UNCDF

Unlocking Public and Private Finance for the Poor

CASE STUDY OF TANZANIA SUMMARY

Accelerating MFI integration into an Inclusive Digital Economy

April 2022

Summary

In 1991, the Tanzanian Government launched ambitious financial sector reforms aimed at liberalizing the country's economy. While this agenda has achieved significant success in some areas of the banking sector, the country's microfinance industry has grown more slowly, limited by challenges including financial constraints, governance and leadership issues, and excessive dependency on donors.
Recognizing the importance of the microfinance industry to underserved populations (such as women and youth), in 1998 the government introduced policy tools and, later, a regulatory framework aimed at reforming the microfinance subsector. Over the last decade, the government has also focused on developing the country's digital infrastructure through initiatives such as the Tanzania National Fibre Broadband Backbone and the Tanzania Instant Payment System (TIPS), which is expected to be launched in 2022. However, Tanzania's microfinance industry has not yet been able to fully benefit from the opportunities created by these initiatives.

In line with its inclusive digital economy strategy aimed at "Leaving No One Behind in The Digital Era", UNCDF can support the digital transformation of MFIs to align with the government's work to digitally transition the economy. By digitizing their operations and systems, integrating with the national payment system, and fully utilizing the digital financial infrastructure, microfinance institutions (MFIs) can become more efficient and develop innovative products to better serve their clients.

This case study provides a snapshot of the state of the MFI industry in Tanzania and highlights options that key stakeholders can exploit to accelerate MFI participation in Tanzania's wider inclusive digital economy.

Why do microfinance institutions matter?

Unlike most commercial banks, MFIs offer affordable financial products and services to communities and individuals who are often excluded from mainstream financial services. This can include micro and small enterprises, low-income households, people living in rural areas and women. Many of these groups rely on informal economic activities with volatile income, increasing their vulnerability to risks and financial instability. MFIs, particularly those offering micro-savings or micro-insurance products, can offer individuals with low incomes the means to protect themselves against risks such as illness or loss of income.

MFIs also offer a route to formalization by linking the formal and informal economic sectors – for example, by combining credit provision with mentorship to micro businesses wishing to grow. Better access to capital and credit allows micro and small enterprises to become more productive; they then experience improved growth rates, which encourages businesses to register, pay taxes and comply with other legal requirements.

The microfinance industry in Tanzania

Tanzania's Microfinance Act (2018) catalysed the formation of a legal framework for the country's microfinance subsector by introducing licensing and compliance requirements that are intended to minimize risks and improve service delivery while protecting consumers from potential harm.

The Act categorizes MFIs into four tiers:

- Tier 1: deposit-taking microfinance service institutions (microfinance banks)
- Tier 2: non-deposit-taking microfinance service providers (e.g., credit companies, money lenders, digital microfinance lenders)
- Tier 3: savings and credit cooperative societies (SACCOs)
- Tier 4: community microfinance groups

As of November 2021, institutions in tier 4 are by far the most common, with over 15,000 licensed MFIs falling into this category. It is likely that regions that are economically poorer, with limited access to bank branches, have more community-based microfinance organizations to fill the gap.

In contrast, there are just five licensed MFIs in tier 1: Access, FINCA, Mwanga Hakika, VisionFund and Yetu Microfinance Bank.[1] There are 578 licensed tier 2 MFIs across the country, most of which are based in the five major cities: Dar es Salaam, Mwanza, Arusha, Dodoma and Mbeya. Finally, as of June 2021, there were 369 licensed SACCOs in Tanzania, playing a vital role in extending credit to households and micro and small businesses.

Data show that Tanzania's MFI industry serves a sizeable segment of the population. In 2018, nearly 4 million customers were served by SACCOs and 1.9 million by tier 1 and 2 MFIs. While the number of tier 4 members is unknown, in 2018 community microfinance groups were estimated to have a capital of TZS58.9 billion (US$25.6 million).[2]

Policy, legal and regulatory framework

The Government of Tanzania has pushed several reforms aimed at increasing the dynamism, depth and efficiency of financial services. In 2000, the government adopted the National Microfinance Policy to "establish a basis for the evolution of an efficient and effective micro financial system in the country, thereby contributing to economic growth and poverty reduction."

Interventions developed from this policy, which included the government-formulated Rural Financial Services Strategy in 2001 and the development of the legal, regulatory and supervisory framework for microfinance operations in the country, have made an important contribution to the growth and quality of microfinance service providers and products.

The 2018 Microfinance Act is the basis of several regulations guiding the management, supervision and administration of the four tiers of MFI. Among other factors, these regulations specify the amount of capital that institutions in each tier must maintain (for example, a tier 1 MFI must maintain a core capital of at least 12.5 percent of its total risk-weighted assets and off-balance sheet exposure; a tier 4 MFI is not required to maintain any specified minimum capital) and determine various operational and administrative requirements, including the criteria that must be met for an MFI to transfer from one tier to another.

1 Commercial banks offering microfinance services are Maendeleo, Mkombozi, Akiba, DCB and TPB, and community banks offering the same are Mufindi, Uchumi, Kilimanjaro and Tandahimba.

2 Unless otherwise specified, the United Nations operational rate of exchange was used (US$1 to TZS2,298.44 on 1 December 2021). See https://treasury.un.org/operationalrates/OperationalRates.php.

Benefits

MFIs in tiers 1, 2 and 3 report that the 2018 Microfinance Act has brought many benefits to the microfinance sector. The Act requires tier 2 and 3 MFIs to submit monthly credit information to the Credit Reference Bureau, which allows MFIs to accurately assess borrowers' risk profiles when making lending decisions. Before the COVID-19 pandemic, this meant that one benefit of the Act was lower default rates, arising from improved credit risk assessment and better-informed customers. However, the recent impact of the COVID-19 pandemic on borrowers' incomes and their ability to repay loans might have resulted in increased default rates in the market.

The Act also requires tier 2 and 3 MFIs to offer financial education to their customers, including information on the terms and conditions of loans and advice on cash flow management. This should ensure that customers are well informed and able to make sound borrowing decisions.

The Act has led to the introduction of industry standards for MFIs, particularly at the licence application stage and in supervision to ensure smooth business operation. Tier 2 and 3 MFIs must meet several requirements designed to 'filter out' less serious or undercapitalized entities. For example, all tier 2 MFIs (except money lenders) must have a governing board and all tier 3 MFIs must have a board of directors with at least five members. By ensuring MFIs meet the specific requirements of the relevant tier, the Act and accompanying regulations are helping to standardize the operating field for MFIs and to improve professionalism in the industry.

Other benefits of the Microfinance Act include: more opportunities for MFIs to attract financing (due to improved professionalism making MFIs more attractive to funders and more likely to pass funders' due diligence processes); better control of fraud and other financial crimes, as it is now illegal to operate an unlicensed MFI; increased industry awareness; and more opportunities for integration with third parties such as electronic money issuers or fintech companies.

Challenges in the microfinance industry

Challenges persist across the microfinance industry in Tanzania. Currently, MFIs are concentrated in certain regions, resulting in saturation and excessive competition for the target market (which is usually low-income populations). To improve the geographical spread and scale of MFIs, investment in delivery channels is vital. Digital innovations, which have a proven ability to deliver outreach and scale efficiently and cost-effectively, should be investigated.
The new legal and regulatory framework requires MFIs to submit periodic reports to their respective regulatory bodies: Bank of Tanzania (BoT) for tier 2 MFIs and the Tanzania Cooperative Development Commission for tier 3. The quarterly reporting process is laborious and heavily paper-based, leading to reports that are prone to human error and that may contain unreliable data. Automating this process could improve both efficiency and data quality.

Prudential regulation can also create challenges for MFIs. For example, in response to high interest rates, averaging about 10 percent per month for tier 2 MFIs, BoT invoked a maximum monthly interest rate to protect consumers from predatory lenders. However, this action could reduce available credit options by forcing some MFIs to withdraw from the market or to limit their activities in certain areas, reducing product diversity and consequently pushing low-income customers back to informal credit markets.

Some MFIs, particularly those in the lower tiers (including SACCOs and community microfinance groups), exhibit weak ownership and management structures that negatively impact their ability to manage risk and enforce credit discipline. Weak governance can also lead to higher operational costs. Tanzania's new regulatory regime should help to address this challenge, as it requires tier 2 and tier 3 MFIs to maintain a credible board of directors.

Other institutional factors, including portfolio quality, financial discipline, funding costs, staff skills and turnover, and inadequate information management/IT systems, can also create challenges for many MFIs. While the Microfinance Act and associated regulations address many of these issues, in practice some MFIs struggle to meet the requirements – for example, while MFIs in tiers 1 to 3 must have an information management system in place at the licence application stage, many MFIs lack the funding, time or skills to implement an effective system.

Digitization: Positioning MFIs for an inclusive digital economy

MFIs acknowledge the need to digitize their core organizational and operational areas to keep pace with innovation in the microfinance sector. In particular, tier 2 and 3 MFIs understand the value and opportunities offered by digitization and acknowledge that digitizing their information-gathering processes and/or their delivery channels is essential if they are to remain competitive.

However, many MFIs remain limited by inflexible core IT and data management systems. In addition, currently the introduction of digital products relies on integration through bilateral arrangements with electronic money issuers, but only the largest MFIs have sufficient capital to afford the costs of this integration.

The digitization of MFI services needs to happen along two lines: (i) the digitization of internal operations and functions and (ii) the digitization of service delivery channels. To date, MFIs have prioritized the digitization of back-office systems. This is an essential part of the MFI digital transformation process, and the adoption of a computerized core banking system is the crucial first step. TIPS presents an opportunity for MFIs to digitize their delivery channels more efficiently and cost-effectively by reducing the costs of digital transactions.

Options for digitization

MFIs in Tanzania have two potential options for participating in the national payment and settlement system:

- Option 1: Individual connection to TIPS. As MFIs must meet minimum functional and technical requirements, this option is limited to tier 1 and 2 MFIs that have core banking systems capable of connecting with TIPS and that can afford upfront investment in integration fees and customer support services.
- Option 2: Connection through an aggregation model. This option supports MFI integration to TIPS through an aggregator.[3] The cost of integration would depend on the level of customization required to accommodate the MFI's existing systems. Facilitating integration to TIPS could be a new revenue-generating channel for aggregators seeking to expand their offerings. However, aggregators that could potentially play this role would require technical and operational capacity strengthening.

Outlook

The Tanzanian microfinance industry must digitize to remain competitive. For digitization to be successful, technological innovation will need to be accompanied by organizational change management and investment in skills and IT infrastructure.

Digitization will require a significant amount of funding and an enabling policy and regulatory environment. In addition, consumers' financial and digital literacy is key in ensuring that the digital transformation of MFIs does not leave their customers behind.

At UNCDF, we are committed to supporting the ongoing efforts of MFIs that have formed working groups aiming to develop technical and functional specifications for a core banking system that meets the needs of their respective tiers. While this support is currently being offered to a small number of MFIs, with continued support from other stakeholders, many MFIs may be able to develop and onboard a shared core banking system to kick off their digital transformation journeys.

3 Aggregators are entities that serve as conduits between payment instrument providers (such as mobile money providers and banks) and third parties.

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