



## MICROFINANCE IN THE ARAB WORLD: THE CHALLENGE OF FINANCIAL INCLUSION

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**Introduction:** Financial inclusion is about introducing justice and equity in financial systems and focuses on:

- (i) Extending financial services to previously excluded populations and micro-entrepreneurs; and
- (ii) Empowering the poor and low income populations that have largely been excluded from access to financial services; and
- (iii) Extending access through provision of holistic services ranging from credit delivery to deposits, insurance and pensions and other financial services.

In the Arab World, where levels of financial exclusion have been exceptionally high, financial inclusion is critically important in dealing with the significant employment challenge. A corner stone of financial inclusion strategies is the development of a sustainable microfinance industry. Experience from around the world demonstrates the need to ensure that microfinance is backed by:

- (i) A proper vision, strategy and an architecture with building blocks for the industry so that it operates as a financially and socially sustainable business;
- (ii) Financially viable alternative channels and mechanisms for delivery;

- (iii) A competitive and prudent regulatory framework backed by an effective infrastructure and sound risk management frameworks; and
- (iv) Community organizations imbued with a culture of encouraging social mobilization and business development.

**The State of Microfinance in MENA:** MENA's microfinance industry, though slow to get off the ground, has been growing at about the same rate as global microfinance since 2006. Still, microfinance in MENA reaches only half the proportion of the working population that it reaches in South Asia or Latin America. In fact, based on a sample of 9 countries, the MENA region, as per Microfinance International Exchange (MIX) data, has barely 2.5 million active borrowers versus 39 million in South Asia and about 11-12 million each in Latin America and East Asia. The market coverage ratio in MENA is about half of that in South Asia and Latin America. More specifically, within the region, Morocco has the largest outreach with 1.2 million borrowers, Egypt and Jordan rank second and third respectively, and Syria and Yemen have introduced progressive microfinance regulations. In West Bank and Gaza, credit information bureaus have opened with a number of agencies supporting outreach.

In the MENA region, more so than in other regions, financial sector development has not encompassed financial inclusion as a key goal. For instance, only an estimated 1 percent of total bank credit in Egypt goes to Micro and Small Enterprises (MSEs) and more than 2 million MSEs have no access to finance. The region has fewer loan accounts and fewer deposit accounts per population as well as fewer branches than all regions except sub-

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Saharan Africa. Moreover, banking systems in the region have a narrow client base and end up lending primarily to the public sector or to the larger corporate sector. Consequently, microfinance in the region is limited in scale, products, and capacity.

**NGOs and Financial Services in MENA:** NGOs only offer credit products and are unable to meet savings and other financial service needs. They are also limited in expanding their operations by a lack of investment opportunities, with investors deterred by a lack of regulatory and supervisory clarity. As a result, postal savings banks, post offices, and state banks continue to be primary providers of non-credit services - principally savings and payment services - for low income households in the region.

**The Regulatory Framework:** Provided Governments allow it, regulators can catalyze the microfinance sector and encourage Micro Finance Institutions (MFIs) to move from being just credit providers towards becoming more holistic financial services providers. While there are different views on the regulation and supervision of MFIs, it is generally agreed that the benefits of regulation outweigh its costs. This is largely because: (i) regulatory oversight facilitates deposit mobilization for MFIs that serve as a source of low cost financing; (ii) depositors in MFIs are given regulatory comfort; (iii) regulations define the licensing requirement of MFIs and mandate adequate capital buffers and guidelines for risks; and (iv) regulations define parameters for client and product risks, while allowing for regulation of branchless and mobile banking. Flexibility for MFIs to operate with a broader mandate and the ability to engage in resource mobilization allows them to grow and develop a sustainable business. Of course, appropriate consumer protection measures would be needed to provide oversight on the MFIs and to protect their clients as needed.

**Regulatory Structures in MENA:** The latest CGAP survey has found that 40% of countries around the world now have either central banks or other regulators regulating MFIs. While MENA is adapting to this practice, the

progress is uneven. Some examples are illustrative of trends in the region:

- (i) The Egyptian Financial Supervisory Authority (EFSA) oversees all Non Bank Financial Institutions (NBFIs) with commercial banks enjoying lower reserve requirements for MFI-loans;
- (ii) In Morocco, the Ministry of Finance (MOF) has primary responsibility over microfinance but the 2006 Banking Law delegated supervisory responsibilities to the Central Bank (CB). However, the 1999 microcredit law prohibits microcredit associations from taking deposits and limits individual credit to 50,000 MAD. The MOF and the CB have issued new rules on loan classification and provisioning, and in 2009 the CB issued a new directive on governance, risk management and internal controls for MFIs. The Federation Nationale des Associations de Microcredit (the microcredit industry association) is developing a code of ethics;
- (iii) Syria now allows 'Social Financial Banking Institutions' offering a range of financial services, including deposits. The CB licenses, regulates and supervises microfinance banks; and
- (iv) Yemeni legislation now allows for the establishment of microfinance banks.

There are, however, still countries with no clear supervisory responsibility or regulatory frameworks for microfinance. Indeed, a number of countries in the region still have interest rate caps that apply to microfinance, impacting the performance of the sector given the high transaction costs associated with micro-businesses. The region has among the most restrictive regulations in the world for branchless banking. Flexibility in this area will help multiply the outreach.

**Financial Infrastructure:** MENA lags behind Latin America and the OECD countries on measures of financial infrastructure, and ranks lowest globally on the issue of legal rights. The legal and institutional framework for secured transactions, including procedures for collateral enforcement also needs strengthening. Rather than state directed credits or subsidized programs, government investments in

supportive financial infrastructure would lower costs and risks for microfinance lending on a larger scale. Credit information in the region on clients/active borrowers is improving in quality and availability with the establishment of credit registries and credit bureaus. Any gaps in information sharing can be costly as evident from a recent microfinance crisis in Morocco where MFIs managed to register an 11 fold increase in their loan portfolios between 2004 and 2007. In the absence of a proper information database, MFIs competed with each other for the same clients in the same market (39% of clients had multiple borrowings), and without appropriate risk management capacities to prevent client over-indebtedness. One of the leading Morocco MFIs had a portfolio with 30% of Non Performing Loans (NPLs) and had to be merged with a stronger institution.

This case is not unique to Morocco; Bolivia underwent a similar microfinance crisis a decade before and emerged with a stronger microcredit system afterwards. Other MENA countries may also be at risk unless NGO microfinance institutions are integrated into formal credit information systems used by the wider financial sector. The Palestinian Monetary Authority has taken a lead in requiring microfinance institutions to upload lending and borrower data and to verify current debts of potential clients into their credit information system. Arrangements to do so are under development in 6 MENA countries, but are not yet finalized.

**Lessons on developing financial inclusion strategies:** A few elements are critical to keep in perspective while developing financial inclusion strategies:

- (i) Recognition of prevailing country financial structure and practices as well as institutional, legal and regulatory frameworks;
- (ii) Recognition that “financial inclusion” requires broader consultation of the Government and regulators with private market participants, microfinance operators, standard setters, industry associations, organizations such as CGAP and the World Bank;

- (iii) Recognition that strong public private partnership involves empowering regulators to develop and enforce prudential regulatory and supervisory frameworks suitable for microfinance and that the government develops a supportive financial infrastructure and legal frameworks. Meanwhile, the private sector should focus on developing market-based solutions to meet outreach goals; and
- (iv) Recognition that consumer protection and financial literacy need to be promoted if necessary with supportive regulations and capacity building.

**Approaches and modalities to financial inclusion:**

*Mobile and branchless banking:* This would help reduce cost and induce efficiency in financial transactions, particularly as market penetration rates for mobile phones in the Arab world are much higher than those for bank accounts. In the wake of regulator issues, MENA has been slow to catch up and it has less than half the number of ATMs per population relative to Eastern Europe and Central Asia, and less than a fifth than observed in OECD countries. For example, Egypt’s central bank issued regulations that now provide regulatory space for mobile phone payments, use of electronic money and the use of service agents, while offering consumer protection, dispute resolution, anti-money laundering, and IT security. Introduction of such regulations has allowed countries in the region to introduce *E-wallet* cards to be used to withdraw cash, pay bills, recharge airtime, make deposits, and for money transfers. Examples include Egypt’s *Vodafone Cash* offered with HSBC, *Mobicash* in Morocco by Maroc Telecom with Attijariwafa Bank and Banque Central Populaire, and *Mobile Money* in Yemen, by MTN with the Cooperative Agricultural Credit Bank.

*Electronic payments of salaries and pensions through bank accounts and smart cards* hold enormous potential for increasing financial inclusion. The Egyptian CB’s Payroll and Pensions Initiative uses the payments system for government payroll and pensions. Up to 12 million individuals are expected to start receiving their monthly payments through ‘basic bank accounts’ and debit cards within 3

years, a dramatic increase in financial inclusion. The Government also makes 30,000-40,000 procurement-related transactions every day, mostly through checks sent to MSE's that could instead be made through the financial system. *Basic bank accounts:* providing savings and payments services and thereby establishing financial records for low-income customers are also being provided in Morocco, including the 'Hissab Bikhir' account offered by Attijariwafa Bank, and the 'Popular' account offered by Banque Central Populaire, promoted through the bank's microfinance association.

*Islamic Micro Finance:* Leading countries for Islamic microfinance in MENA include Lebanon (26,000 active clients) and Saudi Arabia and Yemen with 7,000 clients each. In Egypt, Bank Misr plans to introduce Islamic microfinance activities in its 33 Islamic branches, and also to develop a mudaraba (profit sharing agreement) product. In Yemen, Tadhamon Islamic Bank has an MSE division and in the UAE, Noor Islamic Bank and Emirates Post Holding Group plan to establish a company offering Sharia-compliant financial services to low income clients. Currently, Indonesia, Bangladesh, and Afghanistan account for 80 percent of Islamic microfinance.

*Leasing, Factoring, Insurance:* Leasing and factoring can help overcome information asymmetries and lower the cost and risk of lending to MSEs. There is significant scope for growth of leasing and factoring in MENA, given the right legal and tax frameworks to encourage these financing modalities. Moreover, microcredit NGOs can play a valuable role as agents linking people to insurance policies – as we are starting to see in some countries in the region.

*Utilizing Postal Systems:* These can provide networks for expanding large-scale access to banking services, covering rural populations, the self-employed, and people with irregular incomes. For example, the Moroccan government is creating a new Postal Bank, and post offices currently provide savings passbooks and checking accounts via 17,000 branches to over 4 million people. The Postal Bank will target low income individuals and

offer services such as transfers, payments, debit cards, overdrafts, and mortgage loans.

**The World Bank and Microfinance:** The World Bank has a range of initiatives to promote microfinance and is currently working on developing a Microfinance Facility for the Arab World. These initiatives could play a key role in supporting the transition to a financial sector that provides a range of financial services to a majority – rather than only a minority – of firms and households. The Bank supports policymakers and regulators in providing the regulatory environment and financial infrastructure that is essential to scaling up microfinance. Last year, MENA received 4 loans totaling \$1.3 billion in support of financial inclusion. The Bank offers policy advice, technical assistance, research, and capacity-building support to many countries in the Arab World, in partnership with the IFC and CGAP.

Global experience suggests that in developing microfinance in MENA, the Bank and its partner countries need to achieve a balance between control and oversight, as well as between subsidies and market-driven development. Mainstream financial sector involvement on a commercial basis needs to be encouraged, while balancing growth and innovation in financial services with sufficient attention to risk management. Commercial sustainability is important but not sufficient. To scale up, one also needs to focus on social sustainability – built on better informed microfinance consumers and responsible and responsive financial sector policies.

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