

The Microfinance Sector in Nigeria

Rationale

Since the advent of microfinance banking in Nigeria, the microfinance sector has been confronted with several challenges and the impact of the global financial crisis on Microfinance Banks has been more severe than anticipated.

[MicroFinanza Rating](#) would like to share the main features of the Nigerian microfinance sector, highlighting the major challenges the industry is still facing.

Overview of the microfinance sector in Nigeria

In 1995, the introduction of a dedicated legal framework brought about the creation of a wide number of Community Banks and, with the formulation of the microfinance policy and regulation in 2005, **Microfinance Banks (MFBs)** appeared on the scene.

The **microfinance regulatory framework** (*National Microfinance Policy Regulatory and Supervisory Framework for Microfinance Banks*), designed in 2005, was updated in April 2011 identifying three categories of microfinance banks:

- **Unit:** the MFB is authorized to operate in one location with a minimum capital requirement of NGN 20 mln (USD 128,866). The bank is not allowed to open branches.
- **State:** the MFB is authorized to operate in a single State with multiple branches. The capital requirement is set to NGN 100 mln (USD 644,330).
- **National:** the MFB is authorized to operate in more than one State. The capital requirement is NGN 2 billion (USD 12.88 mln).

As of March 2014, the microfinance sector counts **around 800 licensed MFBs**. Most MFBs fall within the Unit Category (755), followed by 74 state MFB and 5 National MFBs. The sector counts on 21 deposit-taking commercial banks and a number of unregulated NGOs with microfinance activities, some of them of considerable size. In their case, neither the lending nor the savings collection activities are supervised by CBN. According to the revised regulatory and supervision guidelines, the CBN is allowed to transform the relevant unregulated MFIs that attains total assets of NGN 20 mln (USD 128,866) or a total membership of 2,000 into MFBs.

Crisis in the microfinance sector

Following the global financial crisis, the microfinance sector plunged into a liquidity crisis caused by dried up credit lines, intensifying competition and increased credit risk as many customers of MFBs were unable to pay back their credit facilities due to the hostile economic environment.

The liquidity crisis severely weakened the microfinance sector whereby the operating licenses of 224 out of 820 MFBs that were found to be ‘terminally distressed’ and ‘technically insolvent’ were revoked by Central Bank of Nigeria (CBN) in the period 2010-11.

Structure and dynamics of Microfinance Sector

The microfinance sector is very heterogeneous and mostly includes small, barely sustainable MFIs and a few bigger organisations with relevant savings and loan portfolios (either MFB or NGOs). LAPO MFB is by far the biggest player on the market with a portfolio of around USD 146 mln as of Dec-13 and is present in 36 States, followed by Fortis MFB with almost one-third of LAPO's portfolio¹.

The predominant type of informal finance in Nigeria is the *Esusu*, involving the periodical contribution of a fixed amount with the funds rotating among the members in a cycle. The saving and credit associations as well as credit unions operate in more formalised way registered under the Co-operative Association Act.

Some competition is present in the market with the downscaling of some commercial banks. Despite the increase in the percentage of people formally included from 23.6% to 43% from 2008 to 2012, the **unmet demand is still huge compared to the current supply** and in overall there is limited access of credit to the general population (39.7% financially excluded representing around 35m adults). The skewed distribution of MFBs in Nigeria, mostly concentrated in urban areas hampers the access to credit by a vast majority of the economically active poor.

Interest rates are liberal and the Central Bank (CBN) has not prescribed a limit, however some market players take advantage to charge exorbitant prices, while **transparency is quite low**; CBN has not defined minimum pricing disclosure requirements to clients and the display of the effective interest rate is not mandated.

Major challenges

The absence of basic infrastructure represents one of the major difficulties faced by MFBs in Nigeria that are commonly faced by high operational costs because of their nature of business (i.e. small transactions). Unfortunately, these banks are also forced to incur additional costs to provide themselves with electricity and water. The absence of good roads especially in the rural areas also distorts their outreach. All these elements work in concert to drive cost of operations up and put them at a very big competitive disadvantage, if compared to commercial banks. As a consequence, interest rates charged by microfinance banks to their clients are high.

The market forces of demand and supply contribute to this and in overall, it can be observed that one of the key determinants is related to **the presence of a large unmet demand for credit**.

At institutional level, the total **cost of credit charged** to clients is **high and mainly features a complex cost structure** characteristic of high interest rates mostly applied on flat basis, several fees and cash collateral requirements. Likewise, the cost implications are even higher for smaller loan sizes provided over shorter loan cycles. Despite the high level of returns, profit margins are diminished by the level of operating expenses that weigh on the total cost structure. There is limited access to loanable funds within the sector and most MFBs finance portfolio from the savings mobilized. Also, some MFBs have a tendency to have a substantial proportion of financial investments which earn lower yields instead of a higher concentration of portfolio with room for better asset allocation.

¹ MIX Market.

In general, the level of **client financial awareness** is limited due to the low financial literacy levels among most clients and **limited transparency** by the microfinance institutions. The total cost of credit and the components of total cost are not adequately communicated in most instances to clients and there is limited comparison of the product offer by competitors. The **lack of banking culture in the rural areas and among the urban poor** is another factor hampering the progress of microfinance banks.

The failure of many community banks and the withdrawal of the license of 224 microfinance banks in 2010 have severely affected **the reputation of the industry** and public confidence in these banks has dropped. Many microfinance banks are faced with an uphill task of convincing clients that they do not risk losing money since the banks that had failed tarnished their image. On the other hand, the Central Bank of Nigeria has constantly assured the public that it will not allow any commercial bank to fail; this, places the microfinance banks at a great disadvantage by tilting public confidence in favor of commercial banks that are normally bigger and stronger.

Another important factor which negatively affects the performance of microfinance banks in Nigeria is the **limited support for human resources and institutional capacity building**. The paucity of human resources capacity in the microfinance sub-sector in Nigeria has been an issue from the days of community banking. One of the major problems of the microfinance sub-sector is the recruitment of effective and appropriate manpower, which seems to be partly related to the inability of the sector to adequately remunerate staff. Other human resource problems faced by microfinance banks include lack of training opportunities and poor conditions of service. The quality of manpower in these banks is reflected in the poor performance of many of them, inefficiency and high levels of frauds and forgeries. The banks also suffer from high staff turnover, a further indication of low motivation of personnel and poor human resource practices.

Widespread corruption is another factor that affects many sectors of the Nigerian economy, including the microfinance sector. This manifests in many ways, such as, corporate governance failures, frauds and forgeries, theft and refusal by customers to repay loans. The standard of corporate governance in many microfinance banks in Nigeria is poor. Board members are known to misuse their positions to obtain facilities way above the regulatory limit for insider related loans and with no intentions of repaying such facilities. Fraud and forgeries by both insiders and outsiders to the banks are common and people generally obtain loans with no intention to repay.

Conclusion

The number of microfinance institutions in Nigeria is increasing at a rapid rate in response to the growing need for financial services to the poor. The legal framework for these institutions is relatively new and its ability to regulate this sub sector of the financial sector is still to be proven.

Microfinance Banks in Nigeria are still tackling many challenges, such as: regular changes in government policies, lack of human capital with adequate requisite, infrastructural inadequacies that increase their operating costs. In addition to these, the banks are further affected by corruption, frauds and forgeries and poor corporate governance. To address these issues, concerted efforts on the part of regulators, promoters, practitioners and other stakeholders in the microfinance banking subsector is required. On the other side, the extent of poverty being experienced in the country, the large informal finance sector, the huge rural economy and the involvement of over 70% of the population in agriculture and small and medium scale enterprise are clear indications that a huge potential market exists for microfinance institutions.