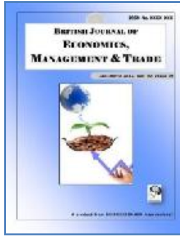

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Role of Regulation in Micro Finance: Application of the Micro Savings Requirement Scheme in Informal Sectors

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Author's contribution

The only author performed the whole research work. Author MO wrote the first draft of the paper. Author MO read and approved the final manuscript

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ABSTRACT

This paper not only addresses how linkages, direct and facilitating linkages, can benefit microfinance institutions – and particularly in jurisdictions where the Savings Group Outreach involvement is particularly low, but also illustrates ways and means whereby group lending and other more recent innovative methods used by micro lenders to secure repayments, could increase the desired effects, efficiency and impact of microfinance in selected jurisdictions. In so doing, it addresses some of the existing and persisting problems of micro finance in rural areas.
An innovative aspect of the paper is evidenced through its recommendation of the Micro-Savings Requirement Scheme - which offers numerous benefits – as will be highlighted in this paper.

Keywords: Microfinance; regulation; agency theory; micro-savings requirement scheme.

1. BACKGROUND TO THE STUDY OF THE ROLE OF REGULATION IN MICRO FINANCE

The basic issues underlying the impediments and challenges faced in microfinance relate particularly to those presented by risk and asymmetric information. Risk being partly attributed to inavailability of collaterals which can be secured by micro lenders and

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asymmetric information which also partly arises as a result of adverse selection. Both features are well known characteristics of financial regulation – the rationale for financial regulation being an embodiment of risk (that is, systemic risks) and asymmetric information. The type of risk associated with microfinance stems largely from uncertainty. Even though risk and uncertainty are frequently used interchangeably, they are distinguished from each other based on their capability of being quantified. Risk is a term usually considered to be more capable of being quantified while uncertainty is also a form of risk which is to a larger extent, considered to be unquantifiable.[1] Group lending, widely acknowledged to be an underlying and defining feature of microfinance, is an innovation which has been proposed to address the challenges relating to the need to facilitate repayments being made to the microlender whilst financial linkages have also evolved as a means of addressing problems presented from a lack of formal institutions operating within rural areas.

1.1 Introduction

An array of approaches has been used in the African microfinance industry - ranging from traditional group based systems to specialised lending by banks, by non-governmental organisations (NGOs), non bank financial institutions, cooperatives, rural banks, savings and postal financial institutions.[2] The majority of microfinance efforts and institutions in Africa operate in the informal sector and it was only in the 1990s, with the intervention of international cooperative movements and specialized NGOs that microfinance was able to reach more clients in Africa – such as the one million clients which exist in Ethiopia.[3]

Given the above statement, as well as figures and facts which support the evidence that a huge component of microfinance activities in Africa revolve round the informal sector, the role of regulation immediately becomes apparent. Without regulation, huge challenges are certainly and most likely to be presented to the microfinance industry in respect of the rationales for the embodiment of financial regulation – that is, issues relating to risks and information asymmetries.

According to Armendáriz de Aghion and Morduch,[4] the absence of formal credit institutions in village economies is often attributed to agency problems[5] – which are accentuated when individuals cannot offer seizable collateral, and when legal enforcement mechanisms are weak.

The above statement therefore also illustrates the link between the issue relating to an inability to provide collaterals, as well as that relating to the agency problem of asymmetric information. Even though such innovations as group lending and financial linkages have gone a huge way to address underlying issues in microfinance, several inefficiencies in the form of high transaction costs (and a proper understanding of what resources and products

[1] *Risk is traditionally associated with probability calculation – which suggests that an event can be predicted and controlled. Uncertainty, however, is not capable of measurement and deals with possibilities incapable of calculation which are based on guesswork and judgement. (Gray and Hamilton, 2006:20) [1]*

[2] *(African Development Bank, 2006: v)[2]*

[3] *Ibid at page 3. Also see Adams et al., 1992.[3]*

[4] *(2005:36)*

[5] *In this sense, three types of agency problems are presented by Armendáriz de Aghion and Morduch, namely: Firstly, the lender having little if any, reliable information about the quality of the borrower (prior to extending a loan); secondly, once the grant of the loan has occurred, the lender does not know entirely how the borrower will use the resources; and thirdly, the lender's inability to verify the magnitude of the returns – once the investment returns have been realized. See ibid*

are most beneficial to microfinance clients in rural areas) still persist. According to CARE,[6] some of the reasons why past efforts involving group linkage has been quite challenging include not only the fact that products have been inappropriate to meet the needs of group members, but also other factors embracing a lack of consideration by linkages of the structure or operating principles of savings groups, as well as a lack of unanimous agreements between group members.

The aims and objectives of this study includes investigating how linkages, both direct and facilitating linkages, can benefit microfinance institutions in Africa – and particularly countries such as the Central Africa Republic, Eritrea, Guinea Bissau, Nigeria and Somalia, where the Savings Group Outreach involvement is particularly low when compared to other African countries. The study also illustrates ways and means whereby group lending and other more recent innnovative methods used by micro lenders to secure repayments could increase their desired effects. Furthermore, the study incorporates the role of regulation in achieving the desired effects of microfinance – in particular, in respect of asymmetric information (agency problems), as well as in mitigating risks emanating from the lack of collaterals in microfinance.

Incentives which are aimed at encouraging formal and less formal institutions to engage on a greater scale, in direct and facilitating linkage arrangements should focus on practices which would facilitate better corporate governance measures. Such incentives including shares or stock options for the Board and management of these institutions – since results from empirical based research have revealed that such agents are more likely to serve the interests of the principal better where their interests are tied up in the firm's shares. Such incentives, however, should be long term based – rather than short term since greater risks may be taken by such agents where they are compensated and rewarded on a short term basis.

This study limits its scope to a brief jurisdictional analysis through a case study which highlights scenarios and situations involving India, Mali, Indonesia, The Phillippines, Honduras and Costa Rica. Hence further suggestions for research could embrace a jurisdictional analysis which paves the way for a more detailed comparative analysis between these jurisdictions. Such comparative analysis could also incorporate empirical based results which would facilitate a basis for international comparisons.

Furthermore, owing to the extant literature on the topic, as well as findings which have revealed that low income clients would rather build and consolidate on assets which help in reducing risk before they start incurring debt, micro savings has been focused on. Very little reference has been made to micro insurance – hence this area is strongly recommended as a suggested future research area in considering its impact and importance to rural inhabitants in their quest to obtain micro credit facilities. Such literature will be considered under the following section.

2. REVIEW OF THE LITERATURE

As highlighted in the previous section, even though such innovations as group lending and financial linkages have gone a huge way to address underlying issues in microfinance, several inefficiencies in the form of high transaction costs (and a proper understanding of

[6] *(CARE, 2011: 39). [4] See also Labie,1998 [5] and McDonald, 2013.[6]*

what resources and products are most beneficial to microfinance clients in rural areas) still persist. This section aims to address issues which have contributed to inefficiencies which, in turn, have accentuated the difficulties and challenges faced by rural inhabitants in gaining access to microfinance facilities. Further, the section aims to contribute to the literature on the current topic by proposing new schemes and arrangements whereby such innovations as group lending and financial linkages could be optimised and implemented with greater efficiency as well as with the aim of generating more beneficial results.

2.1 Conceptual and Theoretical Frameworks

Micro finance is defined as banking and/or financial services which are targeted at low-and-moderate income businesses or households – including the provision of credit.[7] A microfinance institution is also considered to be a financial institution which could be a non profit organisation, regulated financial institution or commercial bank which provides microfinance products and services to low- income clients.[8]

Implementing case study methods, embarked upon the quest to improve an understanding of financial linkages which is aimed at improving rural access to savings, insurance, money transfer and payment services, as well as credit.[9]

Over the past recent years, an increasing number of formal institutions have entered into and engaged themselves in collaborative relationships with less formal institutions. Such relationships could be based on direct financial linkages and facilitating linkages.

Direct financial linkages are considered to be linkages between financial institutions whose main purpose of the linkage is to help less formal institutions diversify their sources of funding[10] whilst facilitating linkages are linkages between institutions in which the formal institutions hires the less formal institutions to act on its behalf. Cases which were used by Pagura and Kirsten to illustrate such collaborative relationships include those from:[11]

- India (ICICI Bank, India's second largest commercial bank's partnership with MFIs in several unique ways to extend credit directly to Self Help Groups in rural areas);
- Mali (where the Banque Nationale de Developpement Agricole, BNDA, is said to have a long history of serving less formal institutions through bulk loans and lines of credit as well as savings accounts to help institutions address cash flow and portfolio expansion projects.
- Indonesia: Where the Bank Pembangunan Daerah (BPD) is acredited with playing a significant parenting role for customary village banks (LPDs) through the provision of services which include staff training, monitoring, as well as supervisory services. The

[7] (African Development Bank, 2006 : iii)[2]
[8] ibid
[9] (Pagura and Kirsten, 2006;page 3 of 15)[7]. According to them, „successful cases in Bolivia, Costa Rica, Honduras, India, Kenya, Mali, Peru, the Phillippines, Rwanda and Tanzania were selected because of the following factors:
- Such cases demonstrated success in expanding access to under-served rural market segments;
- They were based on cost covering principles or had clear exit strategies (if they were externally supported);
- They had been in existence for two or more years
- They added to the diversity of linkages types."see ibid at page 4
[10] See ibid at page 5
[11] For an in-depth analysis of case studies on these countries, see ibid at page 8

BPD is also involved in providing LPDs with savings and loans services which are aimed at assisting smaller institutions in managing their liquidity more effectively.

- The Phillippines: Where government owned apex organisation" PCFC, is involved in a partnership with several microfinance actors through the provision of wholesale credit and training to such institutions.
- Honduras: Covelo, a private first and second tier organisation" provides loans and lines of credit in bulk quantities, to MFIs as well as contributes immensely in the consolidation of internal systems and controls which are aimed improving self-regulation mechanisms.
- Costa Rica: Where the promotion of the incorporation of village banks in the late 1990s by Finca-Costa Rica, a move which was instrumental in paving the way for all units in the network to establish relationships with commercial lines of credit and other financial services, is highlighted.

According to Atkinson et al.,[12] Savings treatments also generate faster pay-down of debt and weakly better overall repayment performance, suggesting that simultaneous savings and borrowing can be complementary activities. They also make reference to a theoretical model which illustrates that the simultaneous provision of debt and a selfcommitment savings products helps a greater fraction of the population to eventually escape a debt-financed equilibrium.

It is also recommended by McDonald[13] that there should be a greater emphasis should be placed on the non-loan aspects of microfinance - such aspects including both financial and non-financial services.

2.2 Global and Jurisdictional Challenges Encountered by Microfinance

As highlighted under the introductory section, basic issues underlying the impediments and challenges faced in microfinance relate particularly to those presented by risk and asymmetric information. Other challenges which are more jurisdiction-specific, and with particular respect to microfinance in Africa, include:[14]

- The absence of strong retail capacity in microfinance institutions (this being considered to be the single largest constraint in the expansion of outreach of financial services to the poor in Africa;
- Extension of access to financial services to the remotest of rural areas in a cost effective manner;
- The impression that microfinance is a social system of resource transfers to beneficiaries at subsidized interest levels, rather than a part of the financial sector – such impression being considered as an explanatory factor to why national enabling environments still restrict MFIs from transferring and moving savings;
- Infrastructure required for microfinance – such infrastructure including training services and facilities, information technologies, credit bureaus.

Given the relatively low Savings Group Outreach involvement in countries such as the CAR, Eritrea, Guinea Bissau, Nigeria and Somalia, where the Savings Group Outreach

[12] *(Atkinson et al., 2012). [8] Also see Rahman, 2003 [9] and Tchouassi 2011[10]*
[13] *(McDonald, 2013:pages 95 and 96)[6]*
[14] *(African Development Bank, 2006:[2] vii). Also see Ahlin et al., 2008, 2010)[11,12]*

involvement (see Table 1) is particularly low when compared to other African countries, it can generally be inferred that there are huge problems and challenges faced in microfinance as regards access to microfinance facilities by rural clients.

As well as providing the explanation why more than 80% of all households in developing countries do not have access to institutional banking services because they lack the collateral to secure loans from formal financial institutions, Okpara also adds that, empirically, there are four major critical factors inhibiting the performance of banks in Nigeria and these are:[15]

- Undue Interference from Board Members
- Political Crises
- Undercapitalization
- Fraudulent Practices

Further as documented by the Central Bank of Nigeria, despite decades of public provision and direction of provision of micro credit, policy orientation, and the entry of new players, the supply of microfinance in Nigeria is still inadequate in relation to demand – suggesting that there is some inefficiency in microfinance operations in Nigeria due to some institutional inadequacies such as undercapitalization, inefficient management and regulatory and supervisory loopholes.[16]

3. RESEARCH METHODOLOGY AND DESIGN OF THE STUDY

The research adopts a predominantly analytical, qualitative approach, as well as comparative approach in arriving at the results and findings of the study, and also in drawing conclusions and recommendations for further study. The section, immediately following the introduction, considers economic theories as well as other literature on the study which have shaped the present literature on the topic. Not only does it aim to explore why there is still an existing gap in the literature,namely, why many rural parts in Africa have no access to microfinance facilities, it also proposes a means whereby such a gap can be mitigated or eliminated. It will have recourse to present innovations in microfinance, as well as incorporate the economic theories discussed in the section in proposing a scheme which should assist in mitigating (if not totally eliminating) the present gaps in the literature. The approach adopted in the study will then be considered before the findings and conclusions to the study are arrived at.

15 (Okpara, 2009: page 5 of 15)[13] and Okpara 2010 [14]

16 Adeyemi (2008)[15] Central Bank of Nigeria Bullion, 32(1) 26-34; cited in Ibid . See also Ghosh and Debraj 1997 [16]

Table 1. Savings groups outreach

Region	Country	AFK	CARE	CRS	Oxfam	Pact	Plan	World Vision	Totals
N. Africa	Egypt		2,845				17,231		20,076
W. Africa	Benin		5,621	33,450			19,722		58,793
	Burkina Faso			9,766	4,000		35,340		49,106
	Cameroon		500	5,833			4,614		10,947
	Congo Republic								0
	Cote d'Ivoire		21,244						21,244
	Gabon								0
	The Gambia								0
	Ghana		22,382	11,238			18,414	1,202	53,236
	Guinea								0
	Guinea-Bissau						1,478		1,478
	Liberia		1,634	779			498		2,911
	Mali		117,562	10,387	338,745		18,903		485,597
	Niger		238,366	451			15,830		254,647
	Nigeria			1,214					1,214
	Senegal			8,345	40,344		849		49,538
	Sierra Leone		30,322	4,516			7,394	6,926	49,161
	Togo						23,008		23,008
East and Central Africa	Burundi		153,209	11,526					164,735
	CAR			1,046					1,046
	Chad								0
	DRC		12,977	5,402					18,379
	Ethiopia		85,223	16,998		14,604		85,875	202,700
	Eritrea		1,000	135					1,135
	Kenya		284,300	89,221		7,276	10,945		391,742
	Rwanda		181,367	37,850			2,340	167,535	389,092
	Somalia		2,000						2,000
	Nothern Sudan			6,028					6,028
	Southern Sudan		1,090	2,049					3,139
	Tanzania	2,556	383,915	71,333		10,255	40,396	12,524	520,979
	Uganda		456,932	72,893		7,600	53,367	4,520	595,312
S. Africa	Angola		9,115						9,115
	Lesotho		12,847	1,499					14,346
	Madagascar	1,909	8,513	1,511		3,010			14,943
	Malawi		102,633	18,179				4,165	124,977
	Mozambique	876	92,630					10,971	104,477
	South Africa		10,906						10,906
	Swaziland							15,786	15,786
	Zambia		1,000	1,005			13,309		15,314
	Zimbabwe		136,781	11,467			2,620	652	151,520
	Total # of SG Members	5,341	2,376,914	434,124	383,089	42,745	286,258	310,156	3,838,627
	Total # of SGs	284	119,409	22,702	17,555	1,989	6,867	3,299	172,105
	Avg. # of Members per SG	19	20	19	22	21	19	N/A	20
	% of Members Who Are Women	65%	77%	70%	100%	99%	73%	77%	80%
	% of Groups Formed By Non Paid Project Staff	0%	64%	8%	60%	N/A	40%	N/A	43%
	Avg. Savings Balance/Member	$14.05	$19.66	$11.32	$14.34	$10.49	$24.11	$1.29	$13.61
	Avg. Loan Size/Member	$29.35	$29.71	$108.20	$2.00	$11.87	$60.00	N/A	$40.19
	Total Assets	$4,494	$17,278,332	$5,288,451	$5,492,141	$483,797	$4,547,735	$399,490	$33,494,440

2011 | Microfinance in Africa: State-of-the-Sector Report

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Source: CARE, CARE-Access-Africa-Closing-the-Gap-2011 Microfinance in Africa: State of the Sector Report at page 12

4. ECONOMIC THEORIES UNDERLYING CHALLENGES FACED IN MICROFINANCE: PRINCIPAL AGENT RELATIONSHIP, ASYMMETRIC INFORMATION AND THE PROBLEM OF INCOMPLETE CONTRACTS

Agency theory explains a mismatch of resources and abilities. (Armendáriz de Aghion and Morduch, 2005:47)[17]

This section is aimed at addressing how such a mismatch of resources and abilities can be addressed. It will also seek to illustrate how the above-mentioned components, namely, principal agent relationship, asymmetric information, and the issue relating to incomplete contracts are linked. Asymmetric information being a feature of many agency relationships and necessitating a role of monitoring on the part of the principal. If the contracts between a principal and the agent were designed in such a way that it was a complete[17] contract, it would reduce the scope at which the agent is encouraged to act in ways which support his personal interests and goals. However, since a degree of flexibility is required in the design of such contracts, it is inevitable that they end up being incomplete. Even in formal financial institutions where regular monitoring and regulation is carried out, principal agency problems arising from incomplete contracts still arise. For this reason it is vital to incorporate some elements of such formalised institutions, namely monitoring and regulation, into the activities of less formalised institutions. Hence, this section considers exclusively how regulation could be better incorporated into microfinance via formal institutions.

As highlighted under the introductory section, the issue of asymmetric information is a very probable and likely characteristic of microfinance institutions in Africa given the fact most microfinance activities revolve round the informal sector – hence the likelihood that such activities will be subject to monitoring, enforcement and sanctions are very low. Furthermore, in the absence of monitoring, supervision and enforcement, certain consequences, namely those highlighted in the previous section, that is, undercapitalization, fraudulent practices, inefficient management and regulatory and supervisory loopholes, are likely and inevitable consequences.

Regulation is therefore to be regarded as a necessary and vital component which should be incorporated into the design of microfinance activities and contracts. Another common and recurring challenge faced by many financial institutions – which has deterred such institutions from engaging themselves in microfinance activities in rural areas, relates to high transaction costs. The relatively high cost of lending in rural areas is attributed to low population densities combined with low loan volume, poor transportation and communication facilities – which make unit delivery costs very high for small financial transactions[18] as well as for larger institutions that frequently operate in urban areas.

Hence if regulation is to be incorporated into microfinance via formal institutions, it should be done through a vehicle and design which is not only aimed at facilitating greater monitoring,

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[17] *It is frequently argued that the principal agent problem would not arise if it were possible to write a complete contract – however it is also added that complete contracts are unfeasible since it is impossible to foresee or describe all future contingencies. (Maher and Andersson, 1999:6)[18]*

[18] *As a result, it is not worth the substantial investment required to move into rural areas – as regards such larger institutions, and for this reason, in many African countries, the providers of rural finance are smaller locally based institutions. (African Development Bank, 2006:6)[2] See also Brandsma and Hart, 2001[19] and Duflos et al. 2013 [20]*

enforcement and supervision within the process but aimed at cost reduction for such institutions involved – be they formal or less formal institutions – particularly in rural areas.

An institutional arrangement and design which would facilitate the reduction of transaction costs for those institutions involved would not only help incorporate greater efficiency into the process, but should also provide clients with a wider range of products and services to choose from – products and services which would, more importantly, meet their needs. Furthermore, the design should be targeted at incorporating regulation, monitoring and supervisory activities at minimal cost for those institutions involved. Since information asymmetries are usually a typical feature of principal agent relationships, it is to be expected that some degree of monitoring will be necessary – particularly given the presence of externalities.

Theories and concepts relating to adverse selection and moral hazard have commonalities owing to the fact that risk is inherent in both. Adverse selection, an economical phenomenon which is said to occur when banks cannot easily determine which customers are likely to be more risky than others (hence preferring to charge riskier customers more than safer customers in order to compensate for the probability of default), is also considered to be instrumental in frequently driving safer customers out of the credit market – since the bank is not certain of who is who and in the process, raises interest rates for everyone.[19]

Another phenomenon, which occurs where bank clients are prone to take higher risks with their investments – especially owing to the fact that they are insured, which is also highlighted by Armendáriz de Aghion and Morduch[20], is moral hazard. Such problems attributed to moral hazard and adverse selection, according to Armendáriz de Aghion and Morduch, could be potentially eliminated if banks were able to engage in affordable means of gathering and evaluating information on their clients, as well as enforcing contracts.[21]

Given the major challenges presented by the inability of some microfinance clients to present collaterals, and the level of risk this presents to micro lenders, micro savings should constitute the primary basis of providing microfinance to any rural client who cannot provide collateral to obtain microfinance in the first instance.

Such an affordable means of gathering and evaluating information on their clients, as well as enforcing contracts, could be achieved through the arrangement of direct or facilitating linkages between formal and less formal institutions. In this sense, an allocation of resources can be achieved in such a way which is aimed at maximising efficiency as well as minimising costs. Such an arrangement/scheme (which will be referred to as the Micro Savings Requirement Scheme) is introduced as follows:

5. THE DESIGN OF CONTRACTS BETWEEN FORMAL AND LESS FORMAL FINANCIAL INSTITUTIONS AND THE ROLE OF CORPORATE GOVERNANCE: THE MICRO SAVINGS REQUIREMENT SCHEME

Where a client has been saving with an institution for at least three years and is capable of demonstrating a steady and acceptable level and source of income with such an institution,

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[19] *Armendáriz de Aghion and Morduch (2005:7)[17]*
[20] *Ibid*
[21] *See ibid at page 8*

preferably, a less formal unregulated institution such as self help groups, farmers' organisation, women's organisations, savings banks and NGOs, such a client should be compensated in form of an incentive – such incentive being provided by the institution which will eventually serve as microlender or provide a greater proportion of the micro lending funds (usually the more formal institution will be expected to provide more funding). The incentives could assume the form of financial backing – that is, an assurance that by saving with the less formal institution or bank, such clients would earn the prospects or possibility of getting the required microfinance after the three year period (or agreed period).

Naturally, the savings generated after the three year period should constitute a reasonable and acceptable percentage of the credit that will be eventually granted by the micro lender. In such cases, linkages between institutions – be it through direct linkage or facilitated linkage, plays a huge and important role since collaboration between formal and less formal institutions also provides an efficient means of diversifying client risks.

Where a client has retained a steady flow of savings over a desired and stipulated period of time with one of the institutions involved in the direct or facilitated linkage collaboration (such institution preferably being the less formal institution for instance, a village bank or savings club), the more formal institution should offer the guarantee of a grant of microfinance facility provided the savings generated over the required minimum period (with the less formal institution) constitutes an acceptable ratio which is considered reasonable enough for the more formal institution to offer such guarantee in granting the required micro credit facility to the client.

The more formal institution is also able to incorporate the previously lacking supervision and monitoring activities into the process once the minimum required savings period has expired. This also incorporates a degree of cost efficiency into the process since, initially, when the client was saving, the less formal institution (where the client had his/her savings) had less reasons to monitor customer activities. This being the case since greater risk was borne by the client (and not the less formal bank/institution) in placing savings with the bank.

However, with the expiration of the savings period and the fulfillment of conditions required to secure the grant of microfinance facility, the risk borne is now transferred to the more formal bank/institution – who in such a case is most likely to provide a greater proportion of the credit facility. Hence there will be greater need for the formal institution to instigate monitoring activities.

The less formal institution is not obliged to commit more resources (hence incurring costs) towards monitoring activities and the more formal institution will simply be engaged in activities which it was previously well equipped and specialised to engage in – thereby ensuring that no extra costs are borne by the less formal institution (in engaging in additional monitoring responsibilities) – and therefore ensuring that a more efficient allocation of resources is facilitated and that an incident resulting in a „mismatch of resources and abilities“ is reduced.

In determining the amount of risk that can be accepted or borne by such an institution, it could have regard to the amount of credit facility granted: relative to amount of savings in client's account, the loan repayments/loan repayment period, and other factors which could serve as indicators of the level of risk being assumed.

The importance of designing a contract which accurately and appropriately reflects all that has been highlighted in this section so far, cannot be over emphasised. Furthermore, good corporate and governance measures and practices will need to be incorporated into the relationship between the formal and less formal financial institutions if they are to effectively and efficiently undertake and execute their tasks and responsibilities.

Governance structures, according to Maher and Andersson, can be regarded as a mechanism for making decisions that have not been specified in the initial contract.[22] Furthermore they add that,[23] corporate governance not only constitutes a key element of improving microeconomic efficiency, it strongly influences resource allocation, as well as the behaviour and performance of firms, innovative activity, entrepreneurship, and the development of an active SME sector.[24]

Armendáriz de Aghion and Morduch [17] also argue that the inefficiencies of adverse selection can be mitigated through group lending.

– The Grameen group lending contract works very differently than a standard banking contract for small business. In a standard relationship, the borrower gives the bank collateral as security, gets a loan from the bank, invests the capital to generate a return, and finally pays the loan back with interest. Since Grameen clients are often too poor to be able to offer collateral, the Grameen contract takes advantage of the client's close ties within their community. To take advantage of those relationships, the loan contract involves groups of customers, not individuals acting on their own. The groups form voluntarily, and, while loans are made to individuals within groups, all members are expected to support the others when difficulties arise.

Even though group lending may serve as a greater means of enforcing repayment and the fulfillment of contractual terms and obligations, the benefits to be derived from a collaboration between formal and less formal institutions (through direct and facilitating linkages) within the context of clients who had no collaterals and initially had to start up through micro savings (in order to obtain the required microfinance facility), are definitely greater. Furthermore, the establishment of group lending arrangements, whilst also incorporating the joint liability condition and whilst facilitating enforcement, does not entirely or substantially address the issue relating to asymmetric information and agency problems.

In addition to the Micro-Savings Requirement Scheme which has been illustrated and described in this section, other features of the Grameen group lending contract could also be incorporated into the contract between formal and less formal institutions – that is group lending and the joint liability condition. However, this would not constitute a pre-requisite for the Micro-Savings requirement. Individuals should be free and eligible to undertake such schemes. The difference between the Micro-Savings Requirement Scheme which incorporates features of group lending and the joint liability condition and the Grameen group lending contract would be the added advantage which the former has over the latter. That is,

[22] *This being particularly the case since many contracts are incomplete contracts. (Maher and Andersson, 1999:6)[18]*

[23] *Ibid at page 4*

[24] *Poor corporate governance mechanisms in certain OECD countries, it is further argued, have proved, in part, to be a major impediment to improving the competitiveness of firms. It is also added that better corporate governance both within OECD and non OECD countries is capable of generating higher levels of economic growth. See ibid.*

whilst the Micro-Savings Requirement Scheme (which incorporates features of group lending and the joint liability condition) offers the added benefit of the client offering some collateral (in the form of savings), a collateral is lacking in the Grameen group lending contract.

CARE also emphasises the importance of microfinance institutions understanding the needs of those very poor people, most of whom live in hard-to-reach places.[25] The importance of loan terms being adequately tailored to meet the intended use of the loan, principals which are not too large, loan terms which are not too short, installment payment systems which fit the cash flow of the investment, are also emphasised.[26]

A number of reasons also proposed as contributory to why past efforts aimed at group linkage has been so challenging include the fact that products have been inappropriate in meeting the needs of group members, linkage has not taken into account the structure or operating principles of savings groups, and that unanimous agreement among group members to link, has been lacking.[27]

6. EMPIRICAL RESULTS AND FINDINGS ON CORPORATE GOVERNANCE

The following conclusions and findings were derived by Bhagat and Bolton in accentuating their contribution to the literature on corporate governance:[28]

- Better governance, as measured by GIM (the Gompers, Ishii, and Metrick)[29] and BCF[30] (Bebchuk, Cohen and Ferrell) indices, stock ownership of board members, and Chief Executive Officer chair separation, is significantly positively correlated with better and subsequent operating performance;
- That implications of the above-mentioned finding on corporate governance include namely, the need for focus on stock ownership of board members in the aim and efforts to improve corporate governance – since in their opinion, corporate governance is not only positively correlated to future operating performance, but also the probability of disciplinary management turnover in poorly performing firms.

It may then be asked or questioned: What are the rewards or compensation which would serve as incentives for those formal and less formal financial institutions to engage in direct or facilitating linkage arrangements aimed at assisting rural inhabitants in gaining access to micro credit facilities – and with particular reference to the proposed Micro Savings Requirement Scheme?

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25 See (CARE, 2011:39)[4]
26 ibid
27 ibid. See also United Nations, 2000 [21]
28 (Bhagat and Bolton, 2008:271)[22]
29 GIM G Index: "The G-Index is constructed from data compiled by the Investor Responsibility Research Center ("IRRC"), as described in Gompers, Ishii, Metrick (2003). A firm's score is based on the number of shareholder rights-decreasing provisions a firm has. The index ranges from a feasible low of 0 to a high of 24. A high G-Score is associated with weak shareholder rights, and a low G-Score is associated with strong shareholder rights. (Bhagat and Bolton, 2006: 34) [23]
30 BCF E-Index: The E-Index is constructed from IRRC data as described in Bebchuk, Cohen, Ferrell (2004). It uses a 6-provision subset of the GIndex. The index ranges from a feasible low of 0 to a high of 6;a high score is associated with weak shareholder rights and alow score is associated with strong shareholder rights. (Bhagat and Bolton, 2006: 34)[23]

As highlighted earlier on in the section, less formal institutions gain advantages in that the more formal institutions undertake monitoring and supervisory activities after the savings period has expired – thus incorporating greater monitoring and enforcement into the process. The more formal institutions should also benefit from better corporate structure and governance arrangements - through their collaboration with the less formal institutions. There may, initially, appear to be some sceptism as regards this view – however greater accountability might be incorporated into the corporate governance process where two institutions (both the formal and less formal) are involved. Based on the empirical results of Bhagat and Bolton,[31] as previously discussed, such improved better governance, should generate better performance results, hence greater profitability.

Even assuming that the empirical results of Bhagat and Bolton are not taken into consideration, and that a collaboration between the less formal and formal institution (via direct or facilitating linkages) does not improve the governance structure of the formal institution, the formal financial institution would still benefit from the process if it generates corporate social responsibility (CSR) reports through which the general public and its extended stakeholders are able to view the positive contribution being made by the firm in improving the lives of those living in poverty through better access to microfinance facilities (micro savings and micro credit facilities inclusively).

6.1 Recent Developments in Microfinance

It is increasingly being acknowledged that microfinance and the provision of micro credit may not always offer the best solution in addressing the needs of the poor. Further, it is maintained that other strategies may serve to better address the issues of social exclusion and poverty.[32] According to Rosset Cambier, a number of examples have been provided of combined microfinance schemes which have very low levels of outreach and are limited in their services owing to geographical, cultural or financial reasons.[33] Further, he adds that there is need for more thorough and formative evaluation approach to combined microfinance evaluation – which builds on lessons learned dealing with combined product design and implementation.[34]

Emerging trends also reveal that many micro lenders are adopting more flexible approaches in obtaining collaterals – particularly given the need and urgency to work more effectively in not so densely populated areas. Such trends include:[35]

- Progressive Lending : The practice of promising larger and larger loans to groups and individuals in good standing. It is also considered to enable the lender to test borrowers with small loans at the start in order to screen out the worst prospects before expanding the magnitude of the loan.
- Public repayments
- Repayment schedules with weekly or monthly installments
- Targeting of women

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31 (Bhagat and Bolton, 2008:271)[22]
32 (Rosset Cambier, 2004:21)[24]
33 ibid
34 Ibid at page 22
35 Flexible approaches to collateral where what matters most, is the value that the customer attaches to losing the item – rather than the value that the lender expects to recover from selling the item. (Armendáriz de Aghion and Morduch, 2005: 119,125 and 142)[17]

7. RESEARCH METHODOLOGY

As indicated under the introductory section, the research will adopt a predominantly based qualitative and analytical approach in arriving at the results and findings of the study, as well as in drawing a conclusion and recommendations for further study. Even though references will be made to empirical research, an analytical, as well as a comparative holistic perspective will primarily constitute the basis of the results and conclusion to the study.

It will initially adopt a holistic/global based approach which will take into consideration approaches which have been adopted in other jurisdictions where similar issues have been addressed and whose outcomes have proved successful. The results generated from comparing results from different jurisdictions will then be applied at a more restrictive level, namely, on a regional basis, before it is narrowed down to a country specific basis.

In adopting a holistic and global based approach, and incorporating the results from a case study,[36] countries which have been selected and considered in this study are as follows:

- India (where partnership was undertaken with MFIs in several unique ways to extend credit directly to Self Help Groups in rural areas);
- Mali (where a long history of serving less formal institutions through bulk loans and lines of credit as well as savings accounts to help institutions address cash flow and portfolio expansion projects, considered).
- Indonesia: Where the assumption of a significant parenting role for customary village banks (LPDs) through the provision of services which include staff training, monitoring, as well as supervisory services, is taken into account.
- The Phillippines: Where government owned apex organisation, is involved in a partnership with several microfinance actors through the provision of wholesale credit and training to such institutions.
- Honduras: Covelo, a private first and second tier organisation provides loans and lines of credit in bulk quantities, to MFIs as well as contributes immensely in the consolidation of internal systems and controls which are aimed improving self-regulation mechanisms.
- Costa Rica: Where the promotion of the incorporation of village banks in the late 1990s by Finca-Costa Rica, a move which was instrumental in paving the way for all units in the network to establish relationships with commercial lines of credit and otehr financial services, is highlighted.

The above results derived from the case study by Pagura and Kirsten are those which have been selected and taken into account and applied at a narrower level in drawing conclusions and recommendations for this research study. Furthermore, more recent developments, theoretical considerations (theories) and emerging trends will be incorporated into conclusions and recommendations derived for the study.

8. FINDINGS AND CONCLUSION

According to CARE,[37] the products offered by MFIs to poor people are often not well suited to meet their needs. Furthermore, it is highlighted that MFIs often offer credit to those who

36 Pagura and Kirsten, page 3 of 15.[7] According to them, successful cases in Bolivia, Costa Rica, Honduras, India, Kenya, Mali, Peru, the Phillippines, Rwanda and Tanzania were selected owing to specified factors. The countries have been narrowed down in the present study.

are unable to afford such and who would rather save than have access to such credit.[38] Findings from CARE also revealed that such low income clients would rather build and consolidate on assets which help in reducing risk before they start incurring debt.[39]

The beneficial features of the Micro Savings Requirement Scheme can also be illustrated through the collaborative arrangements between the formal and less formal institution via direct or facilitated linkages whose benefits have been illustrated – according to a case study which involved various jurisdictions such as India, Costa Rica, the Phillippines, Mali, Honduras, Indonesia. Such benefits include:

- extending credit directly to Self Help Groups in rural areas
- assisting institutions in addressing cash flow and portfolio expansion projects
- the provision of services which include staff training, monitoring, as well as supervisory services
- the provision of wholesale credit and training to such involved institutions
- contributing immensely in the consolidation of internal systems and controls which are aimed improving self-regulation mechanisms.

The above mentioned benefits, along with other benefits inherent in the proposed Micro Savings Requirement Scheme will be of immense benefit to microfinance in countries where access to microfinance in rural areas is severely restricted – and particularly in countries such as the CAR, Eritrea, Guinea Bissau, Nigeria and Somalia, where statistics reveal that the Savings Group Outreach involvement (see Table 1 above) is particularly low when compared to other African countries.

Given the benefits of microfinance - as well as the needs and demands of those who are not able to afford collaterals and who would not wish to incur debt (before consolidating on assets which can be used in mitigating risk), the Micro Savings Requirement Scheme has been proposed. For micro lenders, it offers a more flexible approach and alternative to obtaining a collateral whilst also incorporating the options of having features of group lending and the joint liability conditions.

This study has attempted to investigate how linkages, both direct and facilitating linkages, can benefit microfinance institutions in Africa – and particularly countries where the Savings Group Outreach involvement is particularly low when compared to other African countries. This study has also illustrated ways and means whereby group lending and other more recent innnovative methods used by micro lenders to secure repayments could increase their desired effects. Furthermore, the study has illustrated how regulation could be harnessed in achieving certain desired effects of microfinance – in particular, in respect of addressing asymmetric information (agency problems), as well as in mitigating risks emanating from the lack of collaterals in microfinance.

As highlighted under the introductory section, further suggestions for research could embrace a jurisdictional analysis which paves the way for a more detailed comparative analysis between these jurisdictions. Such comparative analysis could also incorporate

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37 (CARE, 2011: 9)[4]

38 ibid

39 ibid

empirical based results which would facilitate a basis for international comparisons. The largely informal sectors operating in rural areas, as well as inadequate levels of monitoring and the existence of asymmetric information has made it more necessary for regulation to play a role. Through the proposed Micro Savings Requirement Scheme, this scheme has not only provided a means for assisting those in rural areas to secure collaterals more easily, but also introduced arrangements whereby greater formalism could be introduced into the informal sector.

COMPETING INTERESTS

Author has declared that no competing interests exist.

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APPENDIX

	AFRICA				ASIA				LATIN AMERICA			
	Kenya	Mali	Rwanda	Tanzania	India		Indonesia	Philippines	Bolivia	Costa Rica	Honduras	Peru
	K-Rep Bank, SACCOs and MFIs	BNDA and MFIs	Peoples Banks and Self Help Groups	CRDB Bank Ltd., SACCOs, Community Banks and NGOs,	ICICI, MFIs and Self Help Groups	AVIVA Life and MFIs	BPD and LPDs	PCFC, Rural Banks and MFIs	FADES and various partners	Finca Costa Rica, commercial banks and , MFIs	Covelo Foundation, MFIs and producer organizations	Arariwa (NGO), Confianza (EDPYME) partners
Direct Financial Linkages												
Bulk loans and credit lines	x	x		x	x		x	x	x	x	x	x
Savings	x	x		x			x			x	x	x
Facilitating Linkages												
Credit			x		x					x	x	
Insurance						x						
Deposit mobilization									x			
Money transfers									x		x	
Payments									x	x	x	
Salary/pension disbursements									x			

Abbreviations BNDA: Banque Nationale de Developpement Agricole
PCFC: People's Credit and Finance Corporation
BPD/LPD: Indonesian Regional Development Bank and Community Based Village non bank Financial Institutions
FADES: Fundación para Alternativas de Desarrollo
SACCO: Savings and Credit Cooperatives

Fig. 1. Typology of case study linkages

Source: Pagura, M. and Kirsten, M. (2006) [7], Formal Informal Financial Linkages – Lessons From Developing Countries at page 6

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