

MAKING MICROFINANCE WORK IN THE MIDDLE EAST AND NORTH AFRICA

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Preface

This report analyzes microfinance in the Middle East and North Africa and makes recommendations to improve current practices and narrow the gap between demand and supply. The main source of information was a comprehensive survey—the first of its kind—of 60 microfinance programs in the region. (These 60 programs represent about 90 percent of the region’s microfinance activity.) If funding is available, the database generated by this survey will be updated regularly. Over time this database will allow the assessment of microfinance industry trends and financial indicators specific to the region.

Other information was derived from internal World Bank reports (including staff appraisal reports and back-to-office reports and memorandums), a variety of external

sources (including the microfinance organizations themselves), and interviews with task managers and Bank staff involved in microfinance.

The countries covered in detail are Egypt, Jordan, Lebanon, Morocco, Tunisia, the West Bank and Gaza, and Yemen. (Data for Tunisia should be interpreted with caution, however, as they may be unreliable.) In some cases—especially when discussing the need for microfinance and the financing gap—Algeria, Iran, and Syria are also included.

Although many microfinance programs cover both microenterprises and small enterprises, the survey included only the microenterprise components of these programs.

Acknowledgments

This report would not have been possible without the cooperation of 60 microfinance programs and organizations operating in the Middle East and North Africa. These groups not only participated in a comprehensive survey on their operations and challenges, they were also always open to meet with us or answer our telephone calls, faxes, and emails.

The survey was funded by the World Bank's Economic Development Institute and implemented through seven local partners in the region:

- Mongi Bedoui, microfinance consultant in Tunisia.
- Fouad Benjelloun of Al Amana/VITA in Morocco.
- Kais Al Irijani of the Small and Micro Enterprise Development Department of the Social Fund for Development in Yemen.
- Reda Mamari, managing director of Al Majmoua in Lebanon.
- Alex Pollock, senior adviser to the United Nations Relief and Works Agency (UNRWA) Income Generating Program in the West Bank and Gaza.

- Nasser Shraideh, coordinator of Micro and Small Business Development in the Social Productivity Program under the Ministry of Planning in Jordan.
- Dina Abdel Wahab and Earl Wall of the Egyptian Small and Micro Enterprise Association.

These partners collected information and helped the respondents complete the questionnaires. Without their continued support and patience the survey would never have accumulated the wealth of information that formed the core source of this report.

The survey data were entered and analyzed by Amela Sapcanin and Rahul Dhumale, who worked many late nights to meet the deadline. The report was edited by Paul Holtz and laid out by Garrett Cruce, and the cover was designed by Laurel Morais, all with Communications Development Incorporated.

Finally, the authors are grateful to Nemat Shafik, director of the Private and Financial Sector Development Group, and Jacques Baudouy, director of the Human Development Group in the Middle East and North Africa Region at the World Bank.

Executive Summary

Microfinance is a powerful development tool—one that can reach the poor, raise their living standards, create jobs, and contribute to economic growth. Yet of 60 microfinance programs surveyed in the Middle East and North Africa, only 10 have achieved or are close to achieving full sustainability. At least \$1.4 billion is needed to reach the region's (conservatively estimated) 4.5 million entrepreneurial poor who require microfinance. Developing the microfinance industry in the Middle East and North Africa will require building local capacity, increasing the efficiency and sustainability of microfinance programs, and engaging the formal financial sector.

What is microfinance and why is it important?

Microfinance programs provide financial services—such as credit, deposit, and savings services—to the entrepreneurial poor that are tailored to their needs. Good microfinance programs are characterized by:

- Small, usually short-term loans, and secure savings products.
- Streamlined, simple borrower and investment appraisal.
- Alternative approaches to collateral.
- Quick disbursement of repeat loans after timely repayment.
- Above-market interest rates to cover the high transactions costs inherent in microfinance.
- High repayment rates.
- Convenient location and timing of services.

There are many types of microenterprises. At one end of the spectrum is, for example, the woman who sells vegetables. She operates her microenterprise for just a few hours a day because she has other responsibilities, such as taking care of her children. At the other end of the spectrum is the small enterprise that employs several workers.

Though microenterprises create jobs and contribute to GDP, they are often constrained by lack of access to financial services. Providing financial services to the entrepreneurial poor increases household income, reduces unemployment, and creates demand for other goods and services—especially nutrition, education, and health services.

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Microfinance best practice

Experience worldwide has shown that the poor are bankable and willing to pay a premium for quick, reliable, and convenient financial services. Successful microfinance institutions have also demonstrated that, when managed in a business-like manner, banking with the poor can be profitable and sustainable. Several principles guide microfinance best practice.

Covering costs

To become sustainable, microfinance institutions—whether credit unions, cooperatives, nongovernmental organizations (NGOs), or banks—need to cover their costs of lending. If microlending costs are not covered, the institution's capital will be depleted and the continued access of microenterprises to finan-

Microfinance institutions have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding

cial services—and even the existence of the microfinance institution—will be in jeopardy.

Avoiding subsidies

Microentrepreneurs do not need subsidies or grants—but they do require rapid and continued access to financial services. Besides, microlenders cannot afford to subsidize borrowers. Subsidies imply that government or donor funds are a form of charity, which discourages borrowers from repaying. Moreover, microfinance institutions have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding.

Promoting outreach and demand-driven service delivery

Successful microfinance institutions increase access to financial services for growing numbers of low-income clients, offering them quick and simple savings and loan services. Loans are often short term, and new loans are based on timely repayments. Loans are based on borrowers' cash flow and character rather than their assets and documents, and alternative forms of collateral (such as peer pressure) are used to motivate repayment.

Maintaining a clear focus

It takes time and commitment to build a sustainable microfinance program. Thus mixing the delivery of microfinance services with, for example, the provision of social services and technical services is inadvisable because it sends conflicting signals to clients and program staff.

Microfinance in the Middle East and North Africa

The Middle East and North Africa contain more than 60 million poor people—defined as those living on less than \$2 a day—of which just 112,000 have access to financial services. At the very minimum, 4.5 million

more poor people require access to financial services. These potential borrowers need at least \$1.4 billion in microloans; today the region has less than \$95 million in outstanding microloans. This large financing gap does not include the additional funding needed to build sustainable microfinance institutions and increase outreach.

More than 60 microfinance programs are active in the Middle East and North Africa. Most are run by NGOs and quasi-governmental organizations, including state-owned banks operating under government pressure and serving merely as windows for credit delivery. Only one private bank in the region is engaged in microfinance.

Egypt contains 66 percent of the region's active borrowers. But its outreach gap—that is, the share of potential borrowers not being served—of 95 percent is among the highest in the region. In other words, Egypt is serving 5 percent of market needs. The West Bank and Gaza, by contrast, has tapped 23 percent of the market, leaving an outreach gap of 77 percent.

Less than 40 percent of the region's active borrowers are women, though there are large differences between countries and programs. Programs such as Save the Children target women exclusively, while programs that target both men and women tend to reach mainly male borrowers. Across the region, less than 15 percent of microfinance goes to rural areas, though there are sharp differences among countries. In Tunisia and Yemen microfinance is predominantly rural; in Egypt, Jordan, and Lebanon it is mainly urban. Most programs, however, serve high-density areas. Group lending is the dominant lending methodology in the region.

There is a correlation between the average loan size and the depth of poverty of the groups targeted. Only the poor and poorest will bother to take very small loans, incur the transactions costs associated with such loans (such as participating in group meetings), and pay high interest rates. A comparison of average loan size, GDP per capita, and income poverty lines reveals that

Morocco and the West Bank and Gaza have the deepest outreach—that is, they reach the poorest borrowers. This result is not surprising given that most of the active borrowers in these countries are women.

Most programs in the region lack basic information on their performance. They do not know, for example, the number of active borrowers or the outstanding loan portfolio. Even more programs do not know the quality of their loan portfolio (as measured in terms of arrears and portfolio at risk). Most also do not know their operational and financial costs of making and managing loans.

The sustainability of microfinance in the Middle East and North Africa

Of the 60 microfinance programs studied in detail, 2 are fully sustainable and 8 are on the road to sustainability. The “sustainability performance box” provides an analytical framework for evaluating the performance of a microfinance program based on outreach (number of active borrowers) and operational cost recovery (see figure). Programs that do not cover 100 percent of their operational costs will remain dependent on donor or government subsidies to maintain their current activity level. A drop in subsidies would auto-

matically deplete loan capital and cause a loss of borrowers. Programs that cover more than 100 percent of their operational costs do not depend on donors to cover operational costs but do require funds for onlending. Programs that cover their operational costs and financial costs (measured as imputed costs of capital) are financially or fully sustainable.

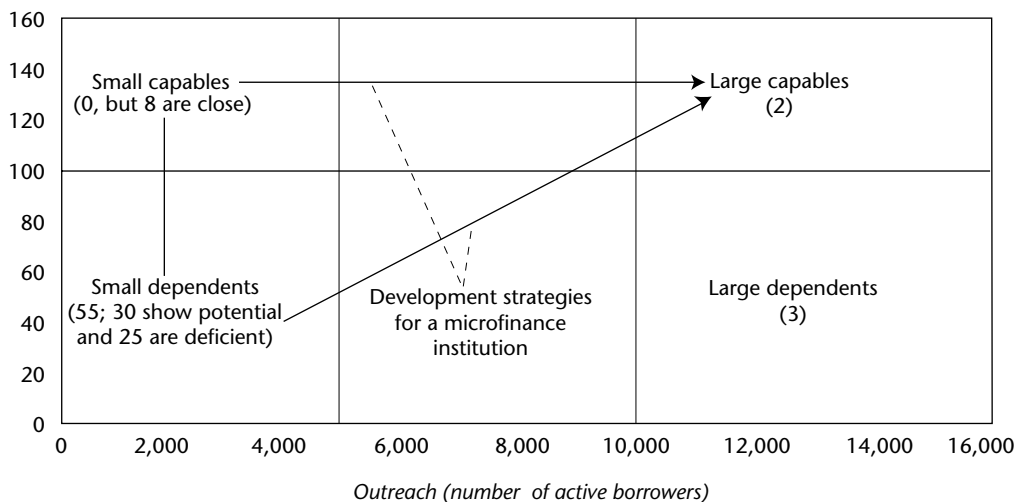
Sustainability cannot be achieved without some minimum level of outreach. Only when a microfinance institution has a certain number of borrowers can it reap economies of scale, which enable it to lower costs. Several small countries in the Middle East and North Africa have limited markets and face a challenge in building sustainable programs. Programs in the region that are already or nearly sustainable indicate that at least 5,000–10,000 borrowers are needed.

Many programs in the region may never become sustainable. Fifty-five programs have not yet achieved minimum outreach and do not cover 100 percent of their operational costs. Of these “small dependents,” 10 are very young programs that started with an explicit objective to become fully sustainable. They are developing their capacity to deliver microfinance services before expanding. Fewer than 20 of the 45 remaining programs may opt for sus-

Many programs in the region may never become sustainable

The sustainability performance box

Operational cost recovery (percent)



Note: Numbers in parentheses are the number of each type of institution in the region.

The formal financial sector should become more active in delivering microfinance services

tainability and—with sufficient exposure to best practices—move up the learning curve while increasing scale.

“Large dependents” have achieved significant outreach but do not cover their operational costs. Often government programs or quasi-government development funds, they are usually inefficient and charge subsidized interest rates. Given their success in reaching a large number of borrowers, suboptimal but “working” management systems, and vested (political) interests, it is difficult to reorient these programs toward full efficiency and cost recovery.

“Small capables” are programs that are designed to achieve sustainability but that have not yet reached sufficient scale. Microfinance programs need time to experiment with loan products, get to know the target group, and develop systems and procedures before pursuing rapid growth. Examples of emerging (but not yet fully) small capables include the Save the Children programs in Jordan, Lebanon, and the West Bank and Gaza, and the United Nations Relief and Works Agency program in Gaza.

The two “large capables”—the Alexandria Business Association and the National Bank for Development, both in Egypt—are star performers. They cover their operational and financial costs while making a profit that is reinvested in the program. The Alexandria Business Association’s immediate challenge is its transition into a formal financial intermediary. The National Bank for Development’s challenge is to expand its program nationwide across all branches.

What next?

More and better microfinance providers are needed to fill the region’s enormous outreach gap. The 60 programs studied would have to increase their number of active borrowers by more than 40 times to provide services to 4.5 million people. Given that it took them an average of five years to get where they are

now—serving 112,000 active clients—it is unrealistic to expect these programs to meet the large unmet demand.

Microfinance could be provided by NGOs or, preferably, microfinance institutions with legal status as nondeposit-taking financial institutions. However, it took the region’s two most successful microfinance institutions about six years and \$20 million to amass 35,000 borrowers. Expanding an NGO or microfinance institution is expensive because tens if not hundreds of new branch offices must be set up to meet the demand.

Thus, to fill the outreach gap and the \$1.4 billion financing gap in a timely manner, the formal financial sector should become more active in delivering microfinance services. The outreach potential of formal financial institutions is perhaps many times that of NGOs and microfinance institutions, because formal institutions have extensive branch networks. In Egypt, for example, banks have more than 2,200 branch offices, and in Morocco they have more than 1,300. The \$1.4 billion financing gap represents less than 0.5 percent of total assets of the banks in the region, and less than 1 percent of their total lending.

Today only one bank in the region is actively engaged in best-practice microfinance (Egypt’s National Bank for Development), and one NGO is transforming itself into a formal financial institution (Egypt’s Alexandria Business Association). The outreach potential of the region’s banks has been neglected by both donors and governments. The only reason a bank should engage in microfinance is because it could be profitable. Emerging best practice from around the world has shown that microfinance can be a profitable and appropriate niche for banks—especially those that are active in retail banking or consumer lending. Promising initiatives include those in the West Bank and Gaza and in Lebanon. For the sake of the poor, such efforts must increase.

The Importance of Microfinance

Worldwide, microfinance has been recognized as a powerful tool for alleviating poverty, raising living standards, creating jobs, and boosting economic growth. But because microfinance is relatively new, there is much confusion about its role in development. Understanding the basic features and potential benefits of microfinance is essential to extending its reach in the Middle East and North Africa.

What are microenterprises and who are microentrepreneurs?

Donors, policymakers, and practitioners often use conflicting terminology when defining microenterprises, especially relative to small enterprises.¹ There is, however, no clear-cut distinction between microenterprises and small enterprises. The formal definition used by the World Bank and the U.S. Agency for International Development—microenterprises have fewer than 10 employees and small enterprises have 10–50 employees—does not contribute to a better understanding of these businesses and the differences between them. Although the distinctions between the two types of businesses are fluid, the key difference is the interdependency between the household economy and the business activity.

In a microenterprise the household economy cannot be separated from the business activity: the household's economic decisions affect the microenterprise, and the microenterprise's economic decisions affect the household. In a small enterprise the household economy and the business activity are

less entwined. A small enterprise may employ some outside workers and may have a rudimentary accounting system separate from the household budget. The household of a small enterprise owner often has achieved economic viability and security, allowing it to invest in or diversify business activity. Small enterprise owners may not be poor. Other differences between microenterprises and small enterprises are described in table 1. Note that the box does not mention number of employees—depending on the influence of the household economy on decisions affecting the business, an enterprise with, say, three workers can be small or micro.

Microenterprise activities are productive investments that generate income for poor people and their households. These activities are inextricably linked to the household's hierarchy of economic goals, which generally seek to increase security over time and across generations. The primary goal is economic viability, or the ability to meet the basic needs of household members, including food, shelter, and clothing. The second goal is economic security, or the ability to protect household assets and income from unpredictable forces or actions, natural or human. The third goal is longer-term economic security and a higher standard of living that will be sustained to the next generation. Households try to minimize the risk of losing the economic security already achieved, and higher-level goals are pursued only when lower-level goals have been met.

For the poor, household viability and security are a primary concern that cannot be taken for granted. Microenterprises and

Microenterprise activities are productive investments that generate income for poor people and their households

Table 1. Distinguishing features of microenterprises and small enterprises

<i>Feature</i>	<i>Microenterprises</i>	<i>Small enterprises</i>
Resources		
Sources of finance	Household savings Retained earnings	Household savings Retained earnings Loans from formal and informal sources
Workers	Working owner Unpaid family members Low-skilled	Working owner Unpaid family members Paid outside workers Low- and medium-skilled
Assets	Very few, mostly current Some low-value fixed assets Insecure tenure Limited access to services	Greater mix of current and moderate-value fixed assets Secure tenure Limited access to services
Inputs	Narrow range, few sources, mostly retail Low quality, irregular supply, uncertain and variable costs	Broader range, more sources, mix of retail and wholesale Better and more predictable quality, more stable supply, and lower costs
Production processes		
Output	Low volume Narrow range Low quality	Higher volume Broader range Mixed quality
Technology	Traditional	Mix of traditional and modern
Management practices	Informal	Mix of informal and formal
Markets	Uncertain and limited size Unstable Customers mainly individual and local end users	Moderate to large More specialized and more predictable Customers a mix of local and nonlocal end users and informal and formal businesses
Financial performance	Often moderate to high profitability but low absolute amounts Uncertain income	Moderate profitability More stable income

other productive activities are both a means through which the poor subsist and a means to gain a slight economic foothold (by accumulating assets) to put them one step ahead of the next crisis. Both functions are tied to poverty alleviation.

Microenterprises exist within a larger portfolio of household economic activities.

Decisions about microenterprises—whether made jointly or individually by household members—can be understood more clearly when considered relative to tradeoffs within the overall household economy. Tradeoffs are important because microenterprises depend to varying degrees on their households for capital, labor, and other inputs. An example is a household's decision to use accumulated assets to send a child to school or to buy a cart to transport vegetables to the market.

Households will not take risks that endanger their basic viability and security. The availability of surplus resources is directly associated with the household's level of economic security and is key to understanding how households move to higher levels of security. Households with a minimum base of income and assets are highly vulnerable and thus are likely to be risk averse. Because even small losses could threaten their viability, any surpluses will be used for low-risk ventures. Households with a broader base of income and assets are more secure and better able to balance risks by diversifying their resources across a mix of higher- and lower-risk investments.

One of the constraints facing microenterprises is lack of access to finance. For the most vulnerable households—those with a minimum base of income and assets—this often means lack of access to savings services, meaning a safe place to store funds as a cushion against income shocks. For households that have surplus assets above the level required for minimum viability and security, lack of access to finance means often lack of access to credit. Access to credit enables them to increase household income and to use surpluses to invest in the well being of household members and in microenterprise activities.

Not every poor person makes a good microentrepreneur, and many poor people are better served by nonfinancial services. The international microfinance community distinguishes between two groups of poor people: those that can manage profitable activities and increase their standard of liv-

ing if given access to financing, and those that cannot (box 1). Giving the poor access to financial services can help reduce poverty, at least among the entrepreneurial poor. It can also ease the burden on public funds by cutting subsidies and allocating spending to more productive sectors of the economy. And given that they are labor intensive, microenterprises can absorb a large portion of excess labor. (Conversely, microenterprises are not bound by labor market rigidities, for they involve owner and family labor.)

What is microfinance and why is it important?

Microfinance programs provide financial services—such as credit, deposit, and savings services—to the entrepreneurial poor that are tailored to their needs. Good microfinance programs are characterized by:

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- Quick disbursement of repeat loans after timely repayment.
- Above-market interest rates to cover the high transactions costs inherent in microfinance.
- High repayment rates.

- Convenient location and timing of services (Fruman and Goldberg 1997).

International donors have become increasingly interested in microfinance for at least three reasons. First and most important, more than half the people in developing countries have been neglected or underserved by the formal financial sector. Second, microenterprises and small enterprises can raise the living standards of poor people in most developing countries. Finally, the shift toward private and financial sector development—in response to the declining role of government in the economy—has made microfinance part of the overall strategy for private sector development.

Microenterprises and small enterprises not only raise the living standards of the poor and the self-employed, they also provide jobs and contribute to GDP and economic growth. Yet such enterprises often have limited access to financial services. Providing financial services to the entrepreneurial poor increases household income, reduces unemployment, and creates demand for other goods and services—especially nutrition, education, and health services. Thus microenterprises play an important role in alleviating poverty. Women's World Banking (1995, p. 2) argues that “providing the poor with access to financial services may be the single most effective means to address poverty and cre-

More than half the people in developing countries have been neglected or underserved by the formal financial sector

Box 1. Differentiating between two groups of poor people

The development community distinguishes between two groups of poor people: those that can increase their income by themselves and those that cannot. If properly assisted, members of the first group can generate activities that enable them to move closer to or above the poverty line. The second group includes poor people who have no capacity to undertake any economic activity, whether because they lack skills or because they are extremely destitute.

Members of the first group have been called the “entrepreneurial poor.” The entrepreneurial poor do not need assistance for themselves, but they do need help setting up or managing economic activities that will eventually increase their income. In particular, they

need help accessing the resources required to develop this activity. Credit is often—but not always—among those needed resources. The nonentrepreneurial poor, by contrast, require direct assistance simply to survive.

The concept of entrepreneurial poor allows antipoverty policies to move from purely direct assistance (such as subsidies) to a mix of direct and indirect assistance (such as subsidies for the nonentrepreneurial poor and credit for the entrepreneurial poor). Governments and donors are more interested in indirect assistance because it targets the causes of poverty rather than the poor themselves, making antipoverty policies more cost-effective.

Source: UNCDF 1996.

Banking with the poor can be profitable and sustainable

Box 2. Financial dynamics and profitability in a microenterprise: The case of Sahar

Sahar, a typical microentrepreneur, lives in Egypt near Port Said. She buys and sells fresh fish. Every morning she goes to the fish market with her bicycle cart, which is equipped with an icebox to keep the fish fresh. The cart, built by her husband, cost about \$200. Sahar usually sells her daily merchandise by 3:00 p.m. Each day she buys 100 Egyptian pounds (LE) worth of fish and LE 10 worth of ice; hence her daily working capital is LE 110. Her daily revenue is LE 130, so her daily profit is LE 20. The demand for fish is high in her neighborhood, and she could sell more if she had more working capital.

Sahar works six days a week; thus her weekly profit is LE 120. She uses LE 70 of this profit to support her household of seven, including her unemployed husband, and puts aside LE 30 for emergency savings and LE 20 for depreciation on the bicycle cart. One household member, her uncle, works for a small enterprise and makes LE 60 a week. Her oldest son, an unskilled construction worker, works an average of two days a week and makes LE 12 a day. Hence the weekly household income is LE 154.

Sahar has been offered a loan of LE 110 at 1 percent flat interest per week for a period of one month. Her weekly repayment would be LE 28.6 (LE 27.5 principal and LE 1.1 interest). Should she take the loan? The table below shows that the loan is an attractive proposition for Sahar and her family.

The high interest rate is trivial in this calculation. By paying this rate, Sahar gains access

Deciding on a loan

(Egyptian pounds)

Indicator	Before the loan	After the loan
Daily profit ^a	20	40
Weekly profit ^a	120	240
Emergency savings	30	30
Depreciation on cart	20	20
Loan repayment	0	28.6
Sahar's contribution to household income	70	161.4
Other family income	84	84
Total family income	154	245.4
Daily income per household member (U.S. dollars)	0.92	1.47

a. Before depreciation and finance charges.

to finance. As a result of the loan her daily profit would double, and her contribution to household income would more than double. In fact, Sahar could pay an even higher interest rate and still be better off.

With this loan Sahar could not only increase the standard of living of her household, she could also increase her savings. If, for example, she saved LE 60 a week instead of LE 30, she could afford to send one of her children to school. Alternatively, in fewer than eight months she could invest in a second bicycle cart, allowing one of her unemployed household members to also start a microenterprise activity. This move would not only create an extra job, it would raise household income even more.

ate broad-based economic growth. Finance and enterprise systems that serve the majority can be the pivotal links and the levers, enabling the poor to share in economic growth and giving poor people the means to use social services.” More than 500 million of the world’s economically active poor people run profitable microenterprises and small enterprises.

What is the best way to develop microfinance institutions?

Successful microfinance institutions have emerged in response to the entrepreneurial

poor’s unmet demand for financial services. These institutions have shown that the poor are bankable and that banking with the poor can be profitable and sustainable. Because microenterprises can be highly profitable, microentrepreneurs are willing and able to pay high interest rates for convenient and quick access to well-designed financial services (box 2). A microfinance program that collects loan repayments at an entrepreneur’s business, for example, offers a convenient service that entrepreneurs value and are willing to pay for. If entrepreneurs were to have to close their businesses for, say, half a day to travel across town to make a repayment, half a day’s profits

Box 3. Guiding principles for microfinance best practice

Covering costs

To become sustainable, microfinance institutions—whether credit unions, cooperatives, NGOs, or banks—need to cover their costs of lending. If microlending costs are not covered, the institution's capital will be depleted and the continued access of microenterprises to financial services—and even the existence of the microfinance institution—will be in jeopardy.

Avoiding subsidies

Microentrepreneurs do not need subsidies or grants—but they do require rapid and continued access to financial services. Besides, microlenders cannot afford to subsidize borrowers. Subsidies imply that government or donor funds are a form of charity, which discourages borrowers from repaying. Moreover, microfinance institutions have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding.

Promoting outreach and demand-driven service delivery

Successful microfinance institutions increase access to financial services for growing numbers of low-income clients, offering them quick and simple savings and loan services. Loans are often short term, and new loans are based on timely repayments. Loans are based on borrowers' cash flow and character rather than their assets and documents, and alternative forms of collateral (such as peer pressure through group lending) are used to motivate repayment.

Maintaining a clear focus

It takes time and commitment to build a sustainable microfinance program. Thus mixing the delivery of microfinance services with, for example, the provision of social services is inadvisable because it sends conflicting signals to clients and program staff.

Successful microfinance institutions respond to the special needs of microenterprises

would be lost. This is a much higher price than the interest rate premium. Entrepreneurs are also willing to pay a premium for quick and continued access to financial services. The profits forgone in waiting a few weeks for a loan approval can be many times the interest rate premium paid for getting a loan today.

Successful microfinance institutions respond to the special needs of microenterprises. These needs, which make microfinance different from traditional commercial bank lending, include:

- Access to short-term credit to build up working capital.
- Access to timely credit, due to the highly liquid nature and short-term requirements of their businesses.
- Access to repeat loans, which provides a powerful incentive for timely repayment.
- Access to savings services, especially in remote areas without branches of banks.

Emerging best practice shows that successful microfinance institutions can become successful financial institutions by diversifying their services and targeting specific groups (box 3). Examples include Bangladesh's Grameen Bank, Bolivia's BancoSol, and Indonesia's Bank

Rakyat. Microfinance institutions can expand the range of financial products offered to the poor beyond simple lending to include such services as savings, consumer and housing credits, pawn lending, and money exchange.

What role can commercial banks play in microfinance?

Successful microfinance efforts have encouraged some commercial banks to enter this market. In developing countries private, state-owned, and savings banks play important roles in microfinance. A survey of 206 microfinance intermediaries around the world found that banks and savings banks served more than 70 percent of active borrowers and 90 percent of savers and depositors. The outstanding microfinance loan portfolio of these banks was nearly \$7 billion, serving more than 14 million borrowers. And the banks had mobilized more than \$19 billion in deposits and savings from almost 45 million depositors. Given their large branch networks, banks have a much larger outreach potential than nongovernmental organizations (NGOs) and credit unions (table 2).

Banks may be the most efficient channel for providing microfinance to the entrepreneurial poor

Commercial banks should be encouraged to engage in microfinance for several reasons. Most important, microfinance can be profitable for banks—especially banks that are strong in retail banking or consumer lending. In addition, banks have a large outreach potential through their extensive branch networks. These networks give banks large economies of scale relative to NGOs or microfinance institutions, which would have to make major investments in infrastructure to reach the same number of borrowers or savers.

With well-designed loan delivery mechanisms, operations, and procedures, banks may be the most efficient channel for providing microfinance to the entrepreneurial poor. Moreover, banks have the most accessible source of funds for onlending: their deposit base. For instance, in the Middle East and North Africa total funding needs for microfinance account for less than 1 percent of deposits in the banking system. Finally, banks can offer deposit and savings services to the poor, a financial service often more needed than credit. As financial institutions, banks are governed by regulations that prevent them from jeopardizing other people's money; deposit-taking by NGOs or microfinance institutions, by contrast, should be approached with extreme caution (box 4).

Commercial banks have been reluctant to provide finance to microenterprises and small enterprises and perceive several barriers to entering this field. The main barriers are the riskiness of microentrepreneurs and the informal sector, the inadequate collateral of

microentrepreneurs, the high cost of lending to microenterprises, the inability of microentrepreneurs to pay high interest rates, legal and regulatory constraints, and social constraints. But all these barriers can be overcome, as examples around the world have shown. To be successful in this field, banks must change how they do business and adopt new lending techniques to manage risks and lower costs.

Microenterprise risk

For two reasons, commercial banks perceive microenterprises as high-risk borrowers. Microentrepreneurs usually have no track record and no formal relationship with a bank (that is, a checking or savings account). In addition, most microenterprises are informal, and so lack the legal registration and financial reporting that the formal sector requires.

But microenterprises are no more or less risky than any other business. Most simply need to establish a formal track record with a commercial bank to eliminate the information asymmetry described above. A track record can be built up if a bank initially provides only savings or deposit services, or only small loans with short maturities for working capital purposes. With timely repayment, the size and maturity of loans can be gradually increased.

Lack of collateral

The entrepreneurial poor usually have no assets or valuables to use as a guarantee. Making matters worse, in most developing countries banks accept only registered immovable assets (such

Table 2. Outreach of microfinance intermediaries worldwide

<i>Type of intermediary</i>	<i>Median number of active microborrowers</i>	<i>Median loan size (U.S. dollars)^a</i>	<i>Number of savings accounts</i>	<i>Median savings and deposit amount (U.S. dollars)^a</i>
Banks	44,271	681	39,883	186
Savings banks	2,866	3,011	224,180	950
Credit unions	15,320	449	38,610	409
NGOs	1,781	248	0	0

a. Among banks the sample included some extremely large institutions (more than 1,000,000 active clients), including such well-known examples as Bangladesh's Grameen Bank, Thailand's Bank of Agriculture and Agricultural Cooperatives, and Indonesia's Bank Rakyat Indonesia. Thus the table shows medians instead of means (averages) to offset this bias.

Source: World Bank 1996.

Box 4. When should a microfinance institution mobilize voluntary savings from the public?

As a source of commercial finance for microcredit institutions, voluntary deposits have generated a lot of interest in recent years. Locally mobilized voluntary savings are potentially the largest and most immediately available source of finance for some microcredit institutions. Mobilizing such savings also helps meet the vast unmet demand for local savings services in developing countries.

Three conditions should be met before a microcredit institution starts mobilizing voluntary savings. First, profitable mobilization requires an enabling macroeconomy, an appropriate legal and regulatory environment, political stability, and suitable demographics.

The second consideration concerns the supervision of institutions providing microfinance. To protect their clients, especially depositors, financial institutions that mobilize voluntary savings should be under government supervision. This, of course, requires a

Source: CGAP 1997.

government that is willing to modify its banking supervision so that the rules for microcredit institutions are appropriate for their activities, and to ensure that the supervisory body is able to monitor these institutions effectively.

The third consideration concerns the history, capability, and performance of the microcredit institution. Before mobilizing voluntary public savings, a microcredit institution should have demonstrated consistently good management of its own funds. It should be financially solvent, maintaining a high rate of loan recovery and earning attractive returns. A good track record is important because in many countries low-income people have entrusted their savings to small, unsupervised financial institutions—only to lose their life savings. Once these three conditions have been met, the microcredit institution should carefully consider how to mobilize voluntary savings.

Banks have found ways to lower the transactions costs associated with a large volume of small loans

as land or real estate) as collateral. Legislation and systems to accept more flexible collateral (such as movable assets, inventories, and accounts receivable) are lacking.

Where traditional collateral is unavailable, new types of guarantees have emerged. These include solidarity group guarantees, group lending instead of individual lending, and lending based on the borrower's character and cash flow rather than their assets and documents. Loan officers are recruited from the microentrepreneurs' community and hence have and gain intimate knowledge of the borrowers and can monitor them every week or every other week. Another major incentive to repay—perhaps the most important—is access to continued financial services.

High cost of lending

The operating guidelines and administrative procedures of commercial lenders are designed for large loans. Thus, it is argued, these procedures are costly and inappropriate for the scale of financing required by microenterprises.

It is true that microlending is costly. A study of the world's 12 most efficient microlending programs found that operational costs reach 10–30 cents for every \$1 lent (Christen and others 1994). But microentrepreneurs are willing and able to pay interest rates and fees that enable the intermediary to cover its costs—provided it offers a financial service that is quick, convenient, and tailored to entrepreneurs' needs. At the same time, banks have found ways to lower the transactions costs associated with a large volume of small loans. These include:

- Recruiting loan officers from the areas where borrowers live.
- Making loan officers responsible for both granting loans and collecting repayments, so that they can develop borrower and industry knowledge.
- Rewarding loan officers for their performance—for example, paying a low base salary that can increase substantially based on number of new loans granted and repayments obtained.
- Decentralizing decisionmaking (for example, to the level of the branch manager).

It is a myth
that poor
entrepreneurs
are not
bankable

- Simplifying loan procedures.
- Using information technology to track borrowers and manage loan portfolios.

Inability to pay high interest rates

It is a myth that poor entrepreneurs are not bankable and cannot pay high interest rates. Experience around the world shows that the poor are bankable. Their main constraint is the lack of access to finance—not the price of finance. As noted, microentrepreneurs are willing to pay a premium for access to financial services that are tailored to their needs and delivered in a convenient manner.

Legal and regulatory constraints

In addition to imposing interest rate ceilings, some countries consider banking to informal enterprises illegal. Moreover, prudential loan classification and auditing standards that are appropriate for regular lending are inappropriate for microfinance.

The legal framework and prudential banking standards should not be changed overnight. Instead, financial institutions that are committed to microfinance could be exempted from these regulations. A pilot exemption could be granted for, say, two years, and the financial institution and reg-

ulators could work together to learn from the experience.

Social constraints

Commercial banks tend to avoid providing financial services to low-income communities because of social obstacles that exclude this population from mainstream society. And when they do provide services to the poor, commercial banks do not want to be perceived as charging exploitative interest rates. Thus they often end up providing subsidized loans.

Banks around the world have found creative solutions to these social constraints. One involves “packaging” the terms and conditions of a loan. That is, nominal low interest rates can be charged, but the bank can generate much more revenue than is indicated by the stated nominal rate by calculating a flat interest rate and introducing fees. In addition, some financial institutions have set up microfinance operations under a different legal entity or under a different name.

Note

1. This section draws heavily on studies published under the U.S. Agency for International Development’s Assessing the Impact of Microenterprise Services (AIMS) project, including Sebstag and Chen (1996), CDIE (1995), and Barnes (1996).

Microfinance in the Middle East and North Africa

Microfinance has demonstrated its power and potential in many parts of the world. Likewise, microfinance can help alleviate poverty in the Middle East and North Africa. What impedes its development? And what can be done to extend its reach?

Poverty in the region

Van Eeghen (1995) estimates that 5.6 percent of the people in the Middle East and North Africa were poor in 1990. This corresponds to 11 million people living on less than \$1 a day (the international poverty line) in 1995. The number of poor jumps to 40 million when measured using spending per month of \$50 per capita, and to 60 million when using a poverty line of \$2 a day.

In general, countries in the Middle East and North Africa have low social indicators relative to other countries with similar or lower income levels. Despite high public spending on education and health care, the quality of and access to basic services are limited in most Middle Eastern and North African countries. Except in Jordan, poverty is most pronounced in rural areas. But urban poverty is prevalent and rising among self-employed workers engaged in small-scale trade. Poverty is strongly correlated with a lack of education. In addition, most poor people have large families. As a result the young are disproportionately represented among the poor.

Economic growth remains the most effective way to alleviate poverty. But in the Middle East and North Africa GDP would have to grow by at least 5 percent a year to reduce

poverty. Medium-term World Bank growth projections for the region are 3.5 percent a year. Thus poverty is expected to increase at the projected growth rate. One way to avert this outcome is to extend microfinance services to poor people throughout the region.

Barriers to the development of a healthy microfinance industry

Some of the barriers to the development of a healthy microfinance industry in the Middle East and North Africa are unique to the region. Others are more universal.

Lack of experience and exposure

Some regions, such as Asia and Latin America, have more than two decades of hands-on experience with microfinance. In the Middle East and North Africa, by contrast, the industry is at a nascent stage. Moreover, most microfinance players in the region—microfinance institutions and bankers alike—lack exposure to worldwide best practice. This puts them at a disadvantage and prevents them from learning from the experiences of others. Hardly any best practice material is available in Arabic or French, the most widely used languages in the region.

Political uncertainty and macroeconomic instability

Political factors, including armed conflict, constrain the development of the microfinance industry in some Middle Eastern and North African countries. Still, several well-known

The region's microfinance industry is at a nascent stage

Many of the poor people in need of financial services live in remote areas with inadequate infrastructure

programs have managed to deliver credit even under the most extreme circumstances.

Microenterprises are known for their dynamism and resilience and are generally removed from the effects of macroeconomic instability. But the combination of macroeconomic instability and political uncertainty eventually affects microenterprises. In Gaza, for example, frequent border closures forced microentrepreneurs out of business—because they could not obtain inputs and because they had trouble selling products. The incomes and consequently the purchasing power of their traditional clients (other citizens of Gaza) decreased rapidly as a result of the closures.

Social and cultural barriers

In some countries microfinance is constrained by social, cultural, or religious barriers. For instance, some Islamic groups consider the charging of interest rates to be against *sharia* (the code of law based on the Koran). But microfinance services can also be offered using Islamic banking principles such as *mudaraba*, *murabaha*, or *musharaka*. Several programs in the region offering financial services based on Islamic banking principles show promising results.

Inadequate infrastructure

A lack of adequate infrastructure is another barrier to microfinance. Many of the poor people in need of financial services live in

remote areas with inadequate infrastructure, which dramatically increases a microfinance institution's costs of doing business with these people. It is important to distinguish between two target groups in remote areas. One group faces infrastructure barriers that make it difficult for microfinance institutions to reach microentrepreneurs. A second group faces infrastructure barriers that make it difficult for borrowers to seize economic opportunities.

The obstacles facing the first group can sometimes be overcome using innovations such as mobile branches or decentralized village banking systems. Among members of the second group the demand for financial services may be latent, but it will not materialize until higher-priority needs—such as access to water, electricity, basic education, and health care—are met. For example, lack of access to water and electricity is one of the biggest constraints to microenterprises in some parts of Yemen. Such barriers are difficult to overcome in the short term.

Legal and regulatory barriers

The regulatory framework in the Middle East and North Africa does not impede microfinance. Although laws restrict the provision of financial services by NGOs in some countries (Egypt), set a ceiling on interest rates in some North African countries, and restrict loan sizes, these are rarely enforced. Furthermore, regulatory barriers to the

Table 3. Status of microfinance efforts in the Middle East and North Africa

<i>Indicator</i>	<i>Egypt</i>	<i>Jordan</i>	<i>Lebanon</i>
Outstanding loan portfolio	\$54,938,000	\$20,624,000	\$6,195,000
Number of active borrowers	74,635	9,697	7,111
Rural borrowers (percent)	10	22	11
Female borrowers (percent)	20	45	63
Average outstanding loan balance	\$736	\$2,127	\$871
Type of institutions	14 NGOs, 1 government program, 1 UN agency, 1 bank	6 NGOs, 3 government programs, 1 UN agency	9 NGOs, 1 UN agency

Source: World Bank survey of microfinance institutions.

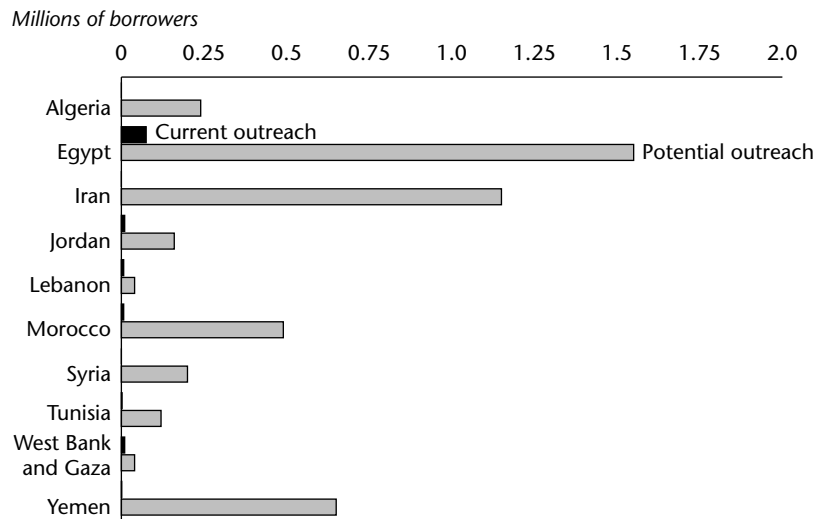
financial sector are being eliminated in most countries as part of macroeconomic stabilization and structural adjustment programs.

Where do things stand?

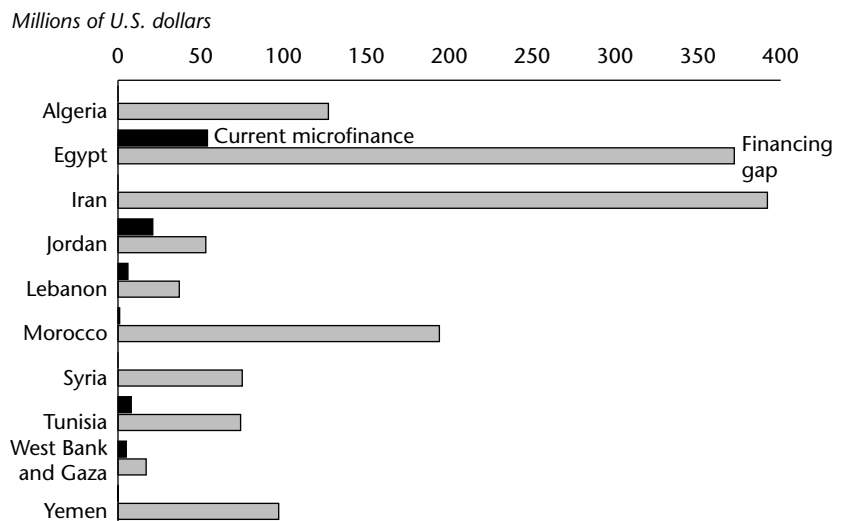
Of the more than 4.6 million potential microfinance clients in the region, only 112,000 are being served (table 3). Thus the supply of microfinance in the region covers just 2.4 percent of the potential demand. (Potential demand is conservatively measured as the number of people who want microcredit and are willing and able to repay their loans.) Three of the region’s ten countries—Algeria, Iran, and Syria—have no microfinance programs (figure 1). Egypt, which has the most microcredit borrowers, barely reaches 5 percent of its estimated microfinance market. The West Bank and Gaza and Lebanon, with about 9,800 and 7,100 active borrowers, have the highest coverage, reaching 23 percent and 17 percent of their potential markets—mainly because of the small size of these markets. Jordan covers less than 7 percent of potential demand, and Morocco and Yemen less than 1.5 percent.

Microfinance in the region also suffers from a sizable financing gap. About \$95 million in microloans is outstanding, while at least \$1.4 billion is needed to meet the demand of the 4.6 million potential borrowers (see figure 1). It is unrealistic to think that this financing gap can be closed solely

Figure 1. The potential for microfinance is much greater than the supply...



...and the financing gap is enormous



Source: World Bank survey of microfinance institutions.

Morocco	Tunisia	West Bank and Gaza	Yemen	Total
\$994,000	\$8,432,000	\$4,640,000	\$242,000	\$96,065,000
7,385	2,512	9,795	1,181	112,316
40	69	2	56	14
73	68	97	35	36
\$135	\$3,357	\$474	\$205	\$855
4 NGOs	6 NGOs, 3 government programs	5 NGOs, 1 UN agency	3 NGOs, 1 government program	47 NGOs, 8 government programs, 4 UN agencies, 1 bank

Available resources need to be used more efficiently, and the private sector must be encouraged to participate in microfinance

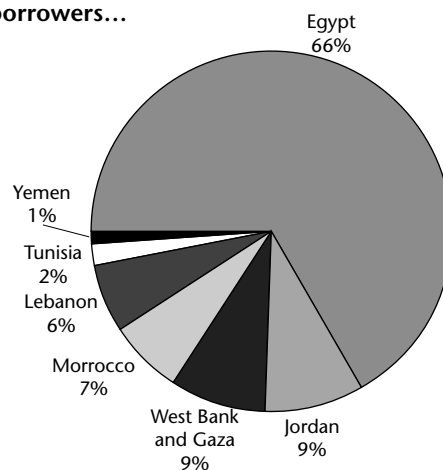
with donor or government funds. Thus available resources need to be used more efficiently, and the private sector must be encouraged to participate in microfinance. Mechanisms that encourage private participation must ensure that such efforts are profitable and help the poor on the one hand, and reduce reliance on donor and government funding on the other.

Sixty microfinance institutions and programs were surveyed in Egypt, Jordan, Lebanon, Morocco, Tunisia, the West Bank and Gaza, and Yemen (see annex 2). The oldest microfinance program, in Jordan, dates to 1937 and was initiated by the Near East Foundation. Egypt and Tunisia have had government and NGO microfinance programs since the early 1970s. These programs are heavily subsidized and are usually components of larger government development and social programs. Despite this seemingly long tradition, however, microfinance remains a fairly new sector in the Middle East and North Africa. Most microfinance programs in the region—70 percent—were launched in 1987–97, and less than 10 percent existed before 1985.

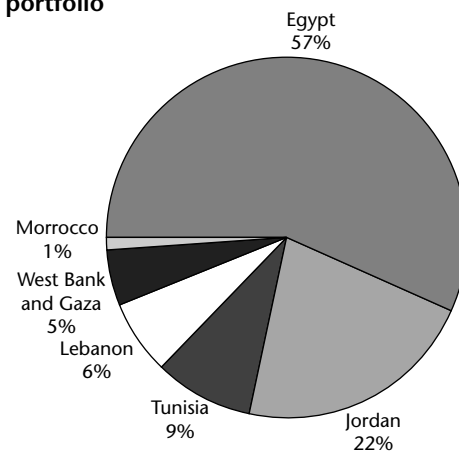
Egypt contains 66 percent of the region's 112,000 borrowers and accounts for 57 percent of the outstanding loan portfolio (figure 2). Though Jordan contains only 9 percent of the region's borrowers, it accounts for 22 percent of the outstanding loan portfolio because loans are fairly large. By contrast, Yemen's recent foray into microfinance involves about 1,200 active borrowers and accounts for less than \$250,000 of outstanding loans.

Loan sizes and uses vary among programs and between countries. Loan sizes also vary considerably within the same program—the upper range of loans can reach 30–60 times that of the lower range. In the Egyptian Small Enterprise Development Foundation and Assiut Business Association programs, for example, loans range from \$150 to \$5,000. This range reflects the various purposes for loans acquired by microentrepreneurs, ranging from low working capital needs to acqui-

Figure 2. Egypt has the most microfinance borrowers...



...as well as the largest outstanding loan portfolio



Source: World Bank survey of microfinance institutions.

sition of small machinery and other investments. Some programs provide fixed capital for periods ranging from 18 months to 20 years.

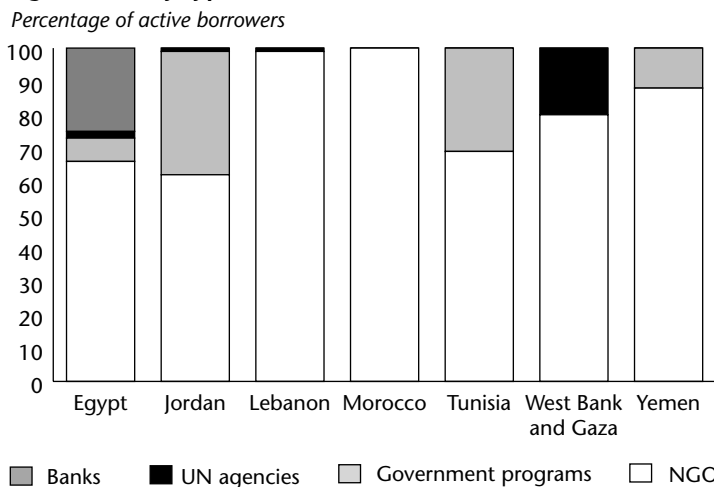
Institutional setup

Microfinance institutions come in a variety of institutional forms, including NGOs, non-profit microcredit entities, government-owned banks operating microfinance units, and commercial banks operating through microfinance subsidiaries. Most of these types of institutions are in place in the Middle East and North Africa (figure 3). Local NGOs are the most common form, followed by government programs operating through the

banking sector (and usually subject to political pressure), by international NGOs such as the Near East Foundation, CARE International, and Save the Children, and by United Nations agencies. Only one bank in the region, Egypt’s National Bank for Development, provides microfinance services without government interference (box 5). International NGOs operate either independently or jointly with local entities using domestic funding, foreign funding, or both. Private microfinance institutions have played a very limited role in the region’s microfinance efforts.

Each type of institution’s share in the total number of active borrowers is not always correlated with its share in the number of microfinance institutions. Local and international NGOs account for 78 percent of the 60 microfinance institutions in the region and serve 72 percent of active borrowers. Governments account for 13 percent of microfinance institutions and serve 8 percent of borrowers. But while the National Bank for Development is the only bank active in microfinance, it serves an impressive 17 percent of borrowers.

Figure 3. Many types of institutions are involved in microfinance



Source: World Bank survey of microfinance institutions.

This impressive performance by the National Bank for Development is not surprising given the economies of scale inherent in its branch network. Moreover, other commercial banks in the region have started to show more interest in microfinance. The Arab Bank, Jordan National Bank, and Commercial Bank of Palestine recently started microfinance programs in the West Bank and Gaza

Box 5. Egypt’s National Bank for Development: A model of best practice and private participation in microfinance

The National Bank for Development’s microcredit program—the only program in the Middle East and North Africa run by a private commercial bank—shows that banks can build profitable microloan portfolios. The bank has assets of \$1.7 billion, capital of \$71 million, and total lending of \$946 million. The microcredit program has been implemented in 33 of its 66 branches.

The microcredit program has 19,000 active borrowers and an outstanding loan portfolio of \$12 million. Like the Alexandria Business Association’s programs, it offers individual successive loans to microenterprises. The initial loan size is \$100, which indicates that the bank targets poorer entrepreneurs than the Alexandria Business Association. The bank also offers small business loans. One of its unique features is the mobile branch. Every week mini-vans—with a driver (who also acts as a security guard), tellers, and loan officers—visit areas

in Cairo where the bank has no branches. Repayments are collected, new loans are disbursed, and applications are reviewed. In areas where the bank has branch offices, loan officers visit borrowers every week to collect repayments.

The outreach potential of the National Bank for Development is considerable given its network of branches. Until a year ago the bank recruited recent graduates to serve as loan officers because it was thought that current staff were “tainted” by traditional banking procedures and could not be trained to issue and manage loans on a cash-flow basis. But the bank may prove this microfinance premise wrong: it recently started using existing staff. This staff is paid partly on a performance-based reward system and works on the microcredit program after official office hours. Initial results are promising and show that financial incentives are a major determinant of performance.

Source: National Bank for Development and World Bank.

Well-designed programs that focus on female participation can be successful

with help from the International Finance Corporation. And at least one bank in Lebanon, one bank in Morocco, and two banks in Yemen are expected to start microfinance operations in the near future. While microfinance practitioners should see these as positive signs, a lot of work is needed to avoid suboptimal practices and results. Monitoring banks' involvement to ensure the development of a solid microfinance sector—based on best practice—is crucial.

Type of services and outreach

Most of the services provided by microfinance institutions (except in some programs in Egypt) are either purely lending operations with some form of compulsory savings or part of an overall package of charitable activities. Group (joint liability) lending and individual lending are the two main forms of lending in all countries (except Morocco, where group lending is the only documented form). In addition, Egypt and Yemen have village banking systems, in which 30–40 villagers save and borrow. In terms of active borrowers, group lending is dominant in all countries except Egypt and Tunisia (figure 4). Group lending is most prominent in Jordan, Morocco, and the West Bank and Gaza.

There is a positive correlation between the poverty of the borrower and the size of the loan: the poorer is the borrower, the smaller is the loan (and the average outstanding loan bal-

ance). Only the poorest seek very small loans. For short-term working capital loans with a maturity of less than six months, the average loan size (that is, the original principal amount lent) is often twice the average outstanding loan balance. A microfinance program's effectiveness in targeting the poor can be gauged by comparing the average outstanding loan balance to the country's per capita income and to the poverty line. In the Middle East and North Africa only Jordan and Tunisia have an average loan balance above per capita income—suggesting that these programs are not targeting the poor and the poorest. Most microfinance programs in the region have an average loan balance somewhere between the per capita income and the poverty line.

Only the programs in Morocco and the West Bank and Gaza have an average loan balance below the poverty line, indicating that they may be targeting the poorest. The programs in these countries—the Save the Children program in the West Bank and Gaza, the United Nations Relief and Works Agency group lending program in Gaza, and Al Amana in Morocco—target exclusively women, who around the world are among the poorest. These programs also rely on group lending, which appears to be more attractive to the poor and poorest. All three programs are well on the road to sustainability. Though there is a perception that it is difficult to reach women in the Middle East and North Africa, well-designed programs that focus on female participation can be successful.

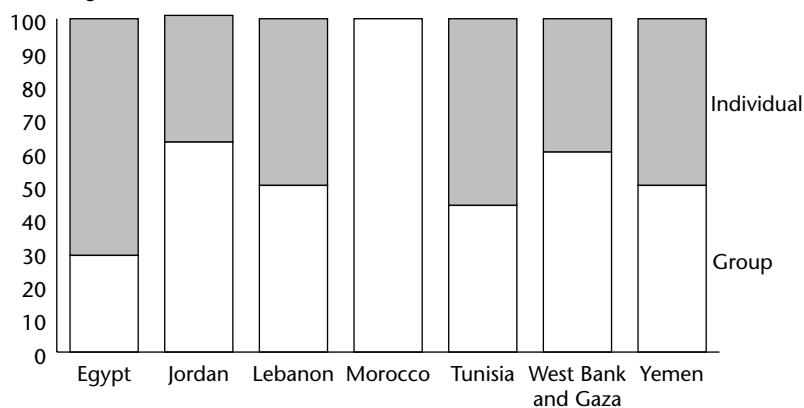
There is no clear relationship between institutional setup and depth of services. While NGOs like Save the Children target the poorest, other NGOs have large, medium-size, and small average loans relative to a country's per capita income. The same applies to government and bank programs.

Target groups

Four of the seven countries studied (Lebanon, Morocco, Tunisia, and the West Bank and Gaza) have more female than male borrowers. Three countries (Egypt, Jordan, and

Figure 4. Group lending is more common than individual lending

Percentage of active borrowers



Source: World Bank survey of microfinance institutions.

Yemen) serve more men than women (figure 5). But given the regional dominance of Egypt’s programs (in terms of number of borrowers), more men than women benefit from microfinance services in the region.

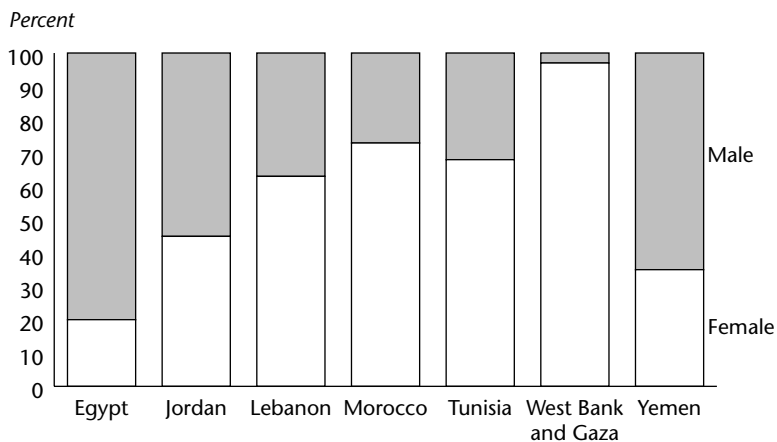
Most programs target both poor men and poor women. But some—such as those run by international NGOs (Save the Children) and UN agencies (United Nations Children’s Fund and United Nations Relief and Works Agency)—focus exclusively on women to promote their participation in economic activity and alleviate their poverty. Thus it is not surprising that the two countries with the largest share of female borrowers (Morocco and the West Bank and Gaza) also have the deepest outreach; because, in general, women are the poorest. Meanwhile, local NGOs and government programs that have no specific gender orientation (as in Egypt) have mostly male borrowers.

In just two countries (Tunisia and Yemen) are more than half the borrowers in rural areas (figure 6). In Egypt, which contains 66 percent of the region’s active borrowers, only 10 percent of borrowers are rural. Even in rural areas microfinance services are concentrated in high-density areas, leaving sparsely populated and remote regions almost untouched. These geographic disparities develop because microfinance services are costly to provide (particularly when the number of borrowers is low) and the difficulty of accessing these groups is aggravated by a lack of adequate infrastructure.

Sustainability and outreach

Sustainability and outreach are the most widely used criteria for assessing microfinance institutions. To be sustainable, a microfinance institution must achieve a certain level of outreach—in terms of number of borrowers—to benefit from economies of scale. In addition, it must generate enough revenue to cover operational and financial costs and allow for excess funds to be reinvested in the institution to serve a growing number of microentrepreneurs.

Figure 5. Though some microfinance programs target women, a majority of borrowers are men

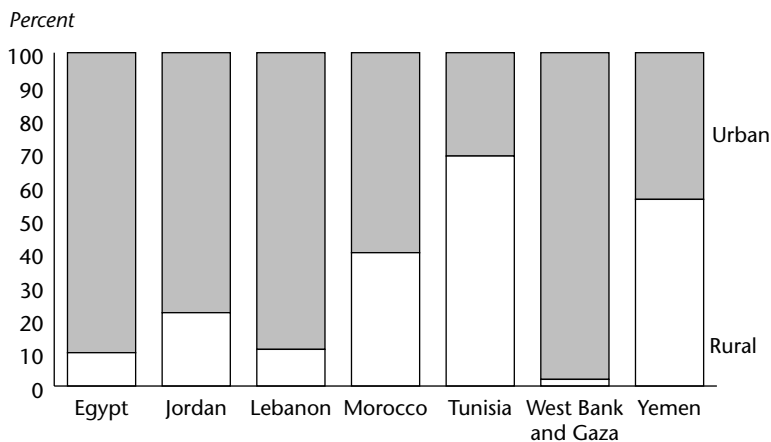


Source: World Bank survey of microfinance institutions.

Although outreach is necessary for sustainability, it is insufficient. A few programs in the region have reached a large number of borrowers—in some cases more than 10,000—but are far from sustainability. Most of these programs are government or quasi-government programs that charge subsidized interest rates. Borrower screening and follow-up are inefficient and loan arrears are high. The political will to transform these programs into sustainable microfinance institutions appears to be lacking.

Sustainability in the region’s microfinance institutions will be a challenge for years to come. About 95 percent of programs have not reached the first level of sustainability:

Figure 6. The region's microfinance programs mainly reach urban residents



Source: World Bank survey of microfinance institutions.

Sustainability
in the region's
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recovering operational costs, including depreciation and loan losses, from interest income and fees. Of the 60 programs surveyed, 46 are unable to recover 50 percent of their operational costs, 11 cover 50–99 percent, and just 3 cover 100 percent. Of the 3 programs covering their operational costs, 2 have achieved full sustainability—that is, they cover their operational costs as well as their financial costs adjusted for subsidies and inflation—and can operate without donor or government support. These are the National Bank for Development and the Alexandria Business Association, both in Egypt.¹ In addition, Save the Children programs in Jordan, Lebanon, and the West Bank and Gaza are well on the way to full sustainability. Table 4 provides details on a few best practice programs in the region. Operational sustainability among the other programs is hampered by the poor quality of loan portfolios, a lack of management information, excessive donor reporting requirements, and inefficient systems and procedures.

Poor loan portfolios. Except for the few following best practice, most microfinance programs in the Middle East and North Africa have lax loan collection methods, leading to high unpaid dues and delinquency rates. In Jordan, for example, some programs have delinquency rates of 70 percent.

Some programs also provide unnecessary subsidies by charging interest rates that are too low to cover costs and granting long grace periods. In some cases, even when microfinance institutions charge interest rates that would enable them to cover costs, governments force them to lower the rates or forgo repayments. Such practices deplete microfinance institutions of capital and assets and limit their ability to achieve outreach and sustainability. Moreover, the large size and long maturity of loans in some programs strain the liquidity of microfinance institutions, and thus require (in addition to high levels of capitalization) longer than average periods for the programs to achieve sustainability and outreach.

Lack of management information. Most microfinance programs suffer from a huge information gap: managers and staff lack basic knowledge on the quality and level of the services they provide. Information such as number of active borrowers or quality of the loan portfolio are hard to come by and do not seem to have any use in most microfinance institutions. This information gap is aggravated by a lack of understanding of microfinance terminology and indicators, and of their usefulness for planning and decisionmaking.

Excessive donor reporting requirements. Many programs must respond to excessive reporting requirements from donors. Programs that are funded by several donors spend a lot of time preparing reports—reports that are designed to meet the needs of the donors rather than of the microfinance institutions. Moreover, reporting requirements do not include key management information data such as number of active borrowers, outstanding loan portfolio, or aging of arrears. Programs can accurately and immediately provide the amount of funds disbursed to date, to satisfy some political constituency in a foreign country. But such information does not serve the managers of microfinance institutions.

Inefficient systems and procedures. Most microfinance institutions do not have a clear mission statement, which translates into an absence of adequate objective statements—particularly for sustainability and outreach objectives. Many institutions also fail to consider the importance of good management ability and structure, including board members and staff qualified in microfinance issues. Accordingly, conflicts often arise between the twin objectives of charity and financial viability. In addition, information systems rarely provide timely information for decisionmaking, monitoring, and evaluation of programs. Finally, few institutions have been exposed to microfinance best practices.

Table 4. Examples of best practice microfinance in the Middle East and North Africa

<i>Indicator</i>	<i>Alexandria Business Association</i>	<i>National Bank for Development</i>	<i>Save the Children microcredit programs</i>
Year founded	1990	1987	1994
Location	Alexandria, Egypt	Egypt	Jordan, Lebanon, West Bank and Gaza
Number of branches	10	Microfinance provided through 33 of 66 branches	Not available
Employees	195; 120 loan officers	390; 160 loan officers	86 loan officers
Number of active borrowers	14,500	18,800	Jordan, 3,700; Lebanon, 3,000; West Bank and Gaza, 7,300
Loans per loan officer	121	118	160
Outstanding loan portfolio	\$11,000,000	\$12,000,000	\$1,500,000
Average outstanding balance	\$765	\$638	\$133
Share of urban borrowers	100 percent	Mainly urban (Cairo 75 percent)	100 percent
Share of female borrowers	12 percent	14 percent	100 percent
Share of manufacturing loans	64 percent	22 percent	Not available
Loan products and delivery mechanism ^a	Individual successive loans from \$300–1,000 with a maturity of 4 months to 2 years; disbursement and repayment through banks	Individual successive loans from \$100–3000; disbursement and repayment through weekly visits by loan officers at borrower's site	Group members each receive same loan and guarantee; disbursement and repayment through banks through group treasurer
Guarantee mechanisms	<ul style="list-style-type: none"> • Post-dated checks • No access to future loans 	<ul style="list-style-type: none"> • Compulsory savings • Promissory notes • Insurance fee • Up-front late payment fee • No access to future loans 	<ul style="list-style-type: none"> • Group liability • Compulsory savings • No access to future loans
Savings	No	Compulsory savings of 10 percent of loan amount	Compulsory savings as down payment
Reward system for loan officers	Incentives based on repayments and number of clients	Bonuses for loans granted and repayments obtained	Based on performance
Institutional setup	Local NGO	Private bank; total assets of \$1.7 billion and total lending of \$946 million	Microcredit programs are part of the larger Save the Children program
Sustainability	100 percent operational and financial cost coverage; profitable	100 percent operational and financial cost coverage	Well under way
Strengths	Highly efficient	Outreach potential	Targets poorest
Weaknesses	Limited willingness of top management to put in own funds	<ul style="list-style-type: none"> • Limited managerial commitment • High overhead costs 	<ul style="list-style-type: none"> • "Mother" organization does not want to let go • Group loans have limited market
Future	Transition into a bank	Nationwide expansion	Spin off into microfinance institutions
Main donor	USAID	USAID	USAID; CGAP

Note: As of December 31, 1997.

a. All three programs charge an annual percentage interest rate that combines interest rates and fees. This rate is set to cover all operational and financial costs at an assumed but realistic break-even lending volume. For confidentiality reasons these rates are not disclosed.

Source: World Bank survey of microfinance institutions.

Few institutions have been exposed to microfinance best practices

The sustainability performance box

Sustainability is a minimum prerequisite not only for a microfinance institution to continue delivering financial services to the poor, but also for growth and ability to serve more entrepreneurial poor. In addition, sustainability enables a microfinance institution to be independent of (unreliable) donor or government funds.

As noted, the basic pillars of sustainability are covering costs and maintaining or deepening outreach. Targeting the entrepreneurial poor and poorest is always a challenge for a microfinance institution. If sustainability becomes a microfinance institution's sole objective, it may be tempted to target borrowers other than the poor. If that happens, the microfinance institution may get diverted from its primary goal—alleviating poverty—and become closed off from local reality, including demand.

The sustainability performance box can be used to analyze microfinance programs, evaluate performance, constraints, and challenges, and suggest strategies for higher achievement (figure 7). The x-axis shows the width of outreach—that is, the number of active borrowers. The y-axis shows operational cost recovery—that is, the percentage of operating costs covered by revenue and fee income. Note that the depth of outreach (how poor borrowers are) is not shown but is taken into account when plotting a microfinance institution's place in the box.

Operational cost coverage

Cost coverage (operational and financial) is a function of pricing, efficiency, and volume. Pricing involves setting interest rates or fees high enough to cover costs. To avoid passing the costs of inefficiency and scaling up on to borrowers, microfinance institutions should base their prices on a realistic forecast of an optimal lending volume.

Efficiency indicators include the number of active borrowers per loan officer and the

ratio of support staff to staff directly involved in lending. In the Middle East and North Africa an efficient and productive loan officer can manage at least 100 individual loans or 200 group loans. As for volume, per unit overhead costs decrease as a microfinance institution increases its lending.

A microfinance institution that does not cover 100 percent of its operational costs will remain dependent on subsidies. If subsidies dry up, these institutions will have to cut lending and will be forced to close in the medium to long term. Note that the sustainability performance box does not measure institutions' ability to cover financial costs—because a microfinance institution must cover operational costs before it can cover financial costs. If the box did show financial cost coverage, all the programs in the region except two would fall in the lower half (see below), without much room for further distinction.

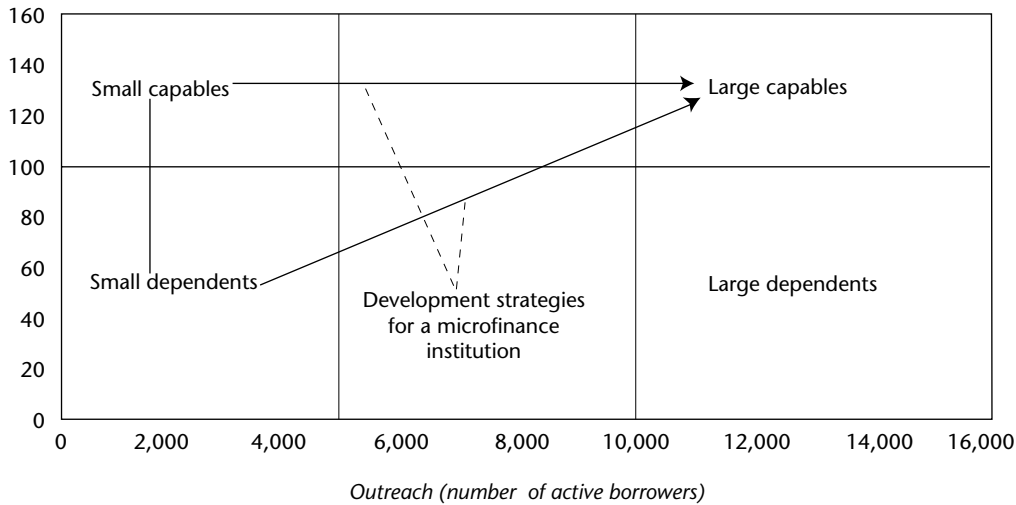
Outreach

In the sustainability performance box, outreach measures the number of active borrowers (width). The more borrowers a microfinance institution has, the higher is its lending volume and the lower are its overhead costs per unit of principal lent. Only by reaching a large number of borrowers can microfinance programs have a sustainable impact on poverty alleviation. As noted, the second dimension of outreach is its depth—how poor borrowers are.

The Middle East and North Africa can be divided into countries with potentially large markets for microfinance (Egypt, Iran, Morocco, Syria), countries with limited markets because of small populations (Jordan, Lebanon, West Bank and Gaza), and countries with a population spread over a large, inaccessible area (Yemen). One of the challenges for the smaller countries is building small but sustainable microcredit programs. Depending on its country (especially costs of living and accessibility of borrowers), loan size, and target group, a

Figure 7. The sustainability performance box

Operational cost recovery (percent)



Only by reaching a large number of borrowers can microfinance programs have a sustainable impact on poverty alleviation

microfinance institution in the region needs 5,000–10,000 active borrowers to become fully sustainable. Microfinance institutions in small markets may never grow much beyond these numbers, but they can deliver needed services on a sustainable and profitable basis.

Four types of institutions

The sustainability performance box shows the four types of microfinance institutions in the Middle East and North Africa: small and large capables and small and large dependents.

Capables. The upper half of the sustainability performance box contains the region’s “capable” microfinance institutions, comprising small capables and large capables. These institutions show clear potential for becoming fully self-sustainable and achieving their objectives, and have put in place the basics of sound management.

The large capables (upper right-hand corner) cover 100 percent of their operational costs, are increasing their market share, face no constraints on expansion, and have the greatest potential for alleviating poverty. Some of the programs in this group cover their operational costs but not yet their financial costs. Thus their challenge is to increase

volume and efficiency to generate a healthy profit, to build a capital base. Only with a capital base can the programs start borrowing commercially for onlending. Institutional setup and independence are crucial during this phase of development. For example, banks will only lend to legal entities that are accountable and transparent. An NGO or microfinance program within a larger social program does not fit this description. Thus a legal transformation appears to be an essential precondition for microfinance institutions seeking to borrow commercially for onlending (not to mention those seeking to take deposits).

The small capables (upper left-hand corner) cover 100 percent of their operational costs. They are familiar with best practice and usually have explicit sustainability and outreach goals. Their main challenges are to increase loan volume and cover financial costs (if they have not yet done so).

For programs operating in small markets this will often entail diversifying loan products—that is, offering several types of loan products, each catering to a different market niche. The United Nations Relief and Works Agency program in Gaza falls into this category. It will probably never become sustainable if it offers only group lending or only individual lending. But if

Becoming sustainable has a price, and some program managers are unwilling to pay that price

it provides different financial services to different target groups, allowing borrowers to graduate from one loan product to another, it will become a small but sustainable program.

For programs operating in large markets, increasing loan volume basically means doing more of the same. The challenge for these programs is to manage growth carefully, ensuring that monitoring systems keep up with the increase in loan volume. In several cases programs in the region have expanded too rapidly and suddenly faced arrears, fraud, and loss of customers.

Dependents. The lower half of the sustainability performance box contains the “dependent” microfinance institutions, comprising small dependents and large dependents. These institutions, unable to generate sufficient revenue, require continuous government or donor funding to maintain their operations, even with no plans for expansion.

The large dependents (lower right-hand corner) have achieved a lending volume that technically enables them to cover their costs, but they do not. Because these programs have always been subsidized (by governments or donors), they have never felt pressure to become sustainable. They are often inefficient and usually charge subsidized interest rates that are well below the prime rate and in some cases negative in real terms. If large dependent microfinance institutions lose their subsidies (without increasing efficiency and prices), they will end up depleting their loan capital and may eventually disappear.

The small dependents (lower left-hand corner) can be divided into two groups: deficient dependents and potential growth dependents. Deficient dependents are programs that will never achieve scale and will never become sustainable. Many have implicitly or explicitly

chosen this path. Not every program should aim for full sustainability, and not every program can become sustainable. Becoming sustainable has a price, and some program managers are unwilling to pay that price. Whatever a program chooses to achieve is justifiable—as long as its choice is based on full information and understanding of the consequences of each option. The challenge for donors is to ensure that these programs are exposed to best practice so that a conscious, strategic choice can be made about whether to strive for sustainability. When a program chooses not to strive for sustainability, donors need to carefully assess whether its benefits outweigh its costs.

Potential growth dependents are young microfinance programs that are expected to scale up and cover costs rapidly. Their challenge is to manage growth while keeping up systems and procedures. Experience shows that early experimentation with loan product delivery systems and procedures is very important. Experimentation may delay growth, but it enables a microfinance institution to test loan products, get to know its clients, and develop systems and procedures. Once these are in place, the institution is ready and able to grow. Evolving from a small dependent to a small capable is preferable to evolving from a small dependent to a large dependent. Evolving from a large dependent to a large capable is difficult. The process consumes considerable time and money, and there is no guarantee that it will work.

Note

1. Sustainability is defined at two levels. Operational sustainability is the ability of a microfinance institution to cover its operational costs, including depreciation and loan losses, from its interest income and fees. Financial sustainability or full sustainability is the ability of a microfinance institution to cover its operational costs as well as its costs of funds (adjusted for subsidies).

Building Institutional Capacity in the Region's Microfinance Institutions

To become sustainable, microfinance institutions in the Middle East and North Africa must extend their outreach and recover operational—and eventually, financial—costs. As things stand, most microfinance institutions are too weak to achieve either goal. What can be done to boost the institutional capacity of the region's microfinance intermediaries?

What is institutional capacity?

Institutional capacity refers to a set of elements that need to be in place for an institution to function properly and achieve its mission and goals. One element of institutional capacity is visionary leadership that sets the direction for an organization. Another element is competent and autonomous management that takes the actions needed to achieve the organization's mission and goals. Thus a clearly stated mission, accompanied by goals and objectives, is also essential.

Among other things, a mission statement for a microfinance institution might pledge to raise the living standards of underserved poor groups by providing financial services that facilitate productive activity and economic independence. The medium- and long-term goals that accompany the mission statement explain the results that are needed to achieve the mission. Goals, in turn, should be divided into short-term objectives that are quantified and time-bound, to help measure the microfinance institution's progress toward the goals.

Institutional capacity also requires an organizational structure that allows the efficient

achievement of those goals and objectives. For example, an institution seeking to serve geographically dispersed borrowers within three days of a request for service should be able to act quickly. Thus the most appropriate structure would be a decentralized organization with well-trained staff at the field office level who are able to make loan decisions quickly.

Similarly, qualified and motivated staff are essential to institutional capacity. Staff should have relevant education and experience, complemented by proper training. Of equal importance is an incentive scheme that encourages employees to act in the interests and according to the objectives of the microfinance institution—as when loan officers are rewarded according to the number of their loans that are repaid on time. In addition, systems and procedures should establish work guidelines in an efficient and transparent manner, with built-in controls to continuously improve operations.

Finally, a microfinance institution cannot function unless it can mobilize resources, both financial and technical, to implement programs. Technical resources include items such as a management information system and decentralized loan processing system. Whether manual or computerized, a management information system should provide managers with timely information so they can make proper decisions.

For microfinance programs to be effective and efficient, good institutional capacity should prevail at three levels:

- *The level of the microfinance institution.*
Building capacity in microfinance insti-

Qualified and motivated staff are essential to institutional capacity

Microfinance best practices are generally not followed in the Middle East and North Africa

tutions will improve management of microfinance programs and increase efficiency in the use of resources (through better cost control and pricing policies), enabling microfinance institutions to achieve larger outreach and higher sustainability.

- *The level of training institutions.* Increasing training capacity will help build the human resources needed to manage microfinance institutions (both existing and new) and develop and disseminate information on best practices. Over the medium to long term higher local training capacity will increase efficiency by lowering the costs of training and information, which otherwise are provided at high costs internationally.
- *The level of microenterprises.* Building the capacity of microenterprises will help them understand basic principles of business management, manage their business efficiently, service their debts, and raise their standard of living. Best practice suggests, however, that building capacity in microenterprises is a nonfinancial service that is best offered by institutions other than microfinance institutions.

Areas to focus on

The survey of microfinance institutions undertaken for this report reveals that microfinance best practices are generally not followed in the Middle East and North Africa. Weak institutional capacity is reflected in a lack of clear mission statements, goals, and objectives; poor institutional structures and unqualified staff; and insufficient systems and procedures. Unless investments are made in human capital and systems development, microfinance will continue to play an insignificant role in the region's economic activity.

Mission statements, goals, and objectives

All but a few microfinance institutions in the region do not have a clear mission. And when mission statements and goals are spelled out,

they are vague and not specific to the microfinance institution. Examples include:

- Promoting socioeconomic development.
- Improving production technology.
- Acting as a development NGO.
- Creating and consolidating employment.
- Increasing national food security and improving the quality of life of communities.

Such goals are hard to achieve. Most objectives are similarly general and lack a timeframe for their achievement. This situation makes it difficult to measure progress toward objectives or to take corrective actions. In addition, most microfinance institutions seem confused about the distinction between the business plan and the goals and objectives, which makes it hard to tell where an institution is heading and how is it measuring progress.

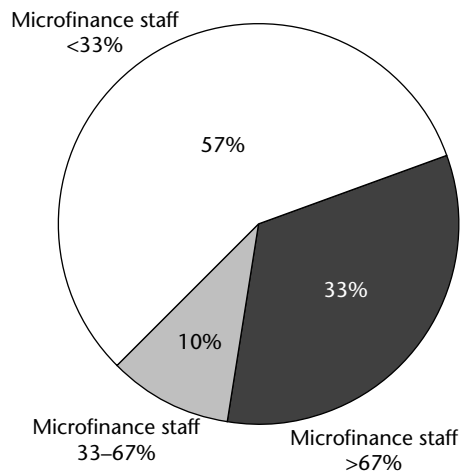
One of the most important objectives for a microfinance institution—one that is often overlooked—is to achieve sustainability. While not a goal in itself, sustainability is necessary to achieve other goals, such as becoming an independent autonomous entity, serving a larger population, and alleviating poverty.

Structure and staff

Most microfinance institutions are organized by function—few are organized by project—and many fall under an overall social development program. A proxy of a program's focus on microfinance is the share of staff working on microfinance (as a percentage of all staff). Among the institutions surveyed, the share of staff working directly on microfinance activities varied. One-third of the institutions have at least 67 percent of their staff working on microfinance (figure 8). Just 20 percent have 100 percent or close to 100 percent of staff working on microfinance; half of these are in Egypt. At the other end of the spectrum, 18 percent of the institutions surveyed have less than 3 percent of their staff working on microfinance—indicating that microfinance is an add-on activity.

In most microfinance institutions decisionmaking is centralized and cumbersome.

Figure 8. Most of the region's microfinance institutions are not fully devoted to microfinance activities



Source: World Bank survey of microfinance institutions.

For example, 78 percent of the institutions surveyed have centralized decisionmaking for loan approval or rely on lengthy and bureaucratic approval procedures. Some loan approval decisions involve board members, an executive committee, and the director of the microfinance institution, while others require a series of approvals before the loan is disbursed.

Most microfinance institutions have untrained staff, and there is a huge need for training in all areas of management—particularly areas related to microfinance. Most of the training provided by microfinance institutions is general and is not tailored to the needs of the institution and staff or to the microfinance industry.

Systems and procedures

Most microfinance institutions do not have internal control systems, effective information systems, or incentive schemes for staff. All the institutions surveyed produce monthly and annual reports, including financial statements. Yet in most cases management of information appears to be deficient.

In many instances basic information—number of staff working on microfinance, number of active urban or female borrowers,

level of funding received by the institution—was left unanswered. Although nearly half of the institutions reported having a performance-based incentive scheme for staff, the descriptions of these schemes reveal that only a third of them can be considered as such.

Building skills with training

Most of the institutional shortcomings in the region's microfinance institutions are not simply related to microfinance practices; they also involve general business practices. Most microfinance institutions recognize the need for professional training in both areas (table 5). Egypt, Jordan, and Tunisia have a relatively higher need for training in microfinance practices. Only Lebanon has a greater need for training in general business practices. The other countries in the region have more or less the same need to learn about general business practices and microfinance practices.

Can microfinance institutions expect to receive such training locally? Maybe. Microfinance practitioners from Egypt, Jordan, and Tunisia, for example, believe that training in most of the general business areas listed in table 5 can be provided locally (table 6). Except for Jordan, the same respondents believe that local training capacity is slightly lower for microfinance subjects. On the other hand, microfinance practitioners in Lebanon, Morocco, and the West Bank and Gaza believe that local training capacity in all areas, particularly microfinance, is very low.

But in countries where local training capacity is believed to exist, training facilities are rarely used or the training tends to be irrelevant to the needs of microfinance institutions. One reason for this weakness is that microfinance institutions do not consider training an important element of strengthening management and motivating employees. Another is that the curriculums of training institutions do not meet the needs of the marketplace. As noted, microfinance training is believed to

Management systems and structures should be updated

Table 5. Microfinance institutions assess their training needs

<i>Training needed</i>	<i>Egypt</i>	<i>Jordan</i>	<i>Lebanon</i>	<i>Morocco</i>	<i>Tunisia</i>	<i>West Bank and Gaza</i>	<i>Yemen</i>
<i>General business practices</i>							
Governance	14	8	1	2	3	7	3
Strategic and business planning	11	8	3	3	33	8	3
Finance and accounting	15	7	3	4	18	10	5
Human resource management	15	6	3	3	7	6	4
Legal and regulatory issues	12	6	2	2	7	8	2
<i>Microfinance practices</i>							
Loan portfolio management	18	9	1	3	20	7	4
Management information systems	19	9	1	3	18	4	1
Delinquency management	19	9	1	4	20	8	4
Fraud management	14	6		2	6	10	3
Product development	20	7	1	3	30	8	4
Accounting, budgeting, and control	17	8	2	4	29	9	2
Targeting and outreach	15	7	1	3	20	6	2
Loan officer incentive systems	20	7	3	2	5	7	3
Program evaluation	17	8	3	3	33	8	2
Maximum possible score	39	33	15	12	36	12	15

Note: Scores show the number of times respondents indicated an area where they need training and skills development. Respondents could score an area from 0 (no need for training) to 3 (training is needed at the basic, moderate, and advanced levels). The maximum possible score is the number of respondents multiplied by 3.
Source: World Bank survey of microfinance institutions.

be less available than general business courses by all respondents except those in Jordan.

The need for microfinance training is expected to increase because of the region's large outreach gap. The expansion of existing microfinance institutions and the entry of new ones should dramatically increase the demand for microfinance

training in the next few years. Despite the large demand for microfinance training, local supply has been almost nonexistent. Few local microfinance experts are capable of conducting good training. Most training is conducted abroad with foreign consultants, making it very expensive for microfinance institutions to meet their training needs.

Table 6. Microfinance institutions assess local training (percent)

<i>Country</i>	<i>Respondents who believe that general business training can be provided locally</i>	<i>Respondents who believe that microfinance training can be provided locally</i>
Egypt	88	82
Jordan	69	77
Lebanon	15	0
Morocco	25 ^a	0
Tunisia	92	81
West Bank and Gaza	25	25

Note: Results for Yemen are not shown because survey responses were unclear.

a. Finance and accounting only.

Source: World Bank survey of microfinance institutions.

What Next?

The provision of microfinance services in the Middle East and North Africa must increase dramatically to even scratch the surface of the poverty challenge. At least 4.6 million entrepreneurial poor need access to financial services, and at least \$1.4 billion is needed for onlending. Although it is unlikely that donor funding for microfinance will decrease—given the increasing role of the European Union in the region, especially in North Africa—for several reasons microfinance intermediaries must become more self-sustainable.

Encouraging microfinance institutions to know their operational and financial costs and strive to cover them builds a culture of self-evaluation and increases efficiency in the use of resources. And increased efficiency, along with good management capacity and ability to generate profits, attracts private capital and helps narrow the financing gap. Sustainability will make microfinance institutions less vulnerable to government interference and donor unreliability.

But practitioners, donors, and governments must do more than build sustainable microfinance programs. They must also focus on delivering financial services to the poor and poorest—especially women and people in rural areas. Sustainable programs that target women exclusively can succeed in the Middle East and North Africa. To do so, they must both target women and pursue sustainability. The next frontier for microfinance institutions in the region is to deliver financial services to the rural poor, who are largely underserved.

Many more providers of microfinance are needed. Banks could play a key, if not a leading, role in this sector. The opening up of Iran and Syria offers a unique opportunity to build sustainable microfinance programs right from the start. In addition, the growing interest of Islamic banks in sustainable microfinance will contribute to new approaches to microfinance that are unique to Middle Eastern and North African countries.

Our recommendations are grouped in two sections. First we offer ways to improve and expand the microfinance industry in the region. Then we translate those recommendations into specific actions for governments, donors, and practitioners.

Developing more and better microfinance programs

The most important recommendation for microfinance institutions is to adopt a business orientation—based on best practices—toward delivering financial services to the poor. Similarly, the performance and outreach of existing microfinance institutions must improve; training will play a key role in this regard. Finally, the formal financial sector must be engaged in microfinance, and new nonbank microfinance intermediaries must be created—especially in countries where they could catalyze the development of the microfinance industry.

Institutionalizing best practices

All microfinance providers should adopt standard principles of management that are pre-

Practitioners, donors, and governments must focus on delivering financial services to the poor and poorest

Managers and staff should be aware of developments in microfinance best practice

requisites for good performance. Several of these principles were either partly or totally absent in most of the microfinance programs surveyed:

- *A capable governing body.* If a microfinance institution has a visionary board of directors and leaders who understand the microfinance business and have clear goals on where they want to go with it, all the rest will follow.
- *A clearly defined mission,* accompanied by medium- and long-term goals that are translated into short-term objectives and strategies. Goals and objectives should be quantifiable and set within a reasonable timeframe.
- *Qualified management and staff,* to design and implement strategies and achieve goals and objectives.
- *Systems and procedures* that clearly define roles, responsibilities, and accountability, and aim to achieve objectives in the most efficient way possible. Services must be tailored to local demand; thus they must be able to adapt to changes in market characteristics.
- *A good management information system* that is easy to use, captures all necessary information (on clients, loans, and staff performance), and produces reports on a routine or ad hoc basis. This information should be used continuously to monitor and evaluate programs.

All these efforts should share efficiency as a common denominator, so that microfinance institutions can be competitive and service clients in the most timely manner and at the lowest cost. Managers and staff should be aware of developments in microfinance best practice and adopt those that allow more efficient and effective ways of doing business.

Building capacity for sustainability and outreach

Of the 60 programs in the region, 2 are large capables, none are small capables (though 8 are considered close), 3 are large dependents, and 55 are small dependents (with 30 poten-

tial growth dependents and 25 deficient dependents). Recommendations for increasing a program's capacity depend on the group in which it falls.

Large capables. The main challenge for large capables—which cover 100 percent of their operational costs and have extensive outreach—is to become fully sustainable (covering financial costs) while maintaining their focus on serving the poor. Such programs must manage rapid growth, decentralize their lending efforts, and obtain legal status as a financial intermediary (in order to borrow commercially for onlending or to take deposits). If these programs do not wish to transform into a specialized financial intermediary or bank, they could merge with banks or sell their loan portfolios to a bank.

Both programs in this category in the Middle East and North Africa have achieved full sustainability. The Alexandria Business Association's challenge is becoming a formal financial institution while staying focused on the poor. The National Bank for Development's challenge is expanding its program nationwide while keeping a focus on efficiency. Both programs, operating in Egypt, have an almost limitless market.

Small capables. The main challenge for small capables—which have the basics right and manage small programs according to best practice—is to grow. Although none of the programs studied technically fits this category, the three Save the Children programs in Jordan, Lebanon, and the West Bank and Gaza and the United Nations Relief and Works Agency program in Gaza are close to 100 percent cost coverage and face similar issues. They all operate in small countries with limited markets; growth means staying small but becoming sustainable. In some cases this will require diversifying the financial services offered because the market may be too small to allow sustainability with just one product. These programs need help designing and testing new loan products and adapting their operational and management

information systems to accommodate these new products. By contrast, small capables in large countries like Egypt could become large capables by reaching more poor people with the same product and maintaining efficiency.

The eight potential small capables mentioned above are all part of larger (sometimes charitable) organizations. Spinning off these microfinance programs from their larger operations is essential for their survival and expansion because they need the freedom to implement managerial and operational systems that are appropriate for microfinance. Whenever possible, these programs should be immediately spun off into a microfinance legal entity instead of an NGO, to avoid a second legal transformation once the program is ready to borrow funds from commercial banks to onlend commercially (see above). In most cases microfinance legal entities should not take deposits as a source for onlending.

The main risk for small capables is that they will grow too fast and their systems will not keep up with their growth. They may need help upgrading their management information systems, introducing fraud control, and decentralizing functions and responsibilities.

Large dependents. The main challenge for large dependents—which have achieved significant outreach but do not cover costs—is to become more efficient and cover all costs. This move usually involves eliminating subsidized interest rates for borrowers. These programs have always been heavily subsidized by donors and governments, and these subsidies are unlikely to disappear. Given the large number of borrowers these programs have reached, their suboptimal but functioning management systems, and vested political interests, it will be difficult to turn these programs into independent, self-sufficient programs that fully cover their costs.

Small dependents. The main challenge for small dependents is to move up the best practice learning curve to become capable, and

to increase the size of their operations to reach more borrowers. First these institutions should strive to become small capables—that is, to develop and test loan products, get to know their markets, implement management systems, and so on. Only when these fundamentals have been mastered will these programs be able to proceed to the next phase: growing and becoming large capables.

About 30 of the small dependents show potential for learning and growth. These are often young programs designed and implemented according to best practice standards, with clearly stated objectives for sustainability and outreach. These programs need tailored assistance to move up the learning curve as soon as possible. The timing and appropriateness of this assistance are of paramount importance to the successful transition.

The 25 deficient dependents have slim chances of ever becoming sustainable. Most suffer from government interference, lack capable leadership and staff, are inefficient and oriented toward charity, and offer subsidized loans.

Increasing training opportunities

The absence of local microfinance training capacity has contributed to the lack of management capacity in most microfinance institutions in the Middle East and North Africa. Developing the microfinance industry in the region will require building human capital in microfinance. Doing so will allow continuous local training for practitioners, lower the cost of training, and develop and disseminate microfinance material and best practices.

To that end, material on best practices in microfinance should be translated (into Arabic and French) and disseminated. Local and regional microfinance training should be developed and provided to all practitioners. Similarly, local, regional, and international training should be given to all potential trainers, to build local training capacity. Training materials should be adapted to market needs. And professional standards, supported by a body of microfinance professionals, should

Developing the microfinance industry in the region will require building human capital in microfinance

be developed, possibly with an accreditation mechanism.

Engaging the formal financial sector

Only one bank in the Middle East and North Africa—Egypt’s National Bank for Development—has engaged in best practice microfinance and is turning a profit. Many other banks have been under government or political pressure to provide credit to microenterprises and small enterprises. These poorly designed programs lack management commitment, since they are imposed rather than chosen. In addition, they usually charge subsidized interest rates. Thus it is not surprising that such programs have poor performance. Along with the cheap microloans provided by NGOs and government agencies, such programs have been major disincentives for banks to engage in microfinance.

Banks and other formal financial intermediaries, such as consumer lending companies, are potentially the main players in the provision of microfinance services. In some countries the outreach potential of banks with thousands of branches is indisputable, and the total funding needed for onlending to microenterprises (\$1.4 billion) represents less than 1 percent of their total assets (table 7).

Banks will only engage in microfinance when it is profitable for them to do so. But traditional asset- and document-based

approaches to lending are inappropriate for microfinance. To succeed in this field, banks must change how they do business, adopting new lending techniques that manage risks and lower costs. In addition, several conditions must be met to build profitable microfinance programs in banks. Banks must be financially viable, with a strategic commitment to microfinance. An enabling legal and regulatory framework must be in place. And government policies must be favorable to the financial sector.

Financial viability and strategic commitment. Not every bank should engage in microfinance. Only banks that see microenterprises (and small enterprises) as a strategic market niche should engage in it. For instance, banks that are strong in retail banking or consumer lending are closer to microfinance target groups than are banks that provide only corporate services. Management commitment is crucial because it means microfinance will be treated like any other product line, giving it due attention in terms of setting objectives and plans, mobilizing human and material resources, and ensuring accountability to boards of directors. If a bank is state-owned, continued commitment to microfinance—for example, after privatization or restructuring—needs to be assured. In addition, any bank engaging in

Banks will only engage in microfinance when it is profitable for them to do so

Table 7. Outreach and funding potential of the formal financial sector
(millions of U.S. dollars unless otherwise noted)

Country	Outreach gap (number of borrowers)	Number of bank branches	Microfinancing gap	Total assets	Total lending	Total deposits
Egypt	1,475,000	2,325 ^a	371	76,000	38,000	51,000
Jordan	145,000	265	54	18,200	6,800	7,100
Lebanon	36,000	200	37	19,000	5,600	15,500
Morocco	485,000	900	194	28,000	15,000	20,000 ^b
West Bank and Gaza	33,000	80	17	2,500	500	2,000
Yemen	649,000	—	97	1,800	300	1,400
Total	2,824,000	3,445	770	145,500	66,200	97,000

a. Excludes 2,900 branches of the postal savings network.

b. Estimated.

Source: World Bank survey of microfinance institutions.

microfinance should be financially viable and in compliance with central bank requirements.

Legal and regulatory framework. Microfinance activities may be impeded by such legal and regulatory obstacles as interest rate ceilings (Morocco), inability to reward loan officers based on performance (state-owned banks in Egypt), lack of legal status for mobile branches (Lebanon), inability to engage in financial transactions with non-registered (informal) enterprises, minimum deposit or savings requirements that exclude the poor from opening accounts, and loan classification rules. In such cases financial sector legislation should not be immediately overhauled. Rather, exceptions should be allowed on a pilot basis for a transition period. Regulators and microfinance practitioners should coordinate their efforts and learn from these pilot programs before making permanent changes to rules and regulations.

Government policies for the financial sector. A deregulated, competitive financial sector creates incentives for banks to seek out new market niches and offer new financial services. Lebanon offers a good example. Such opportunities also exist in Jordan, where steady deregulation has increased the interest of banks in microenterprise and small enterprise finance. Although deregulation is not a prerequisite for microfinance—as Egypt’s National Bank for Development shows—an environment in which banks can compete is more favorable to such activities. More difficult to overcome is the negative attitude of governments toward donor-funded microfinance demonstration programs, especially with private banks. Agricultural banks and postal savings systems should not be excluded from such efforts, but should be treated with caution on a case-by-case basis.

The financial sector’s role in microfinance is not limited to the direct provision of financial services to the poor. Many microfinance intermediaries, when increasing their cov-

erage of operational and financial costs, will turn to banks to borrow for onlending to microenterprises. Donors and governments should make it a priority to promote links between the various players in microfinance. For instance, donors can guarantee loans by commercial banks to sound microfinance institutions. Such links will not only deepen the financial system, they will also enable microfinance institution borrowers to graduate and become bank clients. They will also enable banks to get to know microentrepreneurs, which will help eliminate banks’ misperceptions about them.

Developing new microfinance intermediaries

Engaging the formal financial sector in microfinance will be the most efficient, fast, and cost-effective way to fill the outreach gap and financing gap and serve the needs of many more entrepreneurial poor. Still, for several reasons new, nonbank microfinance intermediaries should be created.

Some target groups—especially the poorest women—have financial needs that banks may never be able or willing to meet because the costs of doing so are too high. In the Middle East and North Africa the poorest, usually women, are served by programs that offer group guarantee lending. This methodology substitutes for the poor’s lack of collateral and enables the microfinance intermediary to transfer to the group the high transactions costs of microlending. Group members evaluate and guarantee one another’s business projects, while the group treasurer usually collects repayments. Although a few banks in the world have successfully engaged in group lending, individual lending appears to be more appropriate for banks. Hence there is a need to replicate the successes achieved with group lending programs in the Middle East and North Africa, both in the same countries and in countries with no microfinance programs. Lessons from emerging best practice group lending pro-

Donors and governments should make it a priority to promote links between the various players in microfinance

The main priority for donor funding is to develop local capacity to deliver services in an effective manner

grams—such as the Save the Children program and United Nations Relief and Works Agency program in Gaza—should be carefully documented. The local staff of these organizations should be involved in the replication process.

A new microfinance intermediary is more visible because it specializes in microenterprises, and its success can help set standards for best practice. Especially in countries with no experience in microfinance (Algeria, Iran, Syria) and countries with limited experience (Morocco, Tunisia, Yemen), a visible and successful microfinance intermediary can set best practice standards right from the start. In addition, its success can motivate banks to enter this market.

Finally, new microfinance intermediaries can help meet the needs of the poor in countries where banks are not ready for or interested in microfinance. In some countries the financial sector is weak or undergoing intensive restructuring. In other countries the financial sector is overregulated and there are no incentives for banks to engage in microfinance. Both situations justify the creation of new microfinance institutions. These institutions should be linked to the formal financial sector whenever possible.

What should governments do?

Governments should create an enabling environment in which microfinance intermediaries and microenterprises can develop and grow, and in which banks can engage in microfinance. Governments should not interfere with or deliver financial services to the poor; rather, they should encourage the private sector and NGOs to do so.

As long as microfinance intermediaries such as NGOs and foundations do not take deposits, there is no need to regulate or supervise the sector because doing so may stifle learning, experimentation, and growth (box 6). Except for Egypt's Alexandria Business Association, no microfinance intermediary in the Middle East and North Africa is ready to take deposits as a source of funds.

Moreover, an easier and possibly cheaper way to raise funds is to borrow commercially from the financial sector.

Legal and regulatory obstacles to microfinance (such as interest rate ceilings) should be removed. Such adjustments should proceed on a pilot basis and build on the lessons learned. In countries where microfinance intermediaries are ready to borrow commercially for lending—Egypt, Jordan, Lebanon, West Bank and Gaza—governments should enhance or create a legal framework for microfinance intermediaries as nondeposit-taking financial institutions. This ensures accountability, transparency, and adherence to financial sector standards. Intermediaries that are ready to become deposit-taking banks should be considered on a case-by-case basis.

What should donors do?

The most important recommendation for donors is to adhere to and implement best practice standards in selecting and funding microfinance programs. Possibly the best-known and most effective platform for donor coordination and dissemination of best practices is the Consultative Group to Assist the Poorest; donors are advised to join this platform.

The main priority for donor funding for microfinance in the Middle East and North Africa is to develop local capacity to deliver services in an effective manner. This requires training, institutional development, technical assistance, and translation and dissemination of best practice materials. Any donor-funded microfinance program should adhere to basic business standards and practices. In designing and implementing new programs, donors should aim to include the formal financial sector.

Donors wishing to target women should fund programs that target women exclusively. Efforts should also be made to increase the poor's access to financial services in rural areas. Despite pressures to disburse, donors should spend their funds with restraint to

Box 6. To regulate or not to regulate?

Bank regulators in many countries must decide whether to regulate the emerging microfinance sector. As unregulated financial entities, healthy microfinance institutions have been able to adapt operating methods to serve their target markets. This has led to the development of a small but growing number of robust, specialized financial institutions, innovative delivery methods, and an extension of financial services. When regulation is warranted, it requires coherent prudential guidelines that allow the microfinance sector to grow while protecting the interests of small savers and supporting the integrity of the financial sector.

Most bank superintendents and their staff, central bank officials, and personnel from other public agencies are unfamiliar with microfinance institutions and the regulatory developments affecting them. Whether microfinance institutions are specialized or part of a commercial bank, supervising them is difficult because of their large number of small transactions, lack of conventional security, and decentralized operations. Many regulations adopted to address the risks of commercial banks do not apply to microfinance institutions.

The challenge facing regulators is complicated by the fact that microfinance institutions range significantly in institutional type, scale of operations, and level of professionalism. Informal rotating savings and credit associations, village banks, national and regional NGOs, credit cooperatives, and commercial banks may all fall within the broad definition of microfinance institutions. A country's regulatory approach must be consistent with the financial sector framework and consider the variety of institutional types. Possible responses to microfinance institutions range from no regulation to full regulation:

- *No regulation.* Because microfinance has evolved outside a regulatory framework, it has been free to develop nontraditional approaches to providing financial services. In some countries, as the local

Source: Berenbach and Churchill 1997.

microfinance industry has matured, microfinance institutions have established associations or interest groups to define best practices and set industry standards.

- *Self-regulation.* Self-regulation occurs when the microfinance industry develops its own supervisory and governance bodies. This has occurred primarily through federations of credit unions or cooperatives.
- *The hybrid approach.* Under the hybrid approach, regulatory authorities contract a third party—such as an accounting or consulting firm—to perform some or all supervisory functions.
- *Existing law or special law.* Some countries have chosen to regulate microfinance institutions within the existing legal and regulatory framework for financial institutions while adapting required ratios and supervisory practices to address their unique risk profile. Other jurisdictions have established special laws.

Most microfinance institutions are small, informal, and operate as voluntary associations at the local level. It is neither feasible nor desirable to regulate them. Instead regulators should focus their efforts on institutions that want to offer deposit-taking services to the general public. Very few microfinance institutions have the ownership structure, management, financial discipline, information systems, and profitability needed to be safe deposit takers. In most countries no more than one or two institutions might warrant regulatory attention. In general, it is only necessary to regulate microfinance institutions that mobilize voluntary savings for the purpose of onlending. But some organizations that mobilize voluntary savings do not need to be regulated. For example, it may not be necessary to regulate village banks and rotating savings and credit associations, which are usually so small that all members know each other. Most experts agree that as long as microfinance institutions do not mobilize savings from the public, they should not be regulated.

As long as microfinance institutions do not mobilize savings from the public, they should not be regulated

avoid flooding the market. Funding for microfinance programs should be contingent on these programs meeting realistic performance standards that become tighter over time.

Donors have to carefully balance a microfinance program's sustainability objec-

tive with its focus on serving the poor and poorest. If sustainability is the sole objective, a microfinance program may become a closed loop, sealed off from reality and the needs of the target groups it was launched to serve.

What should practitioners do?

The main recommendation for the hundreds of microfinance practitioners in the Middle East and North Africa—from loan officers to chairs of supervisory boards—is to learn from the experiences with microfinance elsewhere and to implement best practice principles tailored to local needs. Microfinance is a nascent industry in the region. Thus practitioners are in a unique position to shape the industry, set standards, and develop best practices that reflect the features of Middle Eastern and North African countries.

Strengthening and expanding the region's microfinance industry will require adopting a business orientation toward the delivery of financial services to the poor—whether these

services are provided by existing or new programs. Having basic business standards at all managerial and operational levels is an essential condition for sustainability and for microfinance development.

Local microfinance training capacity should be expanded, and microfinance should be introduced in schools as a field of study and specialization. In addition, professional standards should be developed and a body of microfinance professionals should be formed, possibly with an accreditation mechanism. Microfinance practitioners in each country should set minimum performance standards and guidelines for best practices; doing so avoids excessive government interference.

Annex 1. Financing gap and outreach gap for microfinance in the region

Country	Number of potential borrowers ^a	GDP per capita (U.S. dollars)	Potential outstanding microfinance ^b (U.S. dollars)	Current outstanding microfinance (U.S. dollars)	Financing gap ^c (U.S. dollars)	Number of current active borrowers	Outreach gap ^d
Egypt	1,550,000	832	425,568,000	54,938,000	370,630,000	74,635	1,475,365
Jordan	155,000	1,451	74,218,650	20,624,000	53,594,650	9,697	145,303
Lebanon	43,000	3,046	43,222,740	6,195,000	37,027,740	7,111	35,889
Morocco	492,500	1,200	195,030,000	994,000	194,036,000	7,385	485,115
West Bank and Gaza	43,000	1,537	21,810,030	4,640,000	17,170,030	9,795	33,205
Yemen	650,000	454	97,383,000	242,000	97,141,000	1,181	648,819
<i>Subtotal</i>	2,933,500		857,232,420	87,633,000	769,599,420	109,804	2,823,696
Tunisia	122,500	2,029	82,022,325	8,432,000	73,590,325	2,512	119,988
<i>Subtotal</i>	3,056,000		939,254,745	96,065,000	843,189,745	112,316	2,943,684
Algeria	240,000	1,600	126,720,000	0	126,720,000	0	240,000
Iran	1,150,000	1,033	392,023,500	0	392,023,500	0	1,150,000
Syria	203,000	1,120	75,028,800	0	75,028,800	0	203,000
<i>Total</i>	4,649,000		1,533,027,045	96,065,000	1,436,962,045	112,316	4,536,684

a. Calculated as 50 percent of people living on less than \$2 a day.

b. Calculated as (number of potential borrowers) * (0.33 * GDP per capita).

c. Calculated as (potential outstanding microfinance) – (current outstanding microfinance).

d. Calculated as (number of potential borrowers) – (number of current active borrowers).

Source: World Bank survey of microfinance institutions.

Annex 2. Institutions that participated in the World Bank's microfinance survey

Egypt

Africare
Alexandria Association for Home Economics
Alexandria Business Association Small and Micro Enterprise Project
Association for Community Development of Small Projects
Association of Free Market Economy
Assiut Businessmen Association for the Development of Small Industries
Businessmen Association for the Social Development of Sharkiya
Businessmen Association of Asswan
Economic and Social Development Association
Egyptian Association for Assistance to Small Industries and Handicrafters
Evangelical Charity Association
National Bank for Development
Port Said Business Association
Save the Children Cairo
Save the Children Minia
Social Fund for Development
United Nations Children's Fund

Jordan

Agricultural Lending Association*
Association for Housing Assistance Development
CARE International
Cooperation for Development
Development Employment Fund
General Union of Voluntary Societies
Industrial Development Bank*
Jordanian Women's Development Society (as of 1997), Save the Children (1994–97)

Ministry of Social Development
Noor Al-Hussein Foundation
Queen Alia Fund
United Nations Relief and Works Agency

Lebanon

Association D'Entraite Professionnelle
CARITAS Association Najdeh Liban
Cooperation for Development
CRS/CARITAS Village Bank Program
Istituto Per la Cooperazione Universitaria, Rome*
La Cooperative Libanaise de Developpement
Middle East Council of Churches
Mvt. Libanis
United Nations Relief and Works Agency

Morocco

Al-Amana
Association Marocaine de Solidarite et de Developpement
Fondation pour le Developpement Local et le Partenariat
Foundation Zakoura

Tunisia

Banque Nationale Agricole*
Banque Tunisienne de Solidarite
Comite Regional de Solidarite Social de Mahdia
Comite Regional de Solidarite Social de SILIANA
Commissariat General Au Developpement Regional*

Federation de Tunis de Solidarite Sociale
 Fondation Atlas
 Fondation Tunisienne Pour le
 Developpement Communautaire
 Gouvernorat de Tunis
 Ministry of Economic Development
 Union Tunisienne Solidarite Sociale

West Bank and Gaza

Agricultural Union of Palestine
 CARE
 Centre for Women's Economic Projects,
 Oxfam

Culture and Free Thought Association
 Save the Children
 United Nations Relief and Works Agency,
 Income Generation Program

Yemen

Adventist Development and Relief Agency
 Hodeida Women Union
 Unit of Small Industries Development
 Wadi Siham Cooperative

* These institutions participated in the survey but were not included in the aggregate data because their responses suggested that they served small enterprises rather than microenterprises.

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