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Microfinance Bulletin

Mozambique Microfinance Facility

Savings: An Essential Service with Prudential Requirements

The Mozambique Microfinance Facility (MMF) is a program of the Canadian International Development Agency (CIDA), and implemented by Mennonite Economic Development Asssociates (MEDA) and Development Partnerships (DevPar).

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The main initial focus of microfinance projects is normally the extension of credit. This stems from the need of poorer people to access credit to establish and/or expand economic activities. These activities can lead to enhancements in the welfare of the poor as they gain increasing freedom from the constraints imposed by poverty. The resultant economic, social, health and general welfare benefits of achieving this end have been shown to be essential and impressively beneficial. The challenge of most startups of microfinance institutions (MFIs) or projects is organizing and activating the flow of credit that will meet the need. Despite this orientation, there is considerable research and practical evidence that the poor also have a need for savings services[1]. They either have some savings put aside, or will do so as they become more economically active. These savings are maintained in various ways, nearly all of which place the funds at some level of risk. This is true whether the money is "under the mattress", loaned out to a friend, on deposit with a small local institution, or with a larger bank. This bulletin provides an overview of how savings should be viewed in the agenda of MFI services and with what related prudential considerations.

Risks Associated with Savings[2]

Every form of savings retention presents a degree of risk, whether the savings are kept at home, maintained as goods, loaned out, or deposited in one of many types of financial institutions. There is also a liquidity issue of being able to gain access to the funds when they are needed, especially to cover an emergency, without a reduction in value or excess costs. The conclusion is that poor people who do not have ready access to formal financial institutions need the protection of deposit services more than the financial institutions need sources of funds for expanded lending. A brief review of alternative savings retention forms will emphasize the point.

- If savings are kept in currency at home, or hidden in some other personal location, they face a number of threats. One is physical deterioration, whether by mould, eaten by vermin, burned in a fire, or rendered unusable by some other element. Stories abound of savings having been consumed by fire along with the home, or washed away in a flood. If savings are kept in a personal hiding place, they are vulnerable to petitions from family members and friends by being easily and quickly accessed. And there is always the exposure to theft, which is greater when located in an insecure place.

- In some situations, people involved in trade or other forms of commerce have sought to reduce the amount of cash maintained on their person for fear of theft, loss or some other disaster. They have engaged the services of an agent who collects the funds and either deposits them in a financial institution where they will be safe, or lends them out. This can be happening in a completely informal manner without any oversight by regulatory authorities. Retaining the average of one day's savings each month normally compensates for the service. These agents are responsible for the loss of funds placed in their care, through theft or abuse of one kind or another.

- Some savers, even of smaller amounts, have tried to convert the funds into kind, like grain in storage, livestock or some other form of non-currency. The expectation is that converting the asset back into cash will be easy and convenient. Although not as vulnerable to being borrowed by family members or friends, grain can be eaten by vermin while in storage, animals can be killed or destroyed by disease, and other types of assets can be difficult, costly or time-consuming to liquidate when a need for funds arises.

- And there are savers who

keep their funds "on deposit" with a supplier against future purchases. The threat here is relative to the financial strength of the supplier, something that is often not understood by savers.

- There have been cases where the saver has tried to protect the funds by lending them to friends or family members to support some kind of economic activity. The evidence indicates clearly that this form of "saving" is exposed to a high risk of loss and carries very low liquidity potential if the funds are needed quickly.

- When the saver is poor and lives in a rural area, the alternatives for protecting savings from the problems cited above are very limited, if they exist at all. Some have suggested that revolving savings and credit associations could meet the need. The evidence is that these informal circles of depositing and lending have sometimes had problems in overcoming the losses from non-repaying borrowers. The result has been losses of savings. This is not an argument against this form of activity, but a statement of fact from the perspective of some savers.

- There are other institutional options that the reader might expect to be extolled, but the reality is that they all carry some risk to the saver. The local and small financial cooperative, or its equivalent, can have difficulties recovering loan funds from borrowers, or suffer from theft or fraud, or lose enough money through operations that erode the deposited savings. All MFIs can present the same risks. Even larger banks can fail under certain circumstances. The reasons can be completely hidden from the saver in that they could originate with weak economic conditions, inadequate controls or other obscure causes (in the eyes of the poor saver, assuming they had access to the institution in the first place).

All of this indicates is that there is a need for savings services to the poor, especially in remote rural areas. It also underscores the need for regulations to protect those savings from both loss of value and from illiquidity. Some of the prudential measures will need to be taken up by each deposit-taking institution. Basic requirements will be imposed by supervisors before authorizing institutions to offer and to continue offering the services. But, prudential requirements must be seen in the overall light of the prevailing scarcity of "safe" savings alternatives and the risk of loss even without formal financial institutions being involved.

Savings in Mozambique

Through the OPHAVELA Project in Nampula, and a similar project in Inhambane, CARE International in Mozambique is providing training and organizational support to communities to establish, organize and manage groups for collecting savings and providing small loans to groups members. The goal of the project is to improve the socio-economic conditions of rural and peri-urban low income population by offering them access to a permanent system of savings and credit. The project has a particluar interest in enabling women to access this service. OPHAVELA in Nampula is working in 7 districts with the Mata Musa Dubara methodology, originally developed by CARE in Niger. It has achieved a total of 2,924 members, of whom 1,572 are men and 1,352 are women. In the Inhambane project, the emphasis is on promoting women's savings groups, working with more than 900 women entrepreneurs to help them to save and manage their own incomes.

This program has stimulated trade and improved the economic conditions of several families. Most poor people are more interested in access to savings services than credit. The biggest benefit of the various rotating savings and credit methodologies is that it imposes a discipline to save on the group members and they share similar values for time and money.

Advantages of these systems are that members can save, take loans according to their needs, get a return on their savings and they enjoy and insurance against minor illness or losses.

The disadvantages of the system can be found in that the need for keeping strict records is a skill often not available among group members, a lack of transparency in the process, and an accumulation of excess cash represents a risk to the common trust as well as a security risk.

Prudential Measures at the Institutional Level to Protect Savings

There is little one can do for those who choose some of the very personal forms of savings retention, such as keeping them at home, converting them into some other form like grain or animals, or lending them out to friends. It is even difficult to recommend prudential steps for rotating savings and credit associations, although these will have to be addressed in defining conditions for eligibility to participate in the group and to take out loans. The measures that are addressed in this section relate to institutional provisions aimed at ensuring that savings will be protected and become available when they are needed.

There are a number of institutional elements to being able to accept deposits safely. They are all oriented to minimizing the risks and threats, and to return all deposits back to their owners according to agreed terms and conditions. Some relate to the financial capacity of the institution and its ability to absorb risk. Others relate to the handling of the funds in a prudent manner and in accordance with generally accepted internal controls. Others again relate to the safety of the manner in which the funds are deployed while in the custody of the institution. All of these considerations must be dealt with if the institution, whether an MFI, a financial cooperative or a bank. Some important illustrative points can be made along this line as follows:

1) Financial Capacity

Every financial institution will have to make an application for authority to accept deposits from the public, and the regulatory authority will impose conditions for the application to be approved. These conditions cover a variety of provisions that deal with a startup and/or the adoption of deposit taking as a new service. The provisions will relate to the credentials of the backers, the adequacy of capital, the suitability of the business plan and other requirements. Once operating, unless approved with the application, there are at least three general criteria that are cited in defining the institutional financial capacity required to receive authorization to accept deposits from the public. One is having adequate capital. This suggests that meeting this requirement will provide a buffer within the financial institution against losses before they can erode the deposits held by the institution. Of course, practical experience demonstrates that this is only as reliable as the ability of management or the supervising authority to take early corrective measures to resolve problems quickly before too much damage is done.

For that reason, the second criterion is that the financial institution should meet certain minimum standards of management, operations and performance. This means that the institution can demonstrate that it is well-managed and is successfully applying international best practices in all areas of governance, management, marketing, reporting, systems and operations.

Finally, the deployment of funds by the institution to loans, investments or purchases of assets is carried out in accordance with prudential standards and diversified low risk. All of these requirements are aimed at minimizing the adverse results of failures on savers and the integrity of the financial market.

2) Standards For Handling Deposit Funds

There have to be minimum prudential standards and internal controls that a deposit-taking institution complies with fully in order to ensure that funds will be properly administered. Risks in this regard must be contained. This means that the institution will need to apply controls from the point of deposit by the customer through to the return of the funds on withdrawal. Achieving effective internal control can be a challenge when clients are located in less populated rural areas. In these cases, deposit pickups, or other collection arrangements, do not lend themselves to the tight controls that can be applied in a large branches or buildings. The principles that characterize the controls include the following kinds of provisions: (i) that formal pre-numbered, printed receipts are always issued to the customer, copies of which must be surrendered along with the funds when they are passed to the next stage in the handling process; (ii) that two people work together whenever funds are handled until they are placed in a vault, or in a safe location; (iii) that there is always a daily reconciliation of cash transactions with cash on hand, supported by appropriate receipts; (iv) there is provision for regular post-transaction testing of cash transactions; and (v) there are regular staff replacements or rotations to ensure that the procedures and controls are adhered to without exception. Beyond this level of control, there must also be the normal internal controls that involve reporting, reconciliation, cash concentration procedures and other arrangements that serve to maintain effective administration of the deposit funds.

The point of these observations is to emphasize the importance of the responsibility assumed by a financial institution by accepting deposits from clients and the kinds of standards that must be observed. The objective must be to contain risk in all its manifestations throughout the various processes associated with its administration. This will apply to the largest of banks as well as the smallest of microfinance institutions.

Prudential Measures At the National Level To Protect Savings

The normal pattern of measures at the national level to protect savings takes the form of regulatory minimum standards and of risk mitigation arrangements. The challenge in the determination of what should be required is that the need for prudential risk containment must be balanced against the development objectives being served on the one hand, and against the risks that are already being faced by depositors on the other. We have noted above that every form of savings gives rise to some level of risk. And we are also aware that every form of financial institution offers an element of risk. Even large banks have been known to fail and, without deposit insurance, have caused depositors to lose their funds in part or in full.

Key Considerations in Establishing Regulatory Requirements

The regulation of financial institutions, in terms of conditions institutions must meet to be able to carry on business in the country, will be based on a number of considerations. One is the *nature of the business the institution is planning to do.* If the objective is to provide loans and not to take deposits, the risk to the financial market will be considered lower. This is because the effect of problems will be for the account of the sponsor and not the public. It is only when the public is exposed to potential losses that more demanding standards will be required.

A second consideration is the *nature of the institution's ownership* in terms of any risks it presents. Financial cooperatives, for example, are considered to present lower risks to financial markets because the patrons who are exposed to losses are also the owners. It has been demonstrated that financial cooperatives that have a close membership bond will be able to resolve problems more easily in consultation with owners who will often replace lost capital when required, or forego interest or dividend income for a period of time. For this reason, requirements for regulation are often less onerous than for other types of institutions. It goes without saying that a financial cooperative formed without re-

Savings in Mozambique

NovoBanco, a Commercial Bank providing services to microentrepreneurs in Mozambique, started providing savings services to its clients in November 2001. Initially this was piloted in one branch and expanded to all their branches of the bank in 2002. Current accounts and time deposits are offered. The growth of the demand for these services are illustrated by the data provided in September 2003:

	Number of accounts	Total Value of Savings (US$)	Average savings per client (US$)
31 Dec. 2001:			
Current accounts	251	$19,006	$76
Fixed term deposits	45	$11,335	$252
31 Dec. 2002:			
Current accounts	7,362	$321,601	$44
Fixed term deposits	628	$488,499	$778
31 Dec. 2003:			
Current accounts	13,239	$646,013	$49
Fixed term deposits	1,027	$1,917,244	$1,867

The phenomenal growth in savings clients, especially in the branches outside of Maputo, is indicative of the need for savings services specially tailored for the lower income sectors of the economy.

gard to maintaining a tight bond amongst the membership will not offer that kind of lower risk profile. For this reason, it is not wise to offer the same lower standards to any group that chooses to take on the form of a financial cooperative just to be able to provide the financial services at a lower minimum capital. The bond between the members must be close, as in the case of employees of the same company, or citizens of a close-knit group[3]. Even in this form, there must be effective governance and management for operating risks to be contained.

These days, regulators are also concerned about potential owners of financial institutions who could cause problems to financial markets through corrupt practices and money laundering. Careful attention is paid to applications for licenses to do financial business in the country to ensure that the credentials of backers and their relationships with others are carefully checked and cleared before granting a license.

A more difficult decision in the authorization of powers to accept deposits from the public and to set related standards is *where the objective of the institution is to serve development objectives in rural and poorer areas* within the country. These are normally areas where institutions that are solely driven by profit are less likely to locate. The economics of scale are more difficult to achieve. MFIs come closest to being able to operate successfully in these areas because their clientele excludes very few. Financial cooperatives, or NGO sponsored projects, can all operate more economically in these areas than the more commercially driven institutions. Because the business written in these areas by these types of institutions is often smaller in average size and for shorter terms, and the clients are more numerous, the overall risk profile can be lower, if the institution is adhering to international best practices of governance, management and operations. For that reason, lower minimum capital requirements can be set. However, supervision must still be carried out to identify emerging difficulties to enable corrective action to be taken while something constructive can still be done.

Risk Mitigation Provisions

The regulators have other alternatives they can apply to reduce the potential impact of risks that are not adequately contained. In the case of lending problems, a *credit information exchange* can be established. This kind of facility will enable eligible lenders to access central files on current loan and collateral security commitments and past loan experience of potential borrowers. It requires that all participating borrowers submit information on all their borrowing clients on a limited access basis. The loan officer of any participating institution can then check the files before extending credit to ensure that the borrower has a clean record and is not already borrowing undeclared amounts from other institutions. This is a risk mitigation provision in that it should contribute to a reduction of loans to borrowers with poor credit records and therefore lower loan losses. It will normally involve a cost of participation, but can save considerable amounts, especially where there is competition in markets served by more than one member institution.

Another “damage control” provision is a *deposit insurance fund.* What it can do is to insure deposits to some maximum level so that depositors are protected to that extent from institutional failures. They also have the advantage of encouraging depositors to place their funds with insured institutions, thereby bringing them within the measurable market. This enables the central bank to gain a more complete measurement of the amount of funds in the market. Premiums are normally charged to participating institutions. A close working relationship is provided between the coverage by the deposit insurer and the market supervisor to provide for effective monitoring and institutional intervention as soon as required. Problem institutions need to be taken on and their problems resolved on an expeditious basis to minimize losses to the fund.

In summary, there is a pattern of alternatives and requirements that can be applied to ensure that savings are protected and depositors insured against losses. Being able to accept deposits in rural areas will be an important service for people living in these areas. Being able to do so prudently can be achieved in various ways. Moving ahead to extend savings services will achieve development and economic objectives.

Where the MMF Can Assist in Expanding Services and Strengthening Measures to Protect Savings in Mozambique

The role of the MMF is to contribute to the growth and successful development of the microfinance industry in Mozambique. It has a three-fold mandate to contribute to the strengthening of the facilitating environment, provide training and coaching to MFI personnel in best practice policies and procedures and to provide a limited amount of concessionary loan funding where appropriate to expand selected institutions. The objective of this work is to help reduce poverty, especially in the rural areas.

Mozambique is a country with a growing microfinance industry. There is a need to ensure that the industry continues to expand coverage and services to significantly reduce poverty wherever it is found.

Endnotes

[1] A relevant paper that describes the savings situation in Maputo is entitled *Savings Capture In The Informal Urban Sector Of Mozambique: Case Study Of The Informal Financial Sector In Maputo,* prepared by Felisberto Dinis Navalha, December 2000, Translated by Gerry Lewarne, MMF Project.

[2] A very relevant paper on this subject was published by Mircosave-Africa entitled *The Relative Risks to the Savings of Poor People,* by Graham A.N. Wright and Leonard Mutesasira, 2001.

[3] Many financial cooperatives are formed by members of the same religious or social group in order to achieve the required high level of bond.