Policy brief

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Marco Trombetta, María Luque Calvo, and Pablo Casadio

Financial NGOs and micro and small enterprises in Ghana

The potential of the missing middle

In brief

- There is evidence of a structural imbalance of the private sector in Ghana that includes a few large, technologically advanced, capital-intensive, and resource-based enterprises on one hand and a big number of traditional, labour-intensive, and low-productivity micro and small enterprises (MSEs) on the other. The latter are losing competitiveness and gaining a survival and informal character1, creating a "'missing middle"with a shortage of middle-sized growth-oriented enterprises that could make an important contribution to the development of the country.
- Government efforts to build a more inclusive financial system have intensified in the last ten years, creating a framework of policies, regulations, institutions, and initiatives aimed at covering medium enterprises and low-income individuals' financial needs, especially through microfinance.
- , The access and use of financial products and services is still low, and the microfinance sector is currently failing to reach its full potential as a tool for private sector development.
- This brief discusses the role of Financial Non-Governmental Organisations (FNGOs) in promoting the growth of microenterprises (MEs) into small enterprises (SEs) and the issues and constraints affecting their capacity and performance. It recommends measures to strengthen Microfinance Institutions (MFIs) and increase their impact in promoting the growth of MEs.
- The investigators find that the record of FNGOs on microfinance is limited. Having reached only 207,919 clients, their return on assets in 2008- 2012 is negative or barely positive, hindering financial sustainability.
- However, it is also found that FNGOs could play a critical role in terms of outreach, as a first level of formal financial inclusion for micro enterprises, preparing the ground for them to access to an increased number of products and services more adapted to their growth needs.

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Importance of financial inclusion for growth of microenterprises

With an active population of 20 million individuals and the majority of those currently employed (68.7%)[1] being engaged in vulnerable employment), it is important to recognise the role of micro enterprises (MEs) in Ghana as major generators of employment and livelihood strategies that are helping the lowest income individuals reduce their vulnerability.

Most MEs in Ghana participate in sectors with the lowest growth rates[2], operate in small rented premises, and rely on local markets. In the majority of cases, they were started and operated as one-person businesses, although owners were helped often by family members, apprentices, or informal workers. A big percentage of them could be considered as subsistence enterprises, created with a long-term vision and with the objective of being an important part of the family income, but without elaborated plans supporting their viability and growth. This increases their vulnerability to minor income shocks originating both from the business and/or from family life.

Among the challenges preventing MEs' growth is the lack of access to appropriate financial products and services.. Micro-entrepreneurs need to make intensive use of financial products and services exactly because of their limited size and income instability, which forces them to plan in advance, anticipate reductions of their cash flows, anticipate unexpected events, and try to accumulate assets for larger future investments. Those products and services, in order to fulfill their desirable effect, must be adapted to these enterprises´ needs and capabilities.

Despite having one of the most vibrant financial markets in Africa, with 29 banks, 137 rural and community banks, 27 savings and loans companies, and more than 600 licensed non-banking financial institutions (NBFIs), formal financial institutions cater for less than 35% of the population's financial service needs.

Crucial factors contributing to this situation are:

1. Banks, rural and community banks, and savings and loans companies, who account for around 80% of the total microfinance sector[3], focus more on bankable people/areas. They generally don´t have the knowhow, capacity, or interest to serve lower income micro-entrepreneurs, due principally to:
   - Information asymmetries regarding micro-entrepreneurs´ managerial abilities and MEs' performance, preventing financial institutions from estimating correctly the potential risks and returns.

1. The Ghana Living Standards Survey, GLSS 6, Labour Force Report. Ghana Statistical Service, August 2014.
2. Ghana Statistical Service Revised 2014 Annual Gross Domestic Product, June 2015 edition. http://www.statsghana.gov.gh/docfiles/GDP/GDP2015/Annual_2014_GDP_Rev2_June_2015%20edition.pdf
3. Source: GHAMFIN Data collection Unit 2013, from subsector apex associations. Number of institutions reporting may be less than the total number licensed or active in the subsector.

- High transaction costs relative to small loan size (100-1500 GhC) make it necessary to use methodologies that are inefficient for traditional banks (e.g., loan analysis based on client´s ability to pay to substitute collateral, credit with education, group lending, specific training and incentives for loan officers to keep quality of the portfolio, control mechanisms, etc.).

2. FNGOs, the microfinance intermediaries that seem to have the potential to overcome these obstacles and introduce micro-entrepreneurs into the financial circuit, struggle for financial sustainability. Given their social mission, local focus, and roots, FNGOs have access to the informal knowledge of the local clients, which plays such an important role in community microfinance. However, their performance in outreach and sustainability is weak. Only 11 FNGOs out of 42 operating in Ghana have obtained the necessary license from the Bank of Ghana, and their return on assets and equity are negative or very low. Moreover, according to the most recent data available, they have only 207,919 clients in the whole country, with many of them having fewer than 2,000 clients.

However FNGOs are the most ready to spend time organising, training, and assessing clients to learn how to work with financial intermediaries. Our survey of clients shows that they consider the FNGO as something in line with their community values as opposed to other financial institutions which are perceived as distant and dangerous. For this reason, it is crucial to create the conditions for FNGOs to become sustainable because only they have the potential to reach the very poor and help familiarise them with other types of MFIs or banks that could fulfill their financial requirements in the future.

Factors determining the impact of FNGOs in Ghana in facilitating the growth of microenterprises into small enterprises

Without resting importance on the overall current macroeconomic environment and infrastructure situation of the country, below are a selection of factors at Macro, meso, and micro levels that have been identified as major constraints to FNGOs' impact on microenterprise growth.

The lack of a clear national financial inclusion policy is allowing many actors to operate in a disconnected way through different approaches, creating inconsistency and hampering the efforts and impact of stakeholders.

Prudential regulation of FNGOs poses several challenges not only in the Bank of Ghana, in charge of supervising an already saturated market, but especially on these institutions that have to convert from FNGOs with a social mission to regulated, supervised financial intermediaries. Specifically: Legal status of FNGOs hinders them from meeting the capital requirement of 300,000 GhC. As companies limited by guarantee and registered in the

Department of Social Welfare as not-for-profit organisations, FNGOs cannot collect deposits from the public and generally have difficulties accessing commercial funding. All these factors make raising the capital necessary to comply with the capital requirement before June 2016 extremely difficult.

An increase in operational costs challenges FNGOs' capacity to continue serving the lower income population. These institutions are now required to prepare operational plans, report their operations, and count with a minimum risk management framework. This forces them to invest on improving the skills of their staff, computers and appropriate software, and the security of their premises and activities.

Weak infrastructure and capacity of institutions at meso-level may be constraining the effectiveness of macro- level actions as well as the efficiencies of institutions operating at the micro-level, which is already fragile. Specifically, the low human, financial, and technical capacity of the apex bodies prevents them from performing effectively their current core functions of information collection and dissemination dialogue with government, and coordination with donors to organise training programs for their member MFIs.

Structural fragility of the institutions limits outreach and challenges sustainability. Currently FNGOs present operational weaknesses related to the lack of strategic planning, high staff turnover of experienced personnel, lack of appropriate management information systems (MIS), legal status that hinders their access to commercial and long-term financing, and operational challenges related to serving the lower income populations with a large number of small transactions, which , due to the low population densities outside the big cities of Ghana, generally leads to a huge number of points of operations.

Policy recommendations

In order to promote MEs' growth and address all the issues related to the missing middle, government should carefully examine the impact of its existing policies, regulations, and initiatives for enterprise development and redesign its MEs strategies to focus on the three stages of their evolution (start-up, survival, and growth). Moreover, to include MEs into the financial system, government should design a national financial inclusion policy (not only microfinance policy). This policy should be:

- Based on a preliminary country-assessment that (1) allows a deeper understanding of the needs of the microfinance industry, the microenterprises, and people financially excluded and their difficulties in accessing and using products and services appropriately, (2) examines current policies, regulations, and initiatives, and (3) guides all stakeholders towards the achievement of the same goals.
- Designed through joint efforts and specific roles of the different ministries

(Ministry of Finance and Economic Planning, Ministry of Gender, Ministry of Land, and Ministry of Trade and Industry) and related industry stakeholders.

Additionally, the following are a selection of recommendations that should be definitively addressed at macro, meso, and micro levels as part of this national strategy, in order not to constraint past achievements regarding financial inclusion and enable an environment that allows FNGOs to cover micro-entrepreneurs' financial needs appropriately while reaching self-sustainability:

1. Do not subject credit-only Tier 3 institutions (non-deposit taking FNGOs and money lending companies) to prudential regulation, but instead, to non-prudential[4] regulation through an apex body and make a strict control over the compulsory savings taken by them in order to protect clients[5]:

    - Eliminate regulatory and licensing requirements for credit-only institutions. In paragraph 1 relating to the regulated activity of Tier 2 and Tier 3 institutions, instead of saying "all institutions or persons engaged in activities that involve deposit taking or the granting of credit shall obtain a license or an exemption from the Bank of Ghana before commencing or continuing such activities", it should include the word "voluntary" before deposit taking, and eliminate the "or the granting of credit", i.e. "All institutions or persons engaged in activities that involve voluntary deposit taking shall obtain a license or an exemption from the Bank of Ghana before commencing or continuing such activities. "
    - Establish the Association of Financial NGOs (ASSFIN) as a self-regulatory body in charge of supervising the "business standards" requirements imposed on FNGOs by specifying it in the operating rules and guidelines. The application and licensing procedure should include "Register as a member or affiliate of the umbrella association of Tier 3 institutions" and instead of having a section about prudential oversight, it would state "prudential reporting: umbrella Associations of Tier 3 institutions shall collect and collate statistics on the operations of their members and furnish this to the Bank of Ghana periodically as may be determined".
    - Increase Tier 3 institutions′ client protection. In order to protect

4. Non-prudential regulation provides standards of business operations and has the goal of protecting the clients from undesirable actions committed by MFIs (fraud, abusive interest rates, consumer protection, tax and accounting issues, etc). It demands the submission of operating and audited financial reports to the supervisory body.
5. Credit-only FNGOs take compulsory savings as cash collaterals and put it in an escrow account at the institutions′ own names. In case of fraud or failure of the institution when their clients are at the end of their repayment terms or in between consecutive loans, the compulsory savings would exceed the loan balance and the clients would have no option to get their savings back.

clients′ compulsory savings taken by FNGOs, the new requirements should specifically state in the "permissive activities" section that the escrow account cannot be administered without the approval of both the client and the institution and therefore, it should state: "All persons or institutions that are engaged in the granting of credit, taking compulsory deposits as collateral for lending, shall held these deposits in an escrow account with a designated commercial bank that shall not be withdrawn without the approval of both the client and the institution. "

2. Strengthen the human and technical capacity of ASSFIN as a self-regulatory body. Currently ASSFIN is too dependent on donors and fees and the lack of financing prevents them from having the necessary operational capacity to serve their members. The issue of potential for financial sustainability via MFI members' willingness and ability to pay can be addressed via modifying the operating rules and guidelines. The association also needs to build skills and capacity and demonstrate value to its members. Therefore, the human and technical capacity of ASSFIN should be supported by government in early stages of development in order to position the association to:

    - Be in charge of the supervision (off-site and on-site) of fulfilling the minimum business standards and the current requirements imposed on the FNGOs, except by the requirements of a minimum level of capital and of a gearing ratio that should be eliminated.
    - Help establish and uphold standards in performance, responsible finance, and client protection.
    - Provide members with training and support services, like advocacy with government and policymakers, networking, access to funds, participate in the credit bureau, etc.
    - Develop partnerships with government and donors to develop industry infrastructure.

3. Develop a business development services market parallel to the FNGOs sector (through encouraging partnerships) specifically for MEs. Due to the intrinsic characteristics of MEs and lower income populations in Ghana, there is an urgent need to facilitate skills transfer and business advice to micro-entrepreneurs in areas such as marketing and communication, accounting, auditing, financial advice, legal consulting, management, and tax consultancy to enhance competitiveness, efficiency and access to market of MEs, and to facilitate linkages and value chains that allow to take an integrated approach to the development of microenterprises, and allow micro-entrepreneurs to take the necessary risk to go beyond the subsistence level.

4. Promote the involvement of the private sector to, for example, support services like technical assistance, specialised microfinance audit and rating services, development of insurance products for MFIs and their clients, strengthening of the credit bureau, and promotion of cost-

effective distribution channels through technology.

5. Strengthen institutional capacity of FNGOs to deliver their microcredit products adapted to the needs and capabilities of the lower income populations in a sustainable way: FNGOs should clarify their vision, set social goals and take action towards the sustainability of their institutions to expand their reach. This should be based on: development of products focused on clients (based on a clear understanding of target clients' needs and capabilities; improved internal governance, transparency,and accountability; strengthened technical capacity of staff; and improved operational, financial, portfolio, and social performance management by adopting appropriate MIS. Until they reach sustainability, FNGOs must acquire the minimalist approach of focusing on specific groups and providing "credit with financial literacy" only, rather than trying to do everything (the fact that poverty is multi-faceted does not mean that FNGOs have to do everything or that all products fit to all people) to reduce operating costs, improve chances of reaching sustainability, and increase impact, and provide the holistic approach only by facilitating linkages for their clients with other specialised institutions.

Impact

The findings of this research should impact decisions concerning the design of a country's financial inclusion policy based on joint efforts and specific roles of the different ministries. It should also include the review of the laws and the regulations for the institutions of the different tiers involved in microfinance, to promote the creation of infrastructure and technical and human capacity of institutions at meso and micro levels.

Methodology

The brief relies on integrated qualitative methods of data collection to better understand the underlying issues behind microenterprise development in Ghana. Both primary and secondary data were used in this research. Secondary data was gathered through a thorough literature review, and two types of interviews were used to gather primary data:

- Semi-structured interviews with different agents from governmental and non-governmental institutions, to get a deeper knowledge of the current business environment for MEs in the country and the institutions and programs supporting their development. These experts, with their practical knowledge and understanding of the situation of MEs in Ghana, have provided insights that helped identify the research areas and the nature of problems.
- Structured interviews:
  - With 13 FNGOs operating in Ghana, to analyse challenges of FNGOs in terms of regulation, operations, and clients.
  - With a sample of 85 micro-entrepreneurs in urban, peri-urban, and rural areas of seven regions of the country, to gain insights into their perceptions, feelings, and attitudes in different aspects related to their

business.

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