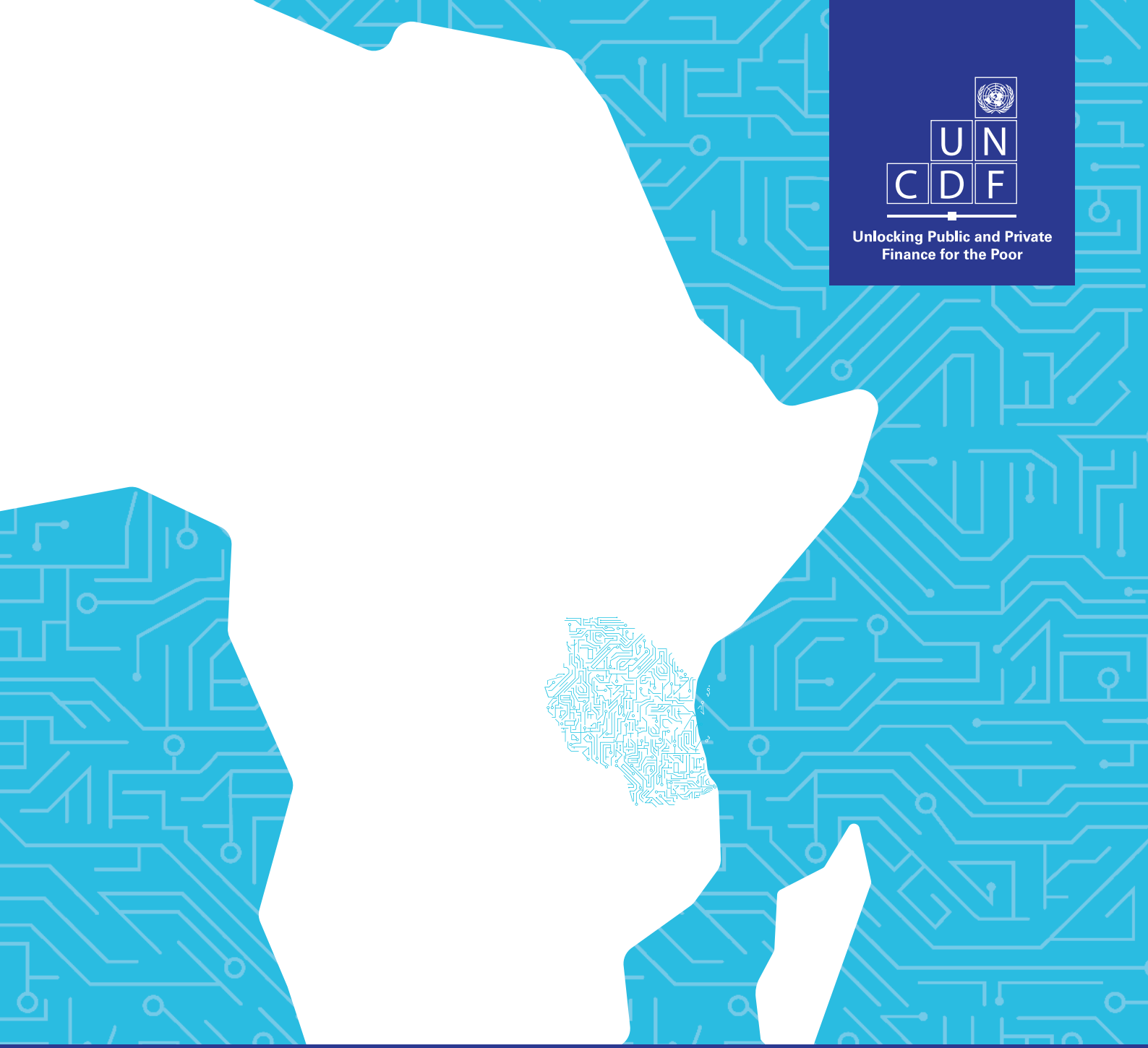

UNCDF

Unlocking Public and Private Finance for the Poor

CASE STUDY OF TANZANIA

Accelerating MFI integration into an Inclusive Digital Economy

April 2022

LEAVING NO ONE BEHIND IN THE DIGITAL ERA

The United Nations Capital Development Fund (UNCDF) strategy 'Leaving no one behind in the digital era' is based on over a decade of experience in digital financial inclusion in Africa, Asia and the Pacific. UNCDF leverages digital finance in support of the Sustainable Development Goals (SDGs) to achieve the vision of promoting digital economies that leave no one behind. The goal of UNCDF is to empower millions of people by 2024 to use services daily that leverage innovation and technology and contribute to the SDGs. To achieve this vision, UNCDF uses a market development approach and continuously seeks to address underlying market dysfunctions that exclude people living in the last mile.

ABOUT THE UN CAPITAL DEVELOPMENT FUND

UNCDF makes public and private finance work for the poor in the world's 46 least developed countries (LDCs). It offers 'last mile' finance models that unlock public and private resources, especially at the domestic level, to reduce poverty and support local economic development.

UNCDF's financing models work through three channels: (1) inclusive digital economies, which connect individuals, households and small businesses with financial ecosystems that catalyse participation in the local economy, and provide tools to climb out of poverty and manage financial lives; (2) local development finance, which capacitates localities through fiscal decentralization, innovative municipal finance and structured project finance to drive local economic expansion and sustainable development; and (3) investment finance, which provides catalytic financial structuring, de-risking and capital deployment to drive SDG impact and domestic resource mobilization.

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Contents

1

Introduction

The emergence of the microfinance industry in Tanzania can be traced from the year 1991,[1] when the Tanzanian Government embarked on an ambitious financial sector reform agenda geared towards the liberalization of the economy. The reforms included the privatization and/or change in the business models of state-owned banks and financial institutions to become more commercial, and the welcoming of private banks to operate in the country.[2] Since then, considerable developments have been registered in the banking sector, including improved quantity and quality of financial services and delivery channels. However, the microfinance sector has lagged behind due to internal and external factors such as financial constraints, governance problems, weak leadership and institutional capacity, excessive donor dependency, and so on.[3] Tanzania realized substantial gains towards meeting the reform agenda objectives, especially in the banking industry. The number of banks more than quadrupled from about 10 in 1994 to 55 in 2014.[4] In spite of this performance, financial access is still low, with only 16.7 percent of the adult population (16 years and above) having access to bank products.[5] In addition, a 2012 study by the Ministry of Industry and Trade found limited access to credit for small business entrepreneurs, resulting in slow growth or transformation of businesses into big enterprises.[6]

In recognizing the importance of the microfinance industry in serving underserved populations (largely composed of women and youth), the government responded, from late 1998, by making conscious efforts to reform this subsector with policy tools and eventually a regulatory framework. To signal its commitment to the microfinance subsector, the government drafted the inaugural National Microfinance Policy (2000), which was updated in 2017[7] and followed by the first Microfinance Act (2018).[8]
Since the 2000s, the Tanzanian financial sector, much like others in eastern and southern Africa, has also expanded into digital financial services, driven by the growth of non-bank financial services. There is ongoing integration of banks and non-bank financial services leveraging technology with the ability to reach underserved populations while providing access to a wide array of financial products and services. Private-sector efforts have been accompanied by government initiatives to support technological market developments. The government has focused its efforts on developing digital infrastructure, which notably includes:

- Tanzania National Fibre Broadband Backbone
- Strengthened institutional framework to supervise, regulate and promote technological advancement and innovation
- National ID project, launched in 2013 to register and provide all adults with a unique national identification
- Government Electronic Payments Gateway (GePG), launched in 2017 to digitize government payments and revenue collection
- Tanzania Instant Payment System (TIPS), expected to be launched in 2022, for the integration and interoperability of all digital financial services in the country

While these initiatives are a move in the right direction, the benefits they bring are not equally accessible by all the players in the ecosystem. In particular, the microfinance industry is yet to fully utilize the advancements in technology to exploit the opportunities made available by these digital rails.
There is potential for microfinance institutions (MFIs)[9] (especially those in lower tiers) to improve efficiency and better serve their clients with innovative products by digitizing their internal operations and systems, integrating with the national payment system, and utilizing the available digital financial infrastructure. With technology as an enabler, MFIs will be better positioned to fully participate in Tanzanian's growing inclusive digital economy and bring on board populations that are often left behind.
In line with UNCDF's inclusive digital economy strategy aimed at "Leaving No One Behind in The Digital Era", UNCDF sees that there is a role for it to play along with strategic partners in supporting the digital transformation of MFIs to keep pace with government efforts to digitally transition the economy.
In this regard, this industry position paper aims to provide a snapshot of the state of the MFI industry in Tanzania and highlight options that key stakeholders can exploit to accelerate MFI participation in Tanzania's wider inclusive digital economy.

2

Why do microfinance institutions matter?

The primary objective of microfinance service providers is to provide micro and small enterprises (MSEs) and low-income households with access to affordable financial products and services.

The microfinance industry in Tanzania has grown over the past decades, primarily serving communities that often cannot access banking services. The observed growth is partly due to increased awareness of convenient, easy and timely access to credit facilities from microfinance institutions instead of the bureaucratic procedures and strict credit conditions of commercial banks. Microfinance institutions cater primarily to borrowers with informal business activities and relatively weak collaterals such as unsurveyed land and house furniture, which the banks do not accept. As such, microfinance service providers are key to financial inclusion and have continued to play a fundamental role in supporting access to capital and financial services, especially to women and people living in rural areas, who are often excluded from mainstream financial services. Many of these groups rely on informal economic activities with volatile income, increasing their vulnerability to potential risks and financial instability.

Evidence demonstrates the role of MFIs in expanding access to financial services for low-income and excluded segments. For instance, in Tanzania historically, a large volume of bank credit has been directed to a small number of corporate clients and salaried employees. As a result, MSEs or households with irregular incomes are limited to accessing credit from MFIs or informal means. Even though banks still provide the great majority of credit by value (85 percent), non-bank financial institutions reach far more consumers. The FinScope 2017 study shows only 3 percent of adult population access credit from banks, compared with those who borrow from MFIs (2 percent), savings and credit cooperative societies (SACCOs; 2 percent) and money lenders (2 percent). The remaining 91 percent borrow from family and friends (69 percent), savings groups (18 percent) and mobile money (4 percent).[10] Therefore, a promotion of microfinance businesses inevitably fills the vacuum created by banks in formal lending. Banks rely on more conservative and collateral-based lending models, which exclude many people who fail to meet the requirements.

Moreover, the growth in microfinance institutions, particularly micro-savings or micro-insurance products, helps low-income individuals to access means for protecting themselves against vulnerabilities such as illnesses or loss of income. These means are not necessarily accessible for individuals with low incomes as they are packaged by traditional commercial banks or insurance companies.

Also, MFIs act as avenues towards formalization through the linking of the informal and formal economic sectors. This is mainly because some microfinance businesses combine credit provision with mentorship to micro businesses wishing to grow. Increased access to capital and credit not only promotes savings and investment for businesses engaged by such microfinance businesses, but also makes their efforts more productive. With increased productivity, it is likely that businesses experience higher growth rates, which in turn encourages businesses to register their entities, operate under regulatory purview, pay taxes and comply with other legal requirements. For instance, an MFI in India (Shaktri) compliments its credit issuing function to its customers with linkage to mentors, making it attractive to informal economy operators wishing to grow.

However, all has not been rosy with the microfinance industry. It has had its share of shortfalls in various markets globally, the most prominent of which was India's microfinance crisis in 2010.[11] The India case provided lessons for other markets to learn from and put in place policy and regulatory frameworks to avoid similar calamities. Among the major issues is the over-indebtedness of microfinance consumers due to several factors, including high interest rates, aggressive and reckless lending practices, limited financial education and weaknesses in consumer protection regimes. Other lessons learned include the risk of money laundering through unregulated MFI service providers. These issues emphasized the urgent need for a balanced policy and regulatory framework. In response, the government put in place the Microfinance Act (2018) and accompanying regulations,[12] the Anti-Money Laundering Regulations (2019)[13] and the Financial Consumer Protection Regulations (2019),[14] which have formed a robust regulatory framework for the licensing, authorization and supervision of MFIs.

3

State of the microfinance industry

Microfinance institutions in Tanzania

The enactment of the Microfinance Act (2018) and its regulation (2019) in Tanzania's was structured to distinguish between different types of MFIs and their respective licensing and regulatory approaches. The Act catalysed the formalization of the microfinance subsector by introducing new proportional licensing and compliance requirements, such as governance and automation of operations, to minimize risks and improve service delivery while protecting consumers against potential harm.

The Act categorizes MFIs into four tiers based on the prescribed criteria:

- Tier 1: deposit-taking microfinance service institutions (microfinance banks)
- Tier 2: non-deposit-taking microfinance service providers such as money lenders
- Tier 3: SACCOSs
- Tier 4: community microfinance groups

Table 1 shows the number of institutions per tier, based on available data.[15]

In addition, the latest statistics show that the MFI industry is serving a sizeable segment of the population. For instance, as of 2018, nearly 4 million (3,998,193) members were served by SACCOSs and 1.9 million were served by tier 1 and 2 MFIs. While the number of tier 4 members is unknown, community microfinance groups are estimated to have a capital of TZS58.9 billion (US$25.6 million)[18] as of 2018. Therefore, to ensure consumer protection and the stability and integrity of the financial sector, it was important for the regulators to bring MFIs under their purview. The segmentation of MFIs into tiers clarifies each MFI's permitted activities and accompanying prudential requirements.

Tier 1 – banks and microfinance banks (deposit-taking institutions)

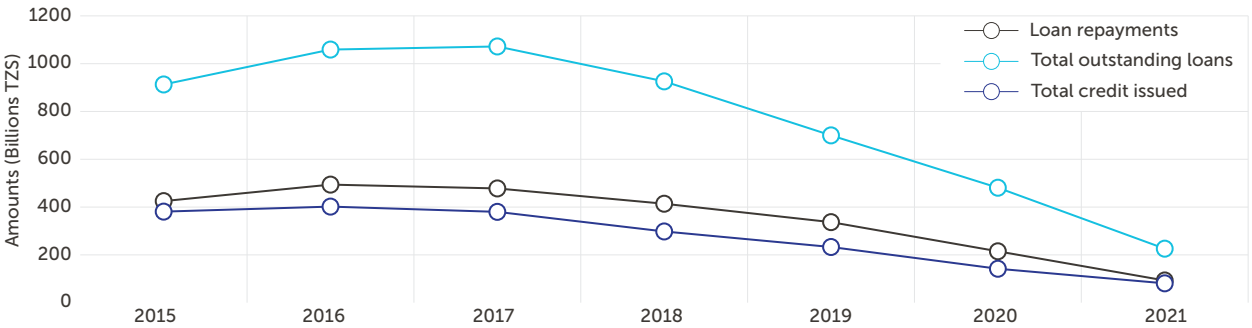
There are five tier 1 microfinance banks in Tanzania – Access, FINCA, Mwanga Hakika, VisionFund and Yetu Microfinance Bank.[19] Mwanga Hakika Microfinance Bank was formed from a merger of three banks – EFC Microfinance Bank, Mwanga Community Bank and Hakika Microfinance Bank. This merger was driven by the need to comply with the bank capital requirements that forced smaller banks to either close or merge with others. The capital difficulties can also be observed in the decline of MFI lending activity. Figure 1 shows that, since 2017, the amounts of credit issued, total outstanding loans and loan repayments from tier 1 microfinance banks have declined.

Table 1: Number of licensed institutions

Tiers	Category of MFI	Number of licensed[16] MFIs as of November 2021
1	Deposit-taking microfinance service institutions	5
2	Non-deposit-taking microfinance service providers	578
3	Savings and Credit Cooperatives Societies (SACCOs)	369[17]
4	Community Microfinance Groups	15,746

Source: Bank of Tanzania

Figure 1: Credit from tier 1 MFIs since 2015



Source: Bank of Tanzania

This further attests to the liquidity tightening that the market experienced at the beginning of 2016 as a result of fiscal operations, including the decline in foreign budget support inflows, transfer of deposits of public institutions from commercial banks to the Bank of Tanzania (BoT), and streamlined government expenditures.[20] The trend continued in 2021 even after an easing of monetary policy to counter the tighter liquidity levels. This could be attributed mainly to the COVID-19 pandemic and its impact on the incomes of households and small business. These are the main borrowers from MFIs and their negative performance in the pandemic period may have triggered risk averseness among MFIs, resulting in lower volume and value of credit issued in the market.

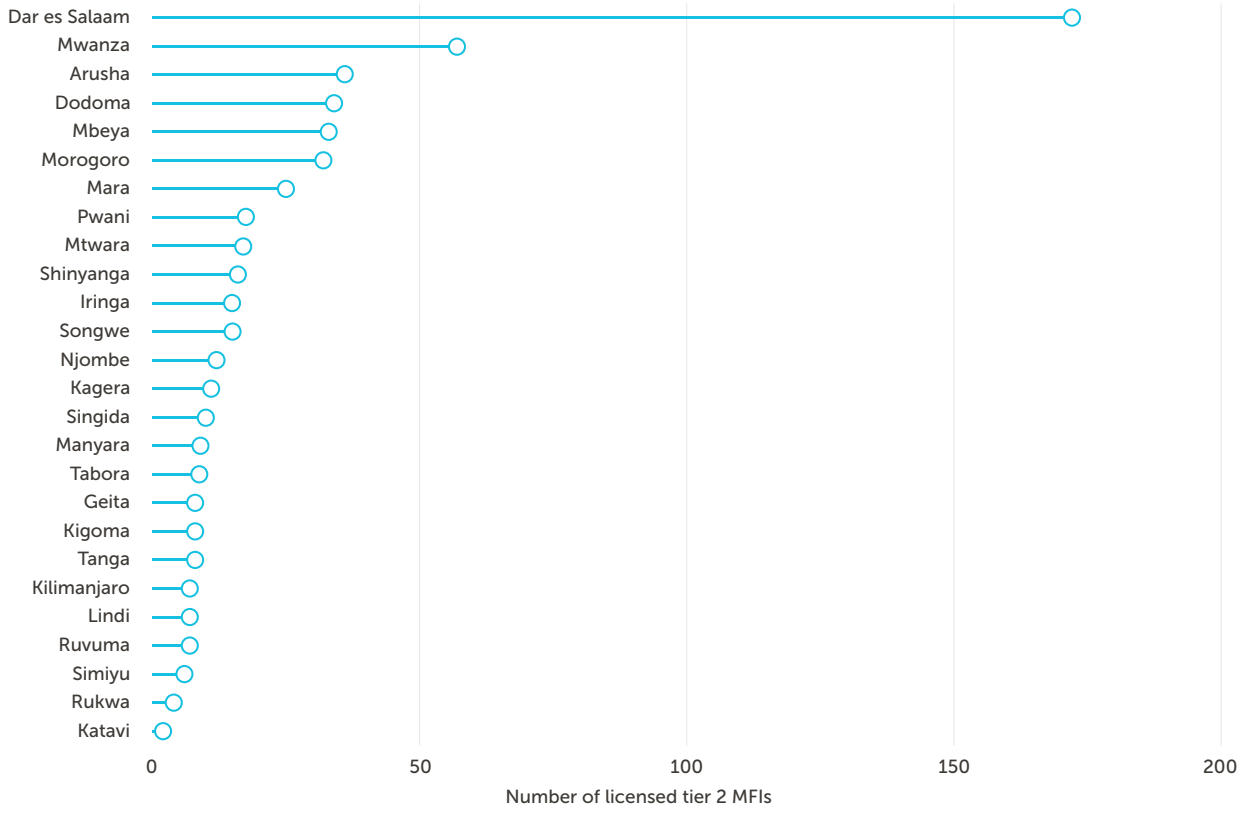
To accelerate the recovery of the economy, BoT continued to institute monetary policy measures to promote credit to the private sector and lower interest rates.[21] Even though these policies are geared towards banks, particularly those that lend to the private sector, increases in lending from banks may have had a trickle-down effect on MFIs, which also increased their lending, as MFIs rely on commercial banks for capital to on-lend to their customers.

Tier 2 – non-deposit-taking institutions and money lenders

Tier 2 institutions are defined to include credit companies, financial organizations, housing microfinance companies, individual money lenders and digital microfinance lenders. As of November 2021, there were 578 licensed (616 registered) tier 2 MFIs across the country. Most licensed MFIs operate in the five major cities – Dar es Salaam, Mwanza, Arusha, Dodoma and Mbeya (see Figure 2) – which is partly attributable to the high demand for financial services in the larger cities. The observed correlation also matches with the distribution of formal financial inclusion across the country. FinScope 2017 study results also shows Dar-es salaam, Iringa, Njombe, Arusha, Mwanza Dodoma, and Mbeya as regions with relatively high percentage of people who are formally financially included.

All in all, the figure provides a quick snapshot of the geographical spread of tier 2 MFIs across Tanzania, which further highlights their contribution to the credit market. This is more so because micro and small business trading and commerce is predominant in the top five regions identified.

Figure 2: Regional distribution of tier 2 MFIs



Source: Bank of Tanzania

Tier 3 – savings and credit co-operative societies

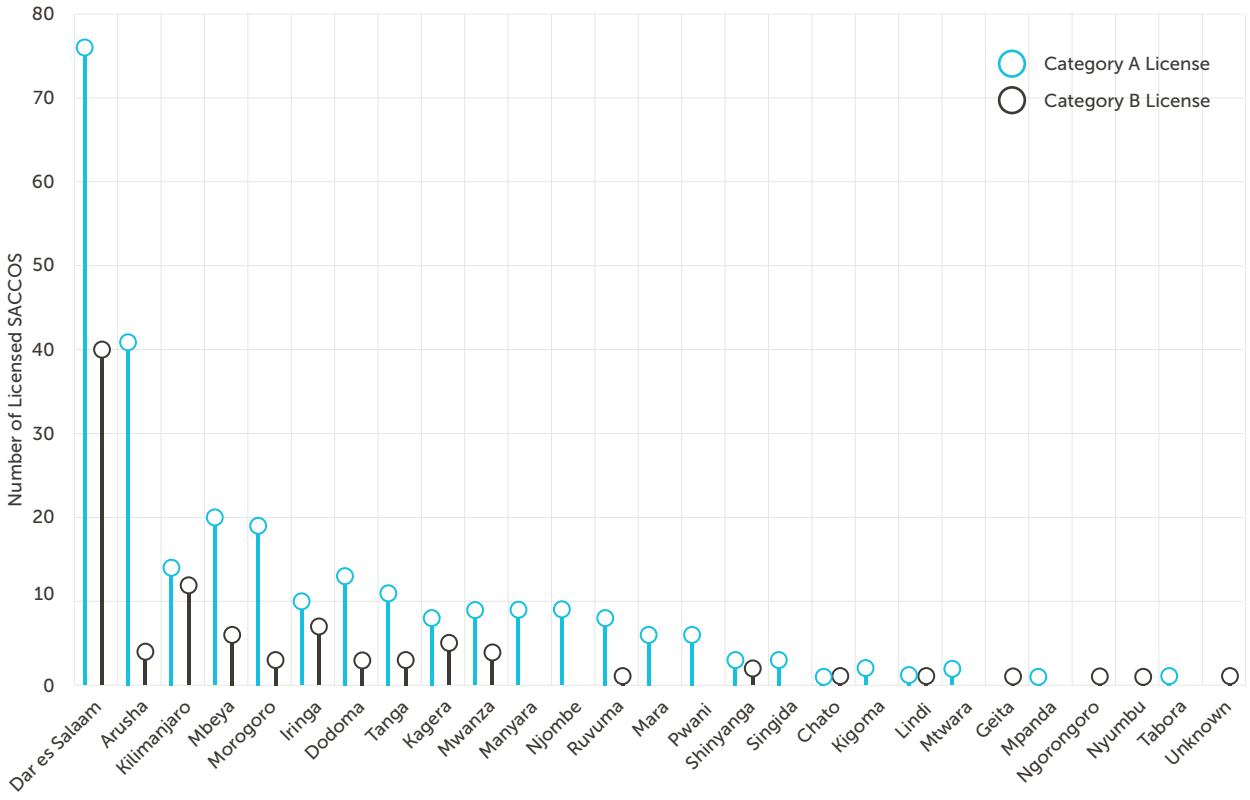
The savings and credit co-operative societies (SACCOSs) play a pivotal role in the extension of credit to the households and micro and small businesses. These are cooperatives created to encourage their members to save and build capital. The capital raised through member savings can in turn be on-lent to members at a reasonable interest rate. The lending practice in SACCOS business is based on multiples of borrowers' savings, where the borrower is obligated to purchase an agreed minimum number of shares. SACCOSs are regulated by BoT through a delegation of its mandate to the Tanzania Cooperative Development Commission (TCDC).

SACCOSs are divided into two main categories – A and B – based on the type of licence they are issued. These differ based on the permitted business activities and minimum capital requirements. These two categories are further divided into two groups:

- Community-based SACCOS: This is the most common type. Primarily found at the village level, they include agricultural marketing cooperatives. They provide a variety of individual loans or loans for small and micro-enterprises
- Employee-based SACCOSs: These are SACCOs in urban areas or at a regional level, drawing members from one employer and disbursing loans in salary multiples

As of June 2021, there were 369 licensed SACCOSs[22] across Tanzania. Over a fifth of these operate in Dar es Salaam, followed by Arusha, Kilimanjaro, Mbeya and Morogoro, as shown in Figure 3. Like tier 2 MFIs, the geographical distribution of SACCOSs could reflect underreporting from areas where most SACCOSs are yet to submit their licence applications. Besides, most SACCOSs are employment-based, which could further explain the correlation with the large cities. This is largely because the main offices or headquarters for many employers are found in major cities. Therefore, SACCOSs under certain employers may be registering the address of their main office as their locational address even though they are serving members through branches of the licensed office.

Figure 3: Regional distribution of tier 3 MFIs



Source: Bank of Tanzania

Tier 4 – community microfinance groups and community-based organizations

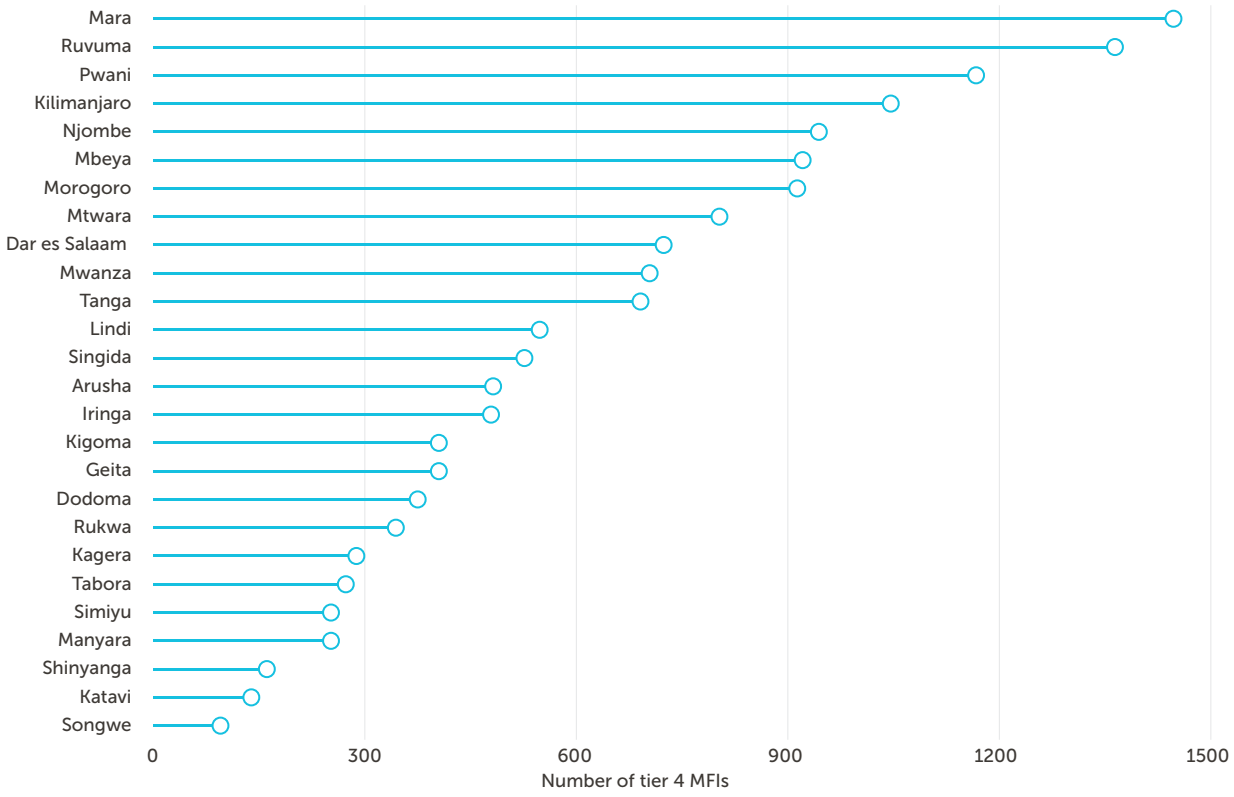
The Microfinance Act, 2018 and its Regulations 2019 demand the registration of community-based microfinance groups that are engaged in lending business. BoT delegated this activity to be undertaken by district authorities under stewardship of community development officers. As of June 2021, about 15,746 community microfinance groups that operate across Tanzania were licensed. Figure 4 shows the distribution of community microfinance groups in Tanzania, with Mara, Ruvuma, Pwani (coastal region), Kilimanjaro and Njombe ranked the top five as regions with a high number of licensed groups.

While these numbers could reflect the approach used to collect data, it could also be due to other factors such as regional differences in the economic status. It is likely that regions that are economically poorer and consequently have more limited access to bank branches are likely to have more community-based organizations to fill this vacuum.

Microfinance industry associations

In Tanzania, MFIs are members of associations that function as platforms for cooperation and advocacy. The most prominent associations include the Tanzania Bankers Association,[23] the Tanzania Association of Microfinance Institutions (TAMFI)[24] and the Savings and Credit Cooperative Union League of Tanzania (SCCULT).[25] Other associations include the Federation of Village Community Bank Implementers in Tanzania, the Tanzania Federation of Co-operatives,[26] the Tanzania Informal Microfinance Association of Practitioners[27] and the Inter-religious Village Community Bank. Membership of these associations is voluntary, but qualification for it corresponds to the MFI tiers as specified by law.

Figure 4: regional distribution of tier 4 MFIs



Source: Bank of Tanzania

4

Policy, legal and regulatory framework for microfinance institutions

Current guiding policies and historical evolution

The financial sector in Tanzania has undergone several reforms to push for the increased dynamism, depth and efficiency of financial services. In 2000, the government adopted the National Microfinance Policy (NMP) 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." The policy mandated BoT to coordinate its implementation while the sector was still in the embryonic stage. Implementation started in 2002 and was accompanied by parallel interventions that contributed to the evolution of the Tanzanian financial sector landscape. These included:

- The government-formulated Rural Financial Services Strategy in 2001
- The development of the legal, regulatory and supervisory framework for microfinance operations in the country, which included:
  a. The Cooperative Societies Act, 2003. The Act makes "provisions for the formation, constitution, registration, and operation of cooperative societies." In 2013, the Act was amended to Cooperative Societies Act, 2013 to provide for the establishment of the Tanzania Cooperatives Development Commission (TCDC) as a regulatory body, among other provisions
  b. The amendment of the Banking and Financial Institutions Act, 2006, which "provides for comprehensive regulation for banks and financial institutions and regulation and supervision of activities of savings and credit co-operative societies and schemes to maintain the stability, safety and soundness of the financial system"
  c. The Bank of Tanzania Act, 2006, which "provides for more responsive regulatory role of BoT in relation to the formulation and implementation of monetary policy, supervision of banks and financial institutions, and other related matters"
- The development of operational guidelines in 2004 for the government and donor interventions in the microfinance sector to ensure such support is well-coordinated according to best practices and consistent with the NMP
- The establishment of the Financial Sector Deepening Trust in 2004 to streamline funding to the financial sector
- The initiation of the process of harmonizing the legal, regulatory and supervisory framework for microfinance operations under the East Africa Monetary Union

These interventions contributed significantly to the growth of microfinance service providers and products, and the quality of financial services. However, weakness in the legal and regulatory framework has resulted in malpractices in the sector, including insufficient disclosure of lending terms and conditions, high interest rates, reckless lending (extension of multiple loans contributing to over-indebtedness) and unfair loan collection and recovery procedures.[28] Moreover, additional complexities and challenges became pronounced as the microfinance subsector grew. For example, there was an increased informality within the sector and a growth in the number of MFIs, concentrated mainly in urban areas. For instance, the number of non-deposit-taking microfinance institutions grew from 9 in 2002 to over 292 in 2016 and SACCOSs grew from 803 in 2000 to 4,093 by December 2015.[29]

These challenges necessitated the revision of NMP 2000 to ensure that the policy kept up with market dynamics and changes in the sector. Consequently, the Ministry of Finance and Planning championed the review of NMP 2000 and launched NMP 2017 as its replacement. The main objective of the NMP 2017 was to "create an enabling environment that promotes the development of appropriate and innovative microfinance products and services to meet the real needs of the low-income population and thereby enhance economic growth and accelerate poverty reduction". Among other specific objectives, NMP 2017 calls for creating a legal and regulatory framework for the effective and efficient delivery of microfinance services.

Policy and regulation for different MFI tiers and corresponding regulators

To implement the NMP 2017, the Microfinance Act was enacted in November 2018.[30] The Act complements the Banking and Financial Institutions Act, 2006 by providing for prudential and non-prudential regulation and supervision in the microfinance subsector.[31]

The Act focuses on a broader definition of microfinance business[32] to capture both formal and informal non-bank financial services providers. The Act categorizes microfinance entities into four tiers to allow BoT to license, regulate and supervise them based on the nature of their microfinance business and their respective financial capacity.

To provide operational guidance for the management, supervision and administration of microfinance business under tiers 2 to 4, the BoT issued

the following regulations: the Microfinance (Non-Deposit Taking Microfinance Service Providers) Regulations, 2019 (GN No. 679 of 2019), the Microfinance (Savings and Credit Cooperative Societies) Regulations, 2019 (GN No. 675 of 2019) and the Microfinance (Community Microfinance Groups) Regulations 2019 (GN No. 678 of 2019). BoT also delegated functions and powers relating to the regulation and supervision of tier 3 MFIs (SACCOSs) and tier 4 MFIs (community microfinance groups) to TCDC and local government authorities, respectively.

Tier 1 MFIs are currently regulated in accordance with the Banking and Financial Institutions Act, Cap. 342, the Banking and Financial Institutions (Microfinance Activities) Regulations, 2014 and the Banking and Financial Institutions (Microfinance Activities) (Amendment) Regulations, 2015.[33]

Tier 1 MFIs are required to always maintain a minimum core capital of at least TZS5 billion ($2.2 million). The MFI needs to distribute this across several banks or financial institutions – no tier 1 MFI is permitted to deposit more than 25 percent of its core capital in a single bank or financial institution.

Tier 1 MFIs are also always required to maintain a minimum:

- Core capital of at least 12.5 percent of its total risk-weighted assets and off-balance sheet exposure
- Total capital of at least 14.5 percent of its total risk-weighted assets and off-balance sheet exposure

Tier 1 MFIs are restricted from lending more than 3 percent of their core capital to a single borrower and not more than 2 percent of their core capital to a single insider borrower. Also, they are restricted to less than 20 percent of their core capital issued as aggregate credit to insiders.

MFIs are not permitted to offer salary advances to any of its officers and employees that exceed the annual remuneration of the borrowing officer or employee.

Tier 1 MFIs may transform into fully fledged banks subject to the approval of BoT after a satisfactory assessment of the available capital to meet the minimum capital requirements, the appropriateness of business premises and an adequacy of the management information system, administrative and operational processes and internal control system.

Tier 2 MFIs are required to maintain a minimum capital of TZS20 million (US$8,705) or higher. BoT may require higher minimum capital for tier 2 microfinance service providers at its own discretion when it has predetermined the likelihood of provider losses from capital deficiency, significant exposure to risk, high volume of low-quality assets or rapid growth without adequate capitalization and risk management. The regulations also require tier 2 MFIs to maintain at least 5 percent of their total assets as minimum liquid assets.[34]

Tier 2 MFIs may transform to tier 1 MFIs on application and satisfactory fulfilment of the required criteria in the Banking and Financial (Microfinance Activities) Regulations, including the minimum capital requirements. Also, BoT may direct a tier 2 MFI to transform to tier 1 when it is satisfied that the MFI is sustainable and meets the transformation criteria. Moreover, a sole proprietor with a loan portfolio of more than TZS200 million ($87,016) or 100 borrowers must form a company and operate as an entity.

As previously mentioned, tier 3 MFIs consist of SACCOS divided into two categories. Category A SACCOSs are required to maintain a minimum core capital of TZS10 million ($4,351) while category B SACCOSs must have a minimum core capital of TZS200 million ($87,016). Also, every SACCOS is required to maintain the following:

- At least 8 percent of total assets in core capital
- At least 6 percent of total assets in institutional capital
- At least 6 percent of total assets in net institutional capital

Moreover, every SACCOS must build a reserve fund and institutional capital by retaining at least 20 percent of its net income.

A SACCOS may apply for transformation to tier 2 or tier 1 after informing BoT or TCDC in writing about its intent, and its members have resolved to change following its constitution or by-laws.

Unlike tier 2 MFIs, the regulation and supervision of SACCOSs started in 2013 by the Cooperative Societies Act, which empowered TCDC to register, regulate and supervise financial cooperatives (SACCOSs).

Tier 4 MFIs are required to apply for registration to local government authorities delegated by BoT. In additional to registering qualified community microfinance groups (CMGs), local government authorities undertake other delegated functions, including: (i) to develop and manage a database of CMGs; (ii) to monitor and evaluate the performance of CMGs; (iii) to issue circulars and guidelines for CMGs; (iv) to ensure the proper management of complaints relating to microfinance business; (v) to ensure the

proper protection of consumers of CMGs, including sanctioning usurious lending practices; (vi) to ensure that CMGs share credit information according to the Credit Reference Bureau Regulations; and (vii) to perform other functions as may be required by BoT for the proper regulation and supervision of CMGs.

Tier 4 MFIs are not required to have or maintain any specified amount of minimum capital. On application and meeting the required criteria, tier 4 MFIs can transform to another tier.

Table 2 summarizes the primary prudential regulations that apply to each tier of MFIs. Based on their respective regulations, MFIs in tiers 1 to 4 are licensed to undertake the permitted activities shown in Table 3. The licensing regime aims to promote financial access to MSEs and low-income individuals, while safeguarding the integrity and stability of the financial sector with limited supervisory resources. Consequently, the regulations restrict MFIs from conducting activities that are perceived to be riskier given the lighter prudential regulations to which they are subjected. These restricted activities include those listed in Table 4.

Table 2: Prudential regulations applicable to MFIs

	Tier 1 (microfinance banks)	**Tier 2 (non-deposit-taking microfinance service providers)**
Minimum capital	TZS5 billion ($2.2 million)	TZS20 million ($8,705)
Minimum ongoing capital	TZS5 billion ($2.2 million)	TZS 20,000,000 (US$ 8,705)
Reserve requirements	None	None
Minimum liquid assets	20 percent of demand liabilities	5 percent of total assets
Capital adequacy	• Core capital of at least 12.5 percent of total risk-weighted assets and off-balance sheet exposure • Total capital of at least 14.5 percent of total risk-weighted assets and off-balance sheet exposure	None
Minimum provisioning rates for loans[35]	Current = 1 percent Especially mentioned = 5 percent Substandard = 25 percent Doubtful = 50 percent Loss = 100 percent	Current = 1 percent Especially mentioned = 5 percent Substandard = 25 percent Doubtful = 50 percent Loss = 100 percent

	Tier 3 (savings and credit cooperative societies)		**Tier 4 (community microfinance groups)**
	Category A	**Category B**	
Minimum capital	TZS10 million ($4,351)	TZS200 million ($87,016)	None
Minimum ongoing capital	TZS10 million ($4,351)	TZS200 million ($87,016)	None
Reserve requirements	At least 20 percent of net income		None
Minimum liquid assets	15 percent of members' total deposits, savings and short-term borrowing and other short-term liabilities		None
Capital adequacy	• At least 8 percent of total assets in core capital • At least 6 percent of total assets in institutional capital • At least 6 percent of total assets in net institutional capital		None
Minimum provisioning rates for loans[36]	Especially mentioned = 10 percent Substandard = 30 percent Doubtful = 50 percent Loss = 100 percent		None

Table 3: List of permissible activities

Tier 1 (microfinance banks)	Tier 2 (non-deposit-taking microfinance service providers)
• Accepting saving deposits • Accepting fixed or time deposits • Accepting special deposits from a development bank, wholesale financial institution or government • Issuing loans to individuals, groups of individuals, MSEs, including microfinance guarantees • Issuing housing microfinance products to individuals, MSEs • Making remittances, payment orders, collection of payment instruments, safe custody, and transfer of funds • Provision of payment services such as salaries and pensions • Loan disbursement services • Maintenance and operation of various types of account • Operation of micro-leasing facilities, hire-purchase and arrangement of consortium lending and supervision of credit schemes • Professional advice to customers on investments in small businesses, rendering managerial, marketing, technical and administrative advice to customers • Raising funds from the public or other refinancing sources • Other activities as may be authorized by BoT	• Issue microfinance loans to individuals, groups, MSEs, including microfinance guarantees • Issue housing microfinance products to individuals • Disburse credit on behalf of a programme • Maintain and operate various types of account with banks and financial institutions in Tanzania • Operate micro-leasing facilities, microfinance-related hire-purchase and arrangement of consortium lending and supervision of credit schemes • Provide professional advice to customers regarding investments in small businesses • Provide micro-insurance as an agent of insurers • Equity investment • Agent banking • Other activities as may be authorized by BoT

Tier 3 (savings and credit cooperative societies)		Tier 4 (community microfinance groups)
Category A	**Category B**	
• Offer membership and voluntary shares • Accept savings from its members • Grant loans to members • Make investments • Other activities as may be authorized by BoT or TCDC	• All activities under category A • Micro-leasing • Microinsurance as an agent of insurers • Agent banking with prior approval of BoT or TCDC • Equity investment • Debit cards • Other activities as may be authorized by BoT or TCDC	• Mobilize contributions from its members • Grant loans to members • Mobilize funds for social economic welfare of members • Other activities as may be authorized by BoT

Table 4: List of prohibited activities

Tier 1 (microfinance banks)	Tier 2 (non-deposit-taking microfinance service providers)
• Operating current account • Foreign exchange business • Foreign trade finance • Trust operations • Equity investment • Participation in the underwriting and placement securities • Purchase or acquisition of any land or any interest or right, except when necessary for conducting business – international commercial papers • Dealing in land for speculative purposes • Investing in real estate, except for use as office accommodation • Extending loans for the account and at the risk of another person or institution	• Accept any type of deposits from the public • Foreign exchange business • Foreign trade operations • Trust operations • Credit and debit cards • Payment orders and transfer of funds • Any business other than providing financial products and services to its members
Tier 3 (savings and credit cooperative societies)	**Tier 4 (community microfinance groups)**
• Operate current accounts for its customers • Accept deposits from non-members • Foreign exchange business • Foreign trade operations • Trust operations • Credit cards • Payment orders and transfer of funds • Any business other than providing financial products and services to members	• Accept savings from non-members • Open a branch, agency, or outlet • Other activities as may be prescribed by BoT

Benefits of the current legal and regulatory framework

According to focus group discussions and engagements with MFIs from tiers 1 to 3,[37] the Act and its accompanying regulations have brought many benefits to the sector. The key benefits are as follows.

Reduced default rates

Prior to the Microfinance Act, only a handful of MFIs and SACCOSs saw value in subscribing to Credit Reference Bureaus (CRBs)[38] to receive regular reports, despite their active participation in the credit market. Most MFIs thought the CRB pricing structure (fixed annual subscription fees and a fee per query) was too expensive for their business models[39] and questioned the quality of data provided by CRBs.[40]

Also, MFI loans have a quick turnaround time ranging from 2 to 24 hours, because most loans are issued to petty traders on a daily or weekly basis to finance their micro-businesses. The expected quick turnaround time is not in sync with CRB processes, which deters MFIs from referencing CRB reports.

However, the Act made the submission of credit information[41] to CRBs mandatory. The respective regulations require tier 2 and tier 3 MFIs to submit monthly credit information to the CRB, while the frequency at which tier 4 MFIs are expected to submit data is at the discretion of BoT. The requirement to submit and use credit information for lending operations has enabled MFIs to access relatively up-to-date information and correctly assess borrowers' risk profiles for lending decisions. This can further be improved with customizing the credit reference databank for MFIs to enable faster response, to near real-time data on MFIs' customer credit reports, ensuring recent borrowing or defaults are considered in the creditworthiness assessment.

In addition to CRB reporting requirements, the respective regulations for tier 2 and tier 3 MFIs require them to provide financial education to their customers/members through different channels, including one-to-one sessions, fliers and brochures, training, seminars, workshops, media such as television, radio, newspapers and social networks, specific websites, and any other appropriate channels. The

regulations specify the topics that MFIs should cover, including:

- Key product or service features
- Terms and conditions of loans
- Cash flow management
- Record-keeping
- Financial decision-making
- Loans management, usage and repayment
- Business planning
- Importance of saving
- Any other topics considered relevant

These regulations aim to ensure that customers/members are well informed and make better borrowing decisions.

The combination of improved credit risk assessment and informed customers contributes to reduced default rates in the market. However, the impact of the ongoing COVID-19 pandemic on borrowers' incomes and their ability to repay loans might have resulted in increased default rates in the market. A recent report showed an increased non-performing loans (NPLs) ratio above the BoT's 5 percent benchmark among small banks.[42] The situation is even worse for MFIs. A BoT report from 2019 showed NPLs of MFIs to be above the 50 percent reference point due to multiple borrowing, the decline in business profitability and poor fund management.[43]

Introduction of industry standards and professionalism

The Act and respective regulations stipulate each MFI's requirements during the licence application stage and supervision to ensure smooth business operation. These requirements have forced the industry to follow standardized procedures on numerous topics. For instance, because of current regulations, all MFIs must be registered and licensed by BoT, TCDC or the local government authority, depending on the tier. In addition to licensing, tier 2 and tier 3 MFIs need to fulfil several requirements that help to filter out less serious or undercapitalized entities. To name a few, these include the following.

- A governing board: This applies to all tier 2 MFIs except individual money lenders. While the regulations do not specify the number of board members for tier 2 MFIs, they require at least two members to be Tanzanians. For tier 3 MFIs, the regulations require each MFI to have a board of directors with at least five members. For category B SACCOSs, at least two board members should have knowledge in finance, business management, accounting, microfinance or economics.
- Audit of accounts: The Act requires an external auditor to audit the accounts of all MFIs annually, except those under tier 4. While tier 4 MFI regulations are silent on the requirements for an internal auditor, those for tiers 2 and 3 require MFIs to appoint an internal auditor responsible for evaluating the adequacy and effectiveness of internal controls, risk management and governance processes, and to report to the board of directors. The internal auditor should hold a diploma in accountancy or its equivalent and have at least one year of work experience.
- Management information system: Regulations for tier 2 and tier 3 MFIs require proof of owning a management information system at the time of the licence application.
- Lending policy: Regulations for tier 2 and tier 3 MFIs require them to enact a lending policy specifying their lending procedures, requirements, and terms and conditions relevant for issuing and repaying loans.
- Consumer protection principles: The Act specifies the need for all MFIs to comply with the core principles of consumer protection, including ensuring that:
  - Terms and conditions of credit or related services are transparent, fair, legible, and protect the rights and interests of customers or members
  - Complaint handling and dispute resolution mechanisms are established. In particular, tier 2 and tier 3 MFIs are required to specify forms and channels for customers to submit complaints, establish a complaints handling desk or a designated officer, and provide timeframes for settling a dispute and communicating feedback. Tier 4 MFIs are required only to appoint a member to handle complaints and disputes of its members
  - Full disclosure of relevant information on the products and services offered
  - Customers or members are financially educated
  - Transparency of rates, fees and penalties (among other principles) to foster fair treatment of customers.

By ensuring all operating MFIs meet the specified requirements, the Act and accompanying regulations are helping to standardize the operating field for MFIs and to professionalize the industry. Prior to these regulations, each MFI was operating based on its own internal operating procedures and did not necessarily have a code of conduct aligned with best practices. While industry associations such as TAMFI and SCCULT could have played the role to enforce specific codes of conduct, their effectiveness would have been limited to their members – a small portion of licensed industry players. Therefore, having an overarching legal framework that covers all active

players in the market is a welcome development that is standardizing and professionalizing the industry.

Increased likelihood to attract financing

Building on the previous point, the professionalization of the industry due to the new policy and regulatory regime is unlocking possibilities for MFIs to access commercial funding, including public deposits. While tier 3 and tier 4 MFIs can lend mobilized deposits and savings from their members, the low savings culture has meant that these MFIs have a weak capital base. Consequently, most MFIs, including tier 2 MFIs, are heavily dependent on working capital from external funders, including commercial banks, pension funds, development partners, government economic empowerment programmes and funds, and other investors.

In the absence of a legal and regulatory framework to govern tier 2 and tier 4 MFIs, data have been difficult to access on these MFIs. For any prospective funders, legal certainty on the status of their operations would be a key factor. Without sufficient information, some funders would likely shy away from lending or investing in the sector, or would provide funds at a very high cost to compensate for high customer due diligence costs. As a result, most MFIs have not secured affordable and reliable financing sources.

Now, with the regulatory framework in place, the industry expects to see an increase in funding or financing opportunities. This is mainly because a licence acts as a regulator's vote of confidence in an MFI business and makes it easy for MFIs looking to unlock commercial funding to pass the funders' customer due diligence process. This is more so for tier 2 and 3 MFIs, which are subjected to lighter prudential regulations. Also, the need for MFIs to maintain and report up-to-date business operations information to regulators has a positive externality on lenders who rely on such information to make MFI creditworthiness assessments. With increased transparency in MFI business operations, lenders' due diligence costs are likely to decrease and their appetite for financing the industry is likely to increase. However, the industry must take care to ensure that the drive to access external funding does not conflict with the pro-poor and poverty reduction focus that MFIs are known for. Evidence from India and Latin America has shown that, as the industry commercializes, many MFIs neglect their double bottom-line objectives, resulting in customer over-indebtedness and repayment crises.[44]

Control of fraud and other financial crimes

The legal and regulatory regime is also helping to filter out entities that might run pyramid/Ponzi schemes[45] to defraud customers or engage in money laundering or terrorist-financing activities. MFIs need to produce an extensive list of documents and proof points during the licence application process. While this does not eliminate all fraudulent MFIs in the market, it reduces illegitimate ones by a large proportion, given that operating an MFI business without a licence from BoT, TCDC or local government authority is now a criminal offence. Additionally, the law requires MFIs to comply with the Anti-Money Laundering Act of 2006. Specifically, an external auditor for tier 2 and tier 3 MFIs must report to the regulator any breaches, money laundering, fraud or losses incurred that may result in the undercapitalization of an MFI.

Increased industry awareness

The new policy and regulatory framework is elevating MFI contributions in addressing the real needs of low-income populations. The process taken to review the MFP 2000 policy, crowdsource ideas for the MFP 2017 policy, and solicit feedback on the Microfinance Bill and the accompanying regulations has helped to spread information about the industry and to build awareness across the country. In ensuring that the regulatory environment continues to facilitate industry growth, TAMFI and SCCULT have been engaging with the regulators in different fora on issues such as an interest cap removal for tier 2 MFIs, among other topics. While these engagements aim to address industry issues with one voice, they also provide platforms for spreading industry awareness to different audiences beyond the active players.

Opportunity for integration with third-party players

As previously mentioned, the legal and regulatory environment legitimizes the MFI industry in Tanzania and makes it attractive to multiple stakeholders, including customers/members and funders. With an increased customer or member base, MFIs may offer a stronger value proposition for players such as electronic money issuers (EMIs)[46] or fintech companies when pursuing integration partners.
Integration with EMIs is important to MFIs, as it enables their customers to receive and repay their loans digitally. However, our engagement with MFIs in tiers 1 to 3 has shown that MFIs face a high cost to integrate with EMIs or payment aggregators, especially for small MFIs that do not have a large customer or member base to use as a bargaining chip.

MFIs anticipate that the legal framework will increase customers' trust in the sector and their adop-

tion of MFI services. MFIs with large customer bases foresee increased EMI interest in integration to tap into their customer base.

General challenges within the microfinance industry

Outreach and scale

MFIs usually target low-income populations. Targeting and serving this customer base requires economies of scale and scope[47] to make sustainable profits. However, as seen in previous sections, MFIs in Tanzania are concentrated in certain geographical areas, resulting in saturation and excessive competition for the target market. Also, with multiple lenders, there is an increased likelihood of customers borrowing from more than one MFI, which may eventually lead to over-indebtedness and defaults.

For MFIs to achieve geographical spread and scale, investment in delivery channels is indispensable. Digital innovations have proved to deliver outreach and scale efficiently and cost-effectively in other verticals and could deliver similar outcomes in the MFI industry.

Prudential regulation

Even though many benefits come from enhancing the legal and regulatory framework, they are accompanied by challenges that threaten the sustainability and existence of many MFIs. The licensing requirements stipulated in the Act and the regulations governing microfinance operations include prudential requirements such as minimum capital, loan loss provisioning ratios, proof of source of funds for capital, and reserve retention. Moreover, in response to high interest rates, averaging about 10 percent per month for tier 2 MFIs, BoT has invoked interest rate cap measures for MFIs that further challenge their high-cost business models. Based on conversations with tier 2 MFIs, BoT informally instituted a target maximum interest rate of 3.5 percent per month on a declining basis.

BoT introduced a maximum monthly interest rate to protect consumers from predatory lenders. However, studies have shown that interest rate caps are not practical tools for accomplishing this objective as they have unintended consequences. Interest rate caps tend to limit the quantity of credit available as some MFIs withdraw from the market or reduce their activities in rural or other costly areas, reducing product diversity and consequently pushing low-income customers back to informal credit markets that are unregulated and likely to involve many predatory lenders. Also, it is expected that, with an interest rate cap, MFIs are less likely to be transparent with the total loan costs, as they introduce new hidden fees to make up for lost interest rate margins.[48]

From the industry perspective, rather than imposing an interest rate cap, MFIs would prefer interventions aiming to address the root cause of high-interest rates, which are mainly transaction and credit costs. MFIs believe that, with increased transparency and information flow in the credit market, operational processes are likely to improve. With increased efficiency, MFIs are likely to lower their interest rates to align with the target established by regulators without needing regulators to intervene with an interest rate cap.

Compliance cost

The new legal and regulatory framework requires MFIs to submit periodic reports to their respective regulatory bodies. The quarterly reporting process is laborious and heavily paper-based, which consumes a lot of MFI human resources. Also, tier 2 and 3 MFIs are required to submit reports to two parallel bodies: tier 2 to BoT and tier 3 to TCDC and to a coordinator from an local government authority where they operate. This duplication in reporting could be avoided if the different supervisory agencies coordinated among themselves or had a data-sharing memorandum of understanding in place, which would allow MFIs to prepare data that met the needs of different agencies.

The manual and paper-based nature of this process also implies that the submitted reports are prone to human error and data may be unreliable. Automating this process may unlock significant efficiency gains and improve data quality for evidence-based policymaking in the sector. For instance, a case study from the central bank of the Philippines shows that automatic reporting submission reduced data points by more than half, from 107,000 to 50,000, and average processing time from 3 minutes to 10 seconds.[49]

Institutional capacity

Governance structure

The quality of an MFI's governance and management structure plays a significant role in determining the ability of an MFI to manage its deposit and lending activities correctly and to act responsibly towards its customers. Many MFIs exhibit weak ownership and management structures that negatively impact their capacities to manage risk and enforce credit discipline. This is even more the case for the lower tiers, especially SACCOSs and community microfinance groups. For instance, weak governance structures among SACCOSs are correlated with

inefficient lending operations and the resulting high operational costs that potentially limit their growth trajectory and sustainability. The new regulatory regime is poised to address this challenge, as it requires tier 2 and tier 3 MFIs to put in place and maintain a credible board of directors.

Portfolio quality

Anecdotal evidence suggests that MFI portfolio quality has declined in response to a tightened fiscal stance. For instance, the government's retroactive tax enforcement has negatively affected small and medium enterprises. As a result, their inability to repay loans from financial service providers has increased the non-performing loans ratios for those institutions lending to affected customers.[50]

In addition, money lenders are categorized as microfinance service providers in tier 2. However, the mission for the two groups differs significantly. Microfinance service providers have a social mission, which includes the labour-intensive work of providing financial education to marginalized low-income populations, whereas the focus of money lenders is purely on making a profit from lending money to customers, preferably with collateral. As a result, traditional microfinance service providers have started to deviate from their core social mission to compete in a market where profit is a driver. With this mission drift, some MFIs focus only on profit generation, even at the expense of recruiting high-risk customers for the sake of increasing their customer base. This trend will further deteriorate the portfolio quality of MFIs engaging in such practices.

From an industry perspective, there may be an opportunity to redirect the industry back to microfinance's core objective if money lenders were regulated differently from other microfinance providers, to level the playing field among providers driven by different missions.

Staff turnover, skills and integrity

Microfinance is a specialized field requiring human resources with foundational knowledge in banking or finance and the ability to work at the intersection of finance and social goals. The industry has been gaining a lot of interest from former bankers able to mobilize resources and meet the capital requirements for licensing. The growing number of former bankers in the industry could be a positive development if complemented by individuals with a deep appreciation for the microfinance industry and its social mission.

Another trend is the rise in staff turnover as MFIs compete for experienced staff, increasing operational costs and jeopardizing MFI growth. Given the shortage of skilled staff across the industry, promising candidates are in high demand and often poached by MFIs with bigger budgets. There is a need to continue building capacity for workers in the industry, to level the playing field in accessing available skill sets in the market.
Moreover, given the profile of customers served by MFIs, staff with high levels of integrity are needed to continue promoting the microfinance industry as a credible development tool. However, conversations with MFIs in tiers 1 to 3 revealed that many MFIs have staff with low levels of integrity, which negatively impacts consumer trust in the sector. The lack of integrity among staff could also reflect fundamental weaknesses in MFIs hiring and/or management processes that need to be addressed through proper training, incentives and oversight.

Funding costs

Most MFIs do not have access to emergency liquidity from BoT through the discount rate channel that commercial banks can tap into. They borrow mainly from commercial banks, and take deposits (for microfinance banks authorized to accept deposits from customers) and raise capital from other types of funder. However, borrowing from commercial banks has remained costly for MFIs, especially in the current low liquidity environment and in the absence of microfinance development funds and a limited number of wholesale microfinance funds.
The industry's liquidity shortage can be attributed to several reasons such as the removal of public funds from commercial banks in 2017 and the introduction of a high-yield 20-year government bond in 2018,[51] which provides a competitive return on investment for risk-averse FSPs, especially during the COVID-19 pandemic where incomes have been declining. A combination of these two events has resulted in the increased cost of short-term funding and crowded out lending to the private sector, especially MFIs that depend on commercial loans for capital.
In addition, reliance on borrowed capital for lending has negative externalities in the market. MFIs that borrow to lend are incentivized to maximize the amount of loans issued and prioritize loan repayments over broader welfare and social concerns. Furthermore, even when MFIs identify financing opportunities, the legal framework restricts the amount an MFI can borrow based on their asset base. For instance, as per the regulations, SACCOSs are limited to borrowing up to 25 percent of their total assets. The combination of restrictive borrowing and the weak savings base of SACCOs has meant that the availability of funds for on-lending is limited.

Financial discipline

Financial discipline is important for MFIs' expansion and sustainability. With better financial discipline,

MFIs can access resources for investment to reach the larger number of poor households and businesses that are potential borrowers and depositors. While the new regulation is appropriate for instilling financial discipline in the industry, the industry still struggles to attain the level of operational efficiency that is key to achieving financial discipline.

Management information system and core IT

Engagement with various stakeholders in the sector has revealed that many MFIs rely on rudimentary IT systems. A small proportion has a core banking system in place, but most operate on Excel spreadsheets or physical ledgers. The absence of advanced IT systems has meant that integration with other systems is challenging and has limited MFIs' ability to develop digital products or channels that enable low-cost and real-time transactions and interactions with customers. While the requirement for a management information system at the time of licence application for MFIs in tiers 1 to 3 is well understood, most MFIs are struggling to meet this requirement for several reasons:

- Adoption of digital management information system requires funding and time that many MFIs are lacking
- Skills required to spearhead digital transformation are typically lacking in MFIs. Moreover, MFIs struggle to afford technology professionals who could support them in adopting digital solutions
- Digitizing MFI systems requires a change in people and culture, both within an organization and among its customers. The low digital literacy of some MFI staff and customers is holding back MFIs from adopting a management information system despite its necessity in the current context

5

Digitization of MFIs in Tanzania: positioning MFIs for an inclusive digital economy

While the financial sector's digital transformation has been driving financial inclusion and innovation, a new 'data divide' among FSPs is emerging between (i) those with access to advanced tools to leverage technology and new delivery channels (such as large banks and fintech companies that have invested in state-of-the-art data infrastructures); and (ii) those that remain analogue or cannot generate or absorb the same amount of data to successfully harness insights from their customers and the ecosystem and to derive a competitive edge from data mining, such as smaller and under-resourced FSPs, MFIs and fintech start-ups.

The imbalance of access to data is likely to continue skewing the development of financial ecosystems in favour of a few prominent players that can leverage digital technologies to reduce costs, increase efficiency and grow in terms of scale and outreach.

A case for the digital transformation of microfinance institutions

For MFIs to keep up with the pace of innovation in the sector, they acknowledge the need to digitize their core organizational and operational areas. MFIs can undertake digital transformation in four ways, as shown in Figure 5.

Each pillar for digital transformation offers specific value to an MFI and demonstrates how an MFI can leverage digital technology to transform their processes, diversify products, expand channels and improve engagement with their customers.[52] Table 5 provides examples of the challenges MFIs face that could potentially be addressed with digital solutions.

Figure 5: Four pathways to digital transformation for MFIs

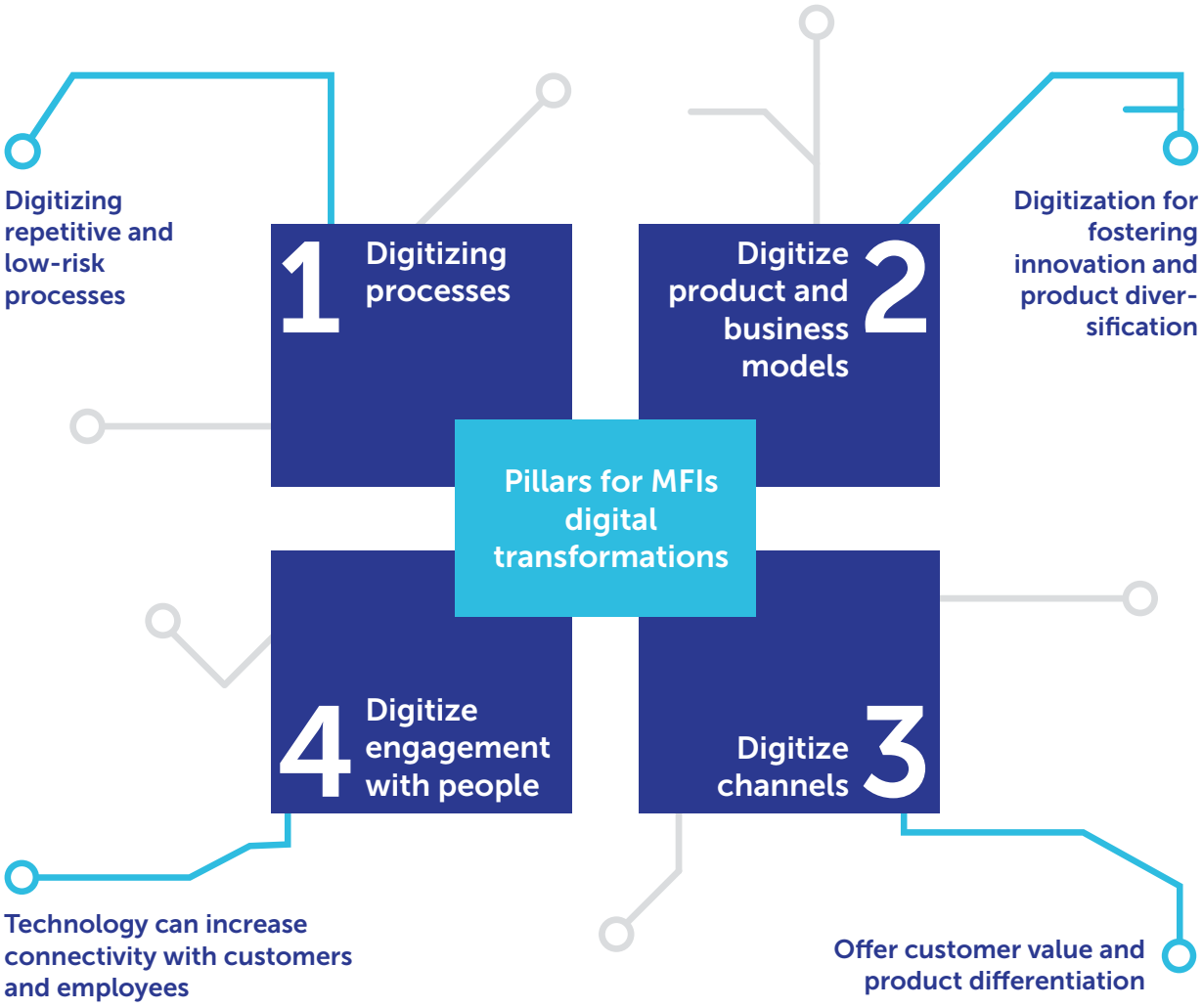


Table 5: Options for digital transformation

Digital transformation pillar	Challenges it aims to solve	Example of possible digital option
Process	• Operational expenses • Client turnover • Credit underwriting through credit scoring model	• Cashless loan repayment • Cashless loan disbursement • Database management • Artificial Intelligence
Product and business model	• Competition from digital financial services • Operational expenses • Servicing hard-to-reach client segments • Customer experience	• Digital credit • Core banking system
Channels	• Cash management • Operational expenses • staff fraud • Cybersecurity	• Cashless loan repayment • Cashless loan disbursement • Database (interactive) management
Customer engagement	• Staff efficiency, turnaround time, operational expenses, onboarding and customer support processes, documentation process, client turnover	• Digital field applications to digitize the workflow

From conversations with tier 2 and 3 MFIs, they are clear on the value propositions for digitization and acknowledge that it is inevitable to digitize their information-gathering processes and/or their delivery channels to remain competitive in the digital age. To them, digitization offers opportunities, including increased customer touchpoints and channels, diversifying product offerings, leveraging data, and accessing digital infrastructure through partnerships. Focus group discussions with these MFIs revealed that, to date, MFIs have prioritized the digitization of back-office systems. However, for many MFIs, an existing pain point remains the lack of flexible core IT and data management systems.[53] MFIs are keen to adopt core banking systems to improve data processing capacity and to integrate and manage new digital applications.

In addition, MFIs face many challenges when introducing digital products, as they currently rely on costly integrations through bilateral arrangements with EMIs or system integrators. While this option has worked for large MFIs with sufficient working capital to afford integration costs, it still does not provide access to products from other players in the ecosystem. MFIs view the incoming national switch, TIPS, as an opportunity to facilitate seamless digital transactions with their customers. With TIPS under way, MFI technological readiness is more relevant than ever if MFIs want to participate in the interoperable system to facilitate the broader scaling up of their offerings.

MFIs are currently not among participating FSPs on TIPS and their timeline or mechanism to integrate with TIPS is not yet determined. However, MFIs would like to prepare for future integration by upgrading their systems, knowing that there are several options at their disposal.

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.

Digitization of internal operations and functions

Most MFIs have basic back-office systems that hinder their data processing capacity and potential integrations for new digital products. Therefore, digitizing operational processes and systems is an essential element of the MFI digital transformation process, and the adoption of a computerized core banking system (CBS) is the crucial first step towards achieving the goal.

Cognizant of the high cost for each individual institution's adoption of a CBS, MFIs across different tiers have expressed the desire to acquire a shared CBS[54] to minimize the upfront investment and maintenance costs.

Digitization of service delivery channels

Digital retail payment platforms such as automated clearing houses, card switches and electronic fund transfers, among others, have played a critical role in promoting financial inclusion. For Tanzania, an inclusive and open payment system such as TIPS

provides an opportunity for MFIs to provide their customers convenient and cost-effective offerings and to increase transaction volumes in the ecosystem.
TIPS also presents an opportunity for MFIs to digitize their delivery channels more efficiently and cost-effectively. MFI access to TIPS (direct or indirect) could reduce costs for digital transactions as it would eliminate the need for bilateral agreements with multiple providers. They would connect once and thereafter pay to and receive payments from everyone, thereby accessing a payment system at full scale to all participants. This, therefore, removes the disadvantage to small players by providing full access to all participants in the payment system.

Options for digitization

MFIs are at different stages of readiness to participate in the national payment and settlement system. Given that MFIs do not have settlement accounts at BoT, MFIs could become indirect participants through either of the following two options.

Option 1: Individual connection to TIPS

Some MFIs will be permitted to have a direct connection to TIPS provided they meet the minimum functional and technical requirements to ensure that they would not compromise the safety and soundness of the payment system.
This option is already applicable to tier 1 MFIs, which are licensed as deposit-taking institutions and regulated by BoT. However, qualified tier 2 MFIs also could access TIPS directly, even though they would still need to settle through intermediaries. As such, the tier 2 MFIs would be sponsored into settlement but be direct participants in clearing, being directly connected to TIPS.
This option, however, is limited to tier 1 and tier 2 MFIs with core banking systems capable of connecting with TIPS that also can afford the upfront investment in integration fees and customer support services to troubleshoot technical challenges. Consequently, it eliminates most MFIs, which run their operations on rudimentary systems and have inadequate technical and financial capacities to manage their application program interfaces (APIs).

Option 2: Connection through an aggregation model

Unlike the previous option, this option supports MFI integration to TIPS through an aggregator.[55] In this case, an aggregator would integrate several MFIs to a payment instrument provider (TIPS).

Similar to option 1, this would work for MFIs with adequate systems in place. The cost of integration would depend on the level of customization required to accommodate the MFI's existing systems.
This option relieves MFIs of the onerous tasks of managing payment reconciliations, payment disputes, technical upgrades and maintenance of APIs, all of which would be the responsibility of the aggregator.[56] It also creates opportunities for aggregators as, over time, mobile network operators have improved their technical capabilities and are opening their improved APIs, reducing the need for aggregators to facilitate integration with third parties. Facilitating integration to TIPS could be a new revenue-generating channel for aggregators seeking to expand their offerings.

Engagement with several aggregators in the market revealed that those who could potentially play this role would require technical and operational capacity strengthening. Their work requires sufficient capital to handle different levels of customization to facilitate smooth integration. Financial resources are also needed to sustain the operation's heavy post-integration support.

Finally, there is no specific regulation for aggregators, implying a legal risk for those interested in entering the market but worried about regulatory uncertainty. Currently, aggregators must acquire a payment service provider licence with no specific regulation for their category.

6

Conclusions and outlook

Considering MFIs' position in the Tanzanian financial landscape and their contribution to the financial inclusion of underbanked or underserved populations, the microfinance industry needs to digitize to remain competitive. Introducing technology is one thing, but for digitization to yield transformational results in the industry, it will need to be accompanied by organizational change management (process), and investment in skills and IT infrastructure. Moreover, digitization needs to happen in parallel with the development of appropriate data architectures for collecting, processing, storing, analysing and extracting insights for critical business decisions on pricing, customer profiling for creditworthiness, portfolio development, risk management, product design and operations optimization.

All are challenging endeavours to undertake and require a significant amount of funding and an enabling policy and regulatory environment to implement them successfully. Table 6 summarizes the different types of support that relevant stakeholders in the ecosystem could offer to ensure digital transformation in the MFI industry is less of a daunting journey.

Consumers' financial and digital literacy is important to ensure MFIs' digital transformations do not leave their customers behind. All the main stakeholders listed in Table 6 have a role to support MFIs' programmes that aim to raise the level of customers' financial and digital literacy.

As UNCDF, we are committed to supporting the ongoing efforts among the representatives from the different MFIs that have come together to form working groups that aim to develop technical and functional specifications for a CBS that would correspond to the needs of their respective tiers. While the support has started with a small number of MFIs, with continued support from other stakeholders, many MFIs may be able to develop and onboard a shared CBS to kick off their digital transformation journeys.

Table 6: Support for MFIs digital transformation

Stakeholder	Type of support
Regulators and policymakers	• Enable a conducive environment for MFIs to operate cost-effectively. This may include reviewing laws and regulations hindering MFIs' adoption of advanced technologies, such as cloud-based solutions, or enacting best in-class customer data protection and privacy regulations • Improve market conduct supervision and ensure customer protection principles are adhered to • Digitization of government payments and implement initiatives that incentivize digital transactions to reduce the demand for cash
Development partners and funders	• Catalyse digital transformation through technical support and funding for digital solutions adoption for MFIs that are willing to invest some of their own funding towards digital transformation
Associations (TAMFI and SCCULT)	• Coordinate MFIs looking to access shared services. Associations should oversee the procurement process for shared services and eventually host data centres

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9 In this context, MFIs include microfinance banks, non-deposit taking microfinance service providers, savings and credit cooperative societies, and community microfinance groups, as defined by the Microfinance Act, 2018.

10 "FinScope Tanzania: Insights that Drive Innovation".

11 Center for Global Development, "Backgrounder on India's Microfinance Crisis", 2010, https://www.cgdev.org/blog/backgrounder-indias-microfinance-crisis, accessed 14 April 2022.

12 The Microfinance Act 2018 and its regulations (2019) applies only to the Tanzania mainland and plans are at advanced stage to come up with a legal framework to supervise micro-finance activities in Zanzibar.

13 Ministry of Finance and Planning, "Anti-Money Laundering (Electronic Funds Transfer and Cash Transactions Reporting) Regulations, 2019", United Republic of Tanzania, https://www.fiu.go.tz/ELECTRONIC_FUNDS_TRANSFER_AND_CASH_TRANSACTION_REPORTING_REGULATIONS_2019.pdf, accessed 14 April 2022.

14 Bank of Tanzania, "The Bank of Tanzania (Financial Consumer Protection) Regulations, 2019", United Republic of Tanzania, https://www.bot.go.tz/Publications/Acts,%20Regulations,%20Circulars,%20Guidelines/Regulations/en/2020031802343226.pdf, accessed 14 April 2022.

15 Regulators have started licensing and supervising previously unlicensed and unsupervised MFIs. Data on tiers 2 to 4 reflect the number of registered or licensed MFIs at the time data were shared. The current number could be more or less than what is reported here as designated regulators continue to consolidate industry statistics.

16 Registered MFIs are those with certificates of registration issued according to the Companies Act for tiers 1 and 2, the Cooperative Societies Act for tier 3 MFIs and the members' resolution for tier 4. Licensed MFIs are those that have been authorized to operate microfinance businesses by the Bank of Tanzania or delegated entities.

17 Number of SACCOSs licensed by TCDC. The total number of registered SACCOSs (including licensed ones), as of September 2021, was 2,541, as reported by BoT (see https://www.bot.go.tz/Publications/Regular/Consolidated%20Zonal%20Economic%20Report/en/2022010515464212.pdf).

18 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.

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

20 Bank of Tanzania, "Annual Report 2016/17", United Republic of Tanzania, https://www.bot.go.tz/Publications/Regular/Annual%20Report/en/2020073013490618.pdf.

21 Florens Luoga, "Policy measures to promote credit to private sector and lower interest rates", Bank of Tanzania, United Republic of Tanzania, 2021, https://www.bot.go.tz/Adverts/PressRelease/en/2021072711314743.pdf, accessed 14 April 2022.

22 This number does not include agricultural marketing cooperatives, which the latest statistic in 2019 numbering about 3,835; International Co-operative Alliance – Africa, "Mapping: Key Figures: National Report: Tanzania ICA-EU Partnership", May 2020, https://coops4dev.coop/sites/default/files/2020-05/Key%20Mapping%20Data%20-%20Tanzania.pdf, accessed 14 April 2022.

23 See https://tanzaniabankers.org.

24 See https://tamfi.com.

25 See https://sccult.com.

26 See https://ushirika.co.tz.

27 See https://www.linkedin.com/in/timap-tanzania-48950295.

28 Loan collection is when follow ups on the loan are directly from creditors and loan recovery is when a creditor enlists the services of a third party to help to recover the debt.

29 Ministry of Finance and Planning, "National Microfinance Policy 2017".

30 Office of the Solicitor General, "THE MICROFINANCE ACT, 2018", act supplement to the Gazette of the United Republic of Tanzania, number 47, volume 99, United Republic of Tanzania, 2018, https://www.osg.go.tz/uploads/publications/sw1570617347-10THE%20MICROFINANCE%20ACT,%202018%20-PASSED%20ON%2016%20NOVEMBER%202018%20final.pdf, accessed 14 April 2022.

31 The Act requires MFIs to comply with the Anti-Money Laundering Act 2006 and applicable laws on local content, including employment and training of Tanzanians. It also subjects MFIs to minimum capital adequacy regulations and exempts tier 4 MFIs from certain provisions.

32 Microfinance business is defined to include receiving money and lending to members or clients, accepting savings and providing loans to micro or small enterprises and low-income households or individuals, providing microcredit, micro-savings, micro-insurance, micro-leasing, micro-pension and micro-housing finance, transfer and payment services, including digital microfinance services, providing financial education services and other related services as indicated in the regulations.

33 Tier 1 MFIs are also expected to comply with other regulations, including: (i) the Banking and Financial Institutions (Disclosure) Regulations, 2014; (ii) the Banking and Financial Institutions (External Auditors) Regulations, 2014; (iii) the Banking and Financial Institutions (Foreign Exchange Exposure Limits) Regulations, 2014; (iv) the Banking and Financial Institutions (Prompt Corrective Action) Regulations, 2014; (v) the Banking and Financial Institutions (Internal Control and Internal Audit) Regulations, 2014; and (vi) the Banking and Financial Institutions (Physical Security Measures) Regulations, 2014.

34 Liquid assets include notes and coins, balances held at banks or microfinance service providers and treasury bills and bonds that are freely marketable and re-discountable at the bank.

35 Loans are classified for provision based on days past due as follows: 0 to 5 days (current), 6 to 30 days (especially mentioned), 31 to 60 days (substandard), 61 to 90 days (doubtful), More than 90 days (loss) for tier 1 and tier 2 MFIs. Tier 3 MFIs (SACCOSs) classify loan portfolio as 0 to 30 days (current), 31 to 90 days (especially mentioned), 91 to 180 days (substandard), 181 to 365 days (doubtful) and more than 365 days (loss).

36 Loans are classified for provision based on days past due as follows: 0 to 5 days (current), 6 to 30 days (especially mentioned), 31 to 60 days (substandard), 61 to 90 days (doubtful), More than 90 days (loss) for tier 1 and tier 2 MFIs. Tier 3 MFIs (SACCOSs) classify loan portfolio as 0 to 30 days (current), 31 to 90 days (especially mentioned), 91 to 180 days (substandard), 181 to 365 days (doubtful) and more than 365 days (loss).

37 Tier 4 MFIs are outside the scope of this engagement and did not participate in the stakeholder workshops.

38 There are two CRBs operating in Tanzania, namely Creditinfo Tanzania Limited and Dun & Bradstreet Credit Reference Bureau Tanzania Limited.

39 IPC, "Tanzania Credit Market Diagnostic", presentation made at a workshop held at the Bank of Tanzania, Dar es Salaam, June 11, 2018.

40 Given the low national ID coverage for customer identification and due diligence, account openers are permitted to use various forms of identification. As a result, the same person is identified by different ID numbers across the different providers, making it difficult to match the person across the various databases.

41 As per the regulations, credit information includes any information about a person's specific identification, full name, date of birth, place of residence, previous places of residence, marital status, spouse's name, place of employment, previous places of employment, paying habits, outstanding debt obligations, assets and inquiries made of credit history or information relating to a legal entity or business that would identify the legal entity or business information on incorporation, tax, directors, governance, outstanding debt obligations, assets, inquiries made on credit history and other business details.

42 "Tanzania Central Bank Introduces New Measures to Address Non-Performing Loans", Tanzania Invest, 8 November 2021, https://www.tanzaniainvest.com/finance/banking/performing-loans-measures-2021, accessed 14 April 2022.

43 Bank of Tanzania, "Financial Stability Report", United Republic of Tanzania, 2019, https://www.bot.go.tz/Publications/Regular/Financial%20Stability/en/20200609220058982l.pdf, accessed 14 April 2022.

44 Anne Pouchous, "The Regulation and Supervision of Microfinance: Main Issues and Progress", The International Institute for Sustainable Development, September 2012, https://www.iisd.org/system/files/publications/regulation_supervision_microfinance.pdf, accessed 14 April 2022.

45 According to the United States Securities and Exchange Commission a Ponzi scheme is an investment fraud that pays existing investors with funds collected from new investors. See https://www.investor.gov/introduction-investing/investing-basics/glossary/ponzi-schemes.

46 The Electronic Money Regulations (2015) define an entity issuing electronic money to be either a bank or financial institution, or a non-bank entity licensed under the regulations. Currently in Tanzania, all EMIs are subsidiaries of mobile network operators.

47 Economies of scale mean that the average cost of a good or service decreases as its volume of output increases. Economies of scope consist of the average cost decreasing as the production of goods and services becomes more diversified.

48 Dirk Zetzsche and Tsany Ratna Dewi, "The Paradoxical Case Against Interest Rate Caps for Microfinance – And: How FinTech and RegTech Resolve the Dilemma", Law Working Paper Series, Paper Number 2018-003. University of Luxembourg, Faculty of Law, Economics and Finance, April 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3159202, accessed 14 April 2022.

49 Simone di Castri, Matt Grasser and Arend Kulenkampff, "An API-based Prudential Reporting System for the Bangko Sentral ng Pilipinas (BSP): R 2A Project Retrospective and Lessons Learned", August 2018, doi: 10.2139/ssrn.3596276.

50 "The Central Bank of Tanzania Takes a Direct Approach Amid Tightening Liquidity", Oxford Business Group, no date, https://oxfordbusinessgroup.com/analysis/central-holdings-tightening-liquidity-scenario-seeing-central-bank-take-more-direct-monetary-policy, accessed 14 April 2022.

51 "The Central Bank of Tanzania Takes a Direct Approach Amid Tightening Liquidity".

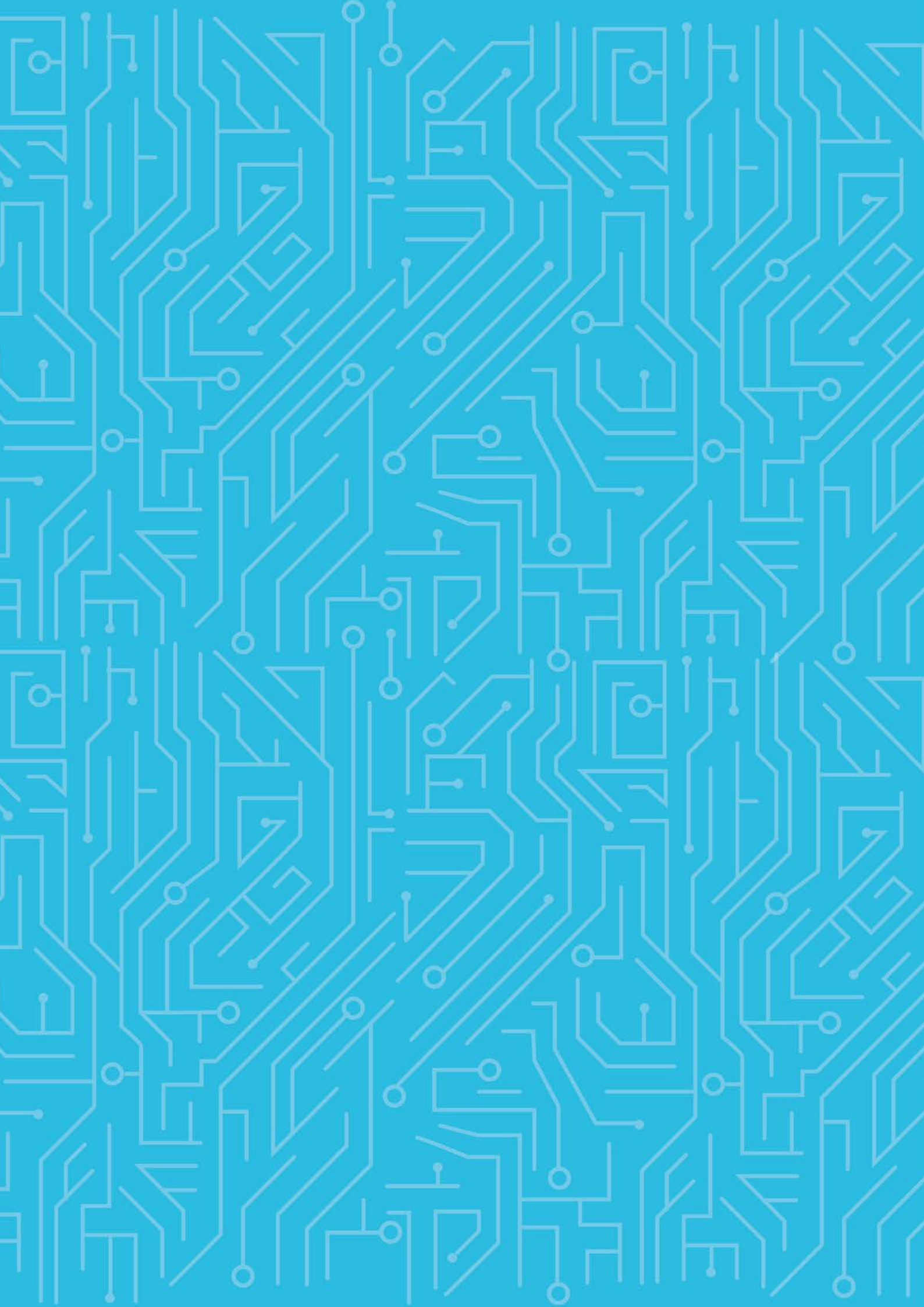
52 Greta Bull, "After the Storm: How Microfinance Can Adapt and Thrive", Consultative Group to Assist the Poor, October 2020, https://www.cgap.org/blog/after-storm-how-microfinance-can-adapt-and-thrive, accessed 14 April 2022.

53 Greta Bull, "After the Storm: How Microfinance Can Adapt and Thrive".

54 Often referred to as a multi-tenant CBS. These systems are increasingly hosted in the cloud and would require national regulations to support cloud-based location systems and customer information.

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

56 Claudia McKay and Rashmi Pillai, "Aggregators: The Secret Sauce to Digital Financial Expansion", Consultative Group to Assist the Poor, January 2016, https://www.cgap.org/blog/aggregators-secret-sauce-digital-financial-expansion, accessed 14 April 2022.



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