SCBF 2012-02 **December 2013**

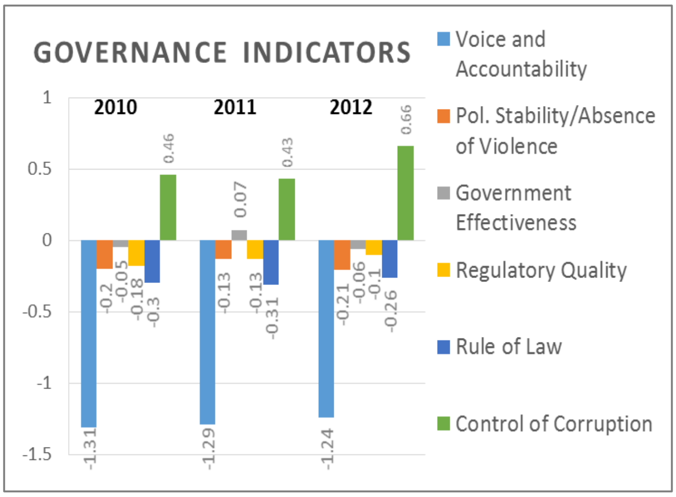
Fostering Financial Inclusion in Rural Areas through Innovative Channels in Rwanda

1. Development relevance

Economic and poverty context: Rwanda is a poor, small, landlocked country with over 80% of the population living in rural areas. The genocide in 1994 destroyed the country's fragile economic base. 73% of Rwandans are engaged in agriculture and about 17% in mineral and agro-processing. Although agriculture is the largest source of employment, it only contributes to about 1/3 of GDP Growth in services (49,1% of GDP in 2011) has been fuelled by expansion in trade, transport and telecom, and increases in finance and insurance. Growth in manufacturing is limited and productivity as well as value adding in agriculture is low. Rwanda is dependent on natural resources and commodities: Minerals, coffee and tea account for most of the export earnings.[i] Tourism is becoming more important.[ii] Imports, mainly consisting of food products, intermediate goods (mainly construction materials and industrial products) and fuel, still exceed export earnings.

Rwanda is one of the most heavily aid-dependent countries in East Africa, with budget support financing 44% of total government spending (2011). Foreign direct investments are fluctuating and insignificant. Inflation has decreased to single-digits in 2010 but slightly grew ever since. The 42% youth un- and underemployment is mainly caused by skills mismatch and limited job growth. For 2013, the government programmed fiscal consolidation prioritising public spending towards strategic investments as well as tight monetary policy. This dampens aggregate demand and deters expansion of private sector credit.

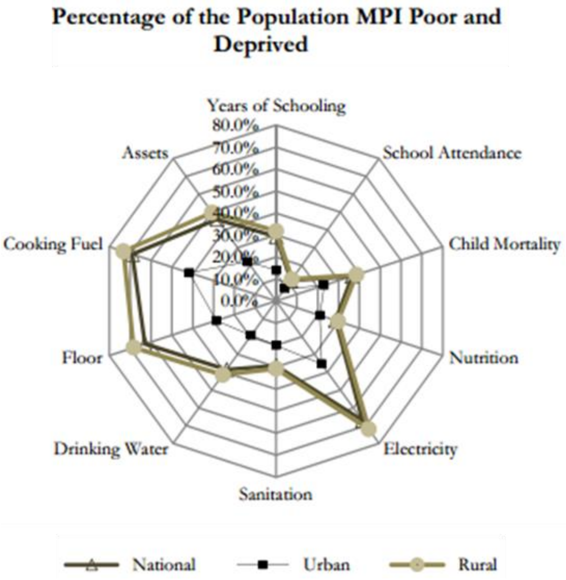
Population and economic indicators[iii]	
Population in million *(2012)*	**11,46**
GDP growth (average: *2008-2012*)	**8%**
Inflation (average: *2008-2012*)	**8%**
Trade balance (% of GDP) *(2012)*	**-20,68%**
Foreign Direct Investment (net) (% of GDP) *(2011)*	**1,7%**
Net ODA & official aid received (% of GDP) *(2011)*	**19,86%**
Workers' remittances (% of GDP) *(2011)*	**1,6%**
Economic Freedom rank[iv] (2012)	**59**
Poverty Indicators	
GDP per capita (2012, current USD)	**620**
Gini Index (2011)	50,8
Multidimensional Poverty Index (2011)	0,35
National/international poverty rates (2011)	44,9%
International poverty rates (USD 1.25/day)	63,2%



Rwanda is among the top four reformers in business environment in Sub-Saharan Africa. However, challenges remain regarding the implementation of systemic institutional reforms and a well-functioning legal system. Key impediments to private sector development include corruption, the high cost of energy and transport, instability in neighbouring countries as well as poor business planning and management skills.

Rwanda is the most densely populated country in Africa and in the bottom decile of the poorest countries in the world, with a GDP per capita of just USD 620. Although poverty rates have been declining, over 44,9% of the 11 million Rwandans still live below the poverty line and 24,1% live in absolute poverty. The poverty rate is much higher in rural (48,7%) than in urban areas (22,1% with 16,8% in Kigali).[v] It ranks 167 out of 182 countries in the 2009 UNDP Human Development Index. At least 22% of households are food insecure and another 24% are highly vulnerable to food insecurity. Over 50% of children are chronically malnourished and one child in four is underweight.[vi]

Financial Sector context: As of June 2012, the banking system was comprised of 13 commercial banks out of which three MFI transformed microfinance banks (Opportunity[vii] in 2007 and Agaseke and Unguka[viii] in 2011). The three largest banks account for about 60% of total deposits, loans and assets. The microfinance sector consisted of 11 MFIs and 486 Saving &Credit Cooperatives (SACCOs). Branch networks expanded rapidly in the last years.



The banking system is stable and financial depth has improved. Financial exclusion has dropped by 46% between 2008 and 2012. In 2012, 72% Rwandan adults used or had access to financial products and mechanisms and 42% were formally served. The Umurenge SACCOs as well as the emergence of insurance services has significantly changed the landscape of financial inclusion. The banked population increased by 9% since 2008, amounting to 23% in 2012. However, many Rwandans still use informal financial services.[ix] In 2011, 11'788 SMEs were active borrowers of commercial banks, out of which 67% were residing in Kigali. Banks provided 95% of the total SME financing, while SMEs constituted 17% of the total loan portfolio in Rwanda.[x] An estimated 410'250 MSMEs are not yet served.

Aside from the three microfinance banks, the banking sector has made little strides in developing pro-poor financial products and services. The banks are focused primarily on corporate and (to a lesser extent) SME lending. Retail banking is developing quickly but is mainly focused on serving relatively affluent urban salary earners. The National Microfinance Policy Implementation Strategy aims at improving the outreach, sustainability and quality of financial services to low-income households. The Vision of the 2020 Umurenge Programme is the main poverty alleviation strategy, implemented by the government with donor support. This programme might generate synergies with bank downscaling strategies like such of the Bank of Kigali (BoK).

Partner Financial Institution[xi]: The BoK was established in 1966 as a commercial bank and is listed at the Rwanda Stock Exchange since 2011. It offers a wide range of services, including retail banking, corporate banking, trade finance, foreign exchange and private banking. As of December 2012, the bank provided its retail and commercial banking services through 60 branches to 206'247 customers. In 2009, it took the strategic decision to include a poverty alleviation component to its financial services. It initiated a small-scale pilot programme to disburse microloans to urban and rural low-income clients and therefore launched its micro lending department in September 2011.

BoK has shown rapid growth in recent years with an asset base that grew by 42% in 2011. It is the leading bank of Rwanda with a market share of about 33% of total banking assets (2011). In 2012, the main shareholders were the Government of Rwanda, the Rwanda Social Security Bond and international institutional investors.[1] In 2011, in the frame of its Corporate Social Responsibility Strategy and with the goal to increase access to finance for Rwandan citizens, the Bank launched a micro lending business line targeting the youth, women and senior citizens. It aimed to enable them start or expand a business with no collateral.

Bank of Kigali	2009	2012
Total clients	108'269	206'247
Number of borrowers	n/a	n/a
Number of depositors	n/a	n/a
Total staff	303	877
Total branches	18	60
Total deposits (USD)	158'400'000	301'742'000
Gross loan portfolio (USD)	132'425'000	317'922'000
Total assets (USD)	270'570'000	554'432'000

[1] Respectively 29,75%, 27,72% and 23,32% of issued shares.

2. Intervention approach

The BoK has piloted microenterprise lending on a very small scale with lending techniques derived from its corporate lending activities reaching 5'000 clients as of December 2012., . However, the microenterprise portfolio suffered from 18,2% portfolio-at-risk 90 days (PAR_{90}) ratio and represented 3,3% of total non-performing loans despite its 1% total portfolio share. This was caused by an aggressive lending strategy that neglected appropriate processes and procedures, products that were not tailored to the needs of low-income households, insufficient numbers of lending staff and an unadjusted MIS.

In order to overcome its lack of expertise and experience in working with the rural microenterprise sector, the BoK approached Business and Finance Consulting (BFC) in Q2 2012 to set up, pilot and roll out best practice micro lending operations with co-financing from SCBF. . BFC's mandate was to assist BoK in introducing a lending approach tailored to low-income households and rural enterprises, including collateral-free loans, fast and convenient lending processes and selection of borrowers by the de facto repayment capacity (and excluding dealing with those micro loans disbursed under the bank's own initiative). The following three phases were initially designedto implement the bank's strategic down-scaling decision and thereby to reach at least 4'500 peri-urban and rural micro- and small entreprises by mid 2014:

Pilot phase 1: Concept design (August 2012 - Mid December 2012)

This phase aimed at creating an organizational structure suitable for the provision of micro lending services to low-income rural individuals and micro enterprises, which included:

- Design and setup of a dedicated micro lending unit and creation of appropriate organizational structures.
- Definition of loan approval mechanisms, procedures, and processes complying with Smart Campaign client protection principles.
- Development of credit products meeting the needs of low-income clients and rural micro enterprises.
- Assessment and identification of a delivery channels scheme to reach customers located in rural areas.

Pilot phase 2: Pilot implementation (Mid December 2012 - August 2013)

This phase aimed at expanding the rural outreach activities by piloting micro lending operations in two regional branches. The location was decided during the project. Finally only one branch was opened in rural area, the other in Kigali. BFC's assistance was focused towards:

- Working with the Human Resources department to create strong staff recruitment procedures and adequate motivation systems.
- Providing intensive day-to-day support in micro lending both at headquarters and pilot branch levels, including active participation in all relevant credit committee meetings. The pilot implementation phase targeted the disbursement of 960 loans.
- Implementing a comprehensive training program for micro lending staff, based on the 'training of trainers' approach.
- Installing and adapting an application processing system (Master APS[2]) in the two pilot branches.

Pilot phase 3: Roll out support (August 2013 - August 2014)

In the course of this phase, it was recommended that BoK should independently roll out and develop micro lending services by means of:

- Opening 7 new micro lending offices countrywide.
- Hiring 20 additional loan officers to manage a portfolio of 4'500 micro enterprises as of August 2013.
- Providing training for newly hired recruits by authorised trainers and implementing continuing supervision overseen by experienced loan officers who were trained during the pilot implementation phase.
- Developing new products in line with market needs which were identified during the previous phase.
- Integrating the Smart Campaign principles for responsible micro financing throughout all activities.

3. Results achieved

The first two phases were partially completed, but the third phase was cancelled as the Board of Directors decided on 28.8.2013 to stop the micro lending project for the following reasons:

- The 'interest rate cap' of 20% Annual Percentage Rate for microloans de facto which was set by the National Bank of Rwanda for BoK. The decision was particularly targeted towards BoK as a state-owned bank and resulted in a declining interest by management to further develop its micro lending activities. This was demonstrated by a lack of support from the Bank to approve and implement important components of the project design, such as appropriate remuneration and a staff incentive system. At the same time, the Board clearly supported the development of micro lending facilities under the premise that it could develop into a profitable and scalable operation under the project.

[2] Micro lending software developed by BFC representing an effective tool for credit approval in lending institutions

- The significant worsening of the bank's 'own' micro loan portfolio[3] to a 18,2% PAR90 ratio[4] .
- The lack of a 'critical mass' of micro lending compared to the overall (strongly growing) asset size.[5]

To summarise, the following task and outputs were implemented with the BoK:

Activities / Milestones		Performance indicators		Status	Comments
Concept Design	**Organizational structure**	Recommendations for organizational structure submitted and discussed.	Process-oriented		An operational organization of branches and headquarters specific to micro lending activities had been proposed to management but was not fully implemented by the Bank.
	Product development	Products developed and agreed upon with Bank's management.			Products had been agreed upon during the concept design phase <u>but unilaterally changed by the Bank's management during the Pilot implementation phase</u>.
	Lending policies and procedures	Updated policies, forms and contracts presented to management.			Policies, forms and contracts had been presented during the concept design phase. Their updated versions were introduced during the implementation phase.
	Smart Campaign criteria	Integration of Smart Campaign criteria into concept design.			Smart Campaign concepts were integrated into credit procedures and transmitted to loan officers.
Pilot Implementation	**Operational support**	New products launched in two branches.	Output-oriented		Only one product (microloans) has been launched in all of the branches.
	Staff selection and HR	At least 10 loan officers hired			13 loans officers were hired and 3 resigned during the pilot implementation phase.
	Staff training	At least 10 loan officers trained; at least 2 trainers trained; at least 10 middle managers trained.			13 loan officers, 3 team supervisors and 1 administrative assistant have been trained. <u>Trainers have not been recruited and thus not trained.</u> Procedures have been shared with the Head of Risk Department and Head of Retail Credit Department.
	Master APS Development and Installation	Master APS installed in two Pilot branches.			An updated version was successfully tested in August 2013. However, for full functionality there is need for constant supervision from Bank's IT Department to adapt the system to any procedural changes.
	Disbursements	A total of 960 clients reached as of August 2013			147 loans were disbursed as per August 31st, 2013.
Roll out phase	**Roll out support**	20 new loan officers hired, 7 new offices opened, 4'500 clients reached as of 08/2013			The roll out phase was cancelled by the bank after August 2013.

3.1 Client level

Financial products: The management accepted in December 2012 a group lon product, a micro loan product, and a MSE loan product. However, only the micro loan product has been offered in two branches. The loan amounts disbursed initially for a maturity period of 6 months were fairly small (around CHF 761). The BoK wished to proceed at first by mitigating risks and offer small loan amounts over a short term maturity. Therefore, the proposed MSE loan product targeting small enterprises was not yet offered. It did not intent to serve micro enterprises via group lending. In the two months after the start of the pilot implementation phase (mid-May 2013), the product characteristics were unilaterally modified by the bank's senior management and immovable collateral located in Kigali became a requirement for all customers. This was justified by the decision to target the upper segment of the micro lending strata. A survey, conducted in July 2013, targeting 350 micro entrepreneurs revealed limited interest in the proposed product[6]. The key reasons were the product's limited maturity (maximum 6 months) and the absence of collateral ownership in Kigali. As a result, loan disbursements fell dramatically in spite of the huge efforts to sell the loan product. Two months after the project ended, the management modified the micro loan product maturity, as requested by the BFC consultants earlier, to 12 months. However, the Bank kept immovable collateral as a mandatory requirement for disbursement. Disbursed loans remained in the bank's micro lending portfolio and the Micro Lending department kept on monitoring them.

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[3] BFC had repeatedly offered the bank support in dealing with the problems concerning loan management in their 'own' loan portfolio but management suggested that we keep focused on implementing the project as initially planned.

[4] Bank's 'own' micro lending portfolio was managed with the banking software but its limited features hampered BFC from defining the PAR 30. Only PAR 90 figures could be extracted.

[5] In December 2012, the Bank's micro lending portfolio represented 0,92% of the total assets (2'958 / 322'794 RWF million), while in June 2013 the given ratio represented 0,66% (2'343 / 356'335 RWF million).

[6] The respondents had the possibility to rate their interest in the product as low, average and high. Respectively, 44% and 42% expressed low and average interest in the product.

Picture 1: Micro entrepreneurs in Nyabugogo Branch

Lending indicators	**31/08/2013**
Portfolio	
Number of loans outstanding as of 31/08/2013	114
PAR>30, number of loans (as of 31/08/2013)	5
Drop-outs during the pilot implementation phase	33
Disbursements	
Number of loans disbursed (March - August 2013)	147
Average size of loan disbursed, CHF	628
Number of loans disbursed to Bank's former clients	15
Number of loans disbursed in rural areas	3
Share of women borrowers	63%
Share of loans disbursed to retail and services sectors	100%
Share of loans disbursed to agriculture sector	0%

3.2 Partner financial institution level

Procedures and tools delivered to the Bank:
The following materials and tools were tested and used during the pilot phase and then handed over to the BoK to enable the bank to pursue and expand their micro lending operations geographically. Based on information received from the micro lending manager in December 2013, the new procedures and tools are still in use by the micro lending team:

- Credit manual, containing procedures for individual lending operations, process maps and forms.
- MIS manual describing technical and operational features of Master APS.
  Training materials related to lending and operational methodology.

Picture 2: Masaka Branch

BFC proposed extending the use of the micro lending appraisal and monitoring methodology developed under the project to SME loans to improve their quality that stood at 7,6% PAR90 as of June 2013.

Staff recruitment and training: At the end of August 2013, 16 employees were working in the Micro Lending department. Recruits were trained by BFC in micro lending technology and analysis as well as MIS procedures during class room sessions and on-the-job. Additionally, the consultants conducted specific workshops related to target accomplishment, productivity, time management and reporting. The microfinance manager was coached and trained on a daily basis. The staff were tested in this twice, at the beginning and end of the pilot phase. Marks increased only slightly between both tests because too few microenterprise loans were disbursed for the development of a solid set of management skills and competences.

Human resources	**Recruited/ Transferred**	**Target**	**Resigned**	**Total**
Micro lending Manager	1	1	0	1
Team Supervisor	3	3	0	3
Loan Officer	13	10	3	10
Administrative Assistant	1	3	0	1
IT Officer	1	1	0	1
Compliance Officer	0	1	0	0
Training Officer	0	1	0	0
Total	**19**	**20**	**3**	**16**

Management Information System: The Master APS has been installed as MIS at BoK to eliminate its weaknesses in application processing and improve the bank's lending cycle. Feedback from BoK deemed the system to be an excellent complement to its own software (Delta).The new MIS's features enable efficient and precise management of micro lending operations because it replicates the successive steps of the micro lending cycle[7]. Furthermore, Master APS is capable of generating reports which are essential for the daily management of micro lending activities (portfolio at risk, disbursement, loan officers' performance, marketing, monitoring reports etc.).

[7] Customers prospection → loan application → loan appraisal → credit committee → disbursement → monitoring → repayment →new cycle

After the Board's decision to stop the micro lending project, the Bank's management (COO and Head of Retail Credit Department) expressed an interest in utilizing Master APS for the existing micro lending portfolio, and tentatively for the SME portfolio. In December 2013, the Bank was still satisfied with the software and used it for facilitating daily management of micro lending operations. However, BoK did not recruit external staff but preferred to draw on internal resources to deal with the technical support of the software. Their insufficient technical experience and knowledge impeded the Bank to take full technical ownership of the software that resulted in limited system maintenance and limited future technical developments. BFC continued to provide informal but regular support to the IT department after the project end to import data on all micro loans disbursed into Master APS in order to strengthen reporting on the entire micro loan portfolio[8].

Picture 3: Giporoso Branch

4. Lessons learnt

Overall, the project has not reached its original aim which was to prepare BoK for a rollout of micro lending operations to low-income households throughout the country. The consultants provided the Bank with the modules comprising a feasible lending scheme as planned. However, unilateral changes by the Bank to product characteristics during the pilot implementation phase, as well as a general lack of support, have largely contributed to the operational targets for the pilot phase not being reached. In an attempt to offset the risk of a pilot project failure the consultants shifted work time planned for the third project phase (roll out) to the second phase (pilot implementation). However, this did not occur due to a strategy shift driven by management away from microfinance activities despite its initially strong commitment to become a leader in micro lending, but .

BFC conducted several attempts to communicate with both senior management and the Board to try and convince decision makers to stay on track. The consultants also repeatedly shared their views with the Bank that the issues which were viewed as obstacles for further development could be overcome through appropriate handling, and indeed even turn into an advantage:

Non-Performing Loans: lack of financial education among clients and challenges associated with their monitoring increase the credit risk. However, the BoK could clearly have limited this risk and maintained an acceptable PAR level by benefiting from a trained team, defined credit procedure, a national credit bureau and a national database allowing registering immovable collateral.

Cap on interest rates: the interest rate cap of 20% requested by the National Bank of Rwanda definitely reduced the appeal of serving micro enterprises by the BoK. However, the bank's wide regional network could have enabled it to limit operating costs to personnel expenses only, as additional branches and facilities were not necessary. Moreover, its deposit taking activities decreased the cost of capital funds, allowing for a greater interest rate spread. The BoK has already been managing a loan portfolio of about 5'000 micro entrepreneurs, and while it needed to be cleansed of non-performing loans, the institution's low operating and financial costs could have generated significant gains from further lending activities.

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i Central Intelligence Agency, 2014, Rwanda Country Profile
ii African Economic Outlook, 2013 and 2012
iii http://data.worldbank.org/indicator, Statistical Yearbook 2012 (National Institute of Statistics of Rwanda)
iv Heritage Foundation, 2012 Index of Economic Freedom, http://www.heritage.org/index/country/rwanda
v Oxford Policy Management, The evolution of poverty in Rwanda from 2000 to 2011
vi WFP, www.wfp.org/countries/Rwanda/Overview
vii http://www.uob.rw/
viii National Bank of Rwanda (2012), 2011 Financial Stability Report
ix FinScope, 2012, Financial Inclusion in Rwanda, Survey Report, http://www.finscope.co.za/finscope/pages/Initiatives/Countries/Rwanda.aspx?randomID=4fadde6d-d300-4337-b800-00346f7a1acc&linkPath=3_1&lID=3_1_10, accessed 10.04.14
x National Bank of Rwanda (2012), 2011 Financial Stability Report
xi Information from http://www.bk.rw and 2009 and 2012 annual reports and meeting

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8 Since February 2013 onwards Bank of Kigali has been managing micro loan disbursement and portfolio via Master APS.