Micro or Rural Finance Units

In this case, a specialized financial services department or subsidiary is created within a state bank, and is given space to recreate culture and policy to serve microfinance units. Two examples are the Bank Rakyat Indonesia's local microfinance units and the CrediAmigo, and independent microfinance unit set up by the Banco do Nordeste, a regional development Bank based in Brazil.

Source: Pearce et al., Rural Financial Services Through State Bank, CGAP, January 2004.

5.5.5. Supporting Other Sectoral Policies Necessary for Financial Sector Development in Rural Areas

Despite concerns over the future of Malawi's export crop the government's attempt at agricultural diversification are making little headway, and there seems to be limited coherence in the government's crop diversification strategy (EIU). Lack of progress impedes financial sector development by increasing risk parameters and generally supporting inefficient markets.

In addition, other sectoral polices must focus on wider market intermediation limitations that have created bottlenecks in production chains. Limited access to input and output markets limits farmers' ability to generate profits and participate in financial markets. Weak physical infrastructure increases transport costs and limits access to markets. Weak communications infrastructure limits suppliers' ability to leverage technology to reach unbanked populations.

5.5.6. Commitment to Finding Long Term Market Based Solutions to Input Credit

While fertilizer subsidies to farmers have been lifted, research reveals that public sector driven programmes to supply inputs to farmers has resulted in market distortions, and that levels of default are high. High levels of default result in de facto subsidies, and limit sustainable access of farmers to these markets. It is permanent access not one time injections of credit that enable farmers to realize gains over time. At a time when there may be pressure to reinstate subsidized programmes to improve farmer well-being where markets don't appear to be materializing, it is clear that sustainable access will require the hard work of finding market based solutions that are sustainable.

Table 5: Opportunities and Main Constraints for the Provision of Rural Financial Services

Products demanded	Service providers of the demanded products	Supply opportunities	Main constraints to address gaps
Agriculture			
Credit for inputs (seeds, fertilizers and equipment)	• Outgrower companies (for cash crops). • Traders and suppliers. • APIP loan distributors (MRFC, Finca, NGOs). • MRFC.	• Facilitate credit to farmer associations for provision of inputs to members. • Provide credit for contract companies to on-lend to members, particularly for new commodities for smallholders (e.g., tea, paprika, etc.). • Facilitate credit to suppliers who provide inputs on credit to farmers. • Financial institutions supply credit directly to farmers.	• Need increased understanding of effective input utilization. • Farmers and farmer associations need increased financial management skills. • High risks due to climatic uncertainty. • High real interest rates over a production period could limit farmer returns. • Weak contract enforcement creates difficulty in recovering money from farmers. • Weak linkages to markets, among farmers and traders, traders and processors, etc. • Subsidy driven programmes distort market.
Credit for planting and field maintenance	• MRFC. • Outgrowers, contract farming companies.	• Advanced payment by contract farming companies. • Provide financing for irrigation.	• Difficulty in monitoring use of funds. • High number of small disbursements. • Presence of equipment suppliers and equipment servicing may be limited.
Warehousing credit	• Not available.	• Develop pilot to facilitate producer associations to store produce in warehouse.	• Unpredictability and volatility of market size that would affect the revenues relative to operational costs. • Lack of experience in managing such a scheme. • Lack of insurance providers and reasonable auditing options.
Agricultural commercialization credit	• Banks (mainly to large traders). • MFIs (especially to itinerant traders).	• Fund to facilitate purchasing advances for associations and traders.	• Volatile prices. • Informal traders are very transient.

Products demanded	Service providers of the demanded products	Supply opportunities	Main constraints to address gaps
Agriculture, continued			
Overdraft facility or line of credit	• Not available.	• Provide overdraft facilities to rural traders and producer associations. • Retailers providing card-based lines of credit at points of sale linked to credit providers.	• Need good MIS system, which is a limitation for many MFIs. • Require monitoring systems.
Price Insurance	• Not widely available.	• Traders or contract farming companies provide price guarantees to farmers in exchange for guaranteed supply and/or opportunity to take advantage of price increases. • Banks use price insurance contracts as form of collateral for lending.	• Need information on price trends and systems for grading quality of output. • Opportunity for speculators to make money from the rise in prices.
Production insurance	• Not widely available.	• Traders work with aggregators to clear sales of commodities on regional/global markets at better prices to producers and margins for traders.	• Need information on price trends and systems for grading quality of output. • Opportunity for speculators to make money from the rise in prices.
Warehouse insurance	• Not available.	• Develop warehouse insurance for processing facilities which require long-term storage (e.g., cashew processors).	• Insurance services for agriculture are absent in Malawi. • Lack of demographic/historical information to estimate risk. • Large area creates high transportation costs during monitoring.
Savings	• Commercial Bank Branches. • OIBM. • MSB.	• Products that enable farmers to accumulate savings to invest in production. • Products that enable farmers to use savings to invest in production. • Savings for consumption smoothing • Targeted at life-cycle events (funeral, school).	• Need efficient MIS with minimal 'back office' requirements. • Seasonality of rural economy potentially creates difficulty in managing liquidity. • Requires licensing • Capacity to prudentially manage public's savings.

Products demanded	Service providers of the demanded products	Supply opportunities	Main constraints to address gaps
Informal Sector			
Credit for working capital	• Microfinance Institutions (for urban based traders): Pride Malawi, FINCA Malawi, OIBM, projects. • Large Traders and Suppliers.	• Increase outreach in rural areas.	• Weak financial management skills of microenterprises.
Credit for investment	• MRFC.	• Develop longer-term credit products.	• Need to help microenterprises develop business plans.
Savings	• Commercial Banks. • Savings Collectors attached to banking institutions. • Community Based institutions (ASCAs, ROSCAs). • SACCOs.	• Study and pilot role of individual savings collectors. • Facilitate expansion of financial institutions into rural areas.	• Many providers are not licensed to provide savings services. • Small transactions are expensive. • Community Based Institutions generally have weak bookkeeping skills. • Need to encourage increased confidence among members in Community Based Institutions.

Products demanded	Service providers of the demanded products	Supply opportunities	Main constraints to address gaps
Household Needs			
Consumption credit (e.g. funeral expenses, medical treatment, and school fees)	• SACCOs. • MFIs (significant portion of credit for microenterprises diverted for household needs).	• Facilitate products enabling short-term, rapid disbursement of credit.	• Most institutions have centralized structure, making rapid disbursement difficult. • Difficulty evaluating whether cash flows significant to support loan repayment, unstable cash flows due to fluctuating prices for commodities.
Household investment credit	• Not available.	• Develop housing loans.	• Weak property rights makes collateral difficult. • Difficult to project long-term income of non-salaried clients.
Savings	• Forced Savings: MFIs (Pride and FINCA). • OIBM. • MSB.	• Develop targeted savings products (e.g., saving for school fees). • Study and pilot role of individual savings collectors. • Facilitate expansion of financial institutions into rural areas.	• Many microfinance operations are not licensed to provide savings services. • Small transactions are expensive. • Community Based Institutions generally have weak bookkeeping skills. • Need to encourage increased confidence among members in Community Based Institutions.
Insurance service	• Not available.	• Pilot death insurance products, health, etc.	• Insurance services are weak in Malawi. • Lack of demographic/historical information to estimate risk. • Large area creates high transportation costs of monitoring.
Money transfer	• Commercial Banks. • MSB. • Retailers that provide access to Bank services through points of sale and access to communications network.	• Facilitate expansion of financial institutions into rural areas.	• Limited telephone linkages in many rural areas. • Moving money in rural areas is expensive in rural areas.

Source: Adapted from Inventory Survey of Rural Finance and Microfinance in Rural Areas of Mozambique, *International Capital Corporation (ICC), September 2004*

Chapter 6: Demand for Microfinance in Malawi

6.1. Who Demands Microfinance Services?

Demand for microfinance services can be approached from the perspective of micro and small businesses that seek access to finance to fund operations and growth. Demand can also be approached from the perspective of poor and low-income households, sometimes called household firms, that seek a range of financial services to generate or increase income, or smooth incomes during lean seasons or periods of crisis.

6.1.1 Households

Households seek loans, savings, insurance (housing, health, crop, life, and price insurance), payment services (to settle bills or receive payments), and pension services. Financial services are used to invest in businesses, improve houses, mitigate risks, and meet household and other consumption needs relating to health, education, and community obligations. Access to financial services plays a strong role in assisting households to mitigate and manage the impacts of risks that poor and low-income households are particularly vulnerable to. Among the lifecycle, economic, environmental and social risks faced by households are drought, price changes for inputs and agricultural production, political instability, death, illness, unemployment, economic crises, loss of social status or other capital. Consumption credit and access to savings is particularly important in food insecure environments like Malawi where timely access to credit and savings may help prevent the occurrence of chronic food insecurity by enabling households to purchase food during off seasons or during bad production years.

Poor and low-income households draw from a range of both formal and informal mechanisms to mitigate risk and manage household cash flow. However, access to sources of finance are limited. According to the Malawi National Gemini MSE Baseline Study (2000), about 19.8% of rural households and 10.5% of urban households reported acquiring a loan from some source, both formal and informal. Little information is available concerning demand for other services. Interestingly, some microfinance operators force clients to come up with "compulsory savings" as cash collateral to access loans. One study found that this requirement was perceived as a "preferred" attribute of the product, indicating demand for savings products and the lack of available alternative savings options from other sources (Enterprising Solutions).

Given that greater than 85% of the population and 80% of MSEs are in rural areas that are highly dependent on agricultural production, demand for loans is highly seasonal. October to January is the peak lending season and loans fall due between April and September. The mix of households' economic activities also varies by region. In the north, households are more likely to rely almost exclusively on farming activities; in the central regions, households manage a mix of farm and non-farm activities, while in the South non-farm economic activities may take on a greater role in the household economy.

6.1.2 Formal and Informal Sector Enterprises

The informal economy dominates Malawi's economy. It includes an estimated 3.5 million people, nearly 80% of the estimated labor force of 4.5 million people (EIU). Micro and small business in Malawi are a visible and productive part of the Malawian economy. Gemini MSE Baseline Study (2000) conservatively estimates 747,000 micro and small enterprises[17] in both the formal and informal sectors. These enterprises employ 1.7 million people, or 38% of the labor force. According to the baseline study, 83% of MSEs were located in rural areas and only 17% in urban areas (Lilongwe, Blantyre, Mzuzu, and Zomba) where microfinance suppliers have the strongest presence.

The overwhelming majority of agricultural households produce for subsistence, not to sell in the market. Only an estimated 7.9% of agricultural households (or 6.7% of all households) sold a significant part of their output in the marketplace. Crops accounted for only 22% of MSEs, and tobacco production dominated both SMEs and market sales, accounting for 70% of crop-based employment. Some percentage of agricultural households however generate cash income from non-farm activities. In Malawi many households develop microenterprises to diversify income sources and as a source of livelihood to fall back on during hard times. Few consider off-farm MSEs as their primary occupation, rather as often one of many activities that play a role in their overall livelihood strategy.

Micro and small business have relatively modest turnover. According to the 2002 Baseline Study, 60% of businesses generate revenues between MWK 6,000 and 50,000. The majority of MSEs (54%) earn profits of less than $125 a year (in year 2000 terms). There appears to be significant entry and exit to the market, as well as seasonality of activity. On average, MSEs operate only about nine months per year to accommodate labor shifts within the agricultural production cycle.

The profile of households' productive activities influences demand for loan and other financial services in Malawi. The market size for loans is largely determined by households' participation in the marketplace and the cash economy which influences their ability to pay high real rates of interest and repay principal. Large segments of the

Box 11: Characteristics of Micro and Small Businesses in Malawi

Some characteristics of micro and small businesses (MSE) in Malawi:

- Women accounted for 42% of the MSE sector.
- Crops account for 22% of SMEs. However, only 7.9% of farm families can be called crop entrepreneurs – farm families are primarily subsistence producers.
- 25% of MSE sector and 70% of crop-based employment is created by tobacco alone.
- The annual turnover of MSEs was modest. Twenty-six percent had gross annual sales of less than MK 10,000 ($166) in the survey year (2000), 21.3% had sales between MWK 10,000 – 20,000, and 23.7% had annual sales between MWK 20,000 – 50,000 ($833).
- 83% of all MSEs are based in rural areas; the 17% found in urban areas are concentrated in the four major cities of Lilongwe, Blantyre, Mzuzu and Zomba.
- Among MSEs, in the north farming activities dominate; a mixture of farming and non-farm activities characterizes the central region, and non-farm activities prevail in the southern region.
- Of the estimated 747,000 MSEs, micro-enterprises (MEs) of one to four workers account for 91.3% (682,387) of the total.
- The distribution of MSEs by type of activity reveals four distinct sectors that account for 98% of the total. These are (i) commerce, trade and tourism (44%), (ii) manufacturing (30%), (iii) crop production (17%), and (iv) services (5%). Due to the dominance of agriculture in the economy, the activities of commerce and manufacturing frequently involve agriculture-related trade in resource inputs and crop processing.
- In terms of total firms and employment, burley tobacco dominates all firms in the country with over 15% of total MSEs and 25% of MSE employment.
- Using criteria of annual sale of MWK 6,000 ($75 in 2000 terms), only 7.9% or 160,805 of total agricultural households and 6.7% of all households (2.4 million) can be classified as crop producing enterprises.
- Rural agricultural MSEs are slightly larger in terms of number of employees. Primary production enterprises have larger sales value than off-farm enterprises.
- In 2000, the majority of businesses were earning less than $125 a year.
- Most businesses in Malawi are home-based.

Source: Gemini MSE Baseline Survey and USAID AMAP Microfinance Sector Assessment of Malawi population in Malawi have limited capacity to repay loans given the characteristics of Malawi's financial sector (high real rates of interest and limited instruments for managing price and production risk for both farmers and institutions), macroeconomic conditions (price instability), and the structure of the economy (a narrow productive base rooted in subsistence agriculture). In aggregate these conditions result in slim, sometimes negative margins. A limited segment of the population are candidates for loan services.

6.2. Effective versus Potential Demand

Up to now, capacity in the microfinance sector, in rural, urban and peri-urban markets, has focused on loans. Little is known about the financial service needs of smallholder farmers that make up approximately 80 % of the labor force. Subsequently, available demand information focuses primarily on credit. The number of self-employed, and micro and small enterprises in both the formal and informal sector is estimated at about 747,000. Credit is recognized as a binding constraint for many of these enterprises, with only a small percentage having access to credit from either informal or formal sources. Households in Malawi demand credit for both productive and consumption needs.

Despite what appears to be a large potential market, real or "effective" demand for loans may be constrained. Demand is limited by both the capacity and willingness of borrowers to repay. More importantly, demand is constrained by the limited range of products that correspond to the risk profile and production patterns of potential borrowers. Capacity and willingness are affected by the following:

- Capacity of borrowers to repay within the context of macroeconomic instability, that creates uncertainty about prices for inputs and what is produced, particularly for commodities like tobacco, tea, and sugar.
- High real interest rates, as well as high transaction costs in rural areas.
- The absence of appropriate financial services that meet the risk management needs of borrowers and institutions.
- The predominant use of business profits to meet households' immediate needs as a coping strategy rather than to reinvest in businesses as a profit-maximizing strategy. As a result, clients may not consistently take loans nor progressively higher loans.
- Relatively low levels of revenue generation, or turnover.

6.2.1 Capacity to Repay

The Malawian economy is dominated by agricultural production and smallholder farmers. The capacity of farmers to repay principal and interest is highly sensitive to farmers' yields and the prices of both agricultural inputs and outputs (Evans and Ford). In Malawi, one study showed that low repayment rates historically have been linked to the decline in the profitability of maize due to devaluation of the kwacha and the rise in the prices of agricultural inputs. Many small producers complain that revenue and profits are also limited by poor access to markets. Borrowers may be eliminated from the credit market when their returns are inadequate to make both interest and principal payments. One study demonstrated that during the 1993-1996 production season that households that took loans realized lower net crop incomes than non-borrowers due to costly in-kind fertilizer products, low yields, and the cost of credit (Diagne and Zeller).

Many factors influence production and yield risks, including government policies and environmental conditions. Few instruments exist that allow producers and institutions to manage the risks they face. Attempts that have been made in the past – minimum price guarantees by state-owned marketing boards – to deal with volatility have proven difficult to sustain, costly and inefficient (Bryla, Varangis, and Tiffen).

Borrowers' capacity to repay is also influenced by the structure of loan products offered. Borrowers often complain that the loan terms, particularly repayment schedules, do not match their own cash flows, making it difficult for them to meet their payment obligations.

6.2.2 Willingness to Repay

Effective demand for credit is also determined by borrower's *willingness* to repay.

Clients' willingness to repay is generally linked first and foremost to their ongoing access to financial services; borrowers and lenders invest in long-term credit relationships. Borrowers are more inclined to repay when the incentive of future access to loans is offered (Gonzalez-Vega).

In Malawi, institutional vulnerability and credit rationing due to undercapitalized operations may affect borrower's perception of the sustainability of services and subsequently their willingness to repay. Willingness to repay may also be affected by constraints in the judicial system that make it difficult for suppliers to enforce repayment obligations.

In addition, there appear to be a number of initiatives with conflicting objectives or political motives that create confusion on the parts of borrowers about whether they are receiving loans or grants or whether they have obligations to repay.

Microfinance operators in Malawi will likely have to pay significant attention to the application of tools and technologies that may enable them to accurately assess both willingness and capacity to repay. Non-performing loans in the formal banking sector in Malawi are high. In some cases, lenders lack systems, expertise and incentives to enforce repayment or to effectively restructure loans during crisis periods. Microfinance operators in Malawi experienced a delinquency crisis in the early 2000s due to both external factors, including drought, but also driven by weak operational systems and policies for maintaining high levels of on-time repayment. While portfolio quality has improved for most microfinance institutions, many still struggle with maintaining portfolio quality that complies with standards required to maintain profitability.

6.3 What is the Estimated Demand for Microcredit Services?

The following demand estimates have been made using two different approaches: 1) a "standard-of-living" approach; and 2) a "private- sector" approach (Brandsma). The estimates are not based on in-depth market research. They are merely scenarios that give some indication of the size of the market based on current patterns in the market for microfinance services. The market is characterized by the following characteristics:

- Of all current loans in the sector, 85% are below $100 or MWK 10,700. Subsequently, the average weighted loan size for Scenario 1 estimates is about $100. For scenario 2, an assumption is made that the average loan size is kept artificially low now by suppliers in the market. Thus in Scenario 2 the average weighted loan is about $130, 30% higher.
- Based on Gemini research, only a very small percentage of the agricultural producers actually sell their produce on the market. In the first scenario therefore, allocates agricultural sector loans to a commensurately small percentage of the population. In the second scenario, it is assumed that the percentage of agricultural loans is higher based on an increased ability of producers to take part in markets for the production and sale of agricultural produce for both subsistence and export products.

These are broad estimates that do not take into account differences in demand according to region, although the varying economic activities by region make it likely that there are tremendous variations among regions, and potentially high seasonality for demand. For example, farmers in the North have much higher average farms (average of 2.4 hectares) versus farmers in the south (average .5 hectare). In the south, households tend to rely on a greater combination of farm and off-farm activities versus households in the north. Additional market research is required to understand those differences. Regarding seasonality, loan portfolios grow dramatically between October and January with many seasonal loans coming due in April.

According to the 2003 Human Development Report, GDP per capita at purchasing power parity in 2001 averaged $570 (Human Development Report). Unadjusted per capita for this period was about $190, with an expected decrease to $132 in 2003 (EIU). Generally speaking, microfinance services range anywhere from 20% of unadjusted per capita GDP for the very poor to 250% of per capita GDP for the vulnerable non-poor. In Malawi, this would create significant demand for microfinance loans ranging from about $25 to $350 (roughly MWK 2,500 to MWK 40,000)[18].

The market estimates provided below correspond to this basic rule of thumb and reflect the market now, with the weighted average of estimated loans corresponding to 50% to 100% of per capita GDP. While this rule-of-thumb gives a ball-park figure for microfinance loan sizes, it should be noted that the unbanked population in Malawi is high. There are significant gaps in supply of both loans and savings services in a wide range of market segments and transaction amounts. These figures are simply meant to orient the reader not provide a constricting definition.

6.3.1 Clients (Loans)

The standard-of-living approach looks at the number of poor and vulnerable households in Malawi. Looking at the household as a unit of analysis is common since *total* household income is often used to determine repayment capacity on loans, versus simply business profits (Brandsma). Using this approach, the market is estimated at between 311,000 clients and 622,000 clients, assuming conservatively that between 20-40% of the market defined by poor households can legitimately access services, based on willingness and capacity to repay. The estimate of 20 to 40% is based on the fact that MSE activities provide profit based income to about 25% of all households in the country (ECI and NSO), but anticipates that additional households access credit for consumption needs. Conservative estimates are also based on the fact that many households enter and exit the marketplace on a continuous basis based on need and market opportunities (ECI and NSO).

Table 6: Demand Estimates: Standard-of-Living Approach

Total Population	Vulnerable Population	Average Size of households	Vulnerable households	20% demand	40% demand
10,800,000	7,000,00	4.5	1,555,555	311,000	622,000

The private sector approach attempts to quantify demand by looking at the number of micro and small businesses in the informal and formal sector and recognizing that 85.5% of employment in Malawi is generated by the non-formal sector. Demand figures for the agricultural sector are particularly rough. Demand estimates recognize the fact that between 80% to 85% of the population's employment is generated by smallholder farmers, including 1.5 million people working on smallholdings, but that only a fraction of households actually sell produced goods in markets. Scenario 2 assumes a significant jump in this figure based on better market conditions for farmers.

Table 7: Demand Estimates: Private Sector Approach

Type of Enterprise	Number	20% demand	40% demand
Micro and Small Enterprises (trading, services) (formal and informal)	767,000	153,400	306,800
		10% demand	30% demand
Small Agricultural enterprises, including household-firms	1,500,000	150,000	450,000
Total	2,267,000	303,400	756,800

Using this approach the total market is estimated at between 303,400 clients and 756,800. This range is not significantly different from the standard-of-living approach. These number can be compared to current supply at just over 200,000, including in-kind loans from the previous growing season.

To give some idea of the potential market size, the market estimates have been divided into market segments defined by average loan sizes for both the standard-of-living and private sector approaches taking into account current loan sizes, distribution among loan size categories, and potential changes in the market (for example, changes brought about by the involvement of more agricultural producers in market-based production and higher loans sizes). These figures are merely indicative, to give some idea of the potential capital needs of a conservatively estimated market. They are based on nothing more than a solid guess.

6.3.2 Portfolio Size

Portfolio Estimates: Standard-of-living approach

Table 8: Loan Capital Needs: Standard-of-Living Approach

			1: Demand (311,000)			2: Demand (622,000)
Average Loan Size	Scen. 1 (% market)	MWK	$ US	Scen. 2 (% market)	MWK	$ US
$50/ MWK 5,300	20%	332,770,000	3,110,000	15%	499,155,000	4,665,000
$75/ MWK 8,000	55%	1,372,676,250	12,828,750	30%	1,497,465,000	13,995,000
$150/ MWK 16,000	20%	998,310,000	9,330,000	40%	3,993,240,000	37,320,000
$300/ MWK 32,000	5%	499,155,000	4,665,000	15%	2,994,930,000	27,990,000
Total	100%	3,202,911,250	$29,933,750	100%	8,984,790,000	$83,970,000

With these estimated loans sizes, the capital requirements are between MWK 3.2 billion (US$30 million) and MWK 9 billion (US$ 84 million). This range can be compared to the current estimated supply of credit of MWK 2 billion (US$18.7 million). It is also useful to compare estimated capital needs against the size of the total private sector credit portfolio, currently MWK 10.5 Billion (US$98 million) (RBM). At higher-end yet conservative estimates, meeting demand would require doubling the supply of credit to the private sector in Malawi.

Estimated capital requirements using private sector approach figures yields slightly higher numbers. The low end estimates assume limited use of credit by the agricultural sector while high end estimates assume that conditions change that enable more participation by the agricultural sector.

Table 9: Loan Capital Needs: Private Sector Approach

			1: Demand (303,400)			2: Demand (756,800)
Average Loan Size	Scenario 1	MWK	$ US	Scenario 2	MWK	$ US
Micro formal ($225)	10%	730,435,500	$6,826,500	20%	3,643,992,000	34,056,000
Micro informal ($100)	55%	1,785,509,000	$16,687,000	35%	2,834,216,000	26,488,000
Agricultural ($75)	25%	608,696,250	$5,688,750	20%	1,214,664,000	11,352,000
Agricultural ($125)	10%	405,797,500	3,792,500	25%	2,530,550,000	23,650,000
Total	100%	3,530,438,250	$32,994,750	100%	10,233,422,000	$95,546,000

Using this approach the total capital requirement is estimated at roughly MWK 3.5 billion (US$ 33 million) to 10.2 billion (US$ 96 million). Whether the reader buys into the most "bearish" or "bullish" estimates it is worth noting that their value is significant, relative to current private sector credit and will require significant additional investment of financial resources, including finance to fund growing loan portfolios and increased reserves. The reader should note that these demand estimates are very conservative; the doubling of average weighted loan size for example to just $200 would effectively double the estimates for loan capital, and would require a 200% increase in credit to the private sector.

These estimates attempt to quantify the market for loans, but do not take into account the wide range of financial services that the unbanked populations demand including savings, insurance and remittances. Taking into consideration the wide array of potential services, beyond loans, demand for services seems infinite.

6.4. What are the Financial Service Demands of the Market Beyond Credit and How Will They Evolve?

The estimates in this section are not based on rigorous data; they are simply ballpark figures intended to demonstrate that even using conservative estimates the size of the potential market for credit services in Malawi is significant. Its capital needs – estimated at between 30% and 100% of the current market for net private sector credit (and five times the amount provided to microfinance clients now) require that the microfinance

Box 12: Demand for Products beyond Short-term Credit

Malawi's financial services market is dominated by the supply of short-term credit. Clients seek a range of services. Chapter 5 provided examples of savings, loan and insurance products for rural and agricultural markets (Boxes 8 and 9). The following box provides examples of other kinds of products that may be attractive to households in Malawi.

Non-agricultural insurance: Non-agricultural insurance services that meet the needs of the poor include health insurance, life insurance, and burial insurance. In the latter the indemnity paid contributes to the funeral costs.

Type of Insurance	Potential Low-Income Community Examples	Relative Risk/ Complexity to Provide
Term Life	• Insurance repays outstanding loan balances upon death of borrower. • Small face value policies designed to cover burial costs (can be either tied to or independent of loans).	**Low**
Endowment and Permanent Life	• Life-Savings insurance. • 'Dowry Insurance' - policies purchased for a 10-15 year term upon the birth of a female child. Provides fixed-term savings vehical with insurance pay out if family's primary income earner dies prior to the end of the term. • 'Retirement Insurance' - similar to above, but with longer terms.	↑
Property	• Insurance against damage, destruction and/or theft of household assets. • 'Crop Insurance' - insurance against specific causes of poor yields for specified crops. • Natural Disaster Insurance - with support from international reinsurers coverage may be possible against some natural disasters.	↕
Health	• Accident insurance - coverage against medical costs due to accidental injury. • Curative Health Insurance - coverage to defray costs of medications and medical attention for specific illnesses and procedures.	↓
Disability	• Limited Disability - Insurance makes on-going loan repayments if borrower becomes disabled.	**High**

Source: Draft Malawi Subsector Assessment of Microfinance, Roberto Cater, 2003 from Providing Insurance to Low-Income Households, Microfinance Best Practices. See also www.microinsurancecentre.org

Housing/shelter finance: Clients seek home improvement loans that allow them to improve their homes under terms that meet their financing needs and repayment capacity. Home improvement loans can not only improve quality of life but also have positive

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impact on home-based businesses. Housing loans may be linked to other financial service products and generally have longer repayment periods (up to three years) and vary from $300 to $3,000 (or MWK 32,000 to MWK 320,000). See also www.chfhq/hilpromo.pdf

Savings: Clients seek a range of services including fully liquid passbook accounts to less liquid accounts that offer them a better return or no withdrawal fees. In addition to accessing a range of traditional current and fixed term accounts, clients seek savings services targeted at specific purposes. Products to explore include customer friendly Voluntary Savings, Youth Savings, Retirement Savings, Institutional Accounts (Donors, churches, NGOs, etc.), Fixed Term Deposits, Special Purpose Accounts (Christmas, Ramadan, House Repair, Education Fund). See also www.microsave-africa.com

Payments and Money Transfers: Currently, in Malawi, the majority of payments and money transfers are payment of pensions and civil servant salaries. Payment and transfer services may be used to move money between family members, to pay bills, to receive payments from different players in the agriculture value chain (e.g., wholesalers to retailers,

industry be understood and developed within the context of the financial sector, the only potential source to meet the sector's financing needs, not ancillary development initiatives.

Significant additional research is required however to understand the depth and breadth of financial service needs of small and microenterprises, smallholder farmers, and households in Malawi. Effective demand should increase as products that meet client needs are developed. MFIs in Malawi and East Africa suffer from a high rate of client exits that exceed 50%. One of the key drivers for client exits are products and processes that do not match client needs and preferences. New product development will emerge from a systematic process that includes market research and new product piloting.

Government policies that encourage: 1) diversification away from farming; 2) diversification among agricultural enterprises; and 3) access to markets for distribution and sale of production should stimulate the integration of subsistence farmers into markets, and subsequently stimulate demand for financial services from agricultural and other households. An increase in the supply of services themselves may encourage clients to diversify enterprises. The mere access to credit, knowing that it is available if needed, will boost a household's risk-bearing ability (Diagne and Zeller).

Increased supply and demand for loan services will also depend largely on the development of other financial services that enable clients and institutions to hedge production and market risks. This may include price insurance products for farmers, like futures and options, and opportunities for institutions to securitize their portfolios, that is, to sell their portfolios to third parties to transfer risk. It will likely involve the participation in international markets to enable broader risk pooling.

6.5. Implications of Demand Analysis

- Even using conservative demand figures, the current supply of micro*credit* services falls short of estimated demand. Demand estimates range from 300,000 to 760,000 clients with loan capital needs of MWK 3.2 billion ($30 million) to MWK 10.2 billion ($96 million). At the higher end this is five times the current supply of microfinance credit and would require doubling credit currently provided to the private sector.
- Heightened risks in rural financial markets in Malawi are real. They are exacerbated by the impacts of broader fiscal and macroeconomic policies and shallow financial markets. Market suppliers should move forward carefully and systematically as they cultivate new markets and products. They should take adequate time to understand the capacity and willingness of clients to repay, financial needs, and clients' preferences. In the agricultural sector, loan officers must be able to assess the yield (production) risk and price (market) risks before a loan is made, and undertake a strong assessment of clients' income and expenditure considering their diversified livelihood strategies. There appears to be significant new opportunity for lending services, particularly in the agricultural sector, but clients need to be carefully evaluated.
- Agricultural sector policies that encourage crop diversification and the development of new products for export, and financial sector and fiscal management policies that influence interest rates and the prices of inputs and outputs will largely drive financial sector development. Policy makers should understand the impact of policies on the capacity of households and financial institutions to create and take advantage of new business opportunities.
- Households, particularly rural households, demand a significantly wider array of service offerings than is currently supplied by the market. These include savings services, insurance services, payment services, and leasing opportunities. Significant additional market research is required to understand those financial service needs.
- Many of those services are dependent on the development of more complex financial instruments that allow risk sharing and spreading on the part of clients as well as financial institutions.
- A number of lending programmes promoted by both NGOs and the government target the poor with loans despite that that many targeted clients do not have capacity to repay loans under current conditions. This may spoil markets for credit services when it creates widespread confusion about client's obligations to repay loans. Governments and donors should examine their programme objectives and strategies to ensure that they are using the appropriate instruments – loans, grants, etc. to reach target markets, and that will enable the creation of sustainable financial institutions and the development of markets over the long term.

Chapter 7: The Supply of Microfinance in Malawi

7.1. What Does the Supplier Landscape Look Like?

Globally, the following institutional models are the most prevalent providers of microfinance services.

- *Non-governmental organizations.* They are generally nonprofit, credit-only institutions. Some NGOs manage microfinance *projects* with no corporate status.
- *Companies,* Limited By Guarantee. Members guarantee to contribute nominal amounts if the operation closes, but there is no share capital and no distribution of profits. They are generally credit-only institutions, initially funded by donors with no interest or capacity to own shares. Special *trusts* owned by the public or private sector may operate similarly.
- *Commercial banks.* They are full service licensed banks with line(s) of business that serve the microfinance market. (Some commercial banks have established *subsidiary operations* that exclusively focus on the microfinance sector.)
- *Specialized microfinance banks,* also licensed, focus primarily, if not exclusively, on micro and small enterprises, and households with low-volume transactions.
- Member-owned *credit and savings cooperatives or credit unions.* They mobilize member share capital and savings and provide lending and other financial services to members.
- In some countries, *non-banking financial institutions,* have entered niche markets for microfinance providing specialized services like leasing or insurance services.

7.1.1. Range of Suppliers Exist, but Government Dominated Market

A range of institutional types provide microfinance services in Malawi, including NGOs, Companies ltd. by guarantee, Savings and Credit Cooperatives, and Commercial Banks, including one bank specialized in microfinance. The establishment of a range of institutional forms promotes competition and enables service delivery to a wide range of market segments. Different institutional types may find competitive advantage in serving specific market niches. Despite the multiplicity of institutional forms, government-owned banks and donor funded, government-backed programmes dominate the microfinance market in Malawi providing an estimated 70% of cash credit and 80% of savings services (USAID AMAP Microfinance Sector Assessment of Malawi).

The largest and most dominant suppliers in Malawi have extensive branch networks, many with national coverage. While the majority of clients served by microfinance suppliers in Malawi are considered rural clients, the percentage of potential households served with financial services in rural areas, representing 86% of Malawi's population, is low. Providers remain challenged to extend service delivery beyond the largest cities and secondary towns deeper into rural areas, with products that meet the *varied* financial service needs of households in rural, agricultural markets. The microfinance industry in Malawi is dominated by loan products, with terms and conditions geared towards a limited number of productive activities. Households and businesses however seek a range of financial services including savings services to build assets and manage seasonal cash flow, insurance services to manage risk, consumption loans to respond to emergencies, and payment and money transfer services.

Malawi Rural Finance Corporation (MRFC), Malawi Savings Bank (MSB) and partners of the Agricultural Productivity Investment Programme (APIP) programme are the predominant suppliers of financial services in rural areas and focus primarily on credit for agricultural production. Pride Malawi, FINCA Malawi, Opportunity International Bank of Malawi (OIBM), and other projects (CUMO, ECLOF, NABW, SEDOM, DEMAT) concentrate service delivery in urban and peri-urban areas focusing on clients in trade and service industries. A number of suppliers, however, notably CUMO, FINCA and Pride Malawi are testing product delivery in more rural environments. The Savings and Credit Cooperatives (SACCOs) operate in both rural and urban areas, focusing primarily on trade and consumption loans.

7.1.2. Absence of One stop Shops and Financial Intermediation in Rural Markets

Beyond the major cities and secondary towns, there is a marked absence of institutions that can collect savings and on-lend savings to borrowers. While MRFC has permission from the Reserve Bank of Malawi to collect savings deposits, it is not permitted to lend them. Currently 70% of the savings deposits collected by MRFC serve as mandatory cash collateral for loans, rather than savings products that microfinance clients can withdraw at will to manage cyclical cash flow. Malawi Savings Bank collects small deposits but does not have the institutional capacity to manage a micro and small loan portfolio; its loan portfolio is dominated by institutional borrowers including parastatals and other quasi-government institutions. The absence of institutions that can effectively and efficiently intermediate savings in rural areas, and provide a "one-stop shop" for clients' banking services is a striking gap in Malawi's market.

Credit in rural areas, both cash and in-kind, is limited primarily to financing crop inputs. The major suppliers are MRFC who provides cash loans to individual farmers and farmer clubs. APIP intermediaries provide farmers with "vouchers" for inputs that must be repaid in cash. Input suppliers also provide input credit directly to farmers.

Beyond credit to finance agricultural inputs at the beginning of the growing season, households have a diverse range of financial service needs throughout the year. Beyond productive credit, rural households seek: (see Boxes 9 and 16, and Table 5)

- consumption loans that enable them to smooth uneven cash flows during the agricultural production cycle;
- savings services that enable them to bank surpluses that can be withdrawn during the lean season;
- payment services that enable household members to collect pensions, receive crop payments or transfer money to other family members; *and*
- insurance and other risk mitigation products that allow households to manage and mitigate risk, for example crop insurance, home insurance, and price insurance.

Despite that the 86% of the population live in rural areas and have a wide range of financial service needs, few institutions serve clients in rural areas and only a limited range of products are available. Institutions currently serving clients in rural areas have limited growth potential, and/or are non-viable in their present institutional form. Institutional shortcomings coupled with unfavourable macroeconomic trends, a difficult operating environment for banking, and limited knowledge about rural financial markets has resulted in limited investment in formal financial intermediaries in rural areas.

7.1.3. Support for Informal and Grass-roots Suppliers

Given the absence of strong financial intermediaries in rural areas that have the capacity to significantly increase scale, and uncertainty about the future of the parastatals operating in rural areas, significant amounts of donor funding have been earmarked to support the development of community-based organizations that support informal finance. Donors and multilateral institutions will support the development of Accumulated Savings and Credit Associations (ASCAs) by financing training to organize communities into groups that collect and onlend savings among members. Donors are also supporting the organization of community-based groups that will link with the formal or semiformal financial institutions now or in the future. These initiatives focus on the development of relationships among community members, or "social capital" that can be used to collateralize loans to groups, or support other community-based development initiatives:

- The European Union had proposed at one point to establish several hundred Rural Financial Associations, federated regionally and supported by a national apex, to meet the needs of rural farmers. It has been suggested that this programme would take over the remaining assets of the EU-financed APIP programme.
- The World Bank will invest about $12 million in its third Phase MASAF programme to train Community Savings and Investment Groups (COMSIGs) and Community

Savings and Investment Clubs (COMSICs), and finance the construction of physical infrastructure for Savings Clubs. Where possible, participants will be linked over time to MFIs. This programme will not, however, capitalize groups.

- African Development Bank supports two programmes within the Ministry of Gender and Community Services and the Department of Local Government budgeted at approximately $15 million to support the establishment and training of community groups. These programmes will try to proactively link community groups to microfinance institutions, through grants and other incentives to MFIs.
- DfID has allocated significant amounts of funding to support a village banking programme in Dedza through Concern Universal Microfinance Organization (CUMO).

7.2 Who are the Dominant Suppliers?

7.2.1 State-owned Banks and Government-led Programmes

MRFC and MSB

The Malawi Rural Finance Corporation (MRFC) and the Malawi Savings Bank (MSB) are the dominant suppliers in the microfinance market serving primarily rural, agricultural markets. MRFC, owned by the Government of Malawi, was established following the dissolution of the Smallholder Agricultural Credit Administration (SACA) with its remaining assets and with technical support funded by the World Bank. MSB, also owned by the Government of Malawi was established in 1992 to take over the financial service activities of the Post Office Savings Bank. Not including the in-kind loans disbursed through government-led programmes, MRFC provides 60% of the microfinance loans in Malawi (USAID AMAP Microfinance Sector Assessment of Malawi). While the majority of its portfolio is seasonal loans to agricultural producers (nearly 70%), the number of business loans and corresponding portfolio has risen steadily in recent years in MRFC's attempt to diversify its portfolio.

MSB is the predominant supplier of savings services. MSB has about 500,000 open accounts, though believes that only a portion of those accounts are active. MSB reported 152,000 clients to the Malawi Microfinance network. As of the end of 2003, MSB had mobilized savings deposits totaling MWK 1 trillion. The majority of accounts have balances between MWK 3,000 and 5,000 (US$28 and $47). While MSB is licensed to collect savings deposits from the public and onlend them, for the most part, its relatively small loan portfolio (MWK 116 million) is limited to large parastatal and corporates. That said, MSB has been experimenting on a small scale with new products including consumer lending, smart cards and money transfer services – all potential high growth retail markets for MSB. While Malawi Savings Bank is licensed to collect deposits and onlend them its total capital, equal to MWK 28 million, falls short of the minimum capital requirements for a licensed bank.

The Central Bank allows MRFC to collect savings from the public through a special exemption to the Banking Law, however, MRFC is not allowed to onlend savings to the public. MRFC has an extensive branch network including 8 branches, 24 satellite offices and 132 sub-branches. For 2002/03 season, MRFC reported that loans were disbursed to 107,000 customers totaling MWK 708 million. The total number of outstanding loans is reported to be 180,000 (presumably many loans are disbursed to groups as there are only 25,905 separate loans accounts.) Due to the very high level of accumulated provisions however, the MRFC net portfolio is MWK 183 million.

MRFC estimates that there are about 135,000 microfinance borrowers in their portfolio. [19] While MRFC remains the dominant lender in Malawi's microfinance market, it has fallen short of the 400,000 borrower goal it had set for itself by end 2005. MRFC has 154,594 deposit accounts (end 2003) with an average deposit per account of MWK 1,609. Nearly all agricultural lending is in-kind, not cash based. While there is pressure for MRFC to become a licensed bank, MRFC has expressed concerns about their ability to manage security issues associated with the development of a savings line of business.

The performance of MRFC and MSB measured by client growth, on-time repayment, and profitability has been weak. Weak performance is attributed to limitations described below and is exacerbated by macroeconomic instability, including unstable prices for agricultural inputs and production. Both MRFC and MSB rely heavily on public funds. Prior to the conversion of MRFC World Bank loans to equity last year, MRFC depended heavily on loans from Government, and MSB depends on deposits from state and parastatal sources to fund its income earning assets (USAID AMAP Microfinance Sector Assessment of Malawi). Over the past several years, MRFC has heavily provisioned its loan portfolio to reflect a high rate of arrears and high expected loan losses. The high costs incurred by a poorly performing portfolio make running a profitable and growing lending operation nearly impossible. MSB faces its own set of challenges including a weak information system that makes managing an extensive branch network difficult, and uneven performance in its network that has resulted in the closure of many points of service (USAID AMAP Microfinance Sector Assessment of Malawi). Subsequently, both MSB and MRFC rely heavily on investments in high-yielding government Treasury Bills to generate revenues, and profits. In 2003, MRFC held MWK 1.3 trillion in Treasury Bills and MSB held MWK 755 million, 63% of its total assets.

Both MRFC and MSB require extensive financial and operational restructuring to improve performance and long-term prospects. Financial restructuring will require recapitalizing, while operational restructuring will require developing business strategies that promote profitability, further developing lending operations, modernizing technology, and reorganizing human resources. Both MSB and MRFC are currently receiving support from the World Bank Privatization and Utility Reform Project (PURP) to undergo this restructuring and privatization process. Each institution is moving through a three-stage process including: 1) an assessment; 2) restructuring; and 3) offering of shares to private sector companies. The Government of Malawi had considered merging MRFC and MSB but ultimately decided to retain two independent entities.

The PURP has outlined a three stage process for privatization of MRFC and MSB including 1) assessment, 2) restructuring, and 3) sale to new shareholders. Based on an assessment carried out in October 2003 , MRFC will begin the restructuring phase through technical assistance in Q2 2005. Financial restructuring has already been initiated with the conversion of a $17 million loan from the World Bank and its accumulated interest into MRFC equity. MRFC share capital grew from MWK 477 million to MWK 1.46 billion in 2004. The restructuring process is meant to get MRFC "investor-ready" over the next 12 months. MRFC notes weaknesses in treasury management, systems development and internal audit as major challenges.

MSB will also begin a restructuring process; however the Commission is hoping to privatize its structure at the same time the restructuring is carried out targeting an ownership arrangement that would include technical partners, MSB management and Community Savings and Investment Clubs (COMSICs) organized under the World Bank funded MASAF II project. The objective of having significant ownership by the COMSICs is to create a "peoples" bank, and create a link between COMSICs and a licensed bank that can provide a range of banking services that otherwise would not be available to COMSIC members. The timetable for privatization however has not been established. The European Savings Banks Group was selected to assist MSB with restructuring.

MSB was chosen by the Ministry of Finance to house the Malawi Rural Development Fund. MSB will not likely directly manage a client loan portfolio. Rather MSB will likely contract MFIs to identify clients and manage loan portfolio repayments for a fee. The loan book is expected to remain on the MSB balance sheet. (Section 3.2 discusses issues relevant to the Malawi Rural Development Fund.) MSB notes that its key weaknesses to be addressed during the restructuring process include a weak IT platform that is not able to accommodate MSB product diversification, weak physical infrastructure including the collocation of its branch structure with Post Offices, creating image problems and weak communications links between the branch network.

Despite the limited capacity of rural financial institutions in Malawi to meet the diverse financial service needs of large segments of the population, their extensive presence in rural areas, strong knowledge of local markets and relationships with local institutions will be critical to support the process of innovation required for financial sector development in Malawi. The knowledge and physical assets of government owned institutions should be attractive to potential investors seeking opportunities to create value by advancing the finance frontier with new products and services.

APIP

The Agricultural Productivity Investment Programme (APIP) was established in 1997 in response to the limited availability of credit for non-cash crop production in Malawi and the overall failure of markets for input credit and supply. Jointly funded by the European Union and the Government of Malawi, APIP supports the provisioning of in-kind seasonal agricultural credit for maize and vegetable crops[20]. The value of fertilizer packages for individual farmers provided by APIP partners ranged from MWK 4,800 to

5,500 on average. Based on the number of borrowers reached, APIP is the third largest player in the microfinance market. Initially, APIP worked with more than 20 government, private and non-government organizations to disburse vouchers for in-kind fertilizer and seed loans and collect repayments from farmers. APIP provides interest free loans to its partner organizations to finance the value of in-kind loans, and subsidizes agencies' costs for providing services. APIP and the GOM assume 75% of the risk of default.

In 1999/2000 growing season APIP provided 275,232 loans with a large percentage provided by the now largely defunct ADMARC. In the 2000/2001 growing season, 162,265 loans were provided; 41,800 were provided in 2001/2002, and 47,495 in 2002/2003. At this time only 34% of the balance due on loans disbursed during the past three growing seasons had been repaid, or MWK 198 million ($1.9 million) out of 590 million kwacha (or $5.5 million) disbursed (USAID AMAP Microfinance Sector Assessment of Malawi). With overall poor repayment (despite strong performance by some individual partner financial service providers) by the 2003/04 growing season the number of partners had reduced to 14 and only 46,890 loans were provided (Agriconsortium, March 2004). Subsequently, despite that APIP financed inputs for a significant number of farmers that otherwise would not have had access, it is unlikely that the programme will result in *sustainable* access to those farmers. A programme evaluation concluded that its operational structure was not sustainable. Based on the significant degree of subsidy provided to partner organizations and weak repayments rates, it was concluded that the programme has the potential to distort markets and hinder the development of markets for inputs supply and credit (Baillie and Stampa).

While some partners performed well, overall, repayment and sustainable access to service was not the primary objective of this programmes, rather the programme was intended to promote national and household food security. A significant percentage of borrowers did not represent a legitimate market for loan services, that is, they did not have the capacity to repay the debt they took. APIP provides an example where credit has been used as a tool to achieve non-financial objectives, which experience demonstrates rarely results in sustainable access to services.

With the recognition that sustainable access to services was not achieved, a new generation programme is under development by the EU and the government of Malawi that claims the goal of financial sustainability. Social safety net programmes that provide grant based support rather than debt will be targeted at subsistence farmers that are unable to repay loans under the current macroeconomic and production conditions.

SEDOM and DEMAT are government-led programmes established to mitigate Banks' lending risk by providing donor-funded bank guarantees. DEMAT intended to introduce banks to a new market segment of micro and small enterprise client and prove the their bankability, later encouraging banks to take on increasing amounts of risk and to expand this line of business. As a result of weak loan repayments, presumably from poor portfolio management practices, the programme did not succeed in its original objectives.

7.2.2 Non-Government and Private Sector Suppliers

While the government-owned operators are the dominant players in microfinance in Malawi, the role of private companies is taking on increased importance as they begin to develop new products, reach new markets and stimulate competition in the industry. Currently, the key private sector organizations in Malawi are the member-owned savings and credit cooperatives (SACCOS), Companies Ltd. by Guarantee, including Pride Malawi and FINCA Malawi, and a licensed commercial Bank, Opportunity International Bank of Malawi (OIBM), specializing in microfinance. The more established players including the SACCOs, Pride Malawi and FINCA Malawi currently provide an estimated 87% of the loan services supplied by private sector entities (43,000 clients) or 28% of the total market. OIBM has recently entered the market, concentrating initially on providing savings services; it is just beginning to develop its lending operation. A number of projects and NGOs (including CUMO, NABW, and ECLOF) also provide loan services.

Apart from the savings and credit cooperatives, OIBM is the only private sector entity licensed to intermediate savings. Of note, the key private sector entities, apart from the SACCOs, were capitalized by donors and many continue to receive donor subsidies to cover operating shortfalls. The shortage of new donor funding however has forced a number of institutions to manage against a tight budget, Pride Malawi and FINCA, of note. On the positive side, both institutions have risen to the challenge and are for the most part covering all cash costs, and sometimes with surplus. On the negative side, severe cost cutting measures have not allowed adequate investment in innovation and infrastructure strengthening.

Companies Ltd by Guarantee

Both Pride Malawi, established in 2000, and FINCA Malawi, established in 1994, are incorporated under Commercial Law as Companies Ltd. by Guarantee. Pride Malawi was capitalized by funding from the United Nations Capital Development Fund (UNCDF), and has subsequently received loan capital from Cordaid, an international NGO, to expand its operations. FINCA Malawi was capitalized by USAID, DFID, Oxfam and DANIDA, and receives commercial bank loans with a donor guarantee. While stakeholders are invested in the performance of institutions they fund, ownership is unclear and increasingly fragmented with new donor contributions.

Pride Malawi has a national network, including 12 branch offices in six cities and six district towns. FINCA operates in 26 out of 28 districts in Malawi through three regional offices, 14 branches and a number of satellite offices where credit officers work out of their homes. The majority of FINCA and Pride Malawi borrowers rely on income from off-farm activities to repay loans. FINCA Malawi does not have its own banking infrastructure, so its Village Banks use branches of commercial banks to access loans and make repayments. Pride Malawi clients receive loans and make repayments on Pride Malawi premises, rather than through commercial bank branches.

As of December 2004, Pride Malawi had 9,712 clients including 7,042 borrowers and an outstanding loan portfolio of MWK 168 million (or $1.57 million), and a PAR[21] of

7%. As of December 2004, FINCA Malawi had approximately 17,000 active borrowers (including 5,000 APIP) borrowers with MWK 225 million (or $2.1 million) in outstanding loans, and a PAR of 6%.

Both Pride Malawi and FINCA Malawi experienced serious repayment problems in 2001 and 2002, with at-risk portfolios measuring greater than 20% at their worst periods. Repayment problems stemmed from a combination of institutional shortcomings and macroeconomic factors, and forced fundamental organizational restructuring in both institutions. Subsequently, arrears rates have dramatically decreased but remain major areas of focus for both organizations. With PAR >30 days greater than the 5% industry benchmark, portfolios remain vulnerable.

The ambiguous ownership structures of Pride Malawi and FINCA Malawi create challenges for institutions' long-term growth strategies. Donors generally don't own institution's capital and are often not permitted to do so by their own rules and regulations. Transformation to a shareholding ownership structure, with owners that can materially gain from strong performance, should strengthen incentives for performance improvements and create clear lines of accountability among management, Boards and the owners that appoint them. Transformed ownership structures will be necessary for both institutions to tap sources of finance (equity, loans, and or savings) to grow and strengthen operations. With unclear ownership and limited liability structures, it will be difficult if not impossible for companies to tap financial markets in any significant way to fund growth. Both Pride and FINCA have lines of credit with commercial banks at between 29 and 32%; the total credit lines remain limited and in the case of FINCA are guaranteed by a donor letter of credit. Both institutions seek a more stable and larger pool of funding and hope in the long term to intermediate savings.

Microfinance Companies in Malawi have suffered from high client exits. A study of Pride Malawi indicated that more than 50% of clients have dropped out since the operation was established. In 2002, 9,483 clients left the programme, about 86% of whom were expelled for not meeting loan conditions (USAID AMAP Microfinance Sector Assessment of Malawi, from Enterprising Solutions). High drop-out rates mean that institutions must invest significant resources to identify new clients and market their products. Clients in early loan cycles are often loss-making due to the high initial costs associated with generating new business. High client exits are expensive and impede financial viability objectives.

Both Companies have responded to high client exits by modifying their products to better meet the repayment capacity and service needs of clients. However, for the most part, expanded offerings have resulted in product "imitation" (traditional asset-based lending) versus true product innovation. Product imitation will do little to advance the finance frontier in Malawi resulting in new products and significantly increasing the number of banked people, particularly among poor and vulnerable populations. Until MFIs have the capacity to innovate, outreach will remain limited (See 7.6.6.).

Credit Unions: MUSCCO and SACCOs

The Malawi Union of Savings and Credit Cooperatives (MUSCCO) and Savings and Credit Cooperatives (SACCOs) are member-owned financial cooperatives that provide financial services to their members. Members of SACCOs are affiliated by community, or occupation. MUSCCO is an apex organization that provides its members – 70 affiliated (SACCOs) – refinancing through its Central Finance Facility (CFF) and other services, including audit and training. The refinancing facility is capitalized by member SACCO's contributions. There are 69 SACCOs that are not members of MUSCCO and that operate independently.

SACCOs are located in both urban and rural areas. As of September 2004, there were 54,582 members, with approximately 75% male and 25% female membership. MUSSCO reports a gross outstanding portfolio valued at MWK 425 million (or $4 million). MWK 50 million (or $467,000) has been mobilized in savings, but loans are financed primarily by member capital. While membership in the MUSCCO network has doubled since 1995 the level of savings has increased only negligibly during the period, while loans have increased dramatically. Loans are primarily geared to consumption and some small business; a very small percentage of loans are intended for agricultural production.

The performance of SACCOs has been mixed. 18 out of 58 SACCOs showed year-to-date losses as of June 2003 (USAID AMAP Microfinance Sector Assessment of Malawi). Historically the SACCO loan portfolio default rate has been as high as 20%. As of end September 2004, only 3% of the portfolio was considered "delinquent" by MUSCCO, defined as loans with payments more than 30 days in arrears. However, at the end of September 2004, 30% of the outstanding portfolio was reportedly in arrears between 1-30 days.

Specialized Commercial Banks

In operation since May 2003**,** OIBM is a licensed bank, 100% owned by a US NGO (Opportunity International) and funded by international donors (USAID and DFID). OIBM focuses on microfinance, but as a licensed bank has few restrictions on potential lines of business. OIBM currently has branches in Llilongwe and Area 25 and plans to expand its services to the three regions through five branch networks over time. OIBM has penetrated the market rapidly with savings services, opening nearly 20,000 savings accounts from May 2003 to December 2004, with an accumulated value of nearly MWK 270 million, or $2.5 million. OIBM has ramped up its lending operation much more slowly with 2,100 clients at the end of December 2004. PAR > 30 days is less than 1%. Though small, OIBM has one of the highest performing loan portfolios.

OIBM issues Smart Cards which enable its client to take advantage of the Central Bank's payment system, Malswitch. SmartCards allow OIBM clients to withdraw funds from ATM machines on bank or retailers' premises that are linked to the national network.

Commercial Bank "Downscalers"

The two largest banks, National Bank of Malawi and Stanbic Bank offer few products for microfinance and rural finance markets. Up to now, the formal banking sector has not targeted micro and small enterprises, and has been involved only to a limited extent in the markets for agricultural production. National Bank has provided finance to the National Association of Small Farmers of Malawi (NASFAM) affiliated clubs and associations for cash crop producers. As of end of last year, MRFC had disbursed MWK 50 million to NASFAM affiliated members. Projects like ECLOF and DEMAT bring a limited number of customers to the bank and guarantee loans on behalf of borrowers.

Two relatively new banks, NBS Bank and First Merchant Bank are moving aggressively into retail banking markets, but are not planning to target microfinance as a significant business area.

Commercial banks apart from OIBM will not likely be major players in the microfinance market at least for some time to come. Banks still continue to generate significant margins from investments in Government Treasury Bills. Competitive pressure to focus on developing new markets is, overall, not significant. In fact, commercial banks have steadily reduced their exposure in agricultural sectors given that repayment of agricultural loans has been weak.

In some countries, commercial banks have entered the market through subsidiary operations with new business models and lending technologies to serve low income and microfinance markets (for example, the Sogesol subsidiary of Sogebank in Haiti (See Box 4). While no banks appear to be considering the establishment of microfinance subsidiaries, it may prove an attractive model for banks in the future. The restructuring of the MRFC and MSB may provide opportunities for private sector commercial bank involvement in companies that serve microfinance markets.

Malawi Rural Development Fund

The Government of Malawi launched a MKW 5 Billion Rural Development Fund geared to rural communities, ideally targeting agroprocessing businesses. The Fund will be housed in the Malawi Savings Bank. Participating retail institutions, NGOs, and other organizations will manage a client portfolio for the Fund for a fee; however, the loan portfolio itself will remain on MSB books. At the time the data was gathered for this report, however, the Fund strategy and management mechanism had not yet been finalized. Chapter 3.2 refers to potential issues to be considered in finalizing the fund structure. The Fund provided no target numbers for service delivery and stakeholders have cautioned the Fund to ramp up slowly.

7.2.3 Informal Suppliers and Projects

Projects

There are a number of NGOs that manage microfinance projects. Among many of these suppliers, the provision of financial services is not the principal objective of their operations; rather the provision of credit has been introduced to complement or supplement their other development programmes (Cater). Organizational cultures tend to be oriented more towards disbursing resources to project beneficiaries rather than the challenging business of building sustainable financial institutions. In many cases, portfolio management is weak and products are underpriced.

Limited attention to repayment and pricing for full cost recovery may undermine efforts to build the microfinance industry. The incentive to repay loans is based first and foremost on the promise and potential for future access to services. Projects that adopt business practices that result in only temporary or one-off access to services create disincentives for repayment, and support a general culture of willful default.

With awareness raising however there are an increasing number of projects which are attempting to manage projects using sound microfinance practices. The Hunger Project supports community "epicenters" in rural areas that serve 25 to 60 villages to address multiple issues dealing with food security and production. This project has a microfinance component that uses a group methodology to provide individual loans to women. With an eye towards sustainability, the project trains groups served by the microfinance component to form stand-alone SACCOs over time, with membership open to both men and women. The programme was serving 3,267 women as of the end of 2004 with an outstanding portfolio of MWK 11.6 million, with average outstanding loans at MWK 3,555, or $33.

Input Suppliers

Input suppliers are significant suppliers of input credit to farmers globally. There are more than 750 agri-inputs dealers in Malawi, including small resellers as well as distribution agents of large suppliers. Some provide input credit directly to farmers. Others participate in government and donor programmes with government guarantees, like APIP. While the number of outlets has increased dramatically over the past several years (*Malawi Agricultural Input Markets (AIMs) Develop Project Annual Report*), many farmers have to travel very long distances to reach input suppliers.

Informal Suppliers

In addition to formal and semi-formal sources of credit, people access loans through family and friends, and money lenders (Katapila). These sources of finance, however, may not represent a consistent source of finance. Some people have access to sums of cash through Rotating Savings and Credit Associations (ROSCAs) in which members save small amounts periodically and receive a lump sum payment at some point during the savings cycle. The World Bank MASAF II project is organizing COMSICs and COMSIGs to increase the supply of informal community based groups with expectation that they will be linked in time to formal suppliers.

Table 10: Registration of MFIs in Malawi

Service Providers					Licensing Authority (GoM Ministries)		
	Trustees	Banking	Companies	Cooperative	Finance	Gender & Youth	Industry & Commerce
FINCA			X				X
PRIDE Malawi			X				X
SEDOM	X						X
DEMAT	X						
MSB		X			X		
OIBM		X			X		
MRFC			X		X		
MUSCCO				X			X
SACCO				X			X
NABW	X					X	

Source: Reprinted from Microfinance Sector Assessment in the Republic of Malawi, *USAID*

7.3. What is the Current Supply of Microfinance?

Businesses and households that have access to credit draw from both formal and informal sources. However, a survey conducted in 2000 (ECI, Malawi National Gemini MSE Baseline Survey, 2000) found that only 6% of micro and small enterprises (MSEs) (equivalent to 32,000 MSEs nationally) surveyed received microcredit from formal credit institutions. 15% of MSEs had received credit considering a broader range of suppliers including agricultural input suppliers, credit institutions, families, and moneylenders. The Baseline Survey estimated that there were 747,396 micro and small enterprises (MSEs) in Malawi in 2000, including 623,182 MSEs in rural areas and 124,214 MSEs in urban areas.[22] Only 7.9% of all agricultural households had enterprises that met the criteria used to define MSEs in the survey, and 70% of these farming enterprises produced tobacco[23]. The overwhelming number of households produce for primary consumption only.

USAID's Microfinance Sector Assessment (January 2004) estimated the current supply of loans at 154, 222 accounts, with outstanding loans valued at MWK 1.83 billion (or $17 million). Updated figures indicate that the overall supply of microfinance services is now just over 200,000 clients. The estimated number of savings accounts is 380,000 with a total value of MWK 1.3 billion (or $12 million). MSB and MRFC account for 80% of savings collected. Of the total supply of microfinance services, the parastatal and government-owned institutions supply 62% of loans (representing 50% of outstanding microfinance loan amounts), and 80% of savings (representing 75% of savings mobilized).

It is worth noting that estimates reflect current borrowers, rather than borrowers with likely long-term access to services. Given high client exits, loan portfolios with high levels of default, institutional vulnerability and/or lack of financial viability of many suppliers in the industry, a fraction of current clients will likely have continued access to services.

With current demand for loans estimated conservatively at between 300,000 and 760,000 borrowers (See Chapter 6), there remains significant unmet demand for loan services in Malawi. Most micro and informal businesses must rely on informal finance, if they can access it. At the lower end, demand estimates (300,000 potential borrowers) take into consideration that the majority of households in Malawi produce almost exclusively for household consumption only. Many households are not likely candidates for debt at this time. Rather, these households may be candidates for cash and other resource transfers that draw them gradually into the financial system. Considering lower end estimates for loan demand, the percentage of demand fulfilled appears relatively high. However, as noted above, a fraction of these clients likely have on-going access to credit. Additionally, demand figures take into account the relatively limited number of enterprises or household firms that can access debt now. As households become integrated into the financial system as a result of economic diversification strategies, increased linkages in the agricultural value chain, and a growing supply of savings services, loan demand estimates should increase.

Of critical importance, the supply analysis has been largely limited to the supply of loan services, and focuses primarily on the needs of enterprises. At the same time that people needs lump sums of cash for productive investment opportunities they also need sums of cash for life-cycle needs (education, child-birth, home-building, funerals, etc.), emergencies (illness, natural disasters, etc.), and assets (furniture, a water-pump, etc.). Where people choose not to access loans or cannot access loans, they often save money to make the lump sum purchases at a later time (Rutherford).

With a diverse range of cash flow needs, rural households demonstrate significant demand for consumption loans. Access to consumption loans for emergency purposes may be even more important to rural households than access to "productive loans." In one study, for example, households prioritized repayments to consumer lenders during difficult times indicating that long-term access to consumer lending was more important for them (Heidhues). (As money can be used interchangeably, however, for different purposes, it is hard to "match" uses with sources of funds.) Consumption loans are particularly important in economies like Malawi where households are reliant on seasonal cash flow tied to agricultural production cycles, and need additional money to meet their basic household needs in between growing seasons.

While there is little information that can be used to draw conclusions about demand for savings services in Malawi, based on increased knowledge about the way poor households manage their financial lives, one can safely conclude that demand for savings services is far greater than supply through formal sources, limited to about 3% of the population now.

Considering the wide array of needs that households have for which lump sums of money are necessary, and which can be accessed through savings, loans, money transfers, or even insurance pay-outs, the demand for financial services appears infinite.

Table 11: Supply of Microfinance Services in Malawi

Updated from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004

Supply of Microfinance Services							
MF Providers	Legal Status	Outreach		Savers		Loans	
		Regions (3)	Service Points	Number	Value (MWK)	Number	Value (MWK)
MSB	GoM Corp.	3	33, plus PO outlets	152,000	750,000,000	2,000	60,000,000
MRFC	GoM Corp.	3	164	154,590	233,417,000	134,000	639,000,000
SEDOM	GoM Corp.	3	31			10,000	200,000,000
	Subtotal			306,590	983,417,000	146,000	899,000,000
SACCOs/ MUSCCO affilates	Coop.	3	62	54,582	50,000,000	20,000	425,000,000
FINCA	Corp.	3	26			17,000	225,000,000
CUMO	NGO	1	?			8,032	22,000,000
Pride Malawi	Corp.	3	13			7,042	168,000,000
OIBM	Bank	1	2	20,000	270,000,000	2,000	20,000,000
Project Hope	Project	1	?			2,734	25,417,840
NABW	NGO	3	?			2,563	2,795,715
ECLOF	NGO	1	1			2,422	49,288,247
The Hunger Project	NGO	1	4			3,267	11,611,000
Other	various	3	?			25,000	125,000,000
	Subtotal			74,582	320,000,000	90,060	1,074,112,802

Notes:

- This table is an updated version of a table originally prepared by the USAID Microfinance Sector Assessment (January 2004) using 2003 data. For the update 2004 data is used; MSB and MRFC data is from 2003.
- Numbers are estimates where hard data was either not available or not consistent with other data.
- APIP loans are included in *Other*. They are estimated based on loans disbursed during the 2003/2004 season but do not include loans already counted in the totals of other providers (for example, MRFC, FINCA).
- MSB savings numbers refer not to total savings mobilized ($1.1 trillion) but some portion belonging to low-income clients. This figure may be underestimated.
- The *number* of SACCO loans are estimated and may be underestimated; total loan portfolio figures are from MUSSCO (September, 2004).

7.4. Supplier Achievements

Suppliers in the microfinance industry in Malawi have embraced a number of sound microfinance practices critical to achieving sustainable service delivery. While supplier practices are moving in the right direction, the industry has identified key institution-building needs that must be addressed to professionalize the industry, attain global performance standards, and build viable institutions.

7.4.1. "Market-Based" Interest Rates, but Subsidies Remain

With the recognition that subsidized lending does not result in widespread access to services, the dominant suppliers charge "market-based rates" with the *intention* of covering their costs and generating profits to expand their services to a growing number of clients. Interest rates (prices) for microfinance services are generally higher than rates charged in the commercial banking sector. Prices are generally higher because the *costs* are usually higher due to the large number of relatively smaller transactions. Additionally, while microfinance portfolios are not necessarily riskier than more traditional portfolios (in fact, repayment rates for microfinance portfolios are often much better), some suppliers include additional risk premiums in their pricing.

While the dominant institutions in Malawi charge rates comparable to market-rates, few institutions have systematically analyzed their costs to determine the appropriate interest rates for reaching full financial viability. In Malawi, some institutions' operating costs are amplified by poorly performing portfolios that carry high loan loss provisioning costs and considerable loan write-offs. Significant write-offs, and delinquent loans translate into large effective subsidies, no matter what the interest rate. While key suppliers have embraced the concept of full cost recovering rates, additional analysis by institutions is required to determine whether or not prices reflect full costs.

7.4.2. Alternative Methods for Managing Risks

Innovative risk management strategies are necessary to reach new markets, particularly poor and low- income clients. Traditional asset-base lending manages the risk of non-repayment by requiring that loans be secured by fixed assets, or cash, often equal in value to more than 100% of loans. In Malawi, particularly in rural areas, few have access to land titles or fixed assets of significant value. Assets like bed, tables, chairs and bikes are absent in 2/3 of Malawi's households.

A number of suppliers are experimenting with a mix of asset-based and non-traditional collateral, often in combination. Non-traditional collateral includes personal guarantees from other borrowers in a group. In some cases group guarantees have worked effectively, while in other cases this practice has not worked well. Practices may be ineffective if service providers do not communicate well how the guarantee system operates or if there is weak social cohesion at the community or group level. In some cases, the practices may prove inoperative where the repayment capacity of clients simply does not match the products offered, or where group members are subject to the same external risks which make it difficult for them to repay for another, for example, a crop failure.

Innovative risk management strategies that transfer or pool risk are critical for developing the financial sector in Malawi. Given the scarcity of cash-based finance for agricultural production, government and donor-supported programmes have attempted to link agricultural producers with input suppliers, using both financial and non-financial intermediaries. Partner organizations in APIP disburse vouchers for in-kind supplies (fertilizer, seeds, etc.) and collect repayments from farmers at the end of the production cycle. APIP assumes the majority of the risk of default. This "alternative" risk management strategy which transfers risk to government and donors has not overall proven effective, given the high level of default on loans provided. Failure may be attributed to the apparent lack of incentives on the part of partner organizations to enforce loan repayments as well as the inability of this mechanism to protect against external factors like prices that may have nothing to do with borrower behavior (USAID AMAP Microfinance Sector Assessment of Malawi). Advancing the finance frontier will require further experimentation with new products that meet client requirements, and alternative mechanisms for managing risk.

7.4.3. Cost Reduction

To reduce the unit costs of delivering services, many operators have experimented with service delivery methods. To reduce administrative costs many suppliers provide a single loan to a group. Group leaders are responsible for onlending to group members and collecting repayments. In other cases, suppliers provide *individual* loans within a group setting.

Operators may form the groups themselves, or link to already created groups. For example, individual smallholders in Malawi often organize into 'clubs' to access finance, as well as other inputs and product markets. National Association of Smallholder Farmers Association of Malawi (NASFAM) has supported this group formation process and estimates that 10% of all smallholders (and 15% all cash crop production) in Malawi are members under its umbrella federation (Cater) which includes 36 Farmers Associations and 96,012 farmers. Suppliers create economies of scale through group service delivery and take advantage of group members' knowledge about each other to better manage risk and enforce repayment obligations.

In some cases the credit officer travels to groups; in other cases group members travel to the service provider, or the nearest commercial bank branch affiliated with the service provider. Where clients have to travel long distances, the effective interest rate to borrowers increases, sometimes dramatically, due to the costs of transport and the opportunity cost of clients' time. Traveling long distances to clients where infrastructure is poor increases the institution's cost of delivering services.

7.4.4. Moving Service Points Closer to the Client

To better meet client needs, some operators are attempting to move their service points closer to clients by developing mobile business units or outlets, affiliated with branches in town centers. In rural areas, challenges remain for suppliers to move closer to the clients in cost-effective ways. They face not only the challenge of weak transportation infrastructure, but security concerns, particularly if credit officers are forced to carry large sums of cash over long distances. The mobile banking units of some suppliers have actually been shut down due to security problems.

While operators have attempted to embrace some key sound practices, significant additional advances are required to create efficient and profitable business models. Advancing the finance frontier requires institutions to develop products that increase value to clients, but at the same time enable them to manage risk and reduce costs. As institutions experiment with product service delivery, they have not always been able to effectively balance this process of increasing value to clients, while managing risk and costs at the same time. No microfinance suppliers are currently operating fully financially viable microfinance businesses, although their overall operations may be profitable due to investments in Treasury Bills.

The number of clients with access to ongoing financial services has increased in recent years, but not appreciably relative to the unserved market. In fact, many new clients have received one-time services but have "dropped-out", voluntarily or involuntarily, and have not benefited from ongoing access to services. The next section describes the ongoing challenges of suppliers at the enabling environment, institutional, and industry levels.

7.5. What is the Supporting Infrastructure for Microfinance?

Box 6 describes key facets of a supporting infrastructure for a microfinance industry including donor consortia, service providers (including consultants with industry expertise, accountants that understand microfinance lines of business), industry networks, funds wholesalers, rating agencies, and research and development organizations. The Malawi Microfinance Network was started in 2000 and has 12 MFI members including CUMO, ECLOF, FINCA, FITSE, MRFC, MSB, MUSSCO, NABW, OIBM, PRIDE Malawi, Project Hope and SEDOM. As of early 2005, the network did not have a fully functioning Secretariat so was able to offer only limited services to its members. Objectives of the network over time include building the capacity of its members in the areas of risk management, monitoring and evaluation of microfinance institutions, delinquency management, portfolio management and setting sustainable interest rates. The network is also interested in working with members to move more aggressively into rural areas, focusing particularly on savings services. The network also seeks support to build a policy agenda and capacity that will enable them to lobby directly with Reserve Bank of Malawi and Parliament on microfinance issues. Currently, the agenda appears to be largely driven by donors and government without adequate participation by MFIs.

As the microfinance industry grows in Malawi and as products evolve, stakeholders point out the need for audit firms that can develop auditing capacity very specific to the microfinance industry (in addition to specialization in other areas of capital market development like insurance.) The emergence of ratings agencies that can evaluate the strength of institutions should increase transparency and confidence of the commercial banking sector and potential investors to invest in or finance microfinance institutions.

7.6. What are the Key Challenges to Suppliers?

While suppliers demonstrate individual strengths and weaknesses, the following themes emerge as critical challenges for the industry.

7.6.1. Reliance on Commercial Banking Infrastructure

To a greater or lesser degree, the quality of services in the micro and rural finance subsectors and their ability to reach new markets is linked to operators' reliance on the mainstream commercial banking network.

Transactions Services

Many operators rely on commercial bank branches to disburse and receive funds from clients, and nearly all operators rely on the commercial bank network to manage their liquidity. Even new smart card technologies that enable customers to withdraw funds from ATMs or other points of sale are dependent on terminals' access to the banking system payments system. The quality of service received by a microfinance customer is influenced by the way a commercial bank affiliate treats an MFI's customers. In many contexts, commercial banks are reluctant to deal with microfinance clients who collect small loans and make frequent but small repayments thus deteriorating the client's quality of service. The location of commercial bank branches has an impact on the effective rate of interest to clients. If they have to travel long distances, their opportunity costs and the effective rate of interest increases.

Access to Finance

An MFI's ability to expand its operations over the long term depends on its access to commercial, domestic loans and other sources of capital. Currently, a number of banks allow MFIs limited overdrafts or access to lines of credit through guarantees provided by donor agencies. Over time however, MFIs must demonstrate credit worthiness to Banks to increase their level of financing. Banks must have the willingness and regulatory space (i.e., capacity to lend to institutions with non-collateralized portfolios without being penalized) to refinance institutions without access to third party guarantees.

7.6.2. Managing Seasonality and Covariant Risk

The demand and supply of services, particularly in rural areas, is driven by the seasonality of farm production. On average, MSEs operate for only nine months of the year as labor shifts to on-farm activities during the agricultural production cycle (USAID AMAP Microfinance Sector Assessment of Malawi). Additionally, high dependence on few crops means that supplier portfolios can be dramatically affected by covariant risk. This means that a large enough pool of subscribers faces the same risks, making it difficult or impossible to write insurance policies. When risks cannot be mitigated at the local or national level, portfolios require reinsurance by global players. Both insurance and reinsurance opportunities in Malawi however appear negligible for small producers and banking institutions.

7.6.3. Facing the HIV/AIDS Challenge

Microfinance institutions (MFIs) are affected directly by HIV/AIDS in multiple ways. Client illness translates into higher MFI exit rates and subsequently rising operational costs. For those clients who miss repayments or can no longer repay loans, it means greater loan loss provisioning. Institutions' staff are also affected when has staff households and staff members themselves face illness. MFIs report falling staff productivity, increased staffing and greater benefit payouts.

As financial institutions, MFIs should not provide AIDS support services or relax lending discipline. Additionally, MFIs should not specifically target HIV/AIDS infected/affected people as explicit targeting with its higher associated costs may affect the sustainability of their services.

However, for the sake of managing their businesses and to better serve clients, MFIs must respond to the challenges posed by HIV/AIDS. MFIs may choose to refine their products for example by encouraging customer responsive savings, allowing clients to not take out back-to-back loans (allowing for a "resting" period) while still maintaining "current" client status and not suffering penalties (for example, on loan size), and allowing clients to take out smaller loans without subsequent penalties.

MFIs may focus on product development including 1) insurance, 2) contractual savings products, and 3) emergency loans. MFI staff may provide HIV/AIDS education to their clients, or cultivate links to AIDS support organizations, home-based care projects and other social service organizations (Cater, from Parker).

7.6.4. Improving Prospects for Profitability

Apart from a limited number of SACCOs, there are no financially viable microfinance operations. Viable operators cover their total costs, including the cost of inflation and generate a profit. (The cost of inflation is equivalent to erosion in the value of an institution's capital). While MRFC shows a surplus in its most recent audited statements, this surplus is highly dependent on the performance of investments in government treasury bills. Both FINCA and Pride Malawi have demonstrated ability to cover cash costs but struggle for full financially viability. Operators face challenges 1) managing costs, 2) getting their products right, and 3) expanding their product lines to grow their businesses.

Understanding and Managing Costs

While most companies operating in microfinance initiated the development of national networks with social, not business objectives in mind, they have built their more recent business strategies around the maintenance and careful expansion of those national networks, with the expectation that successful execution of business strategies will also enable the achievement of social goals. The realization of both social and business objectives is often called achieving the "double bottom line." National networks enable companies to serve an increasing number of clients, diversify loan portfolios and reduce the degree of covariant risk that is present in very localized portfolios. However, Companies face challenges managing many costs centers within these large networks, particularly given weak transportation and communications infrastructure. They must ensure that each cost center generates sufficient revenue to cover a branch's direct operating costs, and contribute to the high administrative costs associated with managing a large network. The challenge of generating adequate revenues is exacerbated by the relatively limited product ranges of most operators in Malawi.

While recognizing massive unmet demand for financial services in rural areas, those organizations with large branch networks that seem best positioned to expand, approach expansion cautiously given the difficulties they have encountered developing profitable cost centers in their networks. Some operators have developed creative branching strategies, including the creation of scaled back outlets managed by "mother branches" or hiring home-based credit officers. Some operators have adopted the risky strategy of subsidizing non-profitable branches with profitable branches. Others have opted to close down branches or outlets that show limited potential to cover costs.

Having embraced market liberalization, most institutions set prices according to "market rates", but often without an underlying analysis of the real costs of delivering services (Cater), including administrative costs, loan loss provisions, the cost of funds in commercial markets, and the cost of inflation. A thorough analysis of cost elements enables institutions to better develop their pricing and business strategy. MFIs should price their services to enable them to cover the full costs of delivering services and generate a profit within a specified time frame.

Microfinance operators seek assistance finding ways and means to develop more efficient operations through the use of technology or reorganizing human resources, particularly in Headquarter units. The use of information technology and electronic banking to more efficiently and cost effectively carry out transactions using electronic infrastructure shows promise, though its business models are largely untested. Electronic "purses" that allow users to store money on electronic cards and either withdraw from ATMs or make cashless payments on point of sale devices (connected to the national payment system) may have cost cutting benefits for both clients and suppliers. Costs now however are high and business models that work for both suppliers and clients are yet unproven.

The SACCO model – in which individual SACCOs serving local markets draw on the services of a national apex for certain financial and non-financial services – offers one business model that may have significant potential for expanding outreach cost effectively in Malawi. MUSSCO takes on certain functions for SACCOs that it can carry out more cost effectively, including some risk management and back office functions. MUSSCO, for example, operates a mandatory deposit insurance programme for its members' members.

7.6.5. Supporting Growth Strategies with Adequate Resources

A number of operators have exhausted their initial start-up capital, and lack access to fresh sources. To avoid going out of business, they have aggressively adjusted their business strategies by raising interest rates, and expanding their product offerings to incorporate new markets. While these measures have been taken as part of a survivalist strategy, the potential for high pay-offs is rivaled by the potential for failure due to inadequate access to technical and financial technical resources to support ambitious growth plans.

In addition, more often than not, suppliers' attempts at introducing new products have resulted in product "imitation". In the place of real product innovation that advances the finance frontier, suppliers offer products already present in the market, relying on traditional technologies, particularly fixed-asset lending to manage risk and costs. In some cases, firms are attempting to innovate without adequately understanding the risks and challenges, placing the health of their portfolios at risk. Firms require access to resources to support a systematic process that leads to product innovation.

7.6.6. Supporting Innovation, Not "Imitation"

In Malawi and elsewhere, when the business environment is uncertain, companies react by developing more aggressive business strategies. They may raise prices or business volumes to become more profitable, but they often neglect innovation, including

- Product development, including product quality improvements, and widening the range of products; *and*
- Process innovation, or the adoption of new technologies (both "high" and "low"). New technologies enable or make less expensive service delivery.

In this context it is common for companies to introduce "new" products that have in fact already been developed for the market. This practice is not uncommon, particularly if appropriate resources are not available or conditions are not present to support the process of innovation. Factors that inhibit innovation include lack of financing, a hostile fiscal environment, a company's low self-image of its innovation potential, and a governance structure that does not reward the successful outcomes of innovation (Bonin and Istvan). It is interesting to note that some key suppliers in Malawi appear constrained by these very factors. The key factors that support the process of innovation include an entrepreneurial corporate culture, access to improvements in technology that can be incorporated by a company in new product development, sufficient financial and human resources, and financial incentives for both employees and company owners.

A recent evaluation of the sector emphasized high dropout rates, limited product choices, and products that do not correspond well to clients' financial service needs or repayment capacity (Enterprising Solutions). While product "imitation" may improve MFI performance, it will go only a limited way in expanding outreach to large segments of unbanked populations. The extent to which operators will be successful in reaching currently unbanked populations will depend on their success in innovation.

Areas of critical importance include the development of:

- **Savings services.** (The business of mobilizing savings deposits however should not be entered gingerly. Significant investment is required to develop systems and products to collect deposits efficiently and manage them prudently.)
- **Financial services** that respond to household's and firms *emergency* and *consumption* needs.
- **Insurance products** that hedge product and price risks created by macroeconomic and weather related events borne by MFIs and their clients.
- **Loan products** that respond to borrowers repayment capacities, access to pledgable assets, and real borrowing needs.

The development of instruments, including insurance, and "derivatives" that enable risk hedging[24] (See Box 8) that address real risks in Malawi's operating environment will be necessary to support innovative loan products.

7.6.7. Strengthening Governance

Microfinance institutions in Malawi operate under a variety of legal frameworks, with different ownership structures and Board requirements. In particular, the governance of companies financed by donors, but without clear ownership structures (for example, the Companies Ltd by Guarantee) create challenges for companies to expand and weak incentives for improved performance. Where companies' ownership structures are not clear, banks and other investors may be reluctant or unable to provide debt and/or equity finance to grow operations. The current "owners" of company equity, including donors and public sector agencies that do not materially benefit from an institution's success or suffer from its failure may lack the appropriate incentives to enforce strong governance.

Additionally where ownership is fragmented, management supervision may break down to the detriment of company performance. Fragmentation happens when ownership is shared among a large number of small investors (like a credit union) or when owners do not share common objectives for a companies performance, for example, if one owner values the political dividends of their investment and another social dividends.

In some cases, governance is weak where Boards are not independent from management.

In Malawi, suppliers in every legal category suffer from governance weaknesses stemming from one or more of these factors.

7.6.8. Building Effective Financial Structures for MFIs

The ability of institutions to expand and reach new markets is dependent on their ongoing access to capital. Currently, most operators have limited access to loans and capital markets (private equity and bonds) to fund growth. In large part, this is because operators are not yet financially viable and may not represent attractive investment opportunities. Additionally, capital markets in Malawi are very shallow and there is a scarcity of capital market financial instruments.

Most suppliers rely on donor funding to cover operational losses and loan portfolios (for example, Pride Malawi, FINCA Malawi, OIBM, and other projects). Their ability to leverage capital, through loans or savings mobilization (apart from OIBM) is weak. Corporations have had some success getting lines of credit, but the amounts remain limited and in one case required a Letter of Credit from a donor agency. One initiative, sponsored by the AfDB, has provided limited lines of credit to selected institutions. In the case of parastatals, institutions have been dependent on loans from public sources (e.g., World Bank) or deposits from other parastatals. Neither source of funding is reliable over the long term. However, the conversion of MRFC's World Bank loan to equity has strengthened MRFC's capital structure.

Apex institutions in some cases successfully wholesale funds to the sector. The Malawi Rural Development Fund however does not allow institutions to strengthen their balance sheets by wholesaling loans to institutions or providing equity capital. At the time this report was written, the government planned to keep the Fund on the books of the Malawi Savings Bank.

Operators require grant capital to fund start-up costs, early stage losses and innovation (for example, new product development). Once MFIs have established sound systems for operations and are moving towards financial viability, access to debt and capital markets to expand growth will be important. This will require concerted efforts on the part of suppliers and stakeholders to demonstrate the credit and investment worthiness of institutions. It may require the services of "brokers" to link MFIs with sources of capital (for example, specialized investment Funds). It will likely require the transformation of ownership structures to create strong incentives for the institutions to perform well. It will require independent boards, and owners committed to strong performance objectives.

Currently, suppliers have access to funds (loans, savings, grant funds) at varying interest rates from 0% (grants) to the more than 30%. Differential access is largely due to organizations' legal and regulatory status. Banks in Malawi that can mobilize savings, particularly current accounts, or that have access to interbank markets have a cheaper source of funds than institutions that borrow money from banks at premium rates. While the cost of funds and different funding sources is determined largely by the creditworthiness and financial soundness of MFIs themselves, differential access to "preferred" funding sources and restrictions on mobilizing cheaper sources of funds might impede the development of a fully competitive market. Experience demonstrates that effective competition results in lower prices for clients and more client responsive services. As the market develops, attention to the development of a level playing field that stimulates competition is critical. (See Chapter 8.)

The absence of adequate physical infrastructure in branches is also a challenge for operators to expand services and professionalize their operations. Inadequate physical security, for example lack of safes, and substandard buildings weaken customer and Central Bank confidence. Customer confidence in the security of their savings deposits and the permanence of services is an essential component of sound banking systems. Inadequate physical infrastructure threatens confidence and prospects for MFI and Bank expansion including Companies, SACCOs, MRFC and MFC (Cater).

7.6.9. Strengthening Repayment and Portfolio Management

Institutions in Malawi have not benefited from consistently high performing loan portfolios. All the leading institutions have struggled with on-time repayment. Compared to international standards that benchmarks performing portfolios with a PAR of less than 5%, few institutions and programmes in Malawi meet international standards. In recent years, operators have experienced particularly high levels of default. A particularly virulent combination of factors devastated the loan portfolios of a number of operators in 2001 and 2002, with long lasting impacts.

Weak performance is attributed to the following factors, sometimes in combination:

- Macroeconomic shocks that affect the ability of borrowers to service debt by dramatically increasing the prices of inputs and/or weakening the prices of outputs;
- "Sub-culture of willful default. " This subculture has been encouraged by political figures that "forgive" debt in efforts to win political favour, thus sending mixed messages to clients about repayment obligations;
- Weak portfolio management practices on the parts of MFIs, that do not adequately enforce loan contracts;
- Programmes that use "credit" as a mechanism for transferring money to food insecure or poor households. In some cases, donors simply do not enforce loan contracts and send confusing messages about the need to repay; in some cases donor credit programs are targeted at households that cannot pay for loans and have no expectation of repayment;
- The inability of lenders to use the legal system to enforce contracts. This happens when legal authorities are unable to process and adequately rule on actions against defaulters (USAID AMAP Microfinance Sector Assessment of Malawi);
- Supply driven products that do not correspond to the cash flow and repayment capacity of clients;
- High real interest rates that influence the ability of borrowers to service debt; *and*
- Failure of credit risk management strategies. For example, "stop orders" are used by banks to collect loan repayments directly from auction houses from the proceeds of farmers' production. Borrowers have been able to circumvent the tobacco stop order system in Malawi.

Some microfinance operators in Malawi have made great strides in strengthening portfolio management practices. These practices have been further strengthened by computerized and robust management information systems. Repayment rates and asset quality will only significantly improve though if 1) government stabilizes macroeconomic conditions and strengthens the legal environment to enforce contracts and 2) suppliers create products that respond to borrowers cash flow needs, but also effectively manage institutional risk.

7.6.10. Raising Performance Standards

In Malawi, there is a strong demand from microfinance suppliers, their funders and policymakers to professionalize the industry, and raise overall performance standards. Raising standards entails 1) establishing industry-wide performance benchmarks, 2) promoting transparent reporting by institutions on key performance indicators, and 3) supporting capacity building initiatives that enable institutions to make performance improvements.

To support performance improvements, institutions require access to technical and financial resources to address institutional weaknesses. While each institution has strengths and weaknesses, the industry overall can benefit from support for 1) the development of robust and electronic-based information systems, 2) company restructuring (both operational and financial), 3) improved governance, including the creation of effective ownership structures, and truly independent Boards, and 4) innovation.

Industry benchmarking and transparent reporting will require concerted action by suppliers and the industry network, drawing on national and international experiences. Key actions include establishing benchmarks and uniform methods of reporting on them, developing management information systems that support accurate and timely reporting and the ability of management to use information to improve performance. It also requires support for the development of industry infrastructure (for example the Malawi Microfinance Network or independent raters) that supports the dissemination of information in the industry.

The Reserve Bank of Malawi, responsible for the overall soundness of the banking system in Malawi, may contribute to the process of professionalization by:

- Creating incentives for microfinance institutions to meet licensing standards over time.
- Making adjustments to the regulatory and/or legal framework where necessary that respond to the business practices of microfinance suppliers (this might include adjustments to asset classification, provisioning rules, income recognition, and appropriate standards for leverage).
- Supporting mechanisms that provide non-prudential oversight of institutions that are not licensed. Support need not entail direct supervision, but could include *delegation of this responsibility to an alternative agency or body.*

7.6.11. Industry Infrastructure

An industry infrastructure that can support the development of microfinance institutions and lines of business is largely absent. Effective supervision of licensed institutions offering microfinance lines of business requires audit firms that understand the unique features of microlending and other microfinance business, for example, microinsurance. While it was once assumed that smart capital would find its way from the banking sector and other capital markets, including both commercially competitive and socially responsible investment funds[25] to good investment opportunities in microfinance, in fact, global experience suggests that specialized "brokers" are required to match sources of finance with good performing microfinance institutions. Brokers have emerged in the form of microfinance Funds that provide finance sometimes in combination with local commercial markets. In order for microfinance institutions or banks to deal with the challenges of designing and implementing new lines of business, consulting firms are often required to provide specialized advice. While a limited number of firms have emerged in Malawi, more competition and more specialized expertise, for example in MIS and new product development would benefit the industry.

Chapter 8: The Legal and Regulatory Environment

8.1. What are Legal and Regulatory Frameworks?

Legal frameworks refer to the laws that govern organizations operating in the financial sector and permit them to provide financial services. In general, microfinance services can be provided by a wide range of institutional models under different legal frameworks, for example, Banking law, Company law, Cooperative law, or NGO law. Primary legislation includes laws and acts passed by Parliament, while secondary legislation includes statutory guidelines and regulations, usually issued by specialized agencies. Institutions register with the government authority responsible for administering laws that govern them, and any directives, rules, or regulations that are associated with the law (*Regulatory Requirements for Microfinance*).

Regulations to which microfinance institutions adhere are prudential and non-prudential. Prudential regulation is designed to ensure the financial soundness of licensed institutions that collect public savings deposits, and to preserve the integrity of the financial system. Generally, only institutions that collect the public's savings are subject to prudential regulation. Non-prudential regulation may include non-prudential reporting requirements, for example, the disclosure of interest rates or periodic performance reporting. The Reserve Bank of Malawi (RBM) oversees the implementation and supervision of banking regulations, while the Ministry of Industry and Commerce is responsible for administering commercial laws and cooperative law. Not-for-profits are governed by the Ministry of Women, Gender, and Youth.

As the microfinance industry evolves, lawmakers have the choice to: a) introduce a special legal framework for microfinance; b) adapt existing frameworks to respond to the business of microfinance; or c) simply require that institutions respond to mainstream banking law, without special provisions. Regulation is meant to both correct abuses in the financial system and enable the entry of new players and products. Sound regulation ensures that new players can enter the market, institutions mobilizing savings deposits remain solvent, and where necessary are exited from the market when they threaten the stability of the financial system.

Development of a regulatory framework for microfinance institutions often comes at a latter stage of industry development. Operating outside a licensed context, it is usually MFIs themselves that lobby for new legislation that legitimizes their status and enables them to more easily leverage their capital to get bank loans, mobilize savings, and attract new investors. In Malawi, non-licensed operators themselves are pushing for a new legal and regulatory framework which explicitly defines their role with the expectation that it will provide them more legitimacy.

Increasingly, governments are choosing to review and in some cases amend legal and regulatory frameworks early on to support the development of a broad range of institutional models, and create a secure operating environment in cases where laws are ambiguous regarding institutions' legal status and scope of activity. Currently in Malawi, the Central Bank is carrying out a study to determine legal and regulatory needs for the microfinance sector. Not limited to protection of savings deposits, some regulatory initiatives aim to promote the growth of the microfinance industry, and to build viable institutions that will ultimately be integrated into the financial sector. This is not without its dangers, however, as establishing a framework in the early stages of microfinance industry development without in-depth knowledge of the markets to be served can result in rigid and difficult-to-change laws that do not suit the needs of the sector.

8.2. What are the Current Legal Frameworks in Malawi?

Institutions that provide microfinance services in Malawi operate under multiple legal forms (see Table 12, *Laws and Regulations for Various Institutional Forms*). The only institutions permitted to collect and on-lend savings deposits from the *public* are institutions licensed under the Banking Act.

Cooperatives may collect and on-lend savings from their members. Companies and not-for-profits may collect savings from members to guarantee loans or facilitate a place for safe storage in commercial banks but are not allowed to intermediate those savings. The following describes the primary legal frameworks under which microfinance suppliers currently operate.

8.2.1. NGOs and Projects

NGOs, including the National Association of Business Women (NABW); government-sponsored projects, including, Small Enterprise Development Organization of Malawi (SEDOM) and Development of Malawian Enterprises Trust (DEMAT), and projects administered by international NGOs such as World Vision, Concern Universal Microfinance Organization (CUMO) and Ecumenical Church Loan Fund (ECLOF) operate under the Trustees Incorporation Act.

Microcredit operations established under this act are usually started as donor or government projects, and fall under the supervision of the Ministry of Women, Gender and Youth.

8.2.2. Companies

Companies are limited by "guarantee" or " shares" and operate under the Companies Act. In companies Limited by Guarantee, where there are no shareholder owners, members' liability is limited by a nominal amount. PRIDE Malawi and FINCA Malawi are examples of Companies Ltd. by Guarantee.

Shareholding companies include the Opportunity International Bank of Malawi (OIBM), owned by the US-based NGO, Opportunity International, and government owned institutions including MRFC and the Malawi Savings Bank. National Bank of Malawi also operates in a limited way in the microfinance sector. Institutions licensed under the Banking Act must be shareholding companies.

The Ministry of Industry and Commerce has oversight responsibility for Companies. The National Bank of Malawi provides regulatory and supervisory oversight over companies that have bank licenses.

8.2.3. Banks and Non-Bank Finance Institutions

Opportunity International Bank of Malawi (OIBM), Malawi Savings Bank (MSB), and National Bank of Malawi are licensed under the Banking Act. Banks are licensed to provide demand savings and time deposits, and are subject to various qualifying requirements and prudential regulations. The Reserve Bank of Malawi supervises licensed banks. MRFC has been given a special exemption by RBM to accept deposits from the public, but is prohibited from using the deposits to fund its lending activities. The minimum start-up capital requirement is US$ 1.5 million (about MWK 160 million).

Non-banking financial institutions (NBFIs) including Finance Companies, Merchant Banks, Building Societies and Insurance Companies are also registered under the Companies Act and regulated and supervised by the Reserve Bank of Malawi. Currently no non-banking financial institutions are active players in the microfinance market. Non-banking financial institutions can collect deposits, but only from larger institutional depositors not from the public. Finance companies have smaller minimum capital requirement equivalent to $US 750,000 in kwacha.

8.2.4. Cooperatives

Cooperatives are member-based organizations in which people are linked by their work or community of residence. The Cooperative Societies Act permits Savings and Credit Cooperatives (SACCOs) to mobilize savings and on-lend savings to its members. The Malawi Union of Savings and Credit Cooperatives (MUSCCO) is a cooperative owned by 69 of the registered SACCOs, and acts as a national apex for member cooperatives.

The Registrar of Cooperatives in the Ministry of Trade and Private Sector Development (formerly Ministry of Trade and Private Sector Development) has oversight responsibility for SACCOs and MUSCCO.

8.3. Key Considerations for Review of Legal and Regulatory Frameworks

Discussion of the legal and regulatory framework below is framed against these key needs to advance the finance frontier. The Central Bank in their detailed analysis of the framework will likely identify specific legal and regulatory issues that enable them to better supervise microfinance lines of business.

Advancing the finance frontier will happen only with:

- The emergence of banking institutions that mobilize and on-lend savings, particularly in rural areas. Efficient intermediaries of *sufficient scale* will be required to reduce real interest rates and expand outreach. Specialized niche institutions may complement large-scale intermediaries, and spur competition.
- Innovative products that respond to the diverse financial service needs of households, particularly in rural areas where the majority of the population lives. Products that enable both institutions and farming households to manage risk, for example commodity price risk, are for the most part absent.
- Professionalization of the industry leading to improved institutional performance and industry performance overall. Professionalization should lead to an increased number of licensed institutions, and increased access to capital to expand the industry, both licensed and non-licensed institutions.

In many countries, work on the legal and regulatory front focuses on:

- Securing legal and regulatory space for microfinance operators.
- Clarifying legal frameworks to ensure that operators under commercial and NGO law have explicit permission to provide financial services, generally limited to credit.
- Opening regulatory space for a new class of microfinance service suppliers, generally with different qualifying criteria and ongoing monitoring requirements.

Initiatives that focus on opening a new regulatory space are intended to encourage new entrants to the industry where current regulatory frameworks discourage the emergence of new suppliers.

8.3.1. No Apparent Significant Barriers to Entry

According to a recent sector analysis there appear to be no powerful legal or regulatory barriers that discourage the emergence of microfinance operators in Malawi (Microfinance Sector Assessment, January 2004). According to this analysis, there appear to be no restrictions on the kinds of institutions that can offer credit services. Banking license requirements, including ownership and minimum capital requirements, are not onerous. Opening a new regulatory space for specialized microfinance institutions is not perceived to be necessary now *(USAID AMAP Microfinance Sector Assessment of Malawi, USAID)*. However, anecdotal evidence suggests that the banks operating in Malawi now that have been licensed with special exemptions may not be able to meet the full requirements of their license including clearing responsibilities. While there is no clear evidence to back up this claim, the Central Bank's current exercise to review the legal and regulatory environment might benefit from the reviewing the experience of Banks with special exemptions to further explore whether specialized legislation is required, rather than the waiving of certain requirements for banking licenses.

Additionally, ongoing regulatory requirements may negatively influence the overall banking environment, for example, the prevalence of high reserve requirements. Generally speaking, prevailing macroeconomic conditions in Malawi and the shallowness of financial instruments present greater obstacles to new entrants than the laws themselves.

While there appears to be no short-term urgency to opening a new regulatory space, a number of issues relevant to the legal and regulatory framework require attention now. These issues include:

- Consistent oversight of institutions operating under different legal frameworks, including performance disclosure requirements that promote industry transparency and professionalization;
- The review of secondary legislation to ensure that it is both friendly to microfinance lines of business and enables supervisors to adequately monitor operators that mobilize deposits; *and*
- Review the case of cooperatives administered under Cooperative Law to ensure adequate supervision of institutions that mobilize member deposits but appear to have weak governance (*USAID AMAP Microfinance Sector Assessment of Malawi*).

While there may be no compelling reason to create a new regulatory window at this time, it is likely that legal and regulatory framework will evolve with the changing needs of the industry. For example, as new instruments, like insurance, or other risk hedging products are developed, a review of the framework for non-banking financial institutions may be necessary. Developing the capacity of regulators to evolve the legal and regulatory framework as the financial sector develops will be critical, and is an effort that should start now as the industry develops.

In fact, the Central Bank is currently working with the First initiative, Strengthening Financial Sectors, to revise the legal and regulatory framework for non-banking financial institutions, and the World Bank on overall financial system legal and regulatory frameworks. Microfinance should be on the agenda of both regulatory initiatives. Non-banking financial institutions have a strong role to play in the delivery of microfinance services; microfinance can only expand exponentially within the context of overall financial sector development.

8.3.2. Promote Oversight and Even Application of Laws

Despite the fact that legal frameworks permit the emergence of different institutional forms, the application of legislation and the monitoring of institutions under various laws is uneven, and in some cases non-existent. The uneven application of laws governing microfinance operators, including the granting of exemptions to institutions in a seemingly ad hoc manner, threatens the development of a level playing field. MRFC has been granted an exemption that allows it to collect deposits from the public (though it is not allowed to intermediate them). With limited payments systems services, for example check clearing, OIBM is not required to follow banking reserve requirements. MSB is also exempted from certain regulatory requirements prior to restructuring. While the granting of exemptions can offer some regulatory flexibility that results in expanded product offerings to clients, it opens the public to risks if institutions are not closely monitored.

The risk of creating an uneven playing field is also heightened where some institutions with similar risk profiles and ownership and capital structures have clear advantages over others, for example, in the differential access to low-cost funds. If institutions with similar characteristics have differential access to sources of capital at widely differing prices as a result of special exemptions, institutions may have difficulty competing effectively.

Of particular note, while cooperative law provides a clear space for SACCOs to provide savings and loan services to members, the requirement for SACCOs to seek exemption from certain tax laws creates uncertainties that make planning difficult. Additionally, cooperative law that applies broadly to cooperative structures with little attention to the unique attributes of various cooperative structures, including the apex MUSSCO, has translated into weak oversight of Cooperatives (USAID AMAP Microfinance Sector Assessment of Malawi).

8.3.3. Encourage Performance Disclosure

There are few enforced requirements for the disclosure of performance by microfinance operators, apart from licensed providers, nor standards against which institutions' performance is judged. While not all institutions require *prudential* regulation, the development of industry benchmarks against which institutions, investors and other stakeholders can measure the performance of MFIs should encourage professionalization of the industry.

The development of performance standards has in some countries been incorporated into non-prudential regulations and/or guidelines. Non-prudential regulation may include regular performance reporting and rules about fitness of participants in the industry. A diverse range of stakeholders may be involved in setting industry standards including relevant government agencies, suppliers, investors and donors, and the microfinance network.

In some cases non-prudential regulations or guidelines are administered by the Central Bank or other appropriate government ministry. The administration of non-prudential rules may enable Central Banks to keep operators on their radar screen and make better judgments in the future regarding applications for a bank license or evolving regulatory needs of the industry. Whether or not Central Banks are involved in non-prudential regulation depends on the staff capacity to manage "non-essential" regulatory activities and respond to the information they collect. If the Central Bank collects information, it may give the impression to the public that it vouches for the soundness and quality of the institution's performance, when in fact their responsibility may be limited only to deposit-taking institutions.

In many cases, the administration of reporting and other non-prudential disclosure requirements are delegated to an independent agency. In South Africa, for example, the government and banking industry have established the Micro Finance Regulatory Council (MFRC), which monitors the performance of non-licensed MFIs and requires the registration of any institutions that seek exemption from the Usury Act.

In some contexts, industry networks have attempted to develop systems of "self-regulation" that place pressure on industry members to perform up to certain standards, though in practice has no enforcement mechanism.

In some countries, regulators have adopted a tiered framework that encompasses both regulated and non-regulated MFIs. Prudential regulation is limited to those institutions that fall into specific tiers and mobilize savings deposits.

8.3.4. Review Secondary Legislation

The business of microfinance differs from traditional banking in some key areas. While the kinds of financial solvency and other ratios applicable to microfinance operations are similar to traditional banks, they are generally more conservative. For example requirements on minimum capital are often lower, and capital adequacy is higher. As specialized microfinance banks emerge and operators develop microfinance lines of business, the Reserve Bank of Malawi should examine guidelines and secondary legislation to ensure that requirements are appropriate for the business of microfinance and enable them to adequately monitor the solvency of microfinance operations. Areas of consideration include capital adequacy (deposits relative to core capital), provisioning and write-off requirements, limitations on risk concentration, reserve and liquidity requirements, ownership requirements, and bank branching policies. In many countries, for example, laws that make establishing new branches difficult and time consuming may discourage the emergence of new access points for unbanked populations.

8.3.5. Consider the Case of Cooperatives

Cooperative law is monitored by Ministry of Trade, Industry, and Commerce and de facto, performance monitoring has been largely delegated to MUSSCO, the SACCO apex. Cooperatives are member-owned and governed, but whether or not governance is working effectively to ensure that management prudently manages member savings is not clear in all cases, particularly for those institutions that operate independently of MUSSCO. Additional attention may be required to ensure that the current legal framework and monitoring mechanism adequately supports Cooperative oversight and expansion of cooperative-driven services. The low level of savings mobilization by cooperatives may indicate a lack of confidence in the cooperative system to protect member deposits.

8.4. Other Legal Frameworks

Apart from laws that govern institutions, laws govern the activities of microentrepreneurs.

- The Business Licensing Act which prohibits activities of hawkers and peddlers, has had a negative impact on microentrepreneurs ability to service loans. A very significant number of microentrepreneurs operate in this capacity in the informal economy (USAID AMAP Microfinance Sector Assessment of Malawi).
- Limited land titling in rural areas particularly for smallholder farmers limits the poor's access to bank loans that require fixed asset collateral.
- In Malawi, the procedures for pursuing unpaid debt obligations are well structured. But, even though legal procedures are in place for exercising the right of collateral, collection is difficult. There are few incentives for processing claims and capacity in the judicial system is stretched (USAID AMAP Microfinance Sector Assessment of Malawi).

Recognizing these limitations in pursuing unpaid debts, the Chamber of Commerce and professionals in the banking and legal industries have created a new mechanism to speed up the process of civil proceedings related to unpaid debts. Where possible to avoid a lengthy court proceeding, mediators will work with parties to develop legally binding agreements to resolve disputes.

8.5. Evolving Legal and Regulatory Frameworks as the Financial Sector Deepens

While the regulatory framework may not require pressing changes now, it is recognized that the future of microfinance in any country lies in a licensed setting that enables breadth of outreach, a wide range of products, including savings (Christen and Rosenberg).

The challenge for regulators is to determine when and where it is appropriate for them to step in. From the perspective of a regulator, financial institutions are differentiated by the structure of their capital (how they fund assets and operations) and their ability to leverage capital to draw in additional resources. Different sources of funds include equity provided by owners, small deposits from the public, deposits from large institutions, bonds, and debt from other banks. It is the differences in funding sources and corresponding risks that trigger the need for and type of external regulation (Gallardo). Regulation is intended to manage the risks associated with an institution's changing capital structure, and ensure that it has enough capital (and access to capital), relative to the quality of its assets so that depositors' savings are not at risk.

Institutions operating in the microfinance sector in Malawi are still actively evolving. MSB and MRFC anticipate future corporate restructuring and Companies, like Pride Malawi, anticipate institutional transformation to a shareholding structure. With these changes, the opportunities for institutions to operate within a licensed context should increase. Licensed institutions can intermediate deposits, increasing value to potential clients, particularly the poor whose demand for deposit services generally far outweighs need for credit. Organizations that can effectively intermediate can reach more people at potentially lower cost.

Licensing new institutions that can increase the depth and breadth of financial service delivery however won't happen overnight. On the part of operators, governance changes, restructuring and capacity development must precede any move towards licensing. Not the least of RBM's and institutions' concerns is the cost of supervision and compliance. Other countries' experience suggests that supervising MFIs cost about 2 % per year of the assets of those institutions, or about thirty times the cost of supervising commercial banks. Secondly, regulators and lawmakers will need more information and a better understanding of the specific requirements of institutions in the business of microfinance (USAID AMAP Microfinance Sector Assessment of Malawi).

The financial sector in Malawi offers a limited range of product offerings. Capital markets are not well developed, and there are few financial instruments that enable institutions to take varying degrees of risk, and to manage and spread risk. There are particularly few services that enable agricultural households to mitigate risk.

Arguably, financial sector development is best served by supporting the development of *scalable financial intermediaries* that concentrate on savings mobilization, and ensuring liquidity and payments in the banking sector where demand is potentially greatest. Up to now, however, primary focus has been on credit, and suppliers have reached a glass ceiling in service delivery as a result of shallow financial markets. The expansion of credit services will not be a matter of simply expanding delivery channels and creating new loan terms. Rather, credit will be dependent on the availability of new instruments, like insurance, that enable both institutions and farmers to mitigate the risk of lending and borrowing.

Non-banking financial institutions may be best positioned to take on product development in this area, which may require engagement of capital markets in international markets. Alternatively, large financial intermediaries may also strengthen their capacity to develop insurance or other products that effectively incorporate risk management in the absence of a strengthening of the non-bank financial institutions. A review of the enabling environment for insurance at the micro level (for example, microinsurance for families) and at the macrolevel (for example, to securitize and sell financial assets of institutions) will be critical to enable the emergence and appropriate regulation of new operators. Similarly, a new generation of suppliers, enabled by developments in technology, for example, retailers that sell Smart Cards that act as deposit substitutes, may stretch the current legal and regulatory frameworks.

Over the long term, as the capital structures of institutions change and the industry evolves, there may be compelling reasons to consider a new framework. In Uganda, a regulatory and legal framework was developed over a several year period to respond to the evolving needs of the industry. The success of Uganda's framework, though long in the creation, has been attributed to a high degree of coordination among stakeholders, and information exchange within a specially created forum. The Microfinance Forum, initiated in the Ministry of Planning and eventually managed by the Ministry of Finance when Finance and Planning Ministries merged, met once a month to discuss key policy issues affecting the industry. This process drew on the opinions and expertise of a wide range of stakeholders including Parliamentarians, responsible for passing laws; government agencies, donors, investors, and players in banking and capital markets.

In some countries, regulators have developed a tiered framework to monitor the performance of microfinance suppliers, both regulated as well as non-regulated institutions. Each tier has a specific set of requirements including *qualifying* criteria (legal form, capital requirements, asset quality, governance, and ownership requirements) and *ongoing monitoring* requirements (audit, on-site inspections daily and other periodic reporting). Institutions can expand the kinds of financial services they provide as they move from non-regulated to regulated tiers. Promoters of a tiered framework argue that the clearly specified requirements give operators clear targets and positive incentives for movement towards a licensed status.

Absent clear oversight of unlicensed institutions, and an evolving legal framework, stakeholder efforts should focus on supporting the development of capacity within institutions that encourages “internal” oversight, including stronger governance, strong internal audit and internal control functions, information systems that allow for up to the minute performance reporting, and timely external audits following the financial year.

This report offers no prescription for changes to the legal and regulatory structure. It makes no explicit recommendation to adopt a tiered framework now or in the future, nor recommendations regarding non-prudential reporting requirements. Keeping in mind key sector needs identified in this assessment – industry professionalization, the emergence of true financial intermediaries that collect and on-lending savings, and the promotion of innovative products, both within and outside the traditional banking sector – regulators, lawmakers, and suppliers should determine through a participatory process what efforts make the most sense in Malawi to support these and other needs that emerge as the industry evolves.

Table 12: Laws and Regulation for Various Institutional Forms (Reprinted from Malawi Microfinance Sector Assessment, Cater)

Financial Institutions	Commercial Bank	NBFI	SACCO	Limited Guarantee	NGO	Merchant Bank	Mortgage Institution
Relevant Institutions	There are 8 fully licensed commercial banks	Multiple Insurance companies,	72 coops and one apex union.	Several Microfinance institutions.	Domestic and international, approx. 10	Merchant Banks	1 Mortgage bank
Type							
By ownership	May include state, private and foreigner owners	May include state, private and foreigner owners	Owned by the membership	Members guarantee liability, but not clear financial ownership	Theoretically owned by the nation. No financial ownership.	May include state, private and foreigner owners	May include state, private and foreigner owners
By legal entity	Joint stock	Joint Stock	Cooperative	Limited Guarantee Company	Not-for profit, non-governmental	Joint stock	Joint stock
By activities	Demand Deposits, Time Deposits, Savings, Fiduciary Activities (if approved)	Lending, Time Deposits, Fiduciary (if approved)	Savings, Shares, Loans	Ambiguous	Loans, compulsory savings.	Lending, Time Deposits, Fiduciary (if approved)	Lending, Time Deposits, Savings, Fiduciary (if approved)
Establishment							
Licensing	Reserve Bank. Approval by Minister of Finance	Reserve Bank. Approval by Minister of Finance	Registrar	Company Act	NGO law	Reserve Bank. Approval by Minister of Finance	Reserve Bank. Approval by Minister of Finance
Branch	Reserve Bank must approve the establishment of any and all new branch offices.	Reserve Bank must approve the establishment of any and all new branch offices.	None	No limitations	Not known	Reserve Bank must approve the establishment of any and all new branch offices.	Reserve Bank must approve the establishment of any and all new branch offices.

Financial Institutions	Commercial Bank	NBFI	SACCO	Limited Guarantee	NGO	Merchant Bank	Mortgage Institution
Establishment, continued							
Applic laws, policies and regulation	Banking Act, Reserve Bank Act, Companies Act	Banking Act, Insurance Act	Cooperative Act	Company Act	Trust Act	Banking Act, Reserve Bank Act, Companies Act	Banking Act, Reserve Bank Act, Companies Act
Highest governing body	General Assembly of Shareholders	General Assembly of Shareholders	General Assembly of Members	General Assembly of Members.	Board of Directors	General Assembly of Shareholders	General Assembly of Shareholders
Decision making principle	One share – one vote	One share – one vote	One member – one vote	Ambiguous	One director – one vote	One share – one vote	One share – one vote
Operation							
Allowed financial activities	Demand Deposits, Time Deposits, Savings, and Fiduciary Activities (if approved).	Lending, Time Deposits, Fiduciary (if approved)	Saving, credit, loan and savings insurances and other related social activities. For members.	Loans. Compulsory savings	Loans, compulsory savings.	Lending, Time Deposits, Fiduciary (if approved)	Lending, Time Deposits, Savings, Fiduciary (if approved)
Prohibited financial activities	Engage in wholesale or retail trade. Purchase or hold immovable property (other than for the purpose of conducting its business).	Demand deposits, savings. Engage in wholesale or retail trade. Purchase or hold immovable property (other than for the purpose of conducting its business).	None	The re-lending of compulsory savings. Any other financial activity other than lending or compulsory savings.	The re-lending of compulsory savings. Any other financial activity other than lending or compulsory savings.	Demand deposits, savings. Engage in wholesale or retail trade. Purchase or hold immovable property (other than for the purpose of conducting its business).	Demand deposits, savings. Engage in wholesale or retail trade. Purchase or hold immovable property (other than for the purpose of conducting its business).

Table 13: Requirements for Licensed Institutions (Reprinted from Malawi Microfinance Sector Assessment, Cater)

	Minimum capital and capital adequacy requirement	Reserves and loan loss provisioning	Limitation on risk concentration	Liquidity reserve requirement	Mgmt. qualification and similar requirements	Customer-or-market-targeting requirements or quotas
Commercial bank	1.5 Million US or its equivalent Core capital of 4% (or more) and total capital of 8% (or more). The ideal is established at 6 and 10% respectively. Capital Adequacy computations are submitted on a quarterly basis.	Definitions are provided for "non-performing loans" under the classifications of "seasonal credit facilities" and "non-seasonal credit facility". Objective and Subjective criteria are provided for sub-standard, doubtful and loan loss classifications. At the discretion of the bank to choose criteria to apply. Provisioning for season loans that have repayment schedules is not required until the loan until the 180 days. A General provision of 1% for the total outstanding portfolio. Substandard provision is 20%. Doubtful provision is 50%. Loan loss is at 100%. Banks are allowed to provision as a pre-tax expense.	No single loan may exceed 25% of the capital base	35% of total deposits and savings to be deposited with the Reserve Bank. Currently this reserve is deposited at 0% interest.	Must have a minimum of 2 qualified executives. Licensing inspection analyses staff composition.	None. License request is based upon "The need for the services in the community to be served and the need for competition in the financial system."
Mortgage Institution and Merchant Bank	US 750,000 or its equivalent. Core capital of 4% (or more) and total capital of 8% (or more). The ideal is established at 6 and 10% respectively. Capital Adequacy computations are submitted on a quarterly basis.		No single loan may exceed 25% of the capital base		Must have a minimum of 2 qualified executives. Licensing inspection analyses staff composition.	None. License request is based upon "The need for the services in the community to be served and the need for competition in the financial system."
NBFI	US 750,000 or its equivalent		No single loan may exceed 25% of the capital base	Not applicable	Must have a minimum of 2 qualified executives. Licensing inspection analyses staff composition.	None. License request is based upon "The need for the services in the community to be served and the need for competition in the financial system."

Table 14: Requirements for Supervision and Reporting (Reprinted from Malawi Microfinance Sector Assessment, Cater)

	Internal supervision requirements	External supervision	Audit requirements	Interest rate	Performance and reporting standards
Commercial bank, Merchant Banks, Mortgage Institutions	General Assembly of Shareholders, Board of Directors, Internal Auditor	Subject to inspections from the Reserve Bank supervision department. Must submit monthly reports to the Reserve Bank	Mandatory yearly external financial audits. Must be submitted within 6 months of close of its financial year and must be published.	No restrictions	Consistent with Basel Accords. Banks should have their ALM policies. LRR is key Reserve Bank indicator. Others include
NBFI	General Assembly of Shareholders, Board of Directors, Internal Auditor	Subject to inspections from the Reserve Bank supervision department. Must submit monthly reports to the Reserve Bank	Mandatory yearly external financial audits	No restrictions	Consistent with Basel Accords
Cooperatives	General Meeting, Board of Directors	MOSSCU, MCI,	Mandatory yearly external financial audits	No restrictions	Must meet PEARL ratios.
Limited Guarantee Company	Board of Directors		Mandatory yearly external financial audits	No restrictions	None
NGO	Board of Directors			No restrictions	None

Chapter 9: Recommendations

Increasing access to financial services to all market segments, including low-income, poor and the vulnerable non-poor, and the availability of a wide range of services to meet people's diverse financial service needs requires:

- Enabling macro economic, financial sector, social and agricultural policies;
- Institutional capacity building for scale and sustainability;
- Financial intermediation in rural markets;
- Industry Professionalization;
- Evolving legal and regulatory frameworks;
- Innovation in financial markets; *and*
- Prudent management of MARDEF.

The following recommendations promote policy and action-oriented initiatives to support these objectives.

9.1. Policy

Financial sector development is dependent on the interaction of policies across sectors. Key policy areas that require attention to support financial sector development in Malawi include the following:

9.1.1. Fiscal Policy

Large fiscal imbalances lead to heavy borrowing from government on domestic debt markets, and the crowding out of private sector investment, higher interest rates, and lack of incentives for financial institutions to develop their capacity to respond to new market segments. Large fiscal imbalances weaken the stability of the currency, making it difficult for farmers, producers and exporters to predict future prices and potential cash flows. When government fails to meet its fiscal targets, confidence is shaken, and foreign direct investment from both public and private sources is driven away. Absent hard fiscal discipline and macroeconomic stabilization, true financial sector development will be difficult, if not impossible.

If the Government of Malawi is serious about developing an inclusive financial system implicit in the microfinance national policy and achieving the objectives of the PRSP, it should take a hard look at its fiscal performance which deters private investment and financial sector development. The Government of Malawi has reduced its fiscal deficit in line with agreed targets but domestic debt and payment arrears to domestic creditors remains high (projected at 2.5% in 2005-2006 [EIU]).

9.1.2. Financial Sector Policy

Bringing down the real cost of borrowing

High real interest rates in Malawi resulting from inefficiency in the banking sector and instability in the macroeconomic environment discourage financial sector development. High real interest rates lead to an inefficient use of productive resources in the economy and discourage the participation of low-income populations, particularly smallholder farmers, from taking advantage of productive opportunities that lay dormant.

The Government of Malawi can stimulate financial sector development by making fiscal policy adjustments that put pressure on high rates of interest. Relying largely on domestic debt markets to fund the deficit, fiscal policy provides incentives for financial sector investment in government bonds and discourages lending to the private sector. Receiving high real rates of interest from the Government, institutions have few incentives to compete for new markets and supporting financial innovations or increase efficiency that will push the finance frontier. Continued pressure on and by government to implement sound fiscal policies is a precursor to financial sector development. Inefficiency perpetuated and enabled by fiscal policies stymies economic growth opportunities. High reserve requirements that provide cheap finance for government also limit real financial sector development.

Promoting competition

With few banks dominating the financial sector, competition remains limited, though the award of new banking licenses recently should heat up competition somewhat (though there is limited competition for new markets, rather jockeying for corporate customers that make up the established market). The privatization process offers new opportunities for foreign direct investment in parastatals that may spur competition in financial markets.

Promoting innovation

There is limited breadth of financial products in Malawi. Insurance and derivative products that help financial institutions, producers and traders to manage production and price risk are virtually absent. Savings products are available to only 3% of the population. While electronic banking offers potential opportunities for new products and delivery channels, there have been few new developments up to now. It is not uncommon for institutions to be reluctant to fund often expensive upfront R&D costs. Once developed, innovations may be easily copied by competitors that don't have to absorb the product development costs. Donor and public money may support initiatives that focus on financial sector innovations by absorbing some of the up front R& D costs. Donor or government initiatives may also support partnerships between technology companies and financial sector companies to support innovations. The following website documents the *e-inclusion* project a venture between Hewlett Packard and a number of financial service providers: www.hp.com/e-inclusion

Venture capital development to support new companies

Capital markets in Malawi provide a limited source of capital for start-ups or expanding companies. The venture capital industry, often the source of capital for emerging sectors or innovative companies, is virtually non-existent in Malawi. In Malawi, public sector initiatives that support the development of a venture industry may be attractive. Such ventures might include partial matching funding for promising initiatives targeting innovation in financial services delivery.

9.1.3. Broad Sectoral Policies

Economic and agricultural development strategy

Malawi is dependent on a very narrow productive base, leading to high levels of systemic risk and limited opportunities for economic growth. Concrete initiatives flowing from Government's expressed policies that encourage economic diversification, the development of value-adding industries, and diversification among agricultural production is critical to create new economic opportunities that Malawi's population can take advantage of. Microfinance allows people to take advantage of new opportunities, it does not create them.

Addressing marketing and infrastructural bottlenecks

Marketing and infrastructural bottlenecks increase transaction costs and deteriorate farmers' ability to generate revenues and profits. Solutions require investments not only in sustainable financial institutions that can provide long-term access to finance, but also complementary initiatives that support the development of input suppliers, farmers associations, buyers, processing companies, marketing channels and linkages between players that increase efficient access to both producers and buyers in both domestic and international markets.

9.1.4. Malawi Rural Development Fund

At the time this report was written, the Ministry of Finance was in the process of designing the management mechanism and operating policies of the Malawi Rural Development Fund, a MWK 5 billion loan fund earmarked for rural lending. This initiative has tremendous opportunity now to "make or break" microfinance markets in

Malawi. A lot is at stake. If the fund fails, it provides yet one more example why rural finance doesn't work, creating strong disincentives for long-term private sector engagement in both rural and microfinance markets.

- Incentives must be in place for retail MFIs and financial institutions to prudently manage loan portfolios. Placing responsibility for portfolio management squarely on partner institutions and their balance sheets will likely have more success than a "Fee-for-service" arrangement that maintains the loan portfolio on MSB balance sheets.
- MFIs must price to manage their costs; the Fund should avoid placing interest ceilings on loans.
- The key weakness to the APIP programme according to its external evaluation was ramping it up too quickly before Fund management systems were in place. Learning from this experience, the Fund would be wise to carefully ramp up its operations and not worry too much about loan disbursement in Year 1.
- Rural finance has been a tough nut to crack globally. The Fund would benefit by supporting real market research that provides new information to organizations regarding identification of markets, products and new service delivery models appropriate for rural areas.

9.1.5. Social Policy

In pursuit of food security, policies should encourage the development of market-based solutions that have long-term impacts. Where market-based solutions appear to hold little potential now, concentration on grant-based programmes may be more appropriate. Government and donors should discourage the use credit as a tool to achieve non-financial objectives where access to credit is a quick fix for transferring cash to vulnerable populations, not a long-term opportunity for accessing financial services.

9.1.6. Policy Dialogue

The development of appropriate polices that take into account links across sectors require an appropriate forum for policy discussion and decision-making. In Malawi, innovative fora have been developed to support good policy and decision making in the health sector, through the Health Swap. Similarly, the National Action Group (NAG) has also experienced success in promoting an effective cross-sectoral dialogue. In Malawi, an appropriate platform that brings together various relevant government ministries (Ministry of Finance, Ministry of Agriculture, Central Bank), the Microfinance Network representing practitioners, donors, banking wholesalers, and other relevant stakeholders has not yet been effectively established. Careful attention to building such a forum and/or piggybacking on an already effective mechanism will be critical to establish supportive policies for microfinance. The Microfinance conference slated for Q4 2005 should provide an important opportunity for establishing such a forum.

At a meeting of microfinance stakeholders in January, the following issues were highlighted as key issues to be addressed in such a forun as well as in complementary initiatives:

- Developing a common understanding of what microfinance is;
- Sharing knowledge about microfinance best practices;
- Creating awareness of Malawi's microfinance policy and potentially revisiting it now that time has passed;
- Clarifying government's role in microfinance (per the Policy);
- Understanding microfinance within the context of financial sector development, and establishing an "organizing" policy for financial sector development encompassing all key financial sector areas – of which microfinance is a part;
- Fragmentation of interest groups in microfinance;
- Donors following a mix of sound and unsound practices;
- Policy interactions that undermine, not support overall policies;
- Fragmentation of donor/DFI initiatives;
- Limited awareness/practices of microfinance in rural or agricultural markets;
- Sharing knowledge about commercial microfinance with mainstream banks; *and*
- Identifying what microfinance can and cannot do to overcome poverty.

Stakeholders agreed to convene a microfinance workshop in 2005 to address some of these issues head on.

9.2. Institution Building

Increasing the supply of financial services to many market segments including rural clients and a significantly larger segment of poor and low-income clients will require building efficient and sustainable financial institutions. It will require the emergence of a diverse range of institutional types that respond to diverse market niches. While a number of institutions on the ground demonstrate potential for long-term financial and institutional viability, there are currently no microfinance operations (or microfinance lines of business) that are fully financially viable. Of note, there is a marked absence of institutions that can intermediate in rural areas.

Financial Intermediation for Rural Areas

Reaching unbanked populations will require building key capacities in financial institutions (see 9.2.1 *Capacity Building Across the Industry*) and supporting licensed institutions that can reach significant scale.

- Financial sector development and deepening in Malawi demands the emergence of viable intermediaries, especially in rural areas, that can efficiently intermediate savings, and support payment systems. Institutions that effectively intermediate reduce the costs of lending and rates to borrowers (Fry). In Malawi, the high real interest rates are a significant bottleneck to increased access to financial services.

- The Government of Malawi with support from development institutions must make a strategic decision about how it will support rural financial intermediation, including determining whether or not state supported institutions are up to the challenge of financial and operational overhaul.
- There are a number of institutions currently operating in rural markets, namely MSB and MRFC, that are a potential platform to fill the intermediation void, particularly once restructuring plans are implemented. Experience suggests that transforming underperforming parastatals, usually with a succession of mandates and management teams saddled with problems of administrations passed, is an extremely difficult task. However, there are some compelling success stories.
- Success will take far more than simply bringing in a private investor or developing a strategic alliance with an external partner, it will require full-scale commitment from government to support institutional transformation.
- Unless radical measures are taken with current operators, achieving intermediation in rural Malawi may require support for a brand new institution (s), a massive undertaking. Malawi's current financial system, dominated by a handful of institutions with substantial market power, have demonstrated limited desire to find new ways of doing business in more challenging markets.

Informal mechanisms, not enough

Of concern, large initiatives of development institutions for example the African Development Bank and the World Bank focus on developing capacity in the informal sector (e.g. community based savings and credit associations) rather than support for formal financial institutions. The recommendation to ensure the emergence of a scalable, financial intermediary that can effectively and efficiently intermediate is based on global experience on development of financial markets (Fry). Determining the appropriate business model for such an institution (s) requires further market evaluation, and may be an important contribution of the Privatization Project as restructuring of MSB and MRFC are contemplated.

What is the best model(s) for rural financial intermediation?

The cooperative model or decentralized financial institutions appear to have some promise for Malawi based on the experience of SACCOs, of which the majority are profitable. Decentralized financial systems should also be reviewed carefully as one model to consider for developing scalable financial institutions in Malawi.

Risk Transfer and Capital Markets – critical for microfinance market development

In addition to a scalable financial institution that serves rural markets, and provides true financial intermediation over the long-term, broad policies should support the development of a range of new institutions to develop niche markets, including capital markets. These might include non-banking financial institutions that can develop insurance and other products that support risk hedging for institutions and clients in both domestic and international or regional markets. Institutions that hedge farmer and banking institution's risk, particularly price risk, with the ability to tap into international capital markets, may underpin the development of real banking services in agricultural markets. Niche players may also stimulate competition in the financial sector with new services that provide alternative sources of finance.

9.2.1. Institution Building -- Current Players

Capacity Building Across the Industry

A number of capacity building needs broadly shared across the industry in Malawi have been identified in the areas of 1) governance, 2) management information systems, 3) operational and financial restructuring, and 4) new product development.

Governance

A number of MFIs in Malawi operating as Companies Ltd by Guarantee have unclear ownership structures. Members have limited liability for company performance and Boards, though highly skilled, have limited incentives and resources to promote sound performance. Recognizing that clear ownership structures are necessary to create the incentives for sound management and to enable institutions to tap capital markets (savings, equity, debt) to meet growth objectives, initiatives that support the transformation of Companies Ltd. by Guarantee into shareholding structures with real owners and incentives for success are needed.

Effective boards are critical to ensure good fiscal management and to preserve and safeguard the missions of the diverse range of institutions that respond to different market segments, and to ensure that financial objectives do not eclipse social objectives. Strong governance and clear ownership is critical for achieving the "double bottom line".

Management Information Systems

Efficient MFIs require strong management information systems that enable data collection, aggregation and analysis. MISs enable strong portfolio management as well as overall financial management. Many institutions in Malawi suffer from weak information systems that frustrate efficiency and performance objectives, and institution's ability to manage loan portfolios. Strong MISs will be required for all institutions to fulfill any prudential and non-prudential reporting requirements that may emerge from the current review of the legal and regulatory framework.

Additionally, strong MISs are critical in order for institutions to take advantage of opportunities presented by the development of electronic banking applications that reduce transaction costs, enable the entrance of new kinds of players among suppliers (for example, retail businesses that offer payment services), and expand products particularly for payment services. Electronic banking is in very early stages in the industry globally. It requires additional piloting and exploration of business models to determine its real potential. It requires the existence of affordable national communications infrastructure and "back end" information and computer systems that will allow MFIs and banks to connect to national payment systems that support electronic banking applications (CGAP IT Innovation Series).

New Product Development

The availability of a diverse range of financial services in Malawi is limited. Up to now, suppliers have focused on the delivery of loan services. People require a vast array of financial services including loans, both consumption and productive, as well as savings, payment services, insurance and pension services. Institutions require the capacity to identify what the market needs, and develop products that respond to those needs. Institutions seek additional capacity to understand the right business models for delivering those services to guarantee financial viability and therefore long-term access to services. Suppliers also require additional capacity building to pilot products and then roll them out institution-wide over the long term. Suppliers require support for developing "supply-side" capacities that support new products including MIS, financial officer training, marketing expertise, and additional financial management skills. Nearly all institutions have identified product development as a critical capacity building need.

Restructuring

Both large parastatals and smaller companies have identified restructuring as a key capacity building need, including both financial and operational restructuring. For smaller companies, financial restructuring is required to develop appropriate shareholding structures that create performance incentives that will increase their capacity to tap additional funding sources like savings and loans. Tapping savings however requires meeting criteria for licensing and developing the capacity to mobilize and prudentially manage savings.

Parastatals dependent on unstable sources of funding, like concessional loans and parastatal deposits require financial restructuring. They also require operational restructuring to take advantage of market opportunities (expansion or rationalization, new product development, technology advances, etc.) that more stable sources of funding will allow.

In the case of parastatal restructuring, experience suggests that intensive technical support is required over a several year period to ensure solvency, develop new products, and prepare the institution both operationally and financially for private sector investment.

In the case of Companies, intensive technical support is required to ensure readiness for private sector participation, identify new owners, diversify sources of funding and support, in some cases including Employee Stock Ownership Plans.

Institutions on the Ground

Building institutional capacity and demonstration models

Opportunities exist for donors and investors to 1) support individual institutions as well as 2) provide broad-based industry support. Individual institutional support may be required for:

- Companies with national branch networks and entrepreneurial management;
- SACCOS with promising low-cost business models;,
- Parastatals with significant knowledge assets given their long experience working in rural areas and extensive branch networks;
- Non-bank financial institutions interested in exploring opportunities in insurance and risk management products; *and*
- Mainstream commercial banks interested in either down-scaling their businesses or developing subsidiary institutions with distinct cultures and operational models that leverage Bank's infrastructure and license to respond to new markets.

More specifically donors may target the following institutions for support.

Private Sector Participation in Parastatals

MRFC and MSB are currently undergoing a process of evaluation to support financial and operational restructuring, with an eye towards selling shares to private sector players. The process will focus on developing business strategies that promote profitability, modernizing technology, and developing products that respond to clients needs. Contingent on political will and credible plans for the future, donors and investors should consider supporting this process. Of note, the parastatals have strong knowledge of local markets built up over time that will be critical to support the process of innovation and substantial physical presence required to develop financial markets in rural Malawi. Knowledge assets may be very attractive to private buyers.

Transforming Companies

Investors and donors can play a role supporting the transformation of Companies Ltd. by Guarantee into shareholding companies with local ownership, including employee ownership, and effective governance structures, and eventually into licensed entities that can mobilize savings deposits once they have demonstrated prospects for long-term financial viability. These MFIs require support to develop innovative products and processes rather than new product lines that replicate traditional ways of doing business. For those companies with ambitions to get a banking license, significant technical support will be required to support the development of savings lines of business.

Start-ups: New Bank or Bank subsidiaries

The establishment of a new, licensed bank with the authority and capacity to offer the full complement of banking services in urban and rural areas should be considered, either as part of restructuring efforts currently underway or as an entirely new enterprise. Alternatively, an institutional model in which banks establish subsidiary operations that leverage the bank's license and capital but focus exclusively on microfinance have demonstrated significant promise. Donors may consider providing funding to cofinance interested banks to evaluate the market potential for this option.

SACCOs

The financial viability of a large number of SACCOs in Malawi indicates promise for this institutional form in Malawi's financial landscape. Financial viability of a significant number of SACCOs has been attributed to a strong discipline of fiscal conservatism in which growth is financed by retained earnings (and not external donor funding), effective corporate governance, and the close proximity of members to branches (Cater). The presence of an apex body that provides services to SACCOS cost effectively, including risk management and other back office functions further strengthens the SACCO model.

Non-banking Financial Institutions

There is an absence of financial instruments and products designed to pool and transfer risk born by both clients and institutions. This includes insurance products (health, life, funeral) as well as financial instruments (like forward and futures contracts) that manage agricultural price and production risk. Donor and investors have a role supporting institutions that offer products which enable banks to hedge overall portfolio exposure, and farmers/traders to hedge the risk of price volatility and production. The development of non-banking institutions will also support markets for long term funding sources.

9.2.2. New Players

The Government and potential investors will determine whether or not current parastatal financial institutions have what it takes to achieve long-term viability, or whether the development of a new financial institution or alternative model is required to serve rural areas. If a new institution is considered, evaluation of the appropriate business model (centralized, decentralized, etc.) given Malawi's experience is critical. In addition to scalable institution(s) that can reach very large numbers of clients, new institutions that respond to niche markets will help build the sector. Niche markets might include for example the offering of insurance or derivative products in agricultural markets, or the issuance of ebanking cards that support lines of credit and/or savings services.

9.2.3. Capital Investment and New Sources of Funding

In addition to capacity building support, institutions require additional capital and links to new sources of funding. This may include debt and equity funding, as well as deposits. Initiatives that support access to new sources funds might include:

- *Preparing institutions to eventually meet criteria for licensing.* There are few institutions operating in the microfinance industry that meet the requirements for obtaining a banking license that will enable savings mobilization. [26]

- *Supporting institutional capacity building for savings product development.* Introducing demand-driven savings products is a complex process requiring capacity in market research, product design and testing, and the development of systems that will support the new product (s).
- *Linking institutions to microfinance debt and equity funds.* Regionally and globally, there are a number of specialized microfinance debt and equity funds that support high performing microfinance institutions and financial institutions. While few institutions in Malawi may meet minimum performance requirements for investment now, over time with institutional strengthening MFIs in Malawi may be able to access such funds. The Network may have a role in brokering information for its members about such funds. Africap Microfinance Fund, for example, focuses exclusively on Africa (see www.africapfund.com). MicroVest is a global fund.
- *Building bridges to local capital markets, both debt and equity.* Globally, even institutions with strong performance records may have difficulty accessing funds from capital markets. Linking MFIs with sources of capital may require an active broker that can present institutions to potential investors or lenders. For any transaction, transparent reporting information that complies with international auditing standards is a prerequisite.
- *Supporting accurate and timely reporting and external rating.* To be considered for investment or debt, institutions must be able to provide accurate, clearly presented and timely information about financial performance. Few institutions operating in the sector present information in a format or with a level of accuracy that would even enable consideration from external financers or lenders. Initiatives that support the presentation of accurate financial statements in an appropriate format, performance reporting on key indicators, and portfolio quality reports are required. Initiatives that allow institutions to be rated by a rating agency once they have reached a high level of performance may also strengthen investor or lender confidence in the sector (see www.cgap.org/priorities/financialtransparency.html).

9.3. Legal and Regulatory Frameworks

9.3.1. Corporate Frameworks

A New Framework or Not?

There appear to be no strong barriers to market entry under the current legal framework in Malawi. However, the Central Bank is systematically reviewing legal and regulatory frameworks now to ensure that they are both supportive of the development of microfinance markets and to ensure that current legislation enables adequate supervision of licensed institutions. Based on international experience, any new legislation that is recommended from this review should undergo a thorough vetting process by stakeholders in a public forum to ensure buy-in and widespread acceptance. During this process, secondary legislation should be reviewed to ensure that legislation is microfinance friendly and enables Bank supervisors to adequately assess the performance of microfinance lines of businesses in licensed institutions. Secondary legislation may include standards for loan loss provisioning and write-offs, liquidity requirements, risk weighting of assets, gearing ratios, etc. Additionally, review of cooperative law to ensure the adequate supervision and monitoring of SACCOS appears urgent.

Non-Prudential Regulation

While the largest players in microfinance are licensed, there are a significant number of institutions offering credit services that are not licensed and therefore not prudentially regulated. The Central Bank may want to consider non-prudential regulation either directly administered or administered by a designated body that requires regular reporting of non-licensed institutions on specific financial performance indicators (See Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Microfinance Consensus Guidelines, http://www.cgap.org/docs/Guideline_definitions.pdf). This will enable the Central Bank to become familiar with institutions that may seek licensing at some time down the road. Additionally, the requirement of performance reporting may very well provide incentives for better performance as there appears to be a strong correlation with transparent and public reporting and better performance (for a list of key indicators see www.cgap.org/docs/Guideline_definitions.pdf

Understanding Microfinance as Integral Part of the Financial System

As the market evolves, ongoing review of the legal and regulatory framework will be necessary. While there are virtually no micro insurance or housing finance products for the poor available on the market now, a framework that supports the delivery of these services by a range of banking and non-banking financial institutions will be required. Significant growth in the microfinance market will require the development of agricultural finance which is contingent on the development of products that enable risk transfer across the financial sector if not locally, then regionally or globally. Microfinance market development therefore requires supportive frameworks for capital market development (for example for derivatives and securitization) and the development of non-banking financial institutions. In short, overall financial sector development is required for microfinance markets to develop. Ghettoizing microfinance in an "hermeneutically" sealed policy that does not recognize the urgency of overall financial sector development and its role in supporting microfinance service delivery will ultimately undermine not support the development of microfinance markets.

Initiatives that support developing the capacity of lawmakers and specialized regulatory agencies to evolve the framework over time are more important than a single act of legislation now. Women's World Banking has developed a "Scorecard" to enable stakeholders to determine to what extent country's financial systems work for the majority. While not comprehensive, it provides a departure for discussions on relevant policy, institution building and financial sector development issues.

In many countries, special forum have been established that promote a broad understanding of the industry and periodic discussion of relevant issues. Such a forum provides an opportunity for stakeholders to better coordinate their interventions, and could be facilitated by a single government ministry or partnership among Ministries, for example the Ministry of Industry and Commerce responsible for implementation the Microfinance Action Plan or other delegated agency.

9.3.2. Other Frameworks

In addition to legal frameworks that govern institutions, frameworks that influence the ability of entrepreneurs to take advantage of productive opportunities should be reviewed and amended where necessary. Currently informal vendors operate in a hostile legal environment. Limited access to land titling constrains entrepreneurs' ability to use land to secure loans. Limited capacity in the judicial system restricts the ability of suppliers to enforce contracts, and is an important constraint, arguably the single most important constraint, that holds back suppliers from advancing the finance frontier.

9.4. Innovative Products and Processes

This study and the work it draws from highlights limitations in the availability of products that respond to the diverse financial service needs of clients in Malawi. Not only are few products available, but institutions that can provide both savings and lending services, one-stop shops, are notably absent. Financial instruments that enable both banks and producers to share and pool risk, particularly for the agricultural sector, are few. Subsequently, the largest markets in the country, agricultural producers and traders have limited access to finance. The World Bank's *Agricultural Investment Sourcebook* provides comprehensive information on innovation in agricultural markets.

With limited support for product development, MFIs have responded to new market segments with few new innovations relying largely on imitation of products already available in the market. Institutional support for the process of innovation – both developing new products and means of delivering them– is critical for pushing the finance frontier.

Supporting the Process of Innovation

Supporting the process of innovation in Malawi will require:

Donor and public funds. For a generally risk-averse and cash-strapped sector, there are significant disincentives to supporting the process of innovation. The process is labor intensive (and therefore costly), has significant potential for failure, and creates diminishing returns for the innovator as innovations can be easily adopted by competitors once the innovation has been successfully developed and tested. Public sector money may also be used to assist potential new providers with technical assistance to assess demand for specific products and or gather information to better understand risk characteristics of new markets, for example, for insurance products.

MicroSave Africa describes a number of key tasks involved in new product development including evaluating the institutional readiness of an institution to introduce a new product, carrying out extensive market research, defining the product concept, cost analysis and revenue projections, pilot testing the product, making adjustments to supply side systems, like information systems, staff incentive plans, etc., and product rollout.

Donor and public funds can be appropriately earmarked for supporting private sector entities serious about supporting innovation in either new product development in financial markets or innovative delivery channels to support access to difficult to reach areas.

Private involvement in public sector companies: Research suggests that public ownership is a major impediment to innovation (Bonin and Istvan), and that foreign-owned companies or domestic companies with foreign involvement are more likely to innovate. Promoting partnerships with the private sector, global players may hasten the process of financial and operational restructuring of the parastatal organizations spearheaded by PURP.

Using information technology

Information technology has the potential to reduce high transaction costs that discourage financial sector development. Information technology can be used to create new delivery channels, and widen the range of financial services including payment and transfer services. The significant investment by RBM in a state-of–the art national payments system (Malswitch) presents exciting opportunities for e-banking applications in areas where communications infrastructure is in place. Innovation through strategic alliances with technology companies should be considered, and merits donor support.

Supporting the development of capital markets and entrepreneurs

Malawi has shallow capital markets. Domestic companies have limited opportunities for accessing equity capital or other forms of finance to support new ventures. New ventures may very well be the source of innovation that stimulates deeper financial markets and the development of products and financial instruments that make financial sector development in rural areas possible.

In a number of developing countries, the government can play a supportive role in the development of national venture capital markets through initiatives that empower both entrepreneurs and encourage the development of national venture capital funds. Israel's Yozma Fund (www.yozma.com) is an example of government initiative that matched up to 40% of other investors' capital to spur the development of a technology industry. This Fund played no role in investment decisions by individual firms and furthermore allowed entrepreneurs the option to buy out the Fund's shares. This Fund has since been fully privatized.

9.5. Professionalization of the Industry

Stakeholders identified lack of uniform performance standards and minimal disclosure requirements as major impediments to professionalization of the industry. Support for mechanisms that encourage professionalization require broad stakeholder participation. Standards setting will require building consensus on key indicators, and should include all relevant parties including Ministry of Industry and Commerce, Reserve Bank of Malawi, commercial banks, MFIs, donors and investors. Donors and investors should hold investee institutions accountable for reaching minimum performance standards. The Malawi Microfinance Network (MMN) can play a strong role in coordinating efforts and building the capacity of organizations to use information for more effective institutional management. The MMN can also play a role collecting performance data and sharing it widely to encourage transparency. The following link provides some information on indicators used by the industry globally to measure the performance of institutions and microfinance operations (www.swwb.org/English/2000/performance_standards_in_microfinance.htm)

Of note, Pride Malawi was one of four institutions in sub-Saharan Africa to be recognized for a high level of compliance with international reporting standards in the CGAP Financial Transparency Awards.

While supervisory bodies are concerned first and foremost with prudential regulation, performance monitoring of non-supervised entities and publishing performance information may contribute to the process of professionalization. In some countries this role is taken on by Central Banks; in most contexts independent bodies take on this responsibility as delegated by government organs responsible for overseeing regulation.

9.6. Building Industry Infrastructure

Specialized knowledge to support the development of retail networks, performance evaluations by independent third-parties (for example, rating agencies), and brokering MFI access to bank financing and capital markets will enhance development of the microfinance sector. Currently, there are a limited number of support institutions operating in Malawi's microfinance industry. Key investments to building capacity of consulting firms and IT firms with specialized expertise in microfinance, audit firms, and ratings agencies are required to develop this capacity.

Brokering deals may be the purview of donors or other public sector stakeholders willing to fill this information gap, until banks and funds develop capacity and incentives to scout their own deals.

9.7. Supporting the Malawi Microfinance Network

The Malawi Microfinance Network seeks to play a key role in the further professionalization of the industry. The Network wants to provide training courses to its network members to strengthen critical capacities for microfinance service delivery. The Malawi Microfinance Network hopes to play a strong role in promoting transparency through

Box 13: Useful Websites: Industry Infrastructure

- The following website provides additional information on developing capacity of audit firms to carry out audits on microfinance lines of business.

  www.microfinancegateway.org/section/resourcecenters/auditcenter/
- The following website provides information on developing information systems for microfinance, including a fund that cofinances information systems expertise.

  www.isfund.org
- The following website provides comprehensive information on ratings for microfinance institutions.

  www.ratingfund.org
- The following website details MicroSave Africa's young executive programme for developing microfinance expertise and becoming certified trainers for MicroSaves technical tools for both savings and lending.

  www.microsave.org/msa_csps.asp?ID=18

support for reporting on commonly used performance standards. As a lobby organization, the Malawi Microfinance Network would like to represent the views of its members to influence policy, legislation and regulation. The Malawi Microfinance Network seeks human and financial resources to implement its Business Plan encompassing activities under the three main areas mentioned above.

9.8. Knowledge Management and Stakeholder Communication

The knowledge base on how to develop financial sectors that include the majority of the population, particularly in rural areas and where economies depend on agriculture remains a work in progress. Additionally, while there may be similarities across countries and general guiding principles, each country develops according to its own opportunities and constraints. As such, a forum in which stakeholders across sectors (agriculture, finance, trade, etc.) communicate to influence financial sector development are critical to exchange knowledge generated from experiences accumulated over time, to debate and reach consensus on policies that make sense, and to ensure that efforts complement, not undermine each other. Such a forum was developed in Uganda for example around issues related specifically to the legal and regulatory framework but could be expanded to include any range of issues. Development of such a forum may be useful to tackle those issues that can be addressed in a collaborative way and to expose policy makers to new information that will influence their policy decisions.

Changes to government policies that positively influence inclusive financial sector development are by definition the responsibility of Government. Donors and Development Financial Institutions however have a strong role to play in lobbying government to adopt policies, summarized in the Table 15, that can positively influence financial sector development.

Table 15: Summary of Recommendations

	Area of Intervention	Key Activities	Potential Impact
Policy	Fiscal Policy	- Reduce budget deficit. - Government relies less on domestic debt markets to fund deficits.	- Real interest rates reduced. - Reduced inflation. - FDI stimulated. - Increased private sector access to credit to drive growth - Innovation in financial service delivery as a result of increased competitive pressures (Banks/NBFIs rely on revenue from T-bills). - New products for currently unbanked, particularly in rural and agricultural markets.
	Financial Sector Policy	- Encourage competition in financial markets through fiscal policy adjustments. - Reduce high reserve requirements - Provide incentives to support product. and delivery channel innovations (see innovations). - Provide incentives for development of capital markets, including venture capital.	- Real interest rates reduced. - Smallholder production and crop diversification in agricultural sector increases. - Products that enable risk sharing and pooling deepen services in rural and agricultural areas (insurance and derivatives). - Efficient savings mobilization and intermediation lowers cost of funds, expanding services to rural areas and agricultural markets. - Private investors respond to incentives and risk capital to offer new products and services.
	Broad Policy and Agricultural Policy	- Implement strategies to broaden the agricultural productive base. - Remove infrastructural bottlenecks by investing in physical infrastructure (roads, communication, etc.). - Enhance linkages (physical, information, etc.) between players in the agricultural value chain to create market systems that work effectively. - Support economic diversification. - Strengthen capacity in judicial system to enforce contracts.	- Reduces dependence on tobacco. - Reduces dependence on international aid. - Higher productivity and better prices for current outputs. - New and more efficient markets (domestic and international) generate wealth. - Better developed markets generate prices that result in better living conditions, income and access to food for the majority of the population. - Financial institutions engage currently unbanked markets given better contract enforcement. - Market based solutions meet long term financial service needs.

Policy, continued	Social Policy	- Target use of cash transfers and safety net progammes using grant based programmes, not credit. - Link "graduates" of grant based programmes to sustainable sources of finance where appropriate.	- Poverty safety nets provide short-run basic needs. - Diminished distortion in markets for credit. - Solutions to increase welfare are sequenced and more effective.
	MARDEF	- Support incentives for strong Fund performance. - Financial intermediaries are responsible for loan funds. - Select intermediaries with strong track record in financial services delivery. - Ensure no interest rate ceilings for end users to ensure full cost recovery. - Support new product development for rural markets including systematic pilot testing prior to large scale disbursements.	- Access to the Fund supports effective MFI financial structures. - Fund increases sustainable loan delivery. - Fund increases capacity of institutions to lend to rural markets. - Rural households have increased access to finance.
Stakeholder Working Group	Effective Policy Development	- Stakeholders organize a national microfinance workshop. - Stakeholders identify a forum -- either new or attached to established group -- to convene key microfinance stakeholders to discuss key policy issues, across sectors.	- Policies that influence the development of inclusive financial systems complement not undermine each other. - Policies take into account multi sector impacts of key economic, agricultural and financial sector policies.

	Area of Intervention	Key Activities	Potential Impact
Institution Building	Strengthen Current Players	- Support capacity building for current suppliers (SACCOS, restructuring parastatals, Companies Ltd, by Guarantee, Banks, non-banking financial institutions) in key identified areas: • Governance. • Management Information Systems. • Transform institutions' ownership structures. • New Product Development.	- Financially viable institutions emerge that provide sustained, not intermittent, access to services. - The cost of financial intermediation is reduced, enabling access to currently unbanked populations. - Prices for consumers are reduced through the emergence of "one-stop shops" reducing clients' transaction costs for services. - Increased supply of financial services in rural areas, especially savings that respond to low-income and vulnerable populations.
	Support Emergence of New Players	- Support business plans of "scalable" institutions with both capital and capacity building. - Support operational and financial restructuring of parastatals and Companies Ltd. By Guarantee. - Promote establishment of companies with new institutional forms or market focus (insurance, subsidiaries of commercial banks, derivatives traders).	- More efficient operators emerge with Incentives and capacity to support innovation that pushes the finance frontier. - Deepened and expanded financial markets result from companies with new capacities (risk pooling for insurance, etc.) that respond to diverse financial needs, particularly risk management needs of the agricultural sector. - Increased competition and supply of financial services lowers prices and improves the quality of services. - More diverse range of services responds to needs of a more diverse and larger market.
	Growth Financing	- Prepare institutions to access capital markets and debt markets (governance, prudential management of savings, reporting). - Facilitate financing for institutions: • Broker deals with institutions and international microfinance funds. • Facilitate development of local capital markets, including venture capital funds.	- Institutions better capitalized and more highly levered, increasing access to services to excluded groups. - Risk capital (domestic and international) finances institutions that provide services that are currently unavailable in the market.

Institution Building, continued	Non-financial services	- Build capacity and support the emergence of institutions that share information to lubricate markets (prices, yield information, etc.). - Build capacity of producer and business associations to link to markets. - Build the capacity of institutions that provide business development services. - Support development of organizations that improve productivity of agricultural sector (warehouses to store output, firms that provide quality grading, firms that provide the public with information about market opportunities and prices, etc.).	- Increased productivity of producers and efficient market development. - Increases in margins for agricultural output and distribution of agricultural products provides incentives for increasing the volume of financial service delivery and the development of more sophisticated financial markets (risk pooling and sharing, etc.) . - Knock-on effects drive financial market development by increasing the capacity of even low income producers to save, borrow and transfer funds. - Overall GDP and GDP per capita increases.
Legal and Regulatory Frameworks	Corporate Frameworks	- Confirm (or deny) that no barriers to entry currently exist. - Review secondary legislation. - Create forum in which stakeholders can review key policy issues influencing financial sector development. - Foster broad-based understanding of financial sector development . - Review treatment of different organizational forms (access to capital at preferential rates, etc.) to ensure a level playing field.	- Environment is hospitable for a wide range of institutional forms. - Legislation does not create disincentives for banks and other licensed institutions to get involved in providing services to a wider range of clients and markets, currently unbanked. - Bank supervisors can adequately assess the performance of microfinance lines of business. - Lawmakers, regulators, parliamentarians, etc. have the knowledge to evolve the legal framework over time.
	Other Frameworks	- Review legislation that restricts informal sector activities. - Support land titling, particularly for small holder farmers. - Strengthen capacity of judicial system to enforce contracts.	- A secure environment for informal sector traders enables regular and predictable cash flows with positive welfare impacts . - Land titles expand sources of collateral for currently unbanked groups to secure loans, overdrafts, and other financial services. - Uncertainties in the environment that limit banks and clients willingness to disburse and take on debt.

	Area of Intervention	Key Activities	Potential Impact
Innovation	Financial Markets	- Create incentives for companies to innovate both products and delivery channels • Insurance/derivatives for pr.ice and production risk. • Savings. • Smart Card applications. • Warehousing. • Consumption lending. - Support technical assistance and information gathering for potential suppliers to assess demand for products and understand specific risk characteristics of new products. - Create incentives for partnerships between technology companies and financial institutions to support products, delivery channels, efficiency gains. - Make tools that enable new product development available and build capacity to use them. - Sell shares of parastatal institutions to private sector and international players, vectors of innovation. - Invest in infrastructure to support electronic banking applications, particularly access points beyond towns and city centers. - Provide incentives for private sector investment of venture capital in start-up and new companies that innovate in the financial sector, or other sectors that support financial market development (e.g., matching VC fund).	- Increase range of services offered and delivery channels, particularly in rural areas, to expand and deepen financial markets. - Encourages private sector and new capital (domestic and international) to invest in Malawi's financial sector. - Up front R&D costs don't act as disincentive to innovation. - Technical support provides potential suppliers with capacity to assess potential for new markets that demand understanding of global and more technical financial markets.

Professionalization of the Industry	Financial Transparency, and Performance Standards	- Adopt core set of performance indicators against which institutions can be measured. - Support development of industry infrastructure that can assess the performance of institutions with microfinance lines of business (including audit firms, rating agencies, etc.). - Develop adequate disclosure requirements for both licensed and unlicensed microfinance institutions. - Consider a framework with prudential and non-prudential standards for different institutional types that encourages transparency and creates incentives for institutions to "graduate" and integrate with financial markets.	- Specialized microfinance institutions and banks with microfinance lines of business have increased access to capital markets. - Higher standards encourage competition that accrues benefits to clients (prices, better services).
	Industry Network	- Support development of the Malawi Microfinance Network's Business Plan (reporting, training, member networking, etc.).	- MFIs develop lobbying block to interact and negotiate with government stakeholders that influence policies and develop laws. - Capacity of institutions strengthened by training opportunities.

	Area of Intervention	Key Activities	Potential Impact
Knowledge Management	Stakeholder communication	- Create a forum in which stakeholders exchange views about key issues that support financial sectors that serve the widest possible range of markets (including poor, low-income, vulnerable non-poor, smallholder, MSE, and other unbanked populations). - Support implementation and/or revision of the Government of Malawi's Microfinance Policy and Action Plan (in effect now). - DFIs and donors lobby government as a bloc to pursue policy recommendations under Policy Recommendations of this table. - Encourage donors and investor to apply uniformly high performance standards to investments .	- Initiatives supported by various stakeholders complement, not undermine, each other. - Forum creates learning environment and network for knowledge management.

Appendix 1: Summary of Primary Microfinance Service Providers in Malawi

(This section was adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004, with some updated performance data.)

MSB

MSB has traditionally been known as the "people's savings bank" because of its extensive presence in rural areas and its large number of accounts with small average balances. MSB got its start when it took over the financial service activities of the Malawi Post Office Savings Bank (POSB). MSB and the Malawi Post Corporation (MPC) signed an agency agreement permitting MPC staff to process transactions for MSB depositors. MSB is currently undergoing a three-stage process aimed at eventual privatization. Following an evaluation carried out last year, MSB will receive technical support from the European Savings Bank Group for restructuring. The Privatization Commission is considering a privatization plan that enables MASAF sponsored Community Savings Banks to have partial ownership of the Bank.

Legal Status and Governance Structure

MSB was incorporated on June 16, 1994 as a private company limited by shares under the Companies Act. All assets and liabilities of the defunct POSB were transferred to it. MSB was granted a banking license in March 1995. While it is subject to all Banking Act regulations, the RBM has provided exemptions from the liquidity reserve requirements. MSB has a six person Board of Directors and its Chairman represents the Ministry of Finance. The GoM holds essentially 100% of issued and fully paid up shares in MSB.

Financial products

MSB offers a variety of savings products that include ordinary savings accounts, thirty, sixty, and ninety-day certificates of deposit (CD), and premium deposit "now" checking accounts. The minimum deposit on savings accounts is MWK 400. The GoM has exempted interest earned on MSB savings and CD accounts from taxation because MSB's customer database is not accurate and it would be unable to collect the tax. This gives

MSB an implied subsidy and a competitive edge over other banks without this exemption.

While MSB is known as the "people's savings bank" because of its mobilization of microsavings, it depends on deposits from parastatal and quasi-government institutions to supplement savings mobilized from individuals. With its banking license MSB is able to on-lend the savings it mobilizes. However, its loan portfolio is quite small (about 10% of total assets), and concentrated in a handful of parastatal or quasi-governmental entities and its contribution to MSB's interest income is small.

MSB has begun piloting consumer loans to salaried employees and money transfers.

Outreach and Savings and Loan Portfolios

MSB has approximately three branches and 30 dedicated agencies. Additionally it has service outlets in offices of the Malawi Post Corporation (MPC). MSB has made efforts over the past four years to improve its client service and performance by opening new branches and MSB-manned agencies that appear preferred by clients. 75% of transactions are managed through the MSB's own agencies and branches.

MSB does not have fully accurate records of its depositors' ledger. Its data problems have been largely inherited from the Malawi Postal Corporation due to mis-posting or non-processing of information. While efforts have been made to reconcile the accounts, the data inconsistencies still exist though are declining.

The majority of MSB's MWK 156 million in gross loans (MWK 116 million in net loans following provisions) outstanding are to GoM parastatals. Malawi Postal Corporation debt of MWK 34.5 million represents the greatest credit risk to MSB. Though MSB showed a net profit in the past year, its capital adequacy has been below the minimum US$1.5 million since 1998 and it is highly dependent on income from investments in government securities. MSB has an estimated 152,000 active "micro" savings accounts estimated at a value of MWK 750 million our of total savings deposits of more than MWK 1 billion.

MRFC

Adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004.

MRFC succeeded the Small Holder Agriculture Credit Administration (SACA) in 1993 with financial and technical assistance from the World Bank. The World Bank provided a US$ 25 million credit line to the GoM under the Rural Financial Services Project and the International Fund for Agricultural Development (IFAD) provided a US$ 12 million credit line under the Mudzi Financial Services Project. Subsequently, $17 million of World Bank Loan has been converted to government owned shares. MRFC began operations in October 1994 retaining much of SACA's infrastructure that consisted of rural extension service offices of the Ministry of Agriculture and Irrigation (MoAI).

MRFC headquarters are in Lilongwe and it operates in all regions of the country through 8 branches, 24 supervisory satellite offices, and 132 local MoAI field offices. MRFC is also undergoing a three-stage process to eventually privatize, and will concentrate the next 12 months on becoming “investor ready”.

Legal Status and Governance Structure

MRFC was licensed under the Companies Act in February 1993 with the purpose of providing financial services in the rural areas. It received a special exemption from the RBM to accept demand deposits from the public but it cannot use savings to capitalize its loan portfolio.

A distinguishing feature of MRFC is its substantial outreach in rural areas. However, MRFC is highly dependent on the nearby presence of commercial banks to intermediate its transactions on clients’ savings accounts and loan disbursements and repayments.

Financial products

MRFC’s principal activities are the provision of seasonal agriculture loans, medium-term agricultural loans, small business loans, and personal loans to employees of various companies/organizations. As mentioned, it can collect savings but cannot intermediate deposits to use in its lending activities.

Seventy percent of MRFC’s lending is for agriculture production. Many of MRFC’s loan officers were agricultural extension agents with intimate knowledge of this market segment. A variety of methodologies are employed, from solidarity group loans to individual lending. Depending on the source of funds, the loans are in-kind or cash; Seasonal agriculture loans are typically disbursed between October to January with reimbursement occurring after harvesting between February and March.

MRFC requires cash collateral and/or chattel and land on all loans except the Mudzi Small Business Loans Scheme. Smallholder farmers taking seasonal loans must have the equivalent of 15% of the loan’s value in a blocked savings account. All others must have 20% cash collateral. Commercial loans require 20% cash plus additional collateral equal to 130% of the amount borrowed. Analysis of repayment data suggests that losses on agricultural loans are close to 50% and 47% of all loans issued were later expensed as losses. However, one needs to be careful in interpreting data presented this way since MRFC’s acquisition of the non-performing portfolio of SACA is probably included in these figures.

MRFC offers an ordinary demand savings product and a type of savings club where the individual contracts to deposit a set amount over a predetermined period. Although MRFC is permitted to mobilize public deposits, it has not concentrated on this line of business. Over the last five years, the average deposit balance per account has barely changed in nominal terms. Looking at the composition of MRFC client deposits, nearly 70% of savings was mandatory collection of cash collateral. However client surveys noted in Section 3 of this report, reported that savings products are highly valued by entrepreneurs.

MRFC has an estimated 154,000 savers with total deposits of MWK 233 million. There are an estimated 134,000 micro loans estimated at MWK 639 million. At end 2003, MRF had total assets of MWK 2 billion; the loan balance at the end of the year was MWK 962 million with 779 million provisioned for created a net balance of MWK 183 million.

PRIDE Malawi

Adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004.

Pride Malawi started operations as a project in March 2000. Pride Malawi has been financed by grant funding from UNCDF through an agreement with the Ministry of Industry and Commerce and a loan from Cordaid.

Legal Status and Governance Structure

Pride Malawi (PM) acquired legal status on May 9, 2002 as a Company Limited by Guarantee. This form of registration has no shareholders but rather "members" who guarantee the repayment of all debts and obligations of PM up to a limit of MWK 1,000. PM has demonstrated interest in transforming itself into a full-service commercial bank so it can mobilize savings.

Financial products

PM offers three loan products: group, consumer and premium. The group methodology combines elements of solidarity group lending and village banking to form a two-tier guarantee system. An average of five businesses of two to three employees self-select to form an Enterprise Group (EG). PM then merges ten EGs to form a Market Enterprise Committee (MEC). Members put up a cash collateral equal to a minimum 25% of the loan size. The cash collateral is used as a Loan Insurance Fund (LIF) in the event of default. At the end of each fiscal year, PM may pay up to a 10% "bonus" to clients based on their average balances in the LIF. PM's consumer and premium individual loans were launched in 2004 to broaden the product line and diversify the loan portfolio. PM also supplies in-kind loans to paprika contract farmers, and loans to employees of a sugar company through arrangements with the parent companies.

Outreach and Loan Portfolio

PM works through thirteen branch offices and outlets located in all three regions of Malawi. Six of the branches are in cities and six in district towns. Clients are mainly urban and as of December 2004, there were 7,042 borrower, nearly 50% being women. 9,172 clients are group members making them eligible for a loan at some point in the future. Pride Malawi loans primarily finance commerce and trade businesses, though has begun financing input loans for paprika growers. The outstanding loan portfolio as of end December 2004 was approximately MWK 168 million.

PM's loan portfolio grew rapidly in its first two years maintaining strong Portfolio at risk ratios. However, in 2002 growth slowed and as with other operators portfolio at risk shot up to 12.6% due to weakening economic conditions and weak internal operating systems. As of December 2004, portfolio at risk was at 7%, and maintaining healthy portfolio quality remains challenging.

Challenges

Similar to most operators in the region, PM's client dropout rate is high, averaging greater than 50% since the start of establishment of operations. This means that Pride Malawi expends significant resources recruiting new clients. Since its most profitable clients are those with whom it has a long established relationship and relatively larger loan sizes, the rapid turnover of clients makes it difficult for Pride Malawi to reach full financial viability.

Pride Malawi aims to transform itself into a Shareholding Company. This will require identifying owners willing to invest share capital.

FINCA Malawi

Adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004.

Foundation for International Community Assistance (FINCA) was established in Malawi in 1994 as a project managed by its parent, FINCA International, a U.S. registered NGO. Over the years it has received assistance from USAID, DFID, Oxfam, DANIDA, and the Rotary Fund.

Legal Status and Governance Structure

Like Pride Malawi, FINCA is registered under the Companies Act, Limited by Guarantee.

Financial products

FINCA follows the village bank methodology in which 15 to 30 persons form a village bank. FINCA makes a single loan to each village bank that then on-lends it to individual members. The initial individual loan is limited to a maximum MWK 10,000. Loans are repaid in equal, weekly repayments of principal and interest over a 16 week loan term.

Borrowers are required to save a minimum of 20% of their loan during the repayment period. An April 2002 Impact Assessment Study of FINCA's village bank members showed they highly value the savings component, despite delays in withdrawing savings upon leaving the programme.[27]

Commercial banks play an important financial intermediation role in the FINCA methodology. As mentioned, village banks must open an account at a bank to deposit savings and excess liquidity. When FINCA finances a village bank, it transfers money to the bank account and the village bank disburses loans to its members in the form of bank checks drawn on its account.

In 2003 FINCA elected to participate in the EU-funded Agricultural Productivity Investment Programme (APIP) implemented with assistance from the Ministry of Agriculture. In-kind vouchers for maize or legume inputs of seeds and fertilizer are distributed at village bank meetings and reimbursement is made when crops are harvested.

Outreach, Loan Portfolio and Sustainability

FINCA operates in 26 out of 28 districts through 3 regional offices, 14 branches, and satellite offices where credit officers work out of their homes. As of December 2004, FINCA served 17,000 clients with an outstanding loan portfolio of MWK 225 million ($US 2.1 million). Portfolio at risk was 6% in December 2004 having come down from 13.6% in August 2002 and 10.1% in August 2001. While FINCA covers its cash operating costs, it is not yet financially viable.

Challenges

Like Pride Malawi and other operators in the region, FINCA suffers a high dropout rate, limited access to financing to fund growth, and an unclear ownership structure. With no clear owners, there are limited incentives for both management and the Board to ensure the safeguarding of the equity donated over the years.

SACCOS and MUSSCO

Adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004.

Private Sector Savings and Credit Cooperatives

Credit Unions: MUSCCO & SACCOs

The Malawi Union of Savings and Credit Cooperatives (MUSCCO) is the apex organization and Central Finance Facility for 70 affiliated Savings and Credit Cooperatives (SACCOs). In addition there are about 69 SACCOs in Malawi that are not members of MUSCCO, nor aligned in another federation. Over the years MUSCCO has received technical assistance from WOCCU, the U.S.-based World Council of Credit Unions, and still maintains close ties with them.

Legal Status and Governance Structure

The Registrar of Cooperatives within the Ministry of Trade and Private Sector Development (formerly Ministry of Industry and Commerce) issues licenses for cooperatives with a common link defined by *community* (members of the same locality) or *occupation* (belonging to the same profession or common employer).MUSCCO and SACCOs are member-owned financial cooperatives whose primary objectives are to provide financial services to their members.

Financial products

MUSCCO set up a Central Finance Facility (CFF) that acts as a financial intermediary to affiliated SACCOs. The CFF offers SACCOs deposit services, loan products, insurance, and other banking services and performs MUSCCO's treasury function. Each SACCO must invest 10% of its member shares in the CFF. SACCOs are also required to invest 15% of their members' deposits in a liquidity reserve account at the CFF to safeguard against bankruptcy or a liquidity crisis.

MUSCCO administers a mandatory microinsurance programme for each SACCO member's deposit accounts and loans. The charge of the insurance is 0.25% of the savings or outstanding loan amount per month. In the event of a member's death or disability, MUSCCO matches the savings account balance (up to MWK 100,000 max.) and adds it to the amount withdrawn when the account is closed. Should a member die leaving an unpaid loan, MUSCCO pays off the loan (up to MWK 225,000 max.) to the SACCO. Until 1999 this insurance programme was underwritten by Credit Union National Insurance, a USA firm. When the firm withdrew from the African market, MUSCCO took it over but has yet to engage an actuary to evaluate MUSCCO's risk on this product to help determine an appropriate fee structure.

Other services MUSCCO provides affiliates are: skills development training, information system technical assistance, financial management tools and accounting books, operating manuals, and advocacy representation.

Outreach

MUSCCO affiliates are located in both urban and rural areas with membership of 54,582 in June 2004, with membership roughly 75% male and 25% female. The total number of members per SACCO ranged from 62 to 3,232 with a mean average of 203 recorded at September 30, 2003. MWK 50 million had been mobilized in savings deposits, or US$ 467,289 in savings has been mobilized and the gross loan portfolio outstanding was at MWK 425 million US$ 3.9 million.

Loan and Savings Portfolios and Sustainability

MUSCCO-Affiliated SACCOs

In the past eight years the SACCO network recorded dramatic growth in most key indicators, except savings mobilization. The table below shows the loan portfolio, savings, and membership figures for all SACCOs since 1995.

Despite an overall strong showing, many affiliated SACCOs are not performing well. Eighteen out of fifty-eight SACCOs reporting at June 30, 2003 posted year-to-date losses.

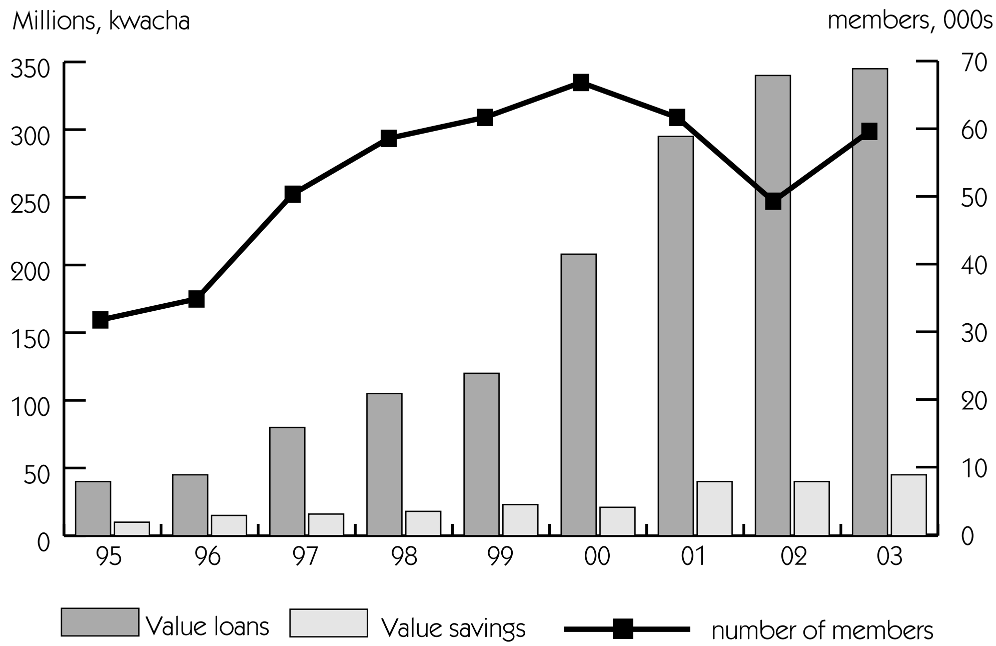
Historically the SACCO loan portfolio default rate is 20%, but in the period ending June 2004, only 3% of the portfolio was considered delinquent, though 30% of the portfolio was considered delinquent between 1-30 days.

MUSCCO Federation

In the period ending December 31, 2002 MUSCCO posted a net profit before dividends of just over MWK 14 million, but taking into account a MWK 22 million grant.

MUSCCO management sited the need for better regulatory and supervisory oversight over SACCO operations, pointing out that the Cooperative Act was too general and did not set operating standards for credit unions or their federated union.

MUSCCO-Affiliated SACCOS



Source: *USAID AMAP Microfinance Sector Assessment of Malawi, January 2004*

Opportunity International Bank of Malawi (OIBM)

Adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004.

OIBM is a licensed commercial bank in operation since May 2003, and its main objective is to deepen access to banking services for the poor and other communities in Malawi who lack access to any banking system. It is part of the Opportunity International Network which is USA-based and operates programs in 31 countries around the world. OIBM acquired the assets of Usiwata Wathia Credit Trust, a previous microcredit project in Lilongwe funded by DFID. However OIBM's staff is completely new as is its approach to the market.

OIBM is funded by USAID and Dfid to set up a retail bank network. It currently has operations in Lilongwe and plans to link with five satellite branches in the three regions over time.

Financial products

OIBM focused on savings mobilization during its initial year of operation and has found the market to be highly responsive to its product offer. It has taken a very market-oriented approach to its business and has carried out several client surveys to understand what its target clientele want in a banking experience.

OIBM provides clients with SmartCard with an imbedded computer chip that registers a client's fingerprint on the card. The SmartCard is linked into the Central Bank's Malawi Switching Centre (Malswitch) infrastructure that interconnects financial institutions. The SmartCard can be used to make withdrawals at ATM machines as well as at point of purchase terminals in retail establishments, like BP gas stations.

OIBM has moved slowly to add credit services. It offers micro loans to groups of 5 – 10 members with 6 month maximum repayment terms and commercial rates of interest.

OIBM has a foreign exchange license which it feels will allow it to attract NGO and project business since they are funded by foreign money transfers to Malawi.

Outreach and savings and loan portfolios

As of December 2004, it had 20,000 savings accounts (MWK 270 million or US$ 2.5 million) and 2,000 borrowers ($187,000). PAR >30 days was reported at less than 1%.

Challenges

OIBM will need to plan its expansion carefully to maintain the online information system it enjoys with a single office. The need for accurate and timely data will need to be reconciled with the need to hold down expenses in rural areas that may not have the infrastructure in place for low cost solutions.

Agricultural Productivity Investment Programme (APIP)

Adapted from USAID AMAP Microfinance Sector Assessment of Malawi, January 2004.

APIP is a joint EU-GoM programme created in 1997 providing seasonal agriculture credit since the 1997/1998 growing season. Its funding source is the European Commission's Malawi Food Security Programme. Over six growing seasons it issued nearly 1 million loans, peaking at 275,232 in 1999/2000 and delivering 46,890 in the 2003/4 season. Loans are issued through different Implementing Agencies (IA). Partners have been NGOs, cooperatives, parastatals, and corporations.

APIP is a directed, in-kind credit programme limited to maize and vegetable crops and consisting of seed and fertilizer input packages. The average value of the loan package per beneficiary in the last season was MWK 5,317.

APIP acts as an apex structure in this scheme by entering agreements with IAs that are responsible for the distribution of vouchers for in-kind supplies and collecting repayments from borrowing farmers before the next growing season. APIP finances the value of the loan, which it provides interest-free to the IAs. APIP and the GoM assume 75% of the risk of default with the IA assuming 25%. Also, APIP subsidizes the IA's direct administration and transportation costs for the programme, which for some amounts to 20-25% of the loans written. Because the cost of capital is nil, many IAs charge borrowers less than commercial rates of interest and the repayment record over the years has been poor. While some of the loans in Table 4-8 are from the growing season 2002/2003 the overall recovery is only 34%. During the two growing seasons 2000/2002, loans outstanding were MWK389 million and repayment received was MWK 146 million, a 38% recovery rate. Included in this was MWK 46 million to the parastatal Admark (0% recovered) and MWK 159 million to FFC (4% collected). FFC (Farmers Financing Company) was the credit arm of Farmers World, a private company with strong ties to the GoM. Given poor recovery, these partners were not included in subsequent years but represented the largest outreach network.

Repayment through some partners however particularly specialized MFIs was strong.

Appendix 2: Conference Outcomes and Recommendations

National Conference on Building Inclusive Financial Sectors in Malawi, held in commemoration of the International Year of Microcredit, 2005

As part of the commemoration of the International Year of Microcredit, Malawi held a National conference from 27th to 28th whose theme was 'building an inclusive financial services sector in Malawi. The conference attracted over 118 top level decision makers from all sectors of Malawi's economy. Participants held discussions and made recommendations around four thematic areas including microfinance best practices, regulatory and supervisory framework, rural and agriculture finance, and new markets in Malawi's microfinance sector. Below, are the major outcomes and recommendations that came from the national conference:

Conference Outcomes and Recommendations

The Conference came up with the following obstacles to achieving progress in building an inclusive financial services sector in Malawi. A consensus was reached on what needs to be done to overcome the obstacles. There was also an understanding on who takes responsibility of ensuring that the obstacle has been or is being taken care of. The obstacles were broken down per theme, as follows:

Theme 1: Best Practices in the Provision of Microfinance Services Obstacles

Obstacle 1. Adoption of Best Practices

While MFIs are trying to follow best practices, some are public funded, as a result, they are prone to government / political interference / influence which brings distortions to the sector. Due to articles of association of some of the MFIs especially member-based MFIs and government funded MFIs, their boards usually do not have the right mix of skills to govern the operations of the MFIs effectively either due to lack of skills or due to political appointments.

What needs to be done:

Government should not to be involved directly in provision of financial services. There are a lot of experiences Malawi can learn from and a good example is a failure of a credit scheme ran by the Government of Uganda where a total of $ 89 million was lost. The conference therefore, recommend that government privatize all MFIs that are funded by government like MRFC, SEDOM, DEMAT and MARDEF. Government should also adhere to its own Microfinance Policy and Best Practices.

Action:

The Government should seriously consider the recommendation of the conference and the MFIs involved should start making plans to be privatized.

Obstacle 2. Management Information System

MFIs understand the need for upgrading their management information systems but new technology was currently unaffordable by most MFIs.

What needs to be done:

MAMN should approach technology providers so that the MFIs could share the cost of the new technologies that the providers could install. Donors should assist the MFIs in acquiring new technology since it can be used to expand services and improve outreach. Government should also upgrade infrastructure so that MFIs can expand to rural areas using new technologies.

Action:

Donors and MAMN must take up this issue.

Obstacle 3. Setting Interest Rates

As MFIs work towards sustainability they charge cost recovery rates that are deemed very high for most clients.

What needs to be done:

The Government must continue to improve macroeconomic conditions to bring down inflation and interest rates so that the rates that MFIs charge to their clients should be affordable. MFIs should also avoid inefficiencies that are passed on to clients through higher interest rates.

Action:

Government through the Ministry of Finance and MFIs

Obstacle 4. Capacity Building

MFIs are aware of the importance of capacity building programs but are unable to implement them because they are very costly to run.

What needs to be done:

MFIs must develop capacity building programs and make every effort to implement them where they can afford the cost. MAMN must take up the responsibility of coordinating the capacity building programs in all the MFIs and also assist the MFIs in soliciting funding for the programs. Development partners should be requested to fund the programs through MAMN and in some cases directly to the MFIs.

Action:

Development partners, MFIs and MAMN

Theme 2: Regulation and Supervision of Microfinance

Obstacle: Lack of Legal and Regulatory Framework

MFIs are currently being registered using different Acts. Some MFIs that are ready to take deposits are not allowed to because of the restrictions under the relevant Act. However, the conference observed that for MFIs to expand their capital base they need to make savings an integral part of their services; therefore, the need for an appropriate legal and regulatory framework.

What needs to be done:

Government through the Reserve Bank of Malawi must speed up the process of developing a regulatory framework for microfinance and the conference recommends a separate legal and regulatory framework with RBM's supervision.

Action:

Government through the Ministry of Trade and Private Sector Development, the Reserve Bank of Malawi, and Development partners engage in a consultative process with all stakeholders.

Theme 3: Rural and Agricultural Finance

Obstacle 1: Availability of Loan Funds

MFIs are failing to meet the demand for loans because of unavailability of adequate capital. Most of the MFIs depend on original funds donated by cooperating partners. Due to the laws governing the operations of most of the MFIs, they are not allowed to take deposits, which would enable the MFI to increase loanable funds.

What needs to be done:

Government must speed up the formulation of an appropriate legal and regulatory framework that will enable some MFIs to start offering savings services to their clients that would increase the Loan Funds. Government should consider organizing a wholesale funding organization to enable MFIs to access these funds and lastly development partners must continue to assist start-up MFIs and other MFIs with capital development funds.

Action:

Government, MFIs, and Development partners

Obstacle 2: Poor Infrastructure

The country has poor road networks especially in the rural areas. Telecommunication and other facilities like electricity are not available in many rural areas which makes it difficult for MFIs to expand services to those areas.

What needs to be done:

Gov should develop appropriate infrastructure to enable MFIs expand services to the rural areas in order to reach many people that are otherwise excluded from financial services.

Action:

Government and development partners

Obstacle 3: Political Influence

Government is currently involved directly in credit delivery, which is bringing distortions on the market. A program like MARDEF, unless it is carefully administered, could impact negatively on MFIs operations, from among other factors, capping of the interest rate.

What needs to be done:

Government should avoid providing financial services and should move towards privatizing all public microfinance services. Meanwhile, government must follow the Microfinance Policy and best practices.

Action:

Government

Obstacle 4: Poor Credit Culture

There is poor credit culture in Malawi mainly because of lack of understanding of the clients and political interference.

What needs to be done:

MFIs must have strategic alliances with community-based organizations, input suppliers and dealers in order to have a joint effort in curbing the problem. MFIs must also provide training to the clients. MAMN must engage politicians in the discussion on best practices in the provision of microfinance services and the politicians should avoid misinforming the public about credit and activities of microfinance. Lastly, all MFIs must develop capacity building programs.

Action:

Government, MFIs and development partners

Theme 4: New Markets in Malawi Microfiannce

Obstacle 1: Lack of Partnerships and Linkages

Many organizations in Malawi are working in isolation; however, partnerships and linkages would help the organizations expand services.

What needs to be done:

MFIs must have strategic alliances with community-based organizations or other service providers in order to expand their services.

Action:

MFIs, Input suppliers, and service providers interested in expanding services in rural areas to engage in partnership building.

Obstacle 2: High Cost of Providing Services to the Agricultural Sector

MFIs find it very costly to provide services to the agricultural sector because of a number of cost drivers like administrative costs e.g. transport, monitoring expenses, and training.

What needs to be done:

Strategic alliances would help to reduce some of the expenses MFIs incur when providing their services. Appropriate infrastructure would also reduce costs.

Action:

MFIs and input suppliers / dealers, community-based organizations, and government to ensure there is appropriate infrastructure

Obstacle 3: High Cost of New Technologies

MFIs are aware of the importance of using new and improved technology but it is very expensive as a result, some are still using manual systems, which is slow and prone to fraud.

What needs to be done:

Development partners must assist MFIS to acquire new technology so that they can expand their services. MAMN should also coordinate technology requirements of MFIs so that as a network they can approach technology providers and take advantage of economies of scale.

Action:

Development partners, MAMN and MFIs

Conference Recommendation

The Conference findings clearly indicated that there is need to have a National Strategy for building an inclusive financial sector in Malawi. The National Committee on International year of Microcredit (IYM) 2005, and the National Steering Committee for the National Conference on Microfinance should transform into a National Committee for Building Inclusive Financial Services Sector in Malawi. It is important for the National Committee to put in place a mechanism, which will allow for a National Forum chaired by the Ministry of Trade and Private Sector Development to establish working committees in line with the themes of this conference for the promotion of the microfinance sector.

Appendix 3: Brief Report on the IYM National Conference

Brief Report on the International Year of Microcredit National Conference Presented to the Minister of Trade and Private Sector Development, Hon. Dr. Martin Kansichi, on 13 February 2006 in Lilongwe.

Hon. Minister of Trade and Private Sector Development, Dr. Martin Kansichi, Principal Secretary and your staff in the Ministry, Mr. Bill Chanza representing UNDP/UNCDF, Mr. Victor Luboyeski representing USAID and in particular DMS project, the Chairman of Malawi Microfinance Network, my Colleagues in the National Committee, Ladies and Gentlemen. It is an honor for me and my colleagues to appear before you Sir.

We are present today to brief you on the recommendations and submissions of the National Microfinance conference held on 27 and 28th of November 2005 at Capital Hotel here in Lilongwe. We are grateful to you for the support extended to our National Committee through your ministry. The Principal Secretary Mr. Kumwembe on your instructions opened and closed the conference. The conference attracted 118 top-level decision makers from all sectors of our economy with a bias to building an inclusive financial sector. The epicenter of the conference was four-dimensional. The four themes directly affect the development of our country and economic advancement of its citizens through microfinance. The themes were as follows:

1. Microfinance Best Practices;
2. Regulatory and Supervisory Framework;
3. Rural and Agricultural Finance and;
4. New Markets in Malawi Microfinance sector

The conference made the following recommendations;

1. Microfinance Best Practices;

a. The Government of Malawi should implement Microfinance Policy approved by the Cabinet in 2002. The Policy framework guides all sectors of microfinance in Malawi on their roles. The government has pivotal role in the policy in terms of creating an effective and enabling environment that supports the operations of microfinance institutions. The conference agreed that an enabling environment would consist of appropriate legislation, regulation and supervision for the microfinance sector.

b. In order to harmonize the financial sector and allow the poor access to current financial services products, Malawi needs to build an inclusive financial sector. In order to achieve this goal a National Taskforce needs to be set up with specific mandate to formulate a National strategy on Building an inclusive Financial Sector. Hon. Minister, UNCDF is already assisting other countries. Senegal is a perfect example. The conference submission is that government should approach UNDP in Malawi to fund and provide technical assistance in this area. The conference noted and appreciated that USAID through DMS Project is supporting efforts to build an inclusive financial sector.

c. The Government of Malawi should revive National Microfinance Forum which should be chaired by your Ministry. The membership will comprise of government ministries directly or indirectly involved in microfinance including Ministries of Finance, Economic Planning and Development, Agriculture and Food Security, Local Government and Rural Development, Gender child Welfare and community Services, Reserve Bank of Malawi, Universities, Microfinance Institutions, Donors and many more. The forum provides an excellent contact and dialogue forum for development of microfinance issues. It provides an excellent meeting place for donors, practitioners and government in resolving and exploiting opportunities in microfinance. Our submission to the government and development co-operating partners is to fund its operations.

d. The government and donor community should deliberately strengthen the Malawi Microfinance Network - MAMN. In order to ensure that microfinance organizations are following best practices and training interventions are being co-ordinated, there is a need to have a vibrant MAMN with strong resource capacity base. The network must be a source of all microfinance sector information in the country. The network must hatch research requirements, co-ordinate all research work, publish and disseminate findings for the benefit of the country. Our network Sir, has been struggling since establishment in 1997 due to inadequate funding. We do not have a full-fledged secretariat with a full time Executive Director. Your support for the goals and objectives of the Network would encourage donors and other cooperating partners to provide the Network with the assistance it requires. Currently, UNDP/UNCDF and USAID through its DMS Project are reviewing requests for funding. Hon. Minister we would appreciate your deliberate efforts on your part to directly engage with the development cooperating partners who have expressed interest in assisting MAMN and others, including NORAD/SIDA, ADF, DFID, EU, World Bank who have requested government recommendation.

e. Most of the existing MFIs lack sufficient loan funds for lending. Most MFIs presently cannot mobilize savings and on lend. In the interim the Government should spearhead the establishment of a wholesale microfinance organization. Apex Funds could lend to microfinance institutions at concessionary rates based on the need of an MFI and its performance in terms of best practices. The Apex Fund also promotes issues of sustainability and availability of credit lines as well as sound performance of microfinance institutions. The conference Sir expressed a wish that such Apex Fund would easily incarnate from the current MARDEF.

f. The conference identified that one of root causes of bad practices in microfinance in Malawi is capacity problems in all sectors. The conference proposes that Government should assist the current institutions in developing microfinance curriculum.

g. The conference lamented the poor credit culture prevalent in the country. The conference recognized that the poor credit culture is broadly not tackled due to non-existence of credit reference bureaus. The conference noted that it is difficult to set up one in Malawi due to lack of National Identification system. The conference is requesting government through you Sir that Ministry of Home Affairs and Internal Security should expedite the implementation of the National Identification Project.

h. The conference furthermore noted that poor credit culture in Malawi is as a result of bad financial services supply being extended by government, some donors and non-governmental organizations. The conference calls upon government to implement the Microfinance Policy already approved as a remedy to this problem and that all microfinance interventions must pass through the Malawi Microfinance Network and discussed in the proposed National Microfinance forum.

2. Regulatory and Supervisory Framework.

a. The conference recognized that Malawi microfinance sector is not regulated and does not have any supervisory framework. The conference noted that a process being managed by a Taskforce led by Reserve Bank is underway. A team of consultants is on the ground doing the research, which will culminate into a Cabinet paper on Microfinance Regulation and Supervision Framework and a draft Bill. The major obstacles being faced is that the funding made available by ADF through your ministry's initiatives may not suffice and furthermore, there is a need for study tours to some countries that have such laws. Through you sir, we request our development cooperating partners to assist.

3. **Rural and Agricultural Finance**

a. The conference recognized that Malawi is an agricultural country and therefore requires a vibrant rural agricultural finance. The conference was saddened to note that in the last ten years or so , various factors including breakdown in social infrastructure, erratic rainfall patterns and poor credit culture made it extremely difficult for microfinance organizations to operate in the rural areas. The conference submits to you sir, that government and our development co-operating partners should concentrate in investing in the social and physical infrastructural development in the rural areas.

b. The conference further noted that Agricultural Extension services and Agricultural Clubs are almost non-existent in the country. This scenario makes provision of microfinance services to farmers difficult and unattainable. The conference submits to the government through you sir that Ministry of Agricultural and Food Security should corroborate with grower associations in strengthening extensions services. The work of NASFAM, FUMU, TAMA, ASSIMAG etc is wonder.

4. New Markets in Malawi Microfinance sector

a. The conference explored avenues whereby microfinance organizations can form strategic alliances and business linkages with other stakeholders in order to serve the microfinance markets efficiently. The linkages of information communication technologies, the biodata and chip technologies, the contract farming, the commercial banks microfinance partnerships, the insurance and microfinance partnerships were all explored and the conference recommends that institutions apart from working through National Strategic Framework for building all-inclusive financial sectors should vigorously explore avenues to link up. The government should provide an enabling environment and enhance regulation that supports the development of new markets.

Hon. Minister am indebted to you sir for affording us this opportunity to meet you and brief you of our conference. Through you sir, I thank UNDP/UNCDF and USAID for funding this conference. I thank you so much Sir.

Chairman – National Committee

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Endnotes

[1] Source: David Porteous

[2] Households and institutions save and invest independently. The financial system's role is to intermediate between them and to cycle funds to where they are needed. As the economy develops, indirect lending by savers to investors becomes more efficient; subsequently, financial assets grow faster than GDP. This process, financial sector deepening, creates wealth that further enhances savings and investment, facilitating economic growth (World Development Indicators 2000).

[3] This concept recognizes the household as an economic unit demanding productive, consumptive and other resources with multiple sources of income and expenditure.

[4] The concept of the "finance frontier" and innovation in financial markets draws from the work of J.D. von Pischke.

[5] Clients "exit" from a service when they decide to stop taking loans. Clients may exit because the product does not meet their service needs, when profit margins are too thin to enable repayment, or if affected by a calamity, like illness or drought.

[6] Chapter 1 adapted from *Microfinance in Turkey* (Burritt, 2003).

[7] Community based financial institutions emerging in Europe in the 19th century on the other hand did become integral parts of the financial system largely attributed to the fact they were regulated and supervised as licensed financial institutions; whereas in many developing country markets they were and remain outside financial sector supervisory mechanisms (Seibel).

[8] A financially self-sufficient institution generates enough revenue to cover all its costs, including non-cash costs like the cost of inflation and the full costs of funds at commercial prices, and generates a surplus.

[9] The concept of extending the finance frontier is used by J.D. Von Pischke in *Finance at the Frontier.*

[10] Payment services include funds transfer between account holders, for example to transfer funds among family members dispersed geographically, to pay utility bills, to

receive payments, for example, from government programmes or tobacco traders selling smallholder production on the auction floor.

[11] This measures the extent to which expenditures exceed revenue as a % of GDP. A global benchmark is < 3%.

[12] Import cover is defined by the number of months that foreign exchange reserves can cover imported goods. The import cover global benchmark is at least 4-6 months. Where import cover is low, there is pressure on the value of the currency and thus vulnerability to devaluation and thus the performance of banks and prices for agricultural producers and traders.

[13] The Human Development Index (HDI) measures a country's achievements in three aspects of human development: longevity, knowledge and a decent standard of living.

[14] All figures here reported at current, not 2004 rate.

[15] The potential for change in the price and the value of an asset or commodity.

[16] See *Rural Financial Services Through State Bank, CGAP, January 2004,* for a more detailed explanation of the options.

[17] On-farm activities were considered MSEs if 50% f their farm production was sold and households earned more than MK 6,000 ($75 in 2000 terms) from their sale. MSEs are defined here as firms with up to 50 employees, but the huge majority of MSEs (91%) have 0-4 employees.

[18] This corresponds roughly with microfinance loan sizes of primary players (in-kind and cash) that predominantly fell between $45 and $300, with some loans both larger and smaller.

[19] The breakdown of borrowers is roughly 95,000 smallholders (receiving loans on average between MWK 10,000 and 12,000); 9,000 estate farmers (receiving loans on average between MWK 20,000 and MWK 30,000 but up to MWK 60,000); and 30,000 very poor borrowers including 10,000 farmers and 20,000 members of IFAD supported groups.)

[20] The loan package for the 2003/04 growing season was designed to supply inputs for the cultivation of up to .5 hectare of maize and additional areas of legume crops (fertilizer, maize seed, and other legume seeds. Since the vast majority of farmers will not sell maize production, the legume seeds are provided so that farmers can generate some income from the sale of legumes to repay loans.

[21] PAR (Portfolio at risk) is defined as balance of loans with any installment more than 30 days past due.

[22] The study warned however that the numbers should be interpreted with caution because they extrapolate from numbers where the survey was carried out, which may not necessarily represent the country as a whole.

[23] Crop production activities were considered MSEs if they generated annual sales of MWK 6,000 ($75 at the time was carried out).

[24] Hedging is a financial arrangement that offsets a price risk by transferring risk inher-

ent in one transaction to another with more robust capacity to manage that risk.

[25] Social Responsible Investment Funds (SRIs) seek returns, but often below mainstream commercial rates.

[26] A note of caution, even though savings deposits appear to be a "low cost" source of funds, savings mobilization can be costly and requires specific capacity for prudential management. This capacity is particularly important within the context of savings products targeted at low-income populations that have high demand for sight deposits, which tend to be more volatile than other deposit products. The value of significant market research to understand clients' needs and behaviors, and a thorough understanding of the business of savings mobilization is critical.

[27] Johnson, Susan, James Copestake and Kadale Consultants. *FINCA-Malawi Impact Assessment Research.* Final Report. April 2002.