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**Working Paper**

## What Matters in Rural and Microfinance

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**University of Cologne**  
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**Arbeitsstelle für Entwicklungsländerforschung**

## **What Matters in Rural and Microfinance**

**By**  
**Hans Dieter Seibel**

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## Executive Summary

### From directed credit to financial systems development

Due to the overall failure of donor-driven subsidized directed credit administered by government-owned development finance institutions, the emphasis in development policy has shifted to (rural) financial systems development and the building of self-reliant, sustainable institutions. While savings-based self-help groups and member-managed small cooperatives are more appropriate to remote and marginal areas, there is little to further differentiate rural and urban microfinance. Regardless of ownership, type of institution, and rural or urban sphere of operation, they ultimately all have to:

- Mobilize their own resources through savings
- Have their loans repaid
- Cover their costs from their operational income
- Finance their expansion from their profits.

Three worlds of finance continue to exist, in which donors may intervene in very different ways:

- The old world of donor-driven development finance, which need to be transformed into sustainable institutions
- A new world of development finance, comprising viable formal and semiformal institutions with a commercial orientation, which do not, or not fully, rely on donor support for expansion
- Informal financial institutions of ancient or recent origin, based on principles of self-reliance and viability with their potential for innovation and mainstreaming, to which donors may contribute..

There are numerous notable new developments in R/MF; but in the majority of countries, there are still major shortcomings that call for country-driven, coordinated interventions. Donors with their projects are found in both worlds; but there is an overall move from the *old world of supply-driven development finance to the new world of demand-driven commercial finance*.

	<i>The new world of R/MF</i>	<i>The old world of R/MF</i>
Policy environment	Prudential deregulation, financial system dev.	Financial repression, no fin. markets
Legal framework	New legal forms for local R/MFs	Lack of private local R/MFIs
Non-formal FIs	Opportunities for upgrading to formal MFIs	Millions of informal MFIs ignored
Semiformal FIs/NGO	Conversions to deposit-taking formal FIs	No standards, no deposit mobilization
Fin. coops (SACCOs)	Self-reliance; low costs, new-name expansion	Unsupervised, ruined by governments
Agricultural dev. banks	Reforms towards autonomy, viability, deposit-taking, portfolio diversification, profits	Political interference; lack of viability and outreach; drain on public resources
Rural banks (RBs)	Legal framework for private RBs; consolidation outreach to the enterprising poor and non-poor	Lack of opportunities for private capital to be invested in local FIs
Commercial banks	Outreach to microentrepreneurs and the poor with appropriate products and services; LBS	Unable to lend to any sector including microentrepreneurs and the poor
Regulation and supervision (R&S)	MF units in CBs; regulation of RBs and MFIs under MF laws; closing of distressed FIs	Coops, MFIs, AgDBs escape supervision; donors keep distressed institutions alive
Agricultural finance	Self-financing thru savings and profits from lucrative (credit-financed) non-agric. IGAs	Lack of self-financing and commercial credit; lack of outreach of AgDBs
Remote and marginal areas	Self-managed savings-based SHGs and small cooperatives operating at low cost	Futile attempts of donors to drive ill-suited MFIs into remote areas
Individual and group technologies:	If properly applied, both can be profitable and reach microentrepreneurs and the poor	Rigid replications without growth of outreach and sustainability
Non-financial services	MFI clients linked to BDS by other agencies	Maximalist approach undermines FIs
Targeting	Differentiated financial products for different market segments	Targeting undermines outreach and viability; excludes entrepreneurs
Linking banks and SHGs/MFIs (LBS)	Spectacular increase in outreach to the poor; profitable if interest rates are free	Lack of healthy banks with a mandate to be of service

Interlinked schemes	Some success under controlled conditions	Lack of institutional sustainability
Self-reliance	Self-financing through deposits and profits; institutional autonomy	NGOs, AgDBs barred from deposit-taking; donor and gov. dependency
Sustainability	Increasing numbers of self-sustaining institutions of any type and ownership	Donors, gov. fail to insist on performance standards and sustainability
Access to financial services	Sustainable access of the poor as users and owners to savings and credit services	No access of many poor and non-poor to savings, credit, insurance

There are hundreds of thousands of formal and semiformal R/MFIs, and informal institutions in the tens of millions. It is therefore recommended:

- not to focus solely on credit NGOs, as many donors do;
- to include among the institutions eligible for support formal, semiformal and informal financial institutions - in private, cooperative, community or mixed ownership;
- to place a special emphasis on support to institutions with include the poor as owners or customers;
- to seek for innovative approaches to include the vast numbers of member-owned informal financial institutions among the eligible institutions.

## What matters in rural and microfinance?

### 1. First of all: client experience matters

Clients have experienced in donor projects that credit can make them poorer or richer:

- Starting with large loans and term finance, as has been common among donor-supported AgDBs, is a guarantee for failure.
- Only small short-term loans allow them to experiment with investments at a reasonable risk; to test their ability to borrow, invest, repay and save; to change to more profitable investments as opportunities emerge; and to grow rapidly with growing internal and external resources.
- Once they are successful, they need a banking partner which responds to their increasing financial needs. This allows them not only to move beyond the poverty threshold, but also to create employment for the poor.

### 2. What matters in terms of origin, history and culture of rural and microfinance?

*Poverty matters:* Poverty has been at the cradle of rural and microfinance:

- The poor need financial services, savings more than credit

*Informal finance matters:* Informal financial institutions in various forms of ownership have been based, some since centuries, on the very principles that many credit NGOs find difficult to adopt: self-reliance, viability, outreach to the poor as owners or users, competition, market-driven innovations, demand-oriented financial products and appropriate risk management.

- Upgrading and mainstreaming through networking, driven by incentives, is one of many ways in which donors can support expansion of outreach and financial deepening of informal financial institutions.

*History matters:* MFIs in Ireland, 1720-1950, have demonstrated how regulation makes and brakes savings-driven R/MF. MFIs in Germany, 1778-2002, started from informal beginnings and evolved, through appropriate regulation and supervision, to cooperative banks and savings banks (*Sparkassen*) with outreach to the majority of the German population in rural and urban areas, accounting for 51% of all banking assets. Among the lessons are:

- Microfinance is not a poor solution for poor countries.
- Savings-driven microfinance institutions, in cooperative or community ownership, are equally feasible in rural and urban areas.

- If properly regulated and supervised, they have great potential in poverty alleviation and development, both in rural and urban areas.

*Crisis matters:* Financial innovations typically emerge as a response to crisis, which must be taken as a positive force:

- Learning from experience means: responding to crisis with innovations.
- Many MFIs in crisis are kept alive, and prevented from reform, through donor support.
- MFIs which fail to respond to crises constructively must be allowed to falter: *close them or reform them!*

*Development matters:* Microfinance is no panacea. It contributes to development, but requires a climate of broader development to be fully effective, both macroeconomically and at the local level:

- Targeting the poor only and excluding the non-poor prevents the development of a village economy, diminishing the chances of employment, self-employment and economic growth of the poor.
- Donors must respect the autonomy of R/MFIs and refrain from imposing targeting.

*Culture matters:* The enthusiasm over the new consensus in R/MF has led to a neglect of cultural factors, which may be of crucial importance to the clients and corporate culture. Eg, a culturally sensitive approach may arrive at two fundamentally different approaches to development:

- **Development from above**, through the established authorities, is more effective in hierarchical or closed societies, which are oriented towards status, tradition and the preservation of stability
- **Development from below**, through participatory processes, is more effective in segmentary or open societies, which are oriented towards competition, experimentation, individual achievement and social change

### 3. What matters at the level of financial systems?

*Financial systems matter:* Well functioning financial systems must be in place if sustainable development and poverty alleviation are to occur. Governments and donors have to realize that financial systems and functioning networks of MFIs evolve over long periods of time:

- Donors can contribute to that evolution, but only in a long-range perspective,
- and in a coordinated goal-oriented manner.

*Capital matters...:* The main functions of capital transfer should be:

The main functions of capital transfer from abroad should be:

- bridging temporary shortages in loan capital through credit lines;
- investing in deposit-taking institutions, providing leverage for savings mobilization;
- strengthening the capacity of R/MFIs to generate their own resources: savings and retained earnings.

*... but capital transfer has undermined rural finance and development:* Reliance on external resources, interest rate subsidization and outside administrative control led to misallocation of scarce resources, corruption and external debts not matched by productivity increases.

Under disbursement pressure,

- donors continue to provide credit lines in substitution of domestic savings, undermining the growth of self-reliant financial institutions.

*Savings matter* at three levels, provided inflation is low and does not erode the value of the savings of the poor:

- as a service to the poor, to deposit and accumulate their savings in a safe place
- as a source of loanable funds and self-reliance for (rural) financial institutions
- as the main source of domestic capital in the national economy.

*Savings and credit matter – but which one comes first* depends on the rate of return:

- Savings-first for subsistence and low-yielding activities
- Credit-first for high-yielding activities.

*Financial intermediation matters:* Institutions, which offer both savings and credit services benefit twofold:

- they generate their loanable funds on a sustainable basis at a low cost;
- they benefit from economies of scope; ie, the additional transaction costs of the second type of service are substantially lower than those of the first.

*Financial sector policy matters:* The two main instruments of financial sector policy are:

- Interest rate deregulation, with interest rate autonomy on deposits and loans
- Institutional deregulation, to freely establish financial institutions and branches.

*The legal framework matters:* Appropriate legal forms allow people to establish their own financial institutions in private, cooperative or community ownership:

- Donors should support the financial authorities in providing an appropriate framework
- The two most important legal forms are privately owned rural banks and financial cooperatives.

*Interest rates matter:* Interest rates are of crucial importance:

- Caps on interest rates cut down on viability and outreach, rob savers and investors of the value of their resources, and ruin MFIs
- Interest rates above the inflation rate on deposits prevent the erosion of capital
- Rural market rates of interest must vary widely between institutions and countries, reflecting cost of funds, risks and services
- High interest rates force the borrower into investments with high returns
- Bringing down interest rates is an internal matter within institutions.

*Institutions matter (projects don't):* Institutions are the social capital of a society, providing continuity and efficiency. Financial institutions fall into three sectors:

- the formal financial sector, which is regulated and supervised by financial authorities
- the semiformal financial sector of institutions officially recognized but not regulated
- the informal financial sector of institutions which are regulated through local norms and traditional law, but are not officially recognized nor regulated by the state.

Donors may:

- support a differentiated financial infrastructure with competitive institutions organized in networks;
- support the expansion of sustainable rural financial institutions and their outreach;
- provide opportunities and incentives for upgrading nonformal to formal institutions;
- **abstain from perverse incentives** which enable NGOs, AgDBs and others to maintain unviable operations.

*Competition matters:* An emphasis on the creation of a competitive environment entails:

- institutional diversity (eg, financial cooperatives, rural banks, AgDB branches)
- pressure to perform, through effective supervision and enforcement of standards
- procedures of bankruptcy for non-performing institutions.

*Prudential regulation matters:* Regulation has failed in many developing countries, but is a prerequisite for financial market development. There are two controversial positions:

- Regulating deposit-taking MFIs only
- Regulating all MFIs, stabilizing the system and protecting small investors.

*Effective supervision matters:* Regulation is ineffective if not enforced by supervision. Donors should strengthen:



- the political will and institutional capacity to enforce standards of performance
- the restructuring or closing of nonperforming financial institutions, instead of preventing it through bail-outs - *bankruptcy matters!*
- bank superintendencies or central banks and, under delegated supervision, networks and auditing apexes of rural banks, SACCOs, and other R/MFIs.

*Knowledge matters:* The wealth of highly variegated institutional experience has largely escaped knowledge management: at the level of donor organizations, countries and regions:

- Donors will have to take up the challenge of establishing a system of knowledge management, perhaps in cooperation with IFAD.

#### **4. What matters at the level of institutions?**

*Institutional reform matters:* There are striking reform of different types of institutions, (eg, BRI, BAAC, CRDB, CARD), leaving no excuse for continual support to unviable institutions. The following lessons can be drawn:

- Financial sector policies such as deregulation of interest rates and the provision of legal forms for regulated financial institutions are conducive to financial innovations
- Any type of financial institution can be reformed, including credit NGOs and AgDBs
- With attractive savings and credit products, appropriate staff incentives, and an effective system of internal control, rural microfinance can be profitable
- The poor can save; rural financial institutions can mobilize savings cost-effectively
- If financial services are offered without a credit bias, demand for savings deposit services exceeds the demand for credit by a wide margin.
- Incentives for timely repayment work
- Outreach to vast numbers of low-income people and sustainability are compatible
- Transaction costs can be lowered, profitability and outreach to the poor increased, by including the non-poor and their demands for widely differing deposit and loan sizes

*Ownership matters:* Credit NGOs lack ownership; private ownership is most effective, but:

- depending on culture, institutions can be sustainable and reach the poor under any type of ownership;
- individual or cooperative ownership by the poor as shareholders of MFIs, including transformed NGOs, deserve special support.

*Institutional autonomy matters:* Management autonomy is more important than ownership. Donors should:

- Insist on management autonomy (vis-à-vis government and donor agencies)
- Refrain from targeting
- Respect management autonomy in customer selection and loan decisions.

*Viability, efficiency, sustainability and self-reliance matter:* Donors should support the enhancement of:

- the mobilization of domestic resources, such as savings, equity and borrowings
- profitability, requiring adequate repayment and coverage of all costs from the margin;
- cost-effective microfinance products and services:
- an adequate regulatory framework.

*Outreach matters - and so does truth in reporting:* In contrast to a ubiquitous credit bias of donors and governments, both saver and borrower outreach matter, of small as of large institutions:

- Support both saver and borrower outreach
- Insist on the reporting of actual, not cumulative figures; the latter conceal the truth.

*Outreach and sustainability matter – together!* There is strong evidence of the compatibility of outreach and sustainability, except under conditions of fixed interest rates:

- Insist on mutually reinforcing growth of sustainability and outreach
- Insist on adequate interest rates, allowing for profits above the inflation rate.

*Sustainable outreach to marginal rural areas* requires recognition of, and support for:

- The primacy of savings and self-financing, due to the absence of markets
- Member-owned SHGs and cooperatives, operating at low costs.

*MFI portfolio diversification matters* as a risk management strategy:

- Support portfolio diversification of both clients and MFIs
- Abstain from imposing loan purposes, which create undue risks

*Lending technology matter* – and should not be a matter of ideology:

- The poor can be reached by either individual or group technologies, if properly applied
- Group technologies with joint liability are more effective for small loans to the very poor
- Individual technologies offer opportunities for *graduating* to larger loans and sustainable movements out of poverty.

*Innovation and flexibility matter*: Rigid replication of success stories is a recipe for failure.

- Support financial innovations and adjustments to local culture.

## 5. What matters at the operational level?

*Good practices matter (not best practices)*: The term *best practices* evokes notions of optimal solutions and leads to inappropriate replications:

- Support satisfactory culturally appropriate solutions

*Institutional size matters, but not absolutely*: R/MFIs benefit from economies of scale, but there is no *best practice* in terms of size.

- Support both, small numbers of large, and large numbers of small, institutions; there is no minimum size of sustainable institutions (such as SHGs or cooperatives)

*Profits matter*: Profits are a source of capital and a major determinant of growth of outreach.

- Support studies of profitability of different credit and savings products
- Support organizational efficiency, bringing down interest rates or increasing profits

*Incentives matter*: While profits are a source of incentive payments, incentives are at the same time a major determinant of profits. Donors may support:

- the transformation of branches into profit centers
- the introduction of systems of staff performance incentives
- client incentives (rather than penalties) for timely repayment.

*Repayment matters*: There are many institutions of different types with repayment rates near 100%; however, enforcing perfect repayment may not be cost-effective and curtail outreach.

Donors may support measure to attain adequate repayment based on:

- appropriate terms like size, instalments, grace periods, purpose, timely disbursement;
- sound practices of loan enforcement, insisting on timely repayment.

*Information matters* – in terms of computerized data and personal knowledge of clients.

- Support adequate Management Information Systems with provide timely information

*Delivery systems matter*: Institutions lower transaction costs; therefore:

- Support measures to bring the bank of MFI to the people, shifting transaction costs from clients to institutions, with cost coverage from the interest rate margin.

*Financial products matter:*

- Support the development of demand-oriented and cost-effective savings and credit products
- Support efficient collection services (eg, at doorsteps).

*Loan protection matters:* Life (health, cattle) insurance is a service to clients, but also part of loan protection.

- Support the development of cost-effective insurance services by MFI, particularly to cover the default risks arising from AIDS/HIV.

## **6. What matters to the poor?**

*Access to savings and credit matters* – far more than interest rates.

- Support institutions which offer both savings and credit
- Insist on the transformation of credit NGOs into institutions collecting voluntary savings.

*Rural enterprise viability matters:* The viability of R/MFIs and rural farm and non-farm enterprises are mutually reinforcing.

- Promote linkages with agencies providing BDS in rural areas and to enterprising poor.

*Household portfolio diversification matters:* IGAs of poor households are usually highly diversified, managing the risks of diverse enterprises.

- Refrain from restricting small loans to single (productive) purposes
- Encourage loans to IGA with high rates of return, including petty trading
- Stay away from financing group enterprises – they have usually failed.

*The poor themselves matter ... and so do the non-poor:* In exploitative cultures, the poor may prefer access to financial services as a separate group depends on culture and the financial infrastructure. Banking with both the poor and non-poor may increase outreach to the poor.

- Promote financial services to the poor and non-poor in separate or mixed MFIs depending on culture
- Instead of targeting, promote financial products for different market segments.

*Culture of labor division matters:* Depending on culture, men, women and R/MFIs may opt for separate or mixed institutions.

- Refrain from targeting women
- Respect the autonomy of women and men and let them decide on separate vs. mixed institutions.

*Autonomy matters:*

- Abstain from targeting and other impositions
- Respect the autonomy of the poor, women, local financial institutions and their owners.
- Support self-selection through particular financial products and services

## **7. Donor policy and coordination matter**

### **7.1 Transmitting policy to operational departments**

There is an emerging consensus on R/MF policy in the community of donors and microfinance practitioners. But transmitting policy to operational departments remains a major challenge:

- Examine the feasibility of a matrix structure, with operational responsibility in the operational units and responsibility for project design and performance in the financial sector & microfinance unit
- Create a mechanism for monitoring the effective implementation of policy.

### *7.2 Cooperation, coordination and co-financing among donors*

The effectiveness of development assistance can be infinitely increased through donor coordination:

- Synergies are created by donor coordination at national level, including cooperation in expert advice, policy dialogue and project supervision
- Bilateral technical assistance agencies can complement multilateral and bilateral financial assistance agencies with grant-financed expertise.
- Standardized reporting on MFIs will facilitate implementation of policy and donor coordination.

### *7.3 Opening markets...*

The total effect of development assistance is small compared to the importance of opening markets in the developed countries for products from developing countries:

- Donors should make every effort for abolishing agricultural subsidies and opening up markets for developing countries

## **Conclusions and recommendations**

(1) Sustainable development requires:

- continual growth and diversification of the rural economy;
- access of all segments of the population including rural microentrepreneurs, farmers and the poor to sustainable financial services such as savings, credit and insurance;
- provided by self-reliant, sustainable financial institutions
- in a conducive macroeconomic policy environment.

(2) Sustainable rural microfinance requires local initiative and careful donor support for the development of institutions, enabling them to:

- offer both savings and credit services,
- mobilize their own resources,
- have their loans repaid,
- cover their costs from their operational income
- finance their expansion to the poor and non-poor from their profits.

(3) Governments, with careful donor assistance, have to provide,

- a conducive policy framework with deregulated interest rates,
- an appropriate legal framework for competitive local and national financial institutions in private, cooperative and community ownership
- a system of prudential regulation and effective direct or delegated supervision.

(4) Donors may contribute to the development of rural financial systems through:

- experts for R/MF units in central banks, R/MF networks and leading R/MFIs
- capacity building in financial authorities, R/MFI networks and R/MFIs
- policy dialogue
- equity investments with leverage through deposits, clear ownership and an exit option
- assistance for the transformation of MFIs into regulated institutions
- assistance for the promotion of ownership of financial institutions by the poor
- no credit lines, except for bridging temporary liquidity gaps
- making good use of the comparative advantages of multilateral and bilateral donors.

(5) Supporting self-help groups in marginal areas through:

- networks or federations of SHGs
- linkages of SHGs with regulated financial institutions.

# What matters in rural and microfinance

## Part I: Two worlds of rural and microfinance

### 1. What is unique about rural finance?

Most people in developing countries live in rural areas; like their countries, they are poor and unable to save; and they need to be helped. These plausible assumptions resulted in a well-intentioned type of development assistance: subsidized targeted credit provided through special programs, administered by agricultural (and other) development banks (AgDBs). During the 1950s and 60s, directed agricultural credit was synonymous with rural development finance. The argument was subsequently extended to urban areas, where many of the rural poor had migrated, and they too became beneficiaries of subsidized targeted programs; these were mostly financed and administered by NGOs. In both cases, AgDBs and NGOs, donors played a crucial role in providing funds and methodologies.

As directed credit failed to deliver the expected results in terms of poverty alleviation and development, a new type of development finance has emerged during the 1990s, both in theory and in practice, backed by an emerging international consensus<sup>1</sup>:

- Agricultural credit has been replaced by rural finance, ie, credit by a range of financial services including savings; the emphasis on agriculture by finance for a broad range of loan purposes
- Rural finance has been integrated into the financial system
- Projects with particular schemes have been replaced by institutions with particular financial products
- Interest rate subsidies have been replaced on the one hand by subsidies for institution building and on the other hand by market rates of interest
- Beneficiaries have turned into customers
- Charitable poverty-lending has turned into a commercial proposition between commercial microfinance institutions and the poor as customers.

Rural and urban areas differ in terms of population density, diversity and social cohesion. This may impose limitations on what kinds of institutions, financial products and risk management are suitable and profitable; but whether much is unique about finance for rural areas remains to be seen. From a systems perspective, differences between rural and urban finance, or commercial banks and rural banks, are more likely to be found at lower operational levels.

At present, three worlds of finance (as providers of rural and microfinance services) exist side by side, both in rural and urban areas:

- The old world of donor-driven development finance, among them AgDBs and NGOs, which for their continued existence rely on government and donor funding for equity capital, loanable funds and operational expenses, in a number of cases also for interest rate subsidies.

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<sup>1</sup> Inspired by the World Development Report 1989 on *Financial Systems and Development*, the early 1990s were a seminal time, also reflected in the biography of this consultant. He contributed a section on linking informal and formal finance to the 1989 World Bank report; prepared the first draft microfinance policy for the Asian Development Bank in 1993/94, revised and published by GTZ as *Financial Systems Development and Microfinance* in 1996; and contributed to the financial sector policy of the BMZ in 1994. In 1999/2000, he prepared the IFAD Rural Finance Policy.

- A new world of development finance, comprising viable formal and semi-formal institutions. Among them are rural banks, some AgDBs, savings and credit cooperatives and other MFIs, with microfinance services on a commercial basis for various market segments including the poor in rural areas. Large numbers of these institutions are self-reliant. Yet there is room for donor support during a limited period of time: to increase their efficiency and expand their outreach to the poor.
- Informal finance (both ancient and new), comprising a multitude of microfinance institutions without official recognition and support – among them rotating savings institutions, non-rotating savings and credit institutions, moneylenders and deposit collectors -, based on principles of self-reliance, viability, competition and outreach to all segments of the population.

The fate of an institution – in terms of sustainability, growth and outreach – depends to a large extent on the intentions of the founders. The test question is whether an institution was established,

- through local initiative and local capital for mutual self-help or profit-making, standing on its own feet from the beginning;
- through outside initiative and a one-off capital injection, but then put on its own feet, either immediately or within a defined period of time;
- with the expectation of continual government and donor dependency.

## 2. Two worlds of rural and microfinance revisited

During the last 25 years, but increasingly so during the last decade, notable new developments have occurred in rural and microfinance in many countries. Macroeconomic stability and deregulation have created a conducive policy environment, which has prepared the ground for reforming rural financial institutions, among them community banks, private rural banks, savings and credit cooperatives, agricultural development banks, Grameen-type banks and credit NGOs. New banking legislation has provided a legal framework for initiating regulated microfinance institutions on a commercial basis. This has also created opportunities for upgrading and mainstreaming informal financial institutions, of which only few donors are fully aware. As a result, increasing numbers of poor people have access to financial services – not only as users but also as owners. However, in the majority of countries, there are still major shortcomings in rural finance that call for country-driven, coordinated interventions.

Table 1: The old and the new world of development finance

	<b><i>Donors, don't support:</i></b> <i>The needs-driven approach of the Old World of Development Finance</i>	<b><i>Donors, do support:</i></b> <i>The institution-building approach of the New World of Development Finance</i>
Policy environment	<b><i>Financial repression:</i></b> Inadequate policy and legal environment; slow implementation of deregulation; inadequate property rights and judicial procedures; repressive liquidity requirements; TB rates make lending unattractive	<b><i>Prudential deregulation - conducive to financial system/market development:</i></b> Macroeconomic stability; interest rate deregulation; ease of setting up banks and branches; low minimum capital requirements for regulated MFIs, enforceable property rights
Legal framework	Lack of appropriate legal forms, particularly for privately or cooperatively owned local FIs; waste of domestic social and financial capital	New legal forms for rural banks, community banks, and commercially-operating MFIs; privately financed start-up

Development approach	Supply-driven	Demand-driven approach
Institutional focus	Single institutions as a monopoly supplier	Rural financial infrastructure with a variety of competing financial institutions
Target group perception	Beneficiaries	Customers
Selection of clients	Targeting by donors and governments	Self-selection through appropriate financial products aiming it different market segments
Outreach	Limited outreach to selected target groups such as farmers, the poor	Potentially all segments of the (rural) economy and society
Incentives	Perverse: leading to misallocation of funds, inefficiency, corruption	Profitable allocation of funds; individual performance rewards
Non-formal financial institutions	The potential for upgrading millions of informal financial institutions remains largely untapped	Legal opportunities for upgrading to formal levels and financial market integration
Semiformal financial institutions and NGOs	NGOs are slow in mobilizing domestic resources; lack of standards and self-regulation; donors support unviable NGOs, providing perverse incentives for continued dependency	Innovative approaches to poverty lending in repressive environments; some successful conversions to deposit-taking formal intermediaries with rapid increase in outreach and financial deepening
Savings and credit co-operatives (SACCOs)	Undermined by credit channelling; lack of effective R&S by authorities and coop networks; wasting a major form of social capital	Self-reliance from deposits; low cost operations through self-management; expansion under new name
Agricultural development banks (AgDBs)	Political interference; lack of viability and outreach; poor risk management; drain on public resources; failure to meet demand for credit and deposit services	Reforms towards autonomy, viability, deposit-taking, portfolio diversification, profit-financed expansion of outreach – with or without privatisation
Rural banks (RBs)	Lack of privately owned RBs;	Legal framework for establishing privately owned RBs; consolidation of regulated RBs; outreach to the poor and non-poor
Commercial banks	Unable to lend to any sector including microentrepreneurs and the poor, hence overliquid	Outreach to microentrepreneurs and the poor with appropriate products and services; expansion of outreach through linkage banking
Regulation and supervision (R&S)	Cooperatives and AgDBs escape supervision; lack of MFI standards; financial authorities unprepared to supervise MFIs; donors keep distressed institutions alive	Central banks establish MF units; regulation of rural banks and MFIs under microfinance laws; awareness of the importance of effective supervision and the closing of distressed institutions; R&S for credit MFIs controversial
Agricultural finance	Self-financing and commercial credit insufficient to meet the demand; inadequate savings mobilization; lack of commercial credit	Self-financing thru savings and profits from lucrative non-agricultural IGAs; non-targeted commercial credit replaces preferential sources
Remote and marginal areas	Futile attempts of donors to drive ill-suited MFIs into remote areas	Self-managed savings-based SHGs and small cooperatives operating at low cost
Individual and group	Lack of familiarity with effective group	If properly applied, both can be

technologies:	or individual technologies; ideology leads to rigid replications without growth of outreach and sustainability	profitable and reach microentrepreneurs, farmers and the poor; solidarity group members graduate to larger individual loans
Non-financial and business development services	Maximalist approach undermines financial institutions if health, nutrition, education and business development services are piggy-backed on FIs without cost coverage	Provided by SHGs, subsidiaries of FIs or other agencies linked to MFIs; sustainable balance of social and financial development
Targeting	Targeting undermines outreach and sustainability; excludes the enterprising non-poor and cuts down on employment opportunities for the poor	Differentiated financial products for different market segments, with interest rates covering all costs and services; employment generation by small and microenterprises
Linking banks and SHGs/MFIs (LBS)	Lack of healthy banks with a mandate to be of service; lack of LBS exposure programs	Spectacular increase in outreach to the poor; profitable if interest rates are free
Interlinked financing schemes	Lack of institutional sustainability on a national scale; breakdown under conditions of liberalization	Successful for commodities under controlled conditions and in confined local environments on a small scale
Self-reliance	Credit NGOs and AgDBs barred from deposit-taking; reluctance to strive for self-reliance; continued donor and government dependency	Institutions of any ownership type may collect deposits and make profits: as a basis of self-financing and institutional autonomy
Sustainability	Donors and governments fail to insist on performance standards and sustainability within a defined period	Increasing numbers of self-sustaining institutions of any type and ownership
Access to financial services	Vast numbers of poor and non-poor lack access to savings, credit, insurance, particularly in rural and remote areas and in the informal urban sector	Outreach of viable local financial institutions to the poor as users and owners drastically increased, with access to savings and credit services; some access to insurance/loan protection

Many donors with their projects are found on both sides of the table (above), some more to the left in the *new world of demand-driven commercial finance*, some more to the right in the *old world of supply-driven development finance*. This is not the place to exactly classify donors. Suffice it to say that they are all on the move towards the left, some more determined and at a quicker pace than others. Putting this into operational practice, supervising and enforcing the implementation of these principles effectively will remain, as in most other donor organizations, a challenge for some time to come.

### 3. A single development finance policy?

Rural and microfinance policies cannot be formulated without reference to financial sector policy and the wider institutional infrastructure, including the central bank and (other) regulatory authorities. Conversely, an agency directed by parliament or its governing board towards poverty alleviation cannot in its financial sector policy ignore rural and microfinance. Moreover, there are overlaps in geographical coverage: many microfinance institutions operate in urban, semi-urban and rural areas; and many towns in rural areas and metropolitan fringes cannot be easily classified as urban or rural. In terms of occupations, small traders and other microentrepreneurs are found in any type of settlement; and financial



institutions and products do not necessarily differ whether they apply to urban or rural microentrepreneurs. In many cases, more depends on a specific situation than on rural-urban differences. Distinctions are thus blurred, as for example the experience with individual and group lending technologies in various countries shows: each may work well or poorly – in either urban or rural settings –, depending on the professionalism and commitment of the respective institution. Self-help groups, small cooperatives and small community-based financial institutions may be solely appropriate in remote rural areas; while, in addition to these, commercial banks, rural banks and other larger-scale institutions may also be appropriate in cities and areas close to functioning markets; but this does not require separate policies. It is therefore recommended:

- To prepare a general development finance policy, comprising an overall financial sector policy, a microfinance policy and a rural finance policy.

This should also facilitate donor coordination and cooperation, avoid damaging interventions and duplications, and contribute to the integration of financial markets, including the sharing of training facilities, money transfer and liquidity exchange between different types of institutions.

#### 4. The rural and microfinance market: How many MFIs are there?

No systematic information is available on the numbers of the various types of institutions. Reported information is highly misleading, ignoring to a large extent institutions established without donor support. Eg, the CGAP Micro Banking Bulletin of November 2001 reported data on 149 MFIs and drew conclusions from a tiny unrepresentative sample, suggesting that there is only a small number of viable MFIs around the world. Yet, in India alone, there are 142,000 primary rural financial units (with 412m deposit accounts and 72m borrowers) under the supervision of NABARD (March 2004); in addition, there are 1.43 million rural SHGs as grassroots financial financial institutions, savings-based and credit-linked to some 36,000 bank branches (*March 2005*); plus large numbers of credit NGOs and other MFIs. In China, there are more than 100,000 rural credit cooperatives (RCCs). On Indonesia (2000), the Asian Development Bank reports 54,000 formal and semiformal microfinance institutions, among them 2,213 rural banks and 3,855 BRI village banking units. In the Philippines, there are 781 rural banks with 1,914 offices; 104 thrift banks with 1,351 offices, 2,200 savings and credit cooperatives (out of a total of 36,000 cooperatives with savings and credit components), an estimated 500-600 credit NGOs. In Africa, numbers are smaller; but Ghana has some 130 rural banks, Nigeria close to 800 community banks (70% of them rural), Uganda some 500 credit NGOs. In most Latin American countries, numbers are small, which seems to have shaped the views of many in the donor community. In most Arab countries, numbers of rural and microfinance institutions are very small; but some do exist, as in Jordan, Egypt and Syria.

In informal finance, there is great variation between regions and countries. But worldwide, the number of informal financial institutions probably runs in the tens of millions; and the number of formal and semiformal rural and microfinance institutions in the hundreds of thousands. In addition, there are vast numbers of informal and semiformal institutions with savings and credit activities as a secondary purpose. It is therefore recommended:

- Not to focus solely on credit NGOs, as many donors still do;
- to include among the institutions eligible for support formal, semiformal and informal financial institutions - in private, cooperative, community or mixed ownership;
- to place a special emphasis on support to institutions with include **the poor as owners or customers**, but refrain from luring MFIs into banking with the poor or poorest only;

- to seek for innovative approaches of including the vast numbers of member-owned informal financial institutions among the eligible institutions.

## 5. A special role for donors in marginal areas?

**Rural-urban and rural-rural differentials:** There are usually wide differences between rural and urban areas. In rural areas,

- population densities tend to be lower,
- paradoxically paralleled by larger family sizes and higher population growth rates
- educational levels tend to be lower, particularly among women
- physical, institutional and IT infrastructures are poorly developed
- access to markets and integration of producers and organizations into national markets is limited
- the range of income-generating activities and the degree of economic diversification is limited
- the profitability of economic activities is lower
- agriculture predominates, with its low profitability and its exposure to co-variant physical and economic risks.

Yet, there are also vast rural-rural differentials within and between countries. Eg, population densities vary from less than 1/km<sup>2</sup> in the Sahel to several hundreds in tropical West Africa and up to more than 1000/km<sup>2</sup> in rural Java; educational levels in rural areas vary greatly between the Balkans and most other developing countries; the rural economy may be based on subsistence crops or cash crops with vastly different profitability rates; risks vary greatly according to the degree of diversification (eg, vegetable production), irrigation and market proximity. At the same time, absolute poverty may be more severe in cities, as in parts of India.

**Alternative strategies – for or against marginal areas:** All this makes generalizations difficult. To remote areas, most of the characteristics in the list above apply. These are areas which have not been at the center of attention during the recent microfinance revolution. Little systematic work has been done on finance in remote and marginal areas. Several alternatives are open:

- (1) Given a policy of minimal involvement of foreign experts in the field, to focus on such areas as building R/MF units in central banks or transforming credit NGOs into regulated financial intermediaries, staying out of remote areas
- (2) To support in-depth field studies of financial innovations in selected marginal areas in preparation of future support
- (3) To support institutional innovations in selected marginal areas through support which includes foreign experts on a substantial scale and over an extended period of time.

There are no generally applicable *best practices* that could be cast into recommendations to donors. In fact, there is considerable variability in what works and what does not work in different countries and geographical areas. Thus, in every particular case, detailed feasibility studies are required to work out an appropriate approach, which subsequently requires careful monitoring and replanning based on actual experience, including termination of a project or closing of institutions if found unworkable or unsustainable.

**How donors may support rural finance in marginal areas – through SHGs:** Donors may want to stick to their focus on marginal areas and the poor; and they may want some more concrete advice, which may have to be taken with due caution, first on inappropriate and appropriate institutional vehicles of support:

- Mostly inappropriate institutional vehicles for marginal areas are commercial banks and credit NGOs.
- Mostly appropriate vehicles are indigenous informal financial institutions on a self-help group basis; and newly established autonomous self-help groups (SHGs).

Projects of promoting SHGs, networks of SHGs and linkages with banks in marginal areas have proven successful in recent years in African Sahel countries such as Mali and Burkina Faso,<sup>2</sup> in Asian countries like India<sup>3</sup>, Indonesia<sup>4</sup> and Nepal<sup>5</sup>, and in Syria<sup>6</sup>; the regional agricultural credit organizations APRACA and AFRACA and have played prominent roles in a number of Asian and African countries.

There are **two basic strategies** for supporting indigenous or new SHGs as autonomous local financial institutions in marginal areas:

- (1) Through networks or federations of SHGs, implying that both SHGs and their networks are being promoted in the framework of a project
- (2) Through linkages of SHGs with regulated financial institutions like AgDBs, rural banks or other types of deposit-taking financial institutions.

In either case, support for new (rather than ongoing) projects requires a thorough feasibility study, a long-term perspective or support, long-term experts, the willingness to work, in the longer run, towards a legal status for the SHGs or their networks or federations, and possibly cooperation with other donors and with regional organizations.

Appropriate partners for the first approach may comprise AgDBs and development NGOs, which will eventually transfer their institution-building and –maintenance functions to networks of SHGs<sup>7</sup>. Partners for the second approach may include AgDBs, rural banks or other types of deposit-taking financial institutions.

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<sup>2</sup> Cf. Transforming Rural Finance in Africa: The Role of AFRACA in Linkage Banking and Financial Systems Development. Internationales Afrikaforum vol. 32 no. 3, 1996: 185-190

<sup>3</sup> Seibel & Khadka 3/2001; Seibel & Dave 11/2002.

<sup>4</sup> Kropp & Clar de Jesus 4/1996

<sup>5</sup> Staschen 2001; Wehnert U. & R. Shakya, 2001

<sup>6</sup> Seibel 2002

<sup>7</sup> An example are the federations of SHGs (promoted by Nabard) in India with the legal status of MACS, a new type of cooperative status. As of end-2002, Nabard has established 500,000 autonomous SHGs with access to bank services, comprising some 40 million family members of very poor rural population segments.

## Part II

### What matters in development finance, microfinance, rural finance?

#### 1. First of all: client experience matters

Nothing matters as much in rural and microfinance as the experience of the clients. Impact studies are of course the proper tool to measure that experience. The results are usually in statistical form, providing insights at higher levels of abstraction. Case studies are rarely representative and provide only anecdotal evidence. If carried out impartially, they provide a picture which is rich in grassroots experience. It is the You-know-it-when-you-see-it methodology which permits us to arrive at an assessment, albeit tentative, of the institution which provides the client with the particular experience of its financial services. Some examples follow, taken from a recent study of *Women and Men in Microfinance* in Jordan, Syria and Uganda.

##### ***The man who keeps planting olive trees, which all dry up:***

Omar Al-Qur'an is 55 years old. He has seven children, 16-23 years old, from his first wife, who died. He is now married again; his wife is pregnant. In 1991 he received a first loan of JD 4,500 (\$6,300) with a maturity of 12-15 years from the government-owned *Agricultural Credit Corporation (ACC)* of Jordan for planting 300 olive trees and building a two-room house. The land is located on a dry plain, and the olive trees died. In June 1992, he received an 8-year loan of JD 6,000 (\$8,400) from an ACC goat smallholder project, which is now fully repaid. In the same year, he planted another 250 olive trees – from his own funds, he says. These also dried up. In 1999, at a time of continued drought, he replanted another 150 olive trees, again from his own resources. In May 2000 he received a third loan from ACC: JD 1,500 (\$2,100) to add two rooms to his house. Omar says that all the dairy produced is consumed by his family; and that there is no other source of income other than his pension of JD 150, from which JD 90 are deducted every month. *"Here in these villages, women do not work outside the house,"* he added. But why does he keep planting olive trees, which all die? *"Without an olive tree project, I have to return the loan at once,"* he explained.

##### ***Starting small, on JD 150 (\$210),... and growing big:***

Khuland in the village of Manshiya in Karak is 30 years old, married, and has 6 children. As a member of a solidarity group, she received a first loan of JD 150 for six months from *Jordan Access to Credit Project*<sup>8</sup>, one of four USAID-supported NGOs, and started a small store at her house in 1999. Subsequently she received two loans of JD 200 and JD 250, both again guaranteed by her solidarity group, to increase her stock. Her monthly payments amounted to JD 26, JD 32 and JD 38, respectively. 18 months after the start, in June 2001, she obtained an individual loan of JD 1,500 (\$2,100) with a maturity of 30 months and rented a store. She spent JD 300 on the renovation of the store, JD 500 on a refrigerator and JD 700 on stock. Her monthly installments are JD 62; this leaves her with a monthly net profit of JD 100. The individual loan is secured by two guarantors. Repayments of all four loans are made individually at a local bank. As Khuland saw Mohammed in a nearby town obtain a loan

<sup>8</sup> The *Jordan Access to Credit Project (JACP)* is a nonprofit company registered since 1998 with the Ministry of Trade and Industry (MTI). With support from USAID, the project was designed as a collaborative effort by the Cooperative Housing Foundation (CHF) in the US, the Jordan River Foundation, the Cairo-Amman Bank, the Bank of Jordan (BOJ), and the Jordan National Bank (JNB). Its funding for the period 1998-2002 is US\$4 million for loans to micro, small and medium enterprises with an additional 20% capital contribution from participating banks. However, the participating banks lost interest; and as of November 2001, all loans are processed through the Housing Bank of Jordan, which has the widest delivery network of all banks in Jordan, while CHF assumes 100% of the risk of group loans. (For a full case study see Almeyda 2001.)

of JD 14,000 (\$19,600) from JACP, she is confident that further growth depends only on her own ability.

***Pouring money down the association drain:***

In 1984, 120 men founded the *Karak Sheep Smallholders Association* in Karak, Jordan. Depending on the number of sheep, each member paid contributions of JD 50 to JD 1000, raising a total capital of JD 23,000 (\$32,200). The association's main activity was the wholesale purchase of sheep fodder and its retail sale to members, which worked well. In 1997, the sheep smallholders association was offered with opportunity of changing into the *Association of Yoghurt Maker* and setting up a dairy plant: with a grant of JD 200,000 from FAO and WFP, a collateral-free loan of JD 13,000 from the ACC/IFAD Income Diversification Project with a maturity of 10 years, a start-up contribution of JD 6,000 from the National Union of Associations and JD 16,000 (7% of the total investment) from their own resources. No payment has ever been made on the ACC/IFAD loan. Yoghurt, cheese and butter are made in the home and also retailed by the housewives. "*Men don't know anything about yoghurt and cheese-making,*" the secretary explained. Therefore, the all-male association temporarily employs seven women, and a man as overseer. The plant ran into problems of milk shortage and of marketing and works only in April and May each year. In Amman, there is an identical donor-funded project, with the same problems.

***15 trips to the bank for a loan:***

In July 2001, Samirah applied to the Agricultural Cooperative Bank of Syria for a loan of SP 50,000 (\$1,000), repayable over 5 years. She had benefited from a women's training and credit component of an IFAD-supported project in Jabal al-Hoss, one of the poorest areas in Syria. According to social etiquette, it is up to the husband to travel to the bank branch for loan negotiations. It took Samirah's husband Barjas 15 visits to the bank branch, plus one visit by the wife to sign the papers. Each visit took 9 hours; together with travel expenses, total borrower transaction costs were SP 6,400, paid up-front – compared to subsidized interest payments of only SP 2,750 during the first year. Disbursement was expected a week after our visit in September; but if the loan officer of the ACB branch happens to be absent, yet another trip is due. Project staff hopes to bring down the number of trips to three or four.

***Having 10 children and opening a store:***

Aminah is 40 years old and has 10 children. She and her husband own 2 ha of farmland in Bnan, Jabal al-Hoss. Her husband has a general merchandise store; but according to Aminah, "you find nothing in it." In January 2001, Aminah joined the new sanduq, a member-owned MFI, and received a loan of SP 25,000 (\$500). Without any other resources, she opened a store for household electrical equipment. From the income, she bought additional stock, took out some money for the family, and repaid the loan after six months. She expects that future loans from the sanduq will finance the expansion of her business and generate additional income for the family.

***Repeat loans for vertically integrated activities:***

Were Kalifani is a rice farmer and rice trader in Mbale District, Uganda, 45 years old, married, with 8 children. He had four loans from Centenary RDB since 1998: Ush 300,000; 550,000; 800,000; and 2 million (\$170-\$1150). He used the loans as working capital on his 2-ha rice farm, for trading, and for the purchase of a rice mill. He employs workers and contract laborers. Since 1998, the value of his assets has increased from Ush3m (\$1725) to Ush7m (\$4000).

***Building a business empire through work, savings and credit:***

Connie Watuwa is around 50, married and has six children. Born in a village, she moved to Mbale, Uganda, where she found business opportunities unlimited. In 1971, she opened a restaurant with her husband. From the income, she saved money in a

bank and opened a hardware store of her own in 1975. In 1986 she got a first loan from the now defunct Cooperative Bank for a lock-up store and, in 1991, a loan from the Uganda Women's Finance Trust for produce trading, buying rice at Ush 400/bag and selling it after 3 months at Ush 1000/bag. When Centenary RDB opened a branch in Mbale in 1998, she became one of its first depositors. "Centenary is a greener pasture, it gives you no headaches", she said. Within two years, she received three loans: Ush 2 million (\$1150), Ush 4 million and Ush 10 million. As all her payments were on time, she recently graduated to a so-called automatic loan of Ush 15 million (\$5750) at a substantially reduced interest rate. She invested the loans in a second lock-up store, a mattress store, and in an extension to the restaurant. She pays for her children's education at Makerere and Nairobi University. The total net worth of her business empire is now Ush 230 million (\$132,000). Her secret of success is hard work and credit: *"I worked when I was pregnant up to my 9<sup>th</sup> month. I can work. All I need to expand is bigger loans."*

**Lessons learned:** What have these clients learned from the experience? Starting with large loans and term finance, as has been common among donor-supported AgDBs, is a guarantee for failure.

Only small short-term loans allow them to experiment with investments at a reasonable risk; to test their ability to borrow, invest, repay and save; to change to more profitable investments as opportunities emerge; and to grow rapidly with growing internal and external resources. Once they are successful, they need a banking partner which responds to their increasing financial needs. This allows them not only to move beyond the poverty threshold, but also to create employment for the poor.

## 2. What matters in terms of origin, history and culture of rural and microfinance?

### Poverty matters

Historically, deep poverty has been the cradle of virtually any microfinance movement. The driving force in the evolution of microfinance systems has been self-help and self-reliance: through savings, self-management, or both. Without these, microfinance institutions have remained few and ineffectual. In many of the now mature economies, microfinance has played an important role in poverty alleviation, rural development, and the development of micro, small and medium enterprises. With successful poverty alleviation and development, microfinance institutions have not disappeared, but evolved into mature financial intermediaries. They continue to provide a full range of financial services to the lower segments of the population.

### Informal finance matters

Where and when rural microfinance originated is unknown; but it is certain that it was not in Bangladesh during the 1970s. Each country and ethnic group has its own history and structure of informal finance. The prehistory of the hui in China and Papua New Guinea, arisan in Indonesia, paluwagan in the Philippines, chit funds in India, esusu in Nigeria and the West Indies, ekub in Ethiopia, chilimba and likilemba in central Africa, sanduq in Arab countries, pasanaco in Bolivia and thousands of other group-based indigenous financial institutions – not to mention the ubiquitous moneylenders – has yet to be written; but in some countries, such as Nigeria, China, and India, they certainly predate the modern era. (Bouman 1977; Seibel & Damachi 1982: 73-79) Modernization and the money economy have led to numerous innovations in informal financial institutions, but not slowed down their expansion.

#### Box 1: Daily deposit collection, a financial innovation in West Africa

Daily deposit collection at doorstep is a financial institution on West African markets, which emerged about 50 years ago. It is called *ajo* among the Yoruba of Nigeria, *anago susu* in Ghana, *nago* in Ivory Coast (*nago* or *anago* = Nigerian), *yesyes* in Southern Togo, *jojuma* among the Kotokoli in central Togo. The deposit collector may serve anything between 200 and 600 clients a day. From each he collects a fixed amount which is then registered on a printed card. By the end of the month he returns the total, keeping the amount of one daily deposit as a collector's fee. As to efficiency: On one of the markets in Accra I measured the average time it took to make a deposit including walking time: 17 seconds; and making a loan just under one minute. In the mid-1980s, the deposit collectors in Accra formed the Greater Accra Susu Collectors Association, which was registered and planned to set up its own bank, but the authorities were not favorable (Seibel & Marx 1987). By 2000, the Ghana Cooperative Susu Collectors Association, with 397 members out of an estimated total of 1040 susu collectors, covered all of Ghana. The World Bank, IFAD and AfDB now support linkages of susu collectors with rural banks. India and Indonesia are among the countries where daily deposit collection is practiced by banks.

Source: Seibel 4/2001; see also Rutherford 2000: 69-70

There are countries where virtually every adult is a member in one or several; this includes many of the poor and the very poor, as found, eg, in July 2002 among Grameen clients in the Philippines. Embedded into their own cultural and economic environment, the informal institutions teach basic lessons, which many donor-supported MFIs still find difficult to accept:

- ✓ self-reliance – mobilizing their own resources
- ✓ viability – covering their costs and yielding a positive return
- ✓ outreach – providing access to financial services for all segments of the population as users or owners
- ✓ near-perfect competition among large numbers of institutions, combined with a rapid turnover of institutions and participants
- ✓ market-driven innovations, including the transition from non-monetary to monetary means of exchange, from reciprocity to demand-oriented services, from rotating to non-rotating associations, from insurance to savings & credit

- ✓ appropriate financial technologies, such as risk management through a zero-cash principle.

There are a number of cases of upgrading where informal institutions have evolved into formal institutions, such as arisan into rural banks in Indonesia, dhikuti into a finance company in Nepal, and informal into formal chit funds in India (Seibel 2001/4); where indigenous informal institutions have entered into linkages with banks (Seibel & Marx 1987); and where donors have promoted linkages of indigenous or newly established groups with banks in Asian and African countries, eg, through AFRACA and APRACA, – the largest such program in India (Seibel 3/2001), with 461,000 self-help groups as of 3/2002. And there are countries like Cameroon, Nigeria and Nepal where indigenous informal financial institutions are the main source of capital for micro and small enterprises.

**Box 2: From dhikuti to finance company: upgrading a RoSCA in Nepal**

Until the 1950s, the *dikur* or *dhikuti* was a rotating savings association among Thakali traders in Nepal. Since then, it has spread throughout all towns and most ethnicities in Nepal and become *the small businessman's self-help bank* (Seibel & Shrestha 1988). As business opportunities grew, secret bidding replaced allocation by lottery. For example, at the first turn, the lowest bidder may accept a pot of \$1000 for \$600, reducing individual contributions by 40% or putting the balance of \$400 into an emerging loan fund. In response to a new law (1992) permitting the establishment of finance companies and without donor involvement, some dhikuti have started to register as finance companies, which has substantially their functioning. Perhaps the most prominent is the Himalaya Finance and Savings Company, offering various savings and credit products to the poor and near-poor throughout Nepal, including contractual savings and term finance. Up to 600 daily savings collectors collected deposits of US\$ 0.15 per day, before new central bank regulations led to a reduction in the number of collectors and an increase in the size of deposits. (Seibel & Schrader 1999)

Donors and donor institutions like CGAP have large left the enormous potential of indigenous informal financial institutions (IFIs) unexplored. In fact, in many countries, large numbers of self-reliant IFIs and small numbers of unsustainable credit NGOs supported by donors exist side by side: a continual challenge. Given the prevalence of the informal financial sector and its capacity for adaptation and innovation, special support may be given to IFIs.

This may entail: (a) enhancing management skills and operational practices; (b) transforming rotating and nonrotating savings and credit associations, funeral societies and deposit collectors into financial intermediaries with a permanent loan fund; (c) availing of opportunities for upgrading to regulated financial institutions; and (d) entering into linkages

with banks. A particular strategy to be supported by donors, in partnership with an NGO, might be **upgrading & mainstreaming through networking among informal IFIs as an incentives-driven option**. IFIs may be offered assistance to establish networks and enlist as members. The network may be registered under a suitable legal form: as an association, a foundation, a cooperative, a company and eventually a formal apex. In a stepwise order, the network may offer services as an incentive to join(Box B3).

**Box 3: Stepwise incentives for mainstreaming IFIs**

Mainstreaming	Incentive
1. Registration	Basic training (accounting)
2. Reporting	Financial management training
3. Legal status	Consultancy services in good practices
4. Prudential norms	Liquidity exchange and refinancing
5. Supervision	Accreditation with a seal of quality

## History matters

*Is microfinance a special solution for poor people in poor countries?*

Attributing the origin of microfinance to recent initiatives misses not only the historical depth and scale of microfinance, but also centuries of experience, which means: learning from trial and error, failure and success. The beginnings in Europe were all informal and small-scale, including informal savings clubs in many countries during the 18<sup>th</sup> century, among them the *box clubs* in England.



*The case of Ireland, 1720-1950: How self-help and legal backing created a mass microfinance movement, until a cap on interest rates brought it down*

The birth of microfinance in Europe dates back to tremendous increases in poverty since the 16<sup>th</sup> century, with the first known bank for the poor established in Holland round 1618. In Ireland, loan funds emerged in the 1720s, using peer monitoring to enforce the repayment in weekly instalments of initially interest-free loans from donated resources. After a century of slow growth, a boom was initiated by two events: (a) a special law in 1823, which turned the charities into financial intermediaries by allowing them to charge interest on loans, enabling them at the same time to collect interest-bearing deposits; and (b) the establishment of a Loan Fund Board in 1836 for their regulation and supervision. Around 1840, around 300 funds collected deposits and provided small loans to the poor, with an outreach to 20% of households in Ireland. The funds offered three times higher deposit rates than commercial banks and started cutting into their core business. Corporate politics led to a cap on interest rates in 1843 and caused the gradual decline of the loan funds during the second half of the 19<sup>th</sup> century, until they finally disappeared in the 1950s. (Steinwand 2001: 52-54).

*The case of Germany, 1778-2002: How self-help, regulation and supervision created the world's largest microfinance system*

*Microfinance with the poor* in Germany has three roots: community-based savings funds, mostly in urban areas; and two movements of savings and credit cooperatives: one rural and one urban. Having learned from the early Irish charities that charity is not sustainable, the first thrift society was established in Hamburg in 1778, the first communal savings bank (*Sparkasse*) in 1801. As the movement spread, the influx of savings forced the savings banks to expand their credit business, including agricultural lending. After the hunger year of 1846/47, Raiffeisen reinvented the wheel of microfinance: first by establishing a rural charity association in Weyerbusch in 1847; and then, after his charities failed, the first rural credit association in Heddesdorf, 1864. This was paralleled by Schultze-Delitzsch's the first urban credit association in 1850, who insisted on self-help without charity from the beginning. Between 1885 and 1914, the number of rural cooperatives in Germany increased from 245 to more than 15,000 and spread to many other countries. (Von Pischke 1991: 43-46; Steinwand 2001: 54-60).

*The spectacular success of microfinance* in Germany, which pushed moneylenders and private banks out of business, is due to several factors:

- self-help and self-reliance, based on savings mobilization
- local outreach with lasting *house-banking* relationships
- the evolution of a legal framework: 1838 first Prussian savings banks decree; 1889 first Cooperative Act; 1934 Banking law covering all financial institutions including savings banks and cooperative banks
- abandoning joint and several liability of cooperative members in favor of limited liability in 1889
- Effective delegated supervision through own apexes, evolving in four stages:
  - 1860s-80s voluntary auditing, resulting in financial difficulties during the 1880s
  - 1889 mandatory auditing by cooperative auditing federations or freelance auditors, resulting in financial difficulties of cooperatives under freelance auditors during the 1920s
  - 1934 mandatory auditing by separate auditing federations for all banking networks including cooperatives and savings banks supervised by the Bank Superintendency
  - 1971 DGRV as national cooperative auditing federation with 11 regional and 6 specialized auditing federations; paralleled by DSGV for savings banks

*Results:* This has resulted in a financial system in Germany in which 51.4% of all banking assets are held by (former?) microfinance institutions (Dec. 1997 data), with:

- 39,000 branches (49% cooperative banks, 51% savings banks)
- 75 million customers (40% cooperative banks, 60% savings banks)
- DM 4.68 trillion banking assets (28% cooperative banks, 72% savings banks).

*The conclusion:*

- Microfinance is not a poor solution for poor countries.
- Savings-driven microfinance institutions in cooperative or community ownership are equally feasible in rural and urban areas.
- If properly regulated and supervised, they have great potential in poverty alleviation and development, both in rural and urban areas.

### **Crisis matters**

Crises play a crucial role in the development of financial systems and institutions.<sup>9</sup> The beginnings of any movement are usually flawed, and innovations are usually crisis-driven. Eg, the crisis of charities in Ireland and subsequently in many other European countries led to the emergence and rapid spread of financial intermediaries, which collect interest-bearing deposits and convert them into interest-bearing loans. In Germany, the collapse of savings and credit cooperatives during the 1880s and again during the 1920s led to effective regulation and supervision. The collapse of numerous rural banks in the Philippines during the early 1980s, which had relied on cheap government funds, led to a strengthening of their deposit base and more professional financial management. Similarly, in Indonesia, the oil crisis of the early 1980s led to the reform of what is now the BRI Microbanking Division; and the Asian financial crisis of 1997 Indonesia produced a healthy rural banking sector. Vast numbers of institutions gained their strength only out of a total reform in response to technical bankruptcy, such as Bank Rakyat Indonesia in 1983, Centenary Rural Development Bank in Uganda in 1992, and Commercial Microfinance Equity Building Society in Kenya in 1993. Crises must therefore be allowed to happen, instead of being prevented by government or donor interventions:

- Many MFIs in crisis are kept alive, and prevented from reform, through donor support.
- MFIs which fail to respond to crises constructively must be allowed to falter.
- Learning from experience means: responding to crisis with innovations.

### **Development matters**

Microfinance is frequently considered as a panacea, intended to sustainably alleviate poverty and produce development. This ignores the interrelatedness of economic development and poverty alleviation in virtually all countries since the industrial revolution. In recent years, all major donors have been emphasizing poverty alleviation as if this could occur without development. A functioning financial system is a prerequisite of sustainable development, and microfinance a prerequisite of poverty alleviation. Financial institutions must be in place if development is to occur; but sustainable poverty alleviation hinges ultimately on economic development on a broader scale. This applies first of all to national economies, where only economic development and the development of the financial system together will lead to poverty alleviation. This also applies to the village economy, where microfinance services for the poor will not suffice in generating development. If a village does not develop as a whole, microfinance services to the poor may ensure their survival and improve their livelihood, but will not transport them sustainably across the poverty threshold. Targeting the poor or very poor or poor women only and excluding the non-poor prevent village development, diminishing the chances of employment, self-employment and economic growth of the poor .

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<sup>9</sup> Historically, there is an inverted relationship between business cycles and cycles of innovation. Peaks of innovation are generally preceded by economic recession and crisis. (G.Mensch, Innovation und industrielle Evolution. Berlin 1974)

## Culture matters

Cultures are immensely complex and influence institutions and behavior, but not in simple and determinate ways. Social, political, economic and religious culture are all intertwined, but to a certain extent may co-vary. Eg, there are marked differences between (a) stratified, centralized, hierarchical, or closed societies, which tend to be oriented towards status, social stability, tradition and obedience; and (b) segmentary, decentralized or open societies, which are oriented towards individual achievement, competition and social mobility. The differences between such societies are mirrored in closed vs. open organizations, which were the object of much research during the 1960s and 1970s. In many African countries, hierarchical and segmentary societies exist side by side. Yet, culture is not among the topics discussed in the microfinance community – as if the CGAP-inspired belief in *best practices* (rather than good practices!) ruled out culture as a determinant of variation in rural and microfinance.

That financial institutions have their own corporate culture and that such cultures widely differ goes almost without saying, taking for example the cultures of the Grameen Bank in Bangladesh with its group lending approach, headed by a leader venerated as charismatic, as opposed to the BRI Microbanking Division in Indonesia or Centenary Rural Development Bank in Uganda, which both do very well with individual lending in terms of profitability and outreach to the poor and have no venerated leader. But the influence of a national or ethnic culture on rural and microfinance (probably less so on commercial banks) is another matter. There is one obvious exception: the influence of religion in a number of Islamic countries, where banks (as in Iran and Sudan) and microfinance institutions (as in Jabal al-Hoss, Syria, see **Box** ) adhere to Islamic banking.

During the 1950s and 1960s, social scientists revisited Max Weber's classical study about *The Protestant Ethic and the Spirit of Capitalism*. Interest in culture might have been due the the struggle between communism and capitalism and the emergence of Japan as yet another culture with a different corporate ethic; but that interest seems to have been eliminated by the apparent convergence of the 1990s.

In my own first studies during 1967-68 of informal finance among all 17 ethnic groups of Liberia, I found that hierarchical societies like the Kpelle tended to form well-organized savings and credit associations with regular meetings, while segmentary societies like the Krahn are more individualistic and unstructured in their approach to savings and credit (Seibel & Massing 1994). In a more systematic comparative study of the hierarchical Igala and the segmentary Tiv in central Nigeria during the mid-1980, Marx, Mönikes & Seibel (1988) arrived at similar results, but also found that the Igala oppose experimentation and change, preserving the prerogatives of their elite; while the Tiv experiment with a variety of financial institutions and are oriented towards competition, growth and progress. The main conclusion was that according to culture, there are two fundamentally different approaches to development, a finding which differed at the time from conventional wisdom:

- **Development from above**, through the established authorities, is more effective in hierarchical or closed societies, which are oriented towards status, tradition and the preservation of stability
- **Development from below**, through participatory processes, is more effective in segmentary or open societies, which are oriented towards competition, experimentation, individual achievement and social change

During the 1980s, GTZ supported a dialogue on sociocultural factors of development; but this did not focus specifically on financial systems and institutions. At the time it seemed more important to work on the fundamentals of rural finance (Schmidt & Kropp 1987) than cultural differences. The topic has rested, perhaps long enough. Given the consensus on fundamentals in the microfinance community, has the time come to revisit culture?

### 3. What matters at the level of financial systems?

#### Financial systems matter

The importance of financial systems in development has long been ignored in the development literature, assuming that capital mattered, but not financial institutions and systems as such – until McKinnon (1973) and Shaw (1973) demonstrated their crucial role. Subsequently, the World Development Report 1989 focused on *Financial Systems and Development* (including attention to informal finance, but not rural finance). They comprise a legal and regulatory framework, a financial infrastructure of different types of financial institutions organized in different networks with various apexes for liquidity exchange, supervision, training and information dissemination, and sound practices. A full and adequate range of financial services can only be provided in the framework of a functioning financial system, not by isolated providers. Well functioning financial systems, including rural finance, must be in place – weathering crises and evolving over time - if sustainable development and poverty alleviation are to occur. Governments and donors have to realize that financial systems, (rural) microfinance institutions and networks of MFIs are no quick-fix solutions; they evolve over long periods of time, as in Europe since the 17<sup>th</sup> and 18<sup>th</sup> century; or in Indonesia where the first rural MFI was established in 1895. Donors can contribute to that evolution, but only in a long-range perspective, and in a coordinated goal-oriented manner. The evolution of a stable and sustainable system must have primacy, not the protection of sick institutions by government as in Japan, Indonesia and many other countries.

#### Capital matters...

The success of the Marshall Plan in the reconstruction of Europe after World War II inspired the newly emerging multilateral and bilateral donors to use capital transfer as main instrument of development. Capital transfer became a core element in the modernization theory of the 1950s and 60s. To implement the transfer at national level, development banks – including agricultural development banks (AgDBs) - were established in virtually every developing country. On the basis of expert advice provided by donors like the World Bank, capital transfer came with a special financial technology: channelling funds at subsidized interest rates to target groups and for purposes as decreed by government and donors, without offering deposit facilities. Each development bank was capitalized by donors and placed under a separate law, which exempted it from prudential regulation and supervision. The main functions of capital transfer from abroad should be:

- bridging temporary shortages in loan capital through credit lines, eg, of the BRI village units in Indonesia during their early expansion phase<sup>10</sup>; or, currently, of some 160 MFIs in the Philippines, to initiate Grameen banking services to rural poor;
- investing at the donor's own risk in deposit-taking rural financial institutions, providing leverage for the mobilization of savings;
- strengthening at the same time the capacity of domestic institutions to generate their own resources: loanable funds through savings mobilization and equity through retained earnings (*profits*).

#### ... but capital transfer has undermined rural finance and development

This combination of sole reliance on external resources, interest rate subsidization and outside administrative control led to a situation of misallocation of scarce financial resources, widespread corruption and a rising burden of external debts not matched by productivity increases. Redtape and inefficiency were extreme – and in many cases continue to be so

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<sup>10</sup> Bridging temporary shortages of loanable funds was the intention of a World Bank loan to BRI's rural microbanking units reformed in 1984. But when the loan came through in 1989, the unit desa network, which had turned out to be highly productive, was already self-reliant in funds. Hence, BRI used the loan for other, unproductive, purposes and, with the Asian financial crisis and the resulting devaluation of the Rupia, saw its domestic value reduced to about 20%.

**(Box ).** The AgDBs not only failed to reach their objectives (increased agricultural production and incomes, outreach to the poor), they also were a drain on public resources, requiring annual budgetary allocations. Capital transfer for directed credit has not only undermined AgDBs and other development finance institutions, but the health of the financial system and the economy as a whole. In many countries, capital transfer has made the country poorer, the AgDBs insolvent, and the farmers, who established a track record of defaulting, unbankable (Box B4 ).

**Box 4: The widow who started big with a loan from ACC in Jordan... and failed for a lifetime**  
*Rajwa Thniebat* is a 50 years old widow in the area of Karak in Jordan, with five children. Her husband died 10 years ago. In January 2000, she received a collateral-free loan of JD 2,100 (US\$ 3,000) from the IFAD-supported Income Diversification Project of the Agricultural Credit Corporation, repayable over 8 years. She bought 20 sheep, which have increased to 24, and went into dairy production. By September 2001, she had sold only 2 kg of goat butter and 6 kg of jameed cheese. *Everybody produces jameed and butter, there is no market*, she says. She has made two payments of JD 30 each, which covers less than the interest due. ACC keeps writing letters and visiting her, but to no avail. With a loan of JD 200 for 8 months, less than one-tenth of the actual loan amount and period, Rajwa could have purchased the equipment and bought milk from sheep farmers for dairy production instead of raising sheep. This would have given her the opportunity of testing the market and her entrepreneurial skills at a manageable risk. Now she is stuck with a bad loan and ineligible for another to go into a more profitable line of business. It was the loan terms imposed on her that made her start big - and fail big. She would like to apply for a loan to buy a sewing machine at a cost of JD 120; but she is a defaulter, and the amount is too small to be financed from an ACC loan.

With loans like to one to Rajwa Thniebat and a lack of institutional autonomy, many of the AgDBs in Africa and Latin America have collapsed, despite donor technical assistance as in the case of the Cooperative Bank of Uganda (by USAID) or Fonader in Cameroon (by GTZ). Many of the remaining ones are technically bankrupt. Lessons have been learned as to what it takes to generate and allocate theoretically unlimited amounts of capital from domestic resources; but under disbursement pressure,

- governmental, non-governmental and multilateral donors continue to provide credit lines in substitution of domestic savings;
- thereby undermining the growth of self-reliant financial institutions.

### **Savings matter - but only under conditions of macroeconomic stability**

In most European countries, once the new MFIs started mobilizing savings, they quickly experienced an abundance of deposits, demonstrating beyond doubt that the poor not only can save, but that depositing and accumulating savings in a safe place is one of their basic needs. Similarly many informal (non-rotating) savings and credit associations accumulate capital beyond their management capacity. A few have evolved into formal institutions; most however distribute the paid-in capital and the profit among the members at year's end and take a fresh start. Savings matter at three different levels:

- as a service to the poor, who need to deposit and accumulate their savings in a safe place, for consumption, the self-financing of investments and insurance purposes
- as a source of loanable funds and a basis of self-reliance for (rural) financial institutions
- as the main source of domestic capital in the national economy.

However, there is a **qualifier**: at the household level, financial savings only matter if there are positive real returns, ie, if the interest rate on deposits exceeds the rate of inflation. Otherwise, the value of the savings are eroded. In this case, people will save in kind and assets. From a development viewpoint, this is not efficient, as it will not contribute to the growth of the financial system and the economy.

The pervasiveness of the need and ability to save is one of the lessons taught by history, but time and again forgotten and not easily learned by development agencies. The importance of domestic resources and the savings potential of the poor and the non-poor is one of the great rediscoveries during the 1980s and 90s. When government-owned BRI, a century-old AgDB in Indonesia, introduced an attractive savings product with positive real returns at village level in 1983, this became the foundation of unprecedented growth of what is now one of the largest microfinance institutions in the developing world: with 27 million savings accounts, a saver-to-borrower ratio of 10:1 and excess liquidity of \$1.5 billion - even during the Asian financial crisis when donors flocked to Indonesia to help the poor with credit lines. Similarly, when Misereor helped Yayasan Purba Danarta, an NGO in Semarang, to establish Bank Purba Danarta in the early 1990s as a commercial bank offering both savings and credit services to the poor in Central Java, it was inundated with savings, at a saver-to-borrower ratio of 20:1. Centenary Rural Development Bank in Uganda, a trust transformed into a bank for the rural poor, has 280,000 savers and 22,000 borrowers (**Box**). Rutherford (2000) describes the many ways in which the poor save. Seen from another perspective: in numerous developing countries including the Balkans<sup>11</sup>, the banking system is overliquid; ie, it mobilizes more savings in urban and rural areas than it is able or willing to lend.<sup>12</sup>

Yet, all over the developing world,

- savings continue being “the forgotten half of rural finance” (Vogel 1984).

Donors tend to ignore savings at institutional and sectoral levels. A striking example (one of many!) is the World Bank’s Second Coffee Improvement Project (SCIP II), 1990-1997, in Kenya, where the Nordic Countries have been trying to build self-reliant cooperatives since the 1960s:

“The savings of coffee farmers are far higher than their borrowings... (but) are not used as the source of funds for coffee loans and this is mainly because cheaper donor funds are available through SCIP II.” Instead, the emphasis of the World Bank and Coop Bank, through which the SCIP loans were channelled, should have been on “promoting local self-financing and increased rural SACCO institution building,” (PriceWaterhouse 1997: 76-82)

**Table 2: Savings and credit in rural SACCOs/UBSs in Kenya, June 1993-1996 (in mn Ksh)**

	1993	1994	1995	1996
Total savings	939	1312	1880	2345
Total credit	482	396	509	591
In % of savings:	51%	30%	27%	25%
Excess liquidity	457	916	1371	1754
<i>SCIP II loans disbursed:</i>				
Cherry Advance Payment System	288	256	826	211
Farm Input Loan Scheme	363	426	860	639
SCIP allocation for CAPS+FILS			1122	1430
in % of excess liquidity of SACCOs/UBSs			82%	82%

### **Savings and credit matter – but which one comes first?**

Both savings and credit matter, for investment as well as consumption-smoothing. From a client perspective, there is little difference as Rutherford (2000) as shown. In both cases, payments may be made in regular, monthly or weekly, instalments. In the case of a loan, the lump sum is received at the beginning of a stipulated period; in the case of savings at the end. The primacy of savings-first vs. credit-first depends on the rate of return: savings-first for subsistence and low-return activities, particularly in agriculture, credit-first for high-return

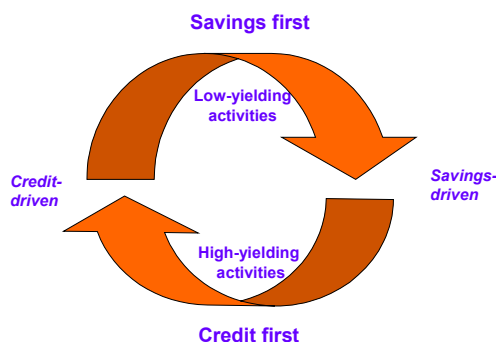
<sup>11</sup> After the chaos: a survey of finance in Central Europe. The Economist, September 14-20 2002.

<sup>12</sup> Among the reasons –rarely addressed by donors – are excessive liquidity and minimum capital requirements and risk-free high returns on treasury bills.

activities such as trading, agricultural processing and other microenterprises, with returns considerably above the interest rate (compensating also for borrower transaction costs).

Graph 1

### The household cycle of savings & credit



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Donors may contribute to speeding up the savings & credit cycle, with growing amounts of savings and credit. However, the autonomy of households has to be respected, particularly concerning their basic orientation: Security-oriented households will tend to increase the share of self-financing through savings; entrepreneurial households will tend to increase the share of external financing, compensating the higher risk with higher expected earnings. However, among the poor and particularly the very poor, the transition to risk-taking on a larger scale is a difficult one, as a recent IFAD (7/2002) evaluation among the Grameen clients of various types of MFIs has shown.

### Financial intermediation matters

There has been a long-standing tradition of donor support - with equity, credit lines and technical assistance - to credit institutions, including AgDBs and credit NGOs. Yet, as long as they remain credit institutions, they are not self-reliant, they are rarely viable, and their outreach remains limited. On the other hand, savings institutions without credit services either have little appeal if the interest rate is not attractive, as in the case of many post office savings banks; or they may have difficulty in investing them profitably. Regardless of their temporary preference, customers require both savings and credit services. CARD Rural Bank in the Philippines realized the limitations of deposit mobilization when it started collecting savings from the non-poor, without giving them access to loans, in order to generate loan funds for poor women. The solution is financial intermediation, ie, the transformation of many small amounts of savings into a few large amounts of credit: a type of finance which emerged in Europe towards the end of the 15<sup>th</sup> century and spread rapidly. Financial intermediation benefits the customers, institutions and the financial system as a whole, whose growth is driven by the growth of financial intermediation. Institutions, which offer both services, benefit twofold:

- they generate their loanable funds on a sustainable basis and at a lower cost;
- they benefit from economies of scope; ie, the additional transaction costs of the second type of service are substantially lower than those of the first.

The Microbanking Division of BRI in Indonesia (**Box** ) and Centenary Rural Development Bank in Uganda (**Box B5** ) are two institutions which have successfully focused on financial intermediation in 1984 and 1992, respectively, with substantial gains in outreach and profitability.

**Box 5: Centenary Rural Development Bank, Uganda: a trust transformed into a financial intermediary**

Centenary RDB is a commercial bank that provides deposit, credit and money transfer services indiscriminately to men and women of lower income. By insisting on loan recovery and cost coverage, it has reached more men and women in rural areas than any other institution in Uganda. With minimum deposits of \$6 and minimum loans of \$30, access barriers are low. 11 of its 16 branches, 73% of its deposits and 82% of its loans are in rural areas. Established by the Catholic Church of Uganda as a trust fund in 1983, it developed a strength in savings mobilization but performed poorly as a financial intermediary. In 1990, the political will to reform the fund evolved in the board, resulting in the fund's transformation into a commercial bank in 1993. With donor support, the bank evolved into the most successful financial intermediary in Uganda. This has made the bank the **African flagship of rural and agricultural banking**, combining sustainability with outreach to the rural poor and demonstrating the feasibility of agricultural lending. With equity capital of \$6.8m and total assets of \$49.85m as of December 2001, it has mobilized \$39.9m from 280,00 depositors, provided \$14m in loans outstanding to 22,000 small borrowers, earned returns of 4% on average assets and 28% on equity, and, since 1999, finances its expansion from its profits.

*Source: Seibel & Almeyda 2001a*

**Financial sector policy matters**

Conducive policies not only provide a framework for the development; in many cases, they generate development. According to a World Bank source, the institutional and policy framework forms the “macro-level social capital” of a society (Quinones & Seibel 2001: 195). At the macroeconomic level, exchange rate deregulation, liberalization of agricultural prices, and the deregulation of foreign trade are essential. Eg, if the national currency is overvalued and allows for the importation of agricultural products at artificially cheap rates – favored by many politicians who live on the granting of import licences –, local crops and livestock are not competitive, farmers revert to subsistence production and are unable to save, and rural financial intermediaries have no market. The two most important instruments of financial sector policy are:

- Interest rate deregulation, allowing each institution to determine interest rates on deposits and loans
- Institutional deregulation, permitting local, national and international investors to establish financial institutions and branches.

A prominent example is Indonesia, which deregulated interest rates on time deposits and loans as instruments of monetary control in 1983; removed restrictions on the establishment of domestic and foreign banks and bank branches in 1988; substantially reduced rural directed credit programs in 1990, phasing out interest rate subsidies; and enacted a new banking law in 1992 with authorization for only two types of banks: commercial banks and rural banks (BPR). This resulted in a massive increase in the number of financial institutions and in the volume of deposit mobilization and lending.

As the experience in the Latin American southern cone has shown in the 1980s, there is a prerequisite for financial deregulation which McKinnon (1973) had overlooked: macroeconomic stability. Under high and volatile inflation rates, the financial sector cannot develop. Without macroeconomic stability, deregulation might lead to the collapse of the financial system.



**Box 6: How policies work: Deregulation and financial deepening in Indonesia**

In response to the change in the policy environment, banks engaged in vigorous campaigns of savings mobilization and credit delivery at market rates of interest. To attract deposits, banks competed with each other by offering a variety of savings products with different terms and highly positive real returns. From 1982, the last pre-deregulation year, to 1996, the last pre-crisis year, savings and time deposits (excluding demand and foreign exchange deposits) increased 67-fold in nominal and 21-fold in real terms. Savings deposits, which are mostly held by low-income groups, grew 126-fold in nominal terms and 39-fold in real terms, indicating that the poor do save and respond to incentives to save.

During the same period, 1982-96, the ratio of  $M_2/GDP$ , a standard measure of financial deepening, increased from 17.5% to 54.2%. The shape of the curve presents visual evidence that policies work: The curve shows a definite incline after 1984, the first full year after interest rate deregulation. 1986 is the year of a major devaluation of the Rupiah, resulting in some leveling-off of the curve. This is followed by a sharp incline of the curve after 1988, the year of banking liberalization. In 1990 it started to level off when Bank Indonesia pulled the tight money policy brakes.

**The legal framework matters**

In a conducive policy environment, the next thing that matters is the legal framework as part of the regulatory environment. Banking and microfinance laws can make or break the development of rural financial institutions, as shown above in the historical development in Germany and Ireland, respectively. In many cases, the passing of an appropriate law (with provisions for prudential regulation and supervision) suffices to attract private capital for the establishment of large numbers of financial institutions. In most countries, such laws are absent. The Philippines (1952), Indonesia (1988) and Nigeria (1990) are countries where rural or community banking laws have led to the emergence of up to 2,000 privately capitalized rural banks. In the Philippines, the central bank has also enabled moneylenders to register as *Private Investors*, which has increased their outreach and brought down their interest rates. In Vietnam, where some 7,200 cooperatives had collapsed after the introduction of the market economy, a new law in 1990, together with highly effective supervision by the central bank, has led to the emergence, within four years, of over 1,000 cooperative *People's Credit Funds*. All these institutions have their own networks and apexes. Such laws have also provided a framework for the upgrading of informal financial institutions.

Ill-conceived laws can hamper the development of rural and microfinance. Examples are the Loi Parmec in West Africa, which restricts the establishment of regulated microfinance institutions to cooperatives and puts a cap on interest rates, preventing private capital owners (eg, *les grands planteurs*) from investing in individually owned rural banks; the microfinance law of Morocco, which bars MFIs from deposit-taking, depriving rural clients from a service and the MFIs from a source of capital; and the microfinance law of Ethiopia, which until recently fixed the interest rate and limited the technology to group lending.

## Interest rates matter

Interest rates on loans and deposits and the margin between them are of crucial importance to the viability of financial institutions. Many socialist countries have prevented the growth of their financial sector and have strangled their financial institutions with an inverted interest rates structure, with deposit rates exceeding lending rates. As shown above, the deregulation of interest rates in Indonesia has led to an upsurge of savings and credit; it has also been at the root of the transformation of BRI into one of the world's largest rural financial intermediaries.

It is of crucial importance that all interest rates are positive in real terms, ie, above the inflation rate, lest the poor, most of whom are net savers, are robbed of the value of their savings. Inflation imposes an inflation tax on all consumers – to the benefit of the state (“the biggest thief”). This is deplorable not only from an economic, but also from a moral viewpoint, as in countries with Islamic banking, where many depositors refuse to accept interest rates. In Iran for instance, with inflation rates of 20-50%, the state has thereby imposed a usurious negative interest of 20-50% on deposits, among them vast numbers of the rural poor as customers of Bank Keshavarzi.

For a fair and effective interest rate regime, calculations have to start with deposit rates above the inflation rate, calculate financial costs on that basis and add administrative and risk costs. The practitioner may be guided by the following example of BRI Microbanking Division the microfinance benchmark institution, with three-year averages for 1994-96 (CGAP/GTZ, 1997: 24):

Inflation rate:	8%
Interest expense on deposits:	9.7%
Average real return to depositors:	1.7%
Total operational costs:	6.5%
Salaries and allowances	2.9%
Office and other costs	2.1%
Provision for loan losses	0.8%
Supervision cost	0.8%
Interest and other operational income	21.9%
Profit	5.5%

To arrive at this result, BRI pays 13% interest on SIMPEDES, its most attractive deposit product, of which 11.5 % is paid directly to the depositor and 1.5% into a lottery. On KUPEDDES, its unique microcredit product with monthly instalments and no grace period, it charges 2% flat per month, which equals 43% effective per year, but pays back a quarter of the interest charges if all payments are on time (as is the case among 95% of borrowers).

Average interest rates of different institutions and countries cannot be directly compared as they are contingent upon average loan size and the cost structure, include the costs of special services (such as doorstep collection).

In Thailand, a more advanced country with much larger loan sizes (\$2,042) and extraordinarily high efficiency, BAAC (with a borrower outreach to 88% of all farm households) charges only 12%, but would require 14-15% break even.

In the Philippines, some 162 Grameen replicators, among them rural banks, cooperatives and NGOs, charge effective interest rates on very small loans of around 50-80% (and substantially more if compulsory savings and various deductions are calculated)<sup>13</sup>. Centenary RDB in Uganda charges close to 50% effective p.a., but brings this down to almost 30% on *automatic loans* of successful repeat borrowers. In contrast, in many countries, there are

<sup>13</sup> GTZ, in its financial sector study of 1998, calculated the effective annual interest of first cycle Grameen loans, including all fees and deductions, of CARD Rural Bank and NGO at 167%.

donor-supported credit NGOs which charge even higher interest rates, but fail to break even. In SHG-based informal financial institutions, I have observed, between 1967 and 2002, self-imposed interest rates around 10% per month – up to 10% on one-day loans to petty-traders, who still make a substantial profit.

These observations lead to the following conclusions:

- Rural market rates of interest must vary widely between institutions and countries, reflecting cost of funds, risks and services
- High interest rates force the borrower into investments with high returns
- Net returns on 6-months microloans are frequently a multiple of the amount borrowed, which explains why borrowers are concerned about access to loans, not the interest rate.
- The worst mistake a donor or government can make is placing a cap on interest rates, cutting down on viability and outreach, robbing savers and investors of the value of their resources, and ultimately eliminating the MFIs
- Bringing down interest rates is an internal matter within institutions, mainly as a result of increased efficiency under conditions of competition.

### **Institutions matter (projects don't)**

Institutions are the social capital <sup>14</sup> of a society. Their advantage lies in the continuity and efficiency of their services; institutions reduce transaction costs. Financial institutions fall into three sectors:

- the formal financial sector, which falls under the banking law and the regulation and supervision of financial authorities
- the semiformal financial sector of institutions officially recognized but not regulated
- the informal financial sector of institutions which are regulated through local norms and traditional law, but are not officially recognized nor regulated by the state.

The competitive advantage of each sector and type of institution depends on the conduciveness or hostility of the policy environment, on the appropriateness of the legal framework, and on the costs of regulation and supervision. Conducive policies and appropriate legal forms have led to the elimination of most types of nonformal financial institutions in the developed world,<sup>15</sup> but not so in developing countries.

The most important rural financial institutions are – varying greatly in importance by country – AgDBs and their branches, rural banks, savings and credit cooperatives, and NGOs. In many countries, where 60-80% of the population is rural, their offices number in the hundreds or thousands (and more than 100,000 in India and China); but their share of total assets of all financial institutions is mostly below 5% - an enormous market for expansion of outreach and financial deepening. Donors may:

- support the development of a differentiated financial infrastructure with competitive institutions organized in networks;
- support the expansion of sustainable rural financial institutions and their outreach to the rural poor
- provide opportunities and incentives for upgrading nonformal to formal institutions, as these are the only ones with an unlimited growth potential within integrated financial markets;

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<sup>14</sup> Social capital is defined as the shared normative system of a group or organization which shapes the capacity of people to work together and produce results according to the group's or organization's purpose. (Seibel 5/2000)

<sup>15</sup> Informal finance in the developed world is mostly marginal, as in the form of savings clubs in German pubs, but not always entirely insignificant, as in the case of loan sharking among the poor in the US and Italy.

- **abstain from perverse incentives** which enable NGOs, AgDBs and other financial institutions to maintain unviable and unsustainable operations.

### Competition matters

Competition is the main driving force of institutional efficiency and outreach to different segments of the market. Competition leads to lower transaction costs, lower interest rates, a wider range of financial products, better services, and services to poorer sections of the population. An emphasis on the creation of a competitive environment entails:

- institutional diversity (eg, financial cooperatives, rural banks, AgDB branches)
- pressure to perform, implemented to effective supervision and enforcement of standards
- procedures of bankruptcy for non-performing institutions.

In many cases, donors have done just the opposite: they have prevented diversity by supporting, during a given period, a single type of institution (eg, Grameen banking, credit NGOs, AgDBs); supporting non-performing institutions over extended periods of time; and preventing the closure of terminally ill institutions. A good example is the Kenya Women Finance Trust, which is doing reasonably well and, over twenty years, could easily have evolved into a self-reliant profitable bank, as some of its competitors did (*Box* ).

#### **Box 7: How donors undermine competition: the case of KWFT**

The Kenya Women Finance Trust, founded in 1981, received donor grants of \$9.8m over the last ten years and attained a remarkable degree of outreach and, compared to the industry average, an excellent level of repayment performance. By September 2001, it had 50 delivery units, over 40,000 members and 26,700 active borrowers, mostly poor women, with Kshs 350m loans outstanding. The repayment rate is 96%. Its portfolio of outstanding loans amounts to \$4.7, though it received double the amount in grants. With an operational self-sufficiency ratio of 91% (up from 48% in 1996), it still does not cover its operational costs – despite the fact that it does not incur financial costs, as all its loanable funds are grant money. Its core problem is the lack of a legal status which would allow for deposit mobilization. Without this authorization, KWFT has been unable to adequately respond to its clients' demands for deposit facilities. As donor funds continue to flow (eg, from IFAD), there is no need for KWFT to turn into a bank and stand on its own feet. (IFAD 3/2002)

### Prudential regulation matters

Prudential regulation of financial institutions, defining standards of performance for different types of institutions, is of crucial importance for their health and growth. Through massive support to unregulated institutions like development banks and NGOs, donors have historically prevented undermined. In recent years, the need for regulation has been recognized on principle.

Yet, donors have been reluctant to insist on regulation. In various countries, there has been a number of factors militating against the regulation of MFIs:

- regulation (frequently not enforced) has not prevented the collapse of commercial banks;
- corrupt governments may use regulation to gain undue influence on MFIs;
- imprudently applied commercial banking standards (such as excessive minimum capital and liquidity requirements) may have a stifling effect on microfinance;
- inappropriate commercial banking regulation (such as interest rate controls) are imposed on MFIs; and
- central banks lack experience in rural and microfinance, are remote from the realities of rural and microfinance, are subject to biased advice by a single donor or consultant, and may pass inappropriate regulation (as in Morocco, where MFIs are barred by law from deposit-taking; or in Ethiopia where they were restricted to Grameen-type group lending at controlled interest rates).

But as many donors – including the World Bank, regional development banks and bilaterals - continue to provide funding regardless of the existence of prudential regulation or regulatory initiatives, progress has been slow. It is only recently that systematic and coordinated attempts are made by donors to introduce prudential regulation for MFIs, as in Uganda where GTZ and Donors work closely together with other donors.

While there is agreement, theoretically, on the importance of prudential regulation, there is one major unresolved issue in the rural and microfinance community: whether regulation should apply to all MFIs or deposit-taking institutions only. There are two positions:

- *Deposit-taking MFIs only*: “The basic principle of regulation and supervision is that its overriding objective is to protect the financial system from unsound practices by deposit taking institutions and thereby... to protect small and uninformed depositors”. (R. Vogel)
- *All MFIs*: “The financial system as a whole needs to be protected, including small investors, and not just the small and uninformed depositors. The overriding objective of regulation and supervision is to protect the stability of the financial system as a whole and prevent a loss of confidence which may result from the breakdown of ANY financial institution - be it a lending, deposit-taking, insurance, leasing, investment or universal banking institution!”

Very small institutions, including large numbers of IFIs, may be excluded from compulsory regulation. For small institutions, regulation should be voluntary and promoted through incentives, as described above for IFIs. In any case, the tendency to evade regulation would be much reduced if there strong positive incentives to join the community of regulated institutions and if donors ceased to offer perverse incentives.

### **Effective supervision matters**

Regulation and supervision are usually seen together. But experience has shown that prudential regulation together with a weak and ineffective supervision system do not suffice. Rarely have donors paid attention to effective supervision in addition to prudential regulation; I am not aware of any case where this has been a conditionality for support to the financial sector. What is required is effective supervision, carried out by organs of supervisions with teeth to bite, ie, with the willingness and ability to close down non-performing institutions, or enforce their restructuring or consolidation. The Philippines is one of the countries where the central bank has been quite rigid in imposing standards; this has led to a consolidation of commercial and rural banks and has exempted the sector from the worst consequences of the Asian financial crisis.

The sector where this ability and willingness has been notoriously absent is the cooperative sector; this has been the main factor in the downfall of cooperatives in developing countries – just as effective supervision has been a dominant success factor in countries like France, the Netherlands and Germany. Vietnam is one of the few developing countries where a new breed of cooperatives, the so-called People’s Credit Funds, have been effectively and successfully supervised by the central bank through its branches.

In the commercial and rural banking sector, the importance of effective supervision and enforcement has been largely overlooked. This explains why many banks in developing countries have collapsed. Eg, Indonesia was one of the model countries of prudential regulation during the first part of the 1990s – until the outbreak of the Asian financial crisis, which demonstrated the weakness of effective supervision in many Asian countries. South Korea was one of the few countries which quickly reacted, cleaned up their banking sector, and went back on the path of growth. Indonesia and Japan did not. These two countries have

shown that the mere existence of structures of supervision does not suffice; there also has to be the political will to enforce:

- Without the fundamentals of prudential regulation and effective supervision, including the political will to enforce standards, much of donor support to financial institutions is wasted.
- Governments and donors must enforce the restructuring or closing of nonperforming financial institutions, instead of preventing it through bail-outs. Bankruptcy matters!
- Bilateral donors, in cooperation with their supervisory organs at national and network level, should focus on strengthening capacities of regulation and effective supervision
- Special assistance should be given to the financial authorities in charge (bank superintendency or central banks) and, within the framework of systems of delegated supervision, to the networks and auditing apexes of the various types of financial institutions including rural banks, SACCOs, MFIs and development banks

### **Knowledge matters**

There is an immense and rapidly growing body of experience in rural and microfinance; particularly during the past decade, many developing countries have seen an explosion of rural and microfinance institutions. This has been paralleled by training, exposure visits and exchange of experience through conferences at national, regional and international levels. CGAP has played an important role in condensing the accumulated experience in operational manuals. But the wealth of highly variegated institutional experience has largely escaped knowledge management, at the level of donor organizations, countries and regions. Knowledge management in rural and microfinance and associated training and exposure opportunities will present a big challenge for some time to come.

#### 4. What matters at the level of institutions?

##### Institutional reform matters

**Bank Rakyat Indonesia, the big bang reformer:** There is now an increasing number of cases of institutional reform, some of them spectacular, the hardest to reform being the agricultural development banks (AgDBs). The flagship of AgDB reform is the Microbanking Division of government-owned BRI. In the early 80s, repayment rates of its 700,000 rural borrowers were around 50%, despite heavily subsidized interest rates (around 10%). Reform came with a big bang, when interest rates were deregulated in 1983 and the bank was given the option of closing its more than 3,000 rural units or standing on its own feet. With TA from USAID/HIID since 1984, it introduced an attractive savings product at 11.5% interest paid to savers, offered non-targeted individual loans with monthly instalments and no grace period at 2% flat p.m., equivalent to 44% effective p.a., and provided powerful incentives: savers participated in a lottery; borrowers received a refund of 11% if they repaid all instalments on time (reducing the effective annual rate to 33%); branches became profit centers; and staff received substantial performance incentives. This made the Division one of the world's largest and most profitable rural institutions. **(Box B8)**

##### **Box 8: BRI Microbanking Division: How a reformed AgDB revolutionized rural finance**

The case of BRI is evidence that, in a deregulated policy environment, a government-owned agricultural development bank can (a) be transformed into a highly profitable, self-reliant financial intermediary, and (b) turn into a major microfinance provider, offering carefully crafted microsavings and non-targeted loans from low-income people at market rates of interest. Making good use of government seed money and a World Bank loan during an initial phase, it has fully substituted, since 1989, savings deposits for external loans as source of funds.

Within a six-year period, 1984-90, BRI became a model case in Asia of the transformation of an ailing government-owned AgDB into a viable and self-sufficient financial intermediary with ever-increasing financial resources and numbers of customers, competing successfully with an array of other local financial institutions. Further strength was added to BRI's microfinance operations during the Asian financial crisis: When the Indonesian banking system collapsed, BRI's Microbanking Division remained profitable. At the peak of the crisis, 6-8/1998, it attracted 1.29 million new savers during that three-months period alone, while demand for credit, because of perceived uncertainties, stagnated. This generated excess liquidity in excess of \$1bn.

With an outreach of 26m million savings accounts and 2.7 million active borrowers (12/2000) through a network of 3,700 village units operating as profit centers, BRI covers its costs from the interest rate margin and finances its expansion from its profits. Its performance is outstanding, with a past-due ratio of 2.5%, an annual loss ratio of 1.1%, operational self-sufficiency of 413%, financial self-sufficiency of 135%, return on assets of 5.4%, self-reliance (Deposits to Loans) of 244% and an efficiency (Administrative costs/Average loans outstanding) of 8.4%. With their non-targeted rural finance operations, the BRI Microbanking Division has weathered the Asian financial crisis well, as the only profitable government banking operation in Indonesia. (Seibel & Maurer 2001)

**Bank for Agriculture and Agricultural Cooperatives, Thailand, the gradual reformer:** BAAC is an example of gradual learning and reform. It has gone through four major phases: 1966-74, laying the foundation for individual lending to farmers through joint liability groups; 1975-87, expanding its lending operations through access to commercial bank and donor funds and consolidating its operations by reducing loan channeling through cooperatives; 1988-96, striving for viability and self-reliance, under conditions of controlled interest rates, through savings mobilization, improved loan recovery and increased staff productivity; since 1997, adjusting to prudential regulation by the central bank and diversifying into non-agricultural lending. The result of gradual reform has been the largest relative outreach by any AgDB: 88% of farm households, combined with institutional viability. In 3/2000, it has 5m borrowers with \$5.7bn loans outstanding, 8.3m savers with \$4.5bn deposits, a past-due rate of 16.5%, operational self-sufficiency of 228% and financial self-sufficiency of 98%. (Maurer et al., 2000)

**Centenary Rural Development Bank, Uganda, reformed through individual lending:** CRDB was established in 1984 by the Catholic bishops of Uganda as trust fund for the rural poor. With assistance from IPC, a German consulting firm, it was transformed in 1993 into a commercial bank and turned into an African flagship of rural and agricultural banking, with a saver outreach of 280,000, a borrower outreach of 22,000, and high profitability (**Box .. above**). Its success is based on an individual lending technology package described below (see: *Lending technology matters*).

**Equity Building Society, Kenya, from housing finance to rural finance:** EBS was established in 1984 as a building society for long-term housing loans. By December 1993, it was declared technically insolvent by the central bank, with non-performing loans of 54% and capital fully eroded. In 1994, with donor support, reform started from within over a five-year period and enabled EBS to transact business like a commercial bank. 65% of its portfolio is agriculture-based.

There is a strong emphasis on **timely repayment**, which is driven by incentives and a holistic approach: (i) an assessment of the ability of the household as a whole to repay and its track record of savings and repeat loans, rather than collateral; (ii) decentralized lending (“knowing the customer”); (iii) repeat loans without red-tape (granted within one day); (iv) decreasing interest rates on repeat loans; (v) lending for an array of purposes; (vi) monthly instalments deducted from the client’s savings account.

IBS is now one of the most vibrant financial institutions and probably the strongest microfinance provider with a rural and agricultural emphasis in Kenya. It is owned by 2,367 shareholders, most of them farmers and microentrepreneurs. From 1995 to 2001, EBS underwent a process of rapid growth which is still ongoing: Total assets grew from Ksh 213m to 1.9bn; the number of depositors grew from 28,000 to 105, 000; deposit balances grew from Ksh 123m to 1.6bn; the number of borrowers grew from 347 to 20,000; loans outstanding grew from 35m to 762m; profits grew from 7m to 54m (before tax); equity grew from 9m to 227m.

**Center for Rural and Agricultural Development in the Philippines, an NGO-turned-rural bank:** CARD started operating in 1988, using grant funds for lending to 150 rural people organized in associations. At a repayment rate of 68%, it was doomed. Two reform measures turned it around and made it the flagship of NGO reform: adoption in 1989 of the Grameen approach of lending through solidarity groups of 5 five poor women; and registration as a regulated rural bank in 1997, combined with financial innovations such as savings mobilization from the non-poor and access to refinancing by PCFC, an apex for MFIs. CARD stands on two pillars: an NGO with 21 branches, which are easy to establish; and a rural bank with 8 branches for voluntary deposit mobilization, the consolidation of financial operations, and for graduating successful Grameen borrowers to a new individual lending program. It now (5/2002) has 92,500 depositors, 56,500 borrowers, a repayment rate of 99.7%, an operational self-sufficiency ratio of 145%; a financial self-sufficiency rate of 119%; a return on assets of 5.2% and a return on equity of 18.8% (fully attributable to Grameen banking!). CARD provides training and exposure services to NGOs and rural banks.

**Table 3: The evolution of CARD, 1988 – 5/2002**

Year	No. of Borrowers	Repayment rate *)	Loans outstanding (in million P)	No. of deposit accounts	Operational self-sufficiency ratio	Financial self-sufficiency ratio
1988	150	68.0				
1989	89	100	.089	89		
1990	307	98	.59	307		



1991	468	96	.66	468	0.31	
1992	949	98.2	1.76	949	0.25	
1993	1,711	98.1	2.63	1,711	0.46	
1994	3,547	98.0	7.30	3,547	0.77	
1995	4,240	98.8	11.41	4,240	0.46	0.42
1996	6,844	99.2	22.35	6,844	0.77	0.68
1997	10,868	100	34.21	10,954	1.22	0.73
1998	20,617	99.9	82.79	20,882	1.00	0.73
1999	28,531	100	149.6	40,367	1.00	0.86
2000	35,704	99.7	387.2	68,127	1.19	1.12
2001	49,784	99.9	379.0	84,037	1.41	1.27
5/2002	56,400	99.7	410.8	92,471	1.45	1.19

Several lessons can be drawn from the experience of reformers in various countries:

- Financial sector policies such as deregulation of interest rates and the provision of legal forms for regulated financial institutions are conducive to financial innovations
- Any type of financial institution can be reformed, including credit NGOs and AgDBs
- The poor can be reached by either individual or group technologies, if properly applied
- With attractive savings and credit products, appropriate staff incentives, and an effective system of internal control, rural microfinance can be profitable
- The poor can save; rural financial institutions can mobilize their savings cost-effectively
- If financial services are offered without a credit bias, demand for savings deposit services exceeds the demand for credit by a wide margin.
- Incentives for timely repayment work
- Outreach of a financial institution to vast numbers of low-income people and financial self-sufficiency (including viability and self-reliance) are compatible
- Average transaction costs can be lowered, and both the profitability of a financial institution and the volume of loanable funds can be increased by catering for both the poor and the non-poor with their demands for widely differing deposit and loan sizes

### Ownership matters

Many NGOs and AgDBs suffer from the fact that they have no proper owner. As a result, there is no accountability and no profit orientation. In the case of **AgDBs**, privatisation has been a common solution in Latin America. In most African and Arab countries, this is rejected, with the result of ailing institutions which are a drain on public resources and, in Africa, the collapse of many. However, there are notable exceptions, including BNDA in Mali, BNA in Tunisia, Bank Keshavarzi in Iran, BRI in Indonesia and BAAC in Thailand. Thus, one has to be careful with generalizations. Much depends on national culture and traditions of public accountability. However, what is ultimately more important is a system of effective regulation and supervision together with internal control. Powerful incentives for individual performance and a system of branches as profit centers, as in BRI, may offset some of the disadvantages of public ownership

This applies similarly to **NGOs**; but the problem of ownership is more difficult to solve, particularly when donors inject equity and NGOs evolve into banks. Constructs of fake individual ownership (backed by contracts between individual owners and the NGO) are legally doubtful. An easy solution would be cooperative ownership by the clients; this however has rarely been accepted the board and management of NGOs. Rigid internal control, regulation and supervision, careful selection of board members, and staff performance incentives are all the more important.

The failure of cooperatives has frequently been attributed to a lack of effective control by the member-owners and by undue influence of the management or board, including collusion

and corruption. However, for many reasons, there may be no alternative to cooperative ownership. Again, the main issue here is effective regulation and supervision; the People's Credit Funds in Vietnam are an excellent example (see also chapter B 2, *History matters*).

One has to be careful recommending privatisation across the board, particularly as privatisation is no substitute for effective regulation and supervision.

### **Institutional autonomy matters**

Management autonomy is crucial for a financial institution, more so than ownership. The secret behind the success of the Microbanking Division of government-owned BRI lies in its autonomy, which included the freedom to reject all and government and donor supported projects; and the reason for the loss-making operations BRI's retail division lies in the lack of that autonomy.

Autonomy of rural and microfinance institutions has three major components: interest rate autonomy; autonomy in customer selection; and autonomy in all loan decisions. Full respect of donors for the autonomy of financial institutions means abstaining from any form of directing and targeting. Interference by donors (or government agencies) with any type of management decision also means that they are responsible for the results, including losses. Taking this argument seriously has far-reaching consequences, particularly for donors like the World Bank, regional development banks and other lenders. Of course, this should not keep donors from supporting institutions with a certain self-selected mandate, such as rural finance. But once selected, a donor who does not wish to undermine an institution's autonomy has to stay away from targeted credit lines; there is little more such a donor can do but equity investments and portfolio refinancing – leaving all credit decisions to management.

### **Viability matters**

An organization is viable to the extent that it covers its costs, including losses, from its operational income (the brake-even point). The viability measure commonly used for donor-supported MFIs is the **operating self-sufficiency (OSS) ratio**:

$\text{Financial income} / (\text{financial costs} + \text{operating costs} + \text{loan loss provision})$ .

Highly profitable microfinance institutions may cover their costs several times over, as in the case of BRI with OSS of 413%, and BAAC with 228%, which are extraordinarily high. Most donor-support MFIs have an OSS below 100%, which means they are loss-making. CARD in the Philippines (see Box) is one of many such institutions which started low: with an OSS of 25% in 1992; but of the few which despite (!) donor support made it across the break-even threshold: 122 in the year it registered as a rural bank and up to 145% as of May 2002.

Financial institutions which are not donor-supported, such as banks and financial cooperatives do not normally calculate operational and financial self-sufficiency ratios but profits, expressed in terms of **return on assets (ROA) and return on equity (ROE)**; shareholders are only interested in the latter.. Examples of profitable MFIs are: Producers Rural Bank Bank in the Philippines with a ROA of 1.5% and ROE of 11.2% Centenary Rural Development in Uganda with a ROA of 4% and a ROE of 28% CARD in the Philippines with a ROA of 5.2% and a ROE of 18.8%. A credit NGO more typical of donor-supported MFIs is ASKI in the Philippines, with a remarkable outreach to 13,729 borrowers, among them 10,626 Grameen clients, but a ROA of –1.7% and a ROE of –8.9% (on equity provided by donors!).

### **Efficiency matters**

OSS, ROA and ROE are measures of cost efficiency, but not of efficiency in a wider sense. Efficiency in the wider sense must take two other factors into consideration: the interest rate,

which of course determines operational income, and the cost of special delivery services provided by an institution (such as services provided in the village or at doorstep instead of transferring them to the clients).

Profits may be high despite high costs— provided an institution is able to charge interest rates which are above their costs. Profits may even be high in spite of high delinquency rates – if an institution charges interest rates which cover these losses. Eg, Shinta Daya, a rural bank on Java, has consistently made profits despite a default ratio around 10%, because its interest rate covered all costs and losses. Conversely, profits may be low despite a high degree of efficiency, not only because of relatively low interest rates but perhaps also because of additional costly services (*lender transaction costs*) provided by the institution, as is the case of Grameen replicators in many countries.

There is no consistency in the definition of efficiency in the wider sense. Eg, efficiency may be expressed in terms productivity, measured as:

Number of active clients/Operational officer; or  
Average number of daily transactions/teller.

### **Sustainability matters**

Adequate financial services can only be permanently and reliably provided by sustainable financial institutions with adequate microfinance products and cost-effective outreach to the poor. In a wider sense, the sustainability of rural and microfinance institutions hinges on several factors:

- a) the mobilization of their own resources, particularly locally mobilized savings and equity, but also borrowings from commercial banks or other external sources and equity participation;
- b) profitability, which requires adequate repayment performance and coverage of all costs from the interest rate margin;
- c) cost-effective microfinance products and services;
- d) an adequate regulatory framework, which comprises appropriate legal forms for rural and microfinance institutions, adequate regulation and effective supervision, including self-regulation and auditing services by networks of microfinance institutions.

In a narrower and more technical sense, sustainability includes viability, but add's an organization's ability of mobilizing its own non-subsidized resources or calculating the opportunity costs of grants or subsidies received, and preserves the value of its resources against inflation. Technically, it is measured by the *financial self-sufficiency ratio (FSS)*:

Financial Income/(financial costs + operating costs + loan loss provision + imputed cost of capital).

FSS is always lower than OSS:

135% (FSS) vs. 413 (OSS) in the case of BRI/Indonesia  
98% vs. 228% in the case of BAAC/Thailand  
119% vs. 124% in the case of Equity Building Society/Kenya  
119% vs. 145% in the case of CARD/Philippines

Under conditions of high inflation, FSS is far below OSS. If an institution under conditions of high inflation does not account for the effects inflation by increasing its capital adequately (any paying a sufficiently high interest rates on the deposits, lest it impoverishes its depositors), it might eventually go out of business despite a high profitability expressed in terms of OSS, ROA or ROE.

### **Self-reliance matters**

Full sustainability (French: *durabilité*) of an institution includes the notion that the institution and its services will be available in the long run. However, an institution with a high FSS that

relies on government or government resources may turn out to be unsustainable despite adequate profits and high OSS and FSS ratios if these resources are suddenly withdrawn, as has been the case in many countries. Donor and government funding is never sustainable! Thus, institutions relying on these sources of funds will eventually experience a serious threat to their survival, as rural banks did in the Philippines during the 1980s and 90s.

In donor-supported MFIs, self-reliance is normally not stressed. In fact, self-reliance measures are rarely offered in the microfinance literature. An exception is the IFAD Rural Finance Policy (App. III/1). Self-reliance is measured by the *internal resources ratio*, referring to the extent to which an organization mobilizes its own financial resources internally instead of depending on government or donor funding:

$$(\text{Non-donated equity} + \text{retained earnings} + \text{deposits}) / \text{total assets}.$$

A variant is the *domestic resources ratio*, which includes domestic commercial borrowings in the numerator:

$$(\text{Non-donated Equity} + \text{Retained Earnings} + \text{Deposits} + \text{Commercial Borrowings}) / \text{Total Assets}.$$

The converse of self-reliance are donor and subsidy dependency. In donor- and government-driven MFIs, the *donations ratio* may be used:

Donated equity/total equity,  
with due inflation adjustments for donations and grants received in different years.

### **Outreach matters ...**

There are two types of outreach: saver outreach and borrower outreach. Concerning these two types of outreach and services, there is an asymmetry between donors together with governments and clients including in particular the poor:

- Historically, governments and donors have had a credit bias. In many cases, outreach is therefore reported in terms of borrower outreach only; savers are being ignored. This may be justified in case of compulsory savings as a loan component, but not in the case of voluntary savings.
- The people and particularly the poor have a savings bias; all people need savings and a safe place to put them; a much smaller number of people need credit at any given time.

### **... and so does truth in reporting<sup>16</sup>**

There are two types of distorting effects - working in opposite directions - in international reporting, which is donor-driven and credit-biased:

- A bias towards outreach to borrowers (as beneficiaries of donor and government interventions), ignoring savers, and thereby underestimating actual outreach by a wide margin, as in the case of most reporting by CGAP
- Reporting of cumulative figures on the number of loans disbursed since inception of an institution or program, accompanied by cumulative figures on the amounts of loans

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<sup>16</sup> A certain difficulty lies in reporting requirements. Central banks require financial institutions to report on amounts of deposits and loans outstanding, not on number of clients. Banks, on the other hand, internally report on number of accounts, but not clients. In most rural and microfinance institutions in developing countries, clients would normally have one loan at any given time; so the number of loan accounts is close to the number of borrowers if not households. Individual clients and households are more likely to have several deposit account: eg, a passbook savings and account and a fixed deposit account; or, if special incentives are provided for opening an account or making deposits (including participation in a lottery), clients and households may hold several deposit accounts, as in the case of Bank Keshavarzi/Iran and BRI/Indonesia.

ever disbursed<sup>17</sup>, a common practice among NGOs and particularly Grameen practitioners, including PCFC, an apex in the Philippines refinancing Grameen replicators.

Cumulative reporting has a tripe distorting effects: first, the amounts of loans disbursed during any given period are always substantially higher than loans outstanding; second, by adding all loans ever disbursed; third, by not writing off bad debts, which has the additional (unwanted) effect of lowering reported performance data in terms of arrears.

The following figures illustrate the discrepancy between saver and borrower outreach of institutions with unbiased voluntary savings and credit services (reporting active accounts only, ie, with savings and balances and loans outstanding, respectively):

- ✓ BRI in Indonesia has 26m savings accounts and 2.7m loan accounts;
- ✓ BAAC in Thailand, which introduced deposit taking only around 1990, has 8.3m savers and 5.0m borrowers
- ✓ Centenary Rural Development Bank in Uganda has 280,000 depositors and 22,000 borrowers
- ✓ Equity Building Society in Kenya has 105,000 depositors and 20,000 savers
- ✓ Daily deposit collectors in West Africa have millions of depositors but only a handful of borrowers.

The impact of group vs. individual financial technologies on outreach will be discussed below.

### **Outreach and sustainability matter – together!**

There has been a longstanding debate, particularly among donors and credit NGOs, on the compatibility of sustainability and outreach to the poor. There is increasing anecdotal evidence that that are non only compatible, but may also be mutually reinforcing – provided of course the financial services are profitable to both the institution and their clients.

**Graph 2**

**The virtuous circle  
of sustainability and outreach with impact**



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However, there is firm evidence that outreach and sustainability can be incompatible, namely under conditions of fixed and subsidized interest rates. Loans to the poor are small and expensive. If the interest rate is fixed, an institution has to chose between many small costly loans to the poor and a few cost-effective large loans to the non-poor, as most AgDBs historically did. However, even this holds only under conditions of equal repayment rates. Recent experience among rural banks in the Philippines has shown that, with effective group technologies of banking with the poor, repayment rates of the poor are far higher than those

<sup>17</sup> Under conditions of inflation, reporting of cumulative figures on loans disbursed is entirely meaningless, unless given in constant prices (which I have never seen done).

of the non-poor. Similarly, many commercial banks found out that transaction costs of big loans may be low; but this doesn't help if they are not repaid.

Once interest rate are free and institutions charge whatever it takes to deliver loans of any size to any market segment, there may be direct correlation between institutional sustainability and outreach to the poor: The larger the number of loans with adequate interest rates repaid by the poor, the higher the profitability of the institution; and with higher profits and levels of sustainability, the institution can finance its further and more rapid expansion to the poor from its profits. The compatibility of sustainability to outreach applies to both individual and group technologies:

- ✓ BRI/Indonesia is one of the most impressive cases using individual technologies, moving from an outreach to 700,000 subsidized borrowers in the early 1980s, with low repayment rates and heavy losses, to profitable financial services to 26m savings accounts and 2.7m active borrowers (12/2000) at high repayment and profitability rates.
- ✓ Similarly, a number of rural banks, NGOs and cooperatives in the Philippines, with interest rate freedom, found the Grameen approach very profitable and within 2-4 years doubled or tripled their outreach as shown below.

**Implications for outreach to remote and marginal rural areas:** Sustainable outreach to remote and marginal rural areas can normally not be achieved by banks and similar formal financial institutions, nor by NGOs under pressures of cost-effectiveness - unless such services are heavily cross-subsidized, which is rarely feasible for wide areas. Sustainable outreach is based on two principles:

- The primacy of savings and self-financing, which is due to the absence of markets with high-yielding investment opportunities
- Member-owned and member-managed institutions, either in the form of informal self-help groups or cooperative societies which operate at very low financial costs.

Donors may assist in the establishment and growth of autonomous local institutions with carefully designed and monitored small equity injections; and with training and consultancy services. An example is the sanduq project in Syria, built on local savings, but promoted into fast growth through a substantial donor input.

**Box 9: Sanduq, a financial innovation in a remote and marginal area of Syria**

*Jabal al-Hoss* is one of the poorest and remotest areas in Syria where UNDP has supported the establishment of self-reliant local financial institutions, *sanduq* (sg.) lit. *savings box*: a revolutionary concept in a command economy. The *sanadiq* (pl.) are self-managed and autonomous in their decision-making, which has included the adoption of Islamic banking. The start-up is self-financed through member share capital, from which small loans for up to three months are given. If initial financial intermediary is satisfactory, UNDP provides an additional capital injection, thereby increasing outreach, loan sizes and loan periods.

Between September 2000 and August 2001, 16 *sanadiq* were established, comprising 2,611 members, with a share capital of SP 2.6 million. UNDP contributed an excessively large amount of equity, SP 12.7 million; but as repayment stood at 100%, it is difficult to be critical. Anecdotal evidence shows that loans permit farmers to bypass trader-moneylenders and sell their produce at a higher price; laborers turn into farmers; and microentrepreneurs use quick-turnover repeat loans for rapid business growth and marketing innovations.

Women opted for integrated *sanadiq*, in which female members manage their own affairs through separate women's committees. They find access to loans easy, as *sanadiq* do not require physical collateral. Loans are used by younger and older women to do business of their own, eg, renting land to plant their own crops and opening small shops. The additional income is used for business growth and family support. It is not rare that women – among them a mother of ten - are the better entrepreneurs, perhaps ushering in a small social revolution.

### **MFI portfolio diversification matters**

As a risk management strategy, portfolio diversification matters for both, rural and microfinance institutions and their clients including their self-help groups. Sustainable institutions need a mixed clientele, e.g., of farmers, microentrepreneurs and small traders, lending for a variety of purposes; or they need a clientele with a mixed portfolio (*see below*). Portfolio decisions have to be left to the institutions. Donors and governments must abstain from imposing loan purposes, lest they create undue risks.

### **Lending technology matters: individual vs. group technologies**

Lending technology is widely a matter of ideology, each with its own adherents, justifications, donors and conventions. Prominent proponents of the individual lending technology are USAID and HIID (with BRI as one of their disciples, after a disastrous experience with group lending during the days of directed credit) and Frankfurt-based IPC with its microenterprise banks (with Centenary RDB as one its disciples and numerous offsprings in Eastern Europe and the Balkans). Among the proponents of the group technology are the Grameen Bank and replicators, FINCA's village banks and probably the vast majority of NGOs. However, choice of technology should not be a question of ideology but of proven practice. Either one can be done well or poorly; each is a particular form of social capital, with has its strengths and weaknesses.

**Individual technology matters:** IPC's highly successful individual technology is based on the following:

- (a) the analysis of the total household as a complex IGA entity;
- (b) an incentives-driven repeat loan system, providing access to lower-interest *automatic loans*;
- (c) flexible but comprehensive loan security requirements, including mobile and immobile collateral; and
- (d) stringent enforcement of timely repayment, backed up by a system of computerized daily loan tracking, instant recovery action and seize of collateral (such as a cow, refrigerator, bicycle), customer incentives, and staff performance incentives at all levels of the bank.

An example is Centenary RDB, which was reformed by IPC (Box...). There are numerous other examples, including Equity Building Society in Kenya and most rural banks in Indonesia and the Philippines. One of them is **New Rural Bank of Victorias** on Negros Island, which has experimented with the PCFC-supported Grameen approach and with USAID-supported individual lending (MABS). Unlike Enterprise Bank (*see below*), it found individual lending profitable and group lending a failure.<sup>18</sup> The bank has 5 branches, 376 microfinance clients under MABS, an arrears ratio of 16.5% and a return on assets of 1.6%.

**Group technology matters:** There numerous group lending technologies which vary widely. One them is *Linking Banks and Self-Help Groups*, practiced in a relatively small number of countries in Asia and Africa, linking either existing SHGS (as in Indonesia, Nigeria, Zimbabwe) or newly established SHGs (as in India) to banks. By 1998, 800 rural banks and 16,000 SHGs of both men and women, poor and non-poor, were involved in Indonesia, without any external capital funds. The largest outreach is in India, involving 461,000 newly established SHG (predominantly of very poor women) and some 20,000 bank branches

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<sup>18</sup> Starting in 1998, the bank lent P1,500 to each Grameen borrower for pig raising. Most loans failed; those clients who repaid were shifted to individual lending. In 2000, the bank dropped out of the program. It appears that GBA failed because the bank had obtained no training and did not prepare its clients; loans were too small, and, with loans for pigs only, risk management inadequate. In contrast, bank staff was properly trained in the MABS technology and the use of its manual; it set up a separate unit; and quality is maintained through monthly replicator meetings for coaching and problem solving.

refinanced by NABARD. What distinguishes linkage banking from other group approaches is the treatment of SHGs as autonomous local financial intermediaries, selecting their borrowers, carrying out creditworthiness examinations and determining their own interest rates and other loan terms. Linkage banking is closely related to upgrading of SHGs to semiformal or formal financial institutions as a follow-up strategy.

Many so-called group lending approaches do not involve lending to groups as legal borrowers, but lending to individuals through solidarity groups with joint liability, as in the case of BAAC in Thailand.

The best publicized group approach is that of the Grameen Bank, which evolved in Bangladesh under conditions of financial repression. Its success is explained by its social capital, a self-regulated normative framework, which prescribes its operations in detail<sup>19</sup>:

- a focus on poor women, gathering detailed target group information and using rigid selection criteria to bar the non-poor from access to its services
- organizing the prospective borrowers in groups of five and centers of about six groups each which in turn come under a Grameen branch
- a credit-first program design, initially financed with donor or government funds
- internal resource mobilization through a compulsory savings component, supplemented by external donor or commercial resources
- reliance on peer pressure and joint liability of solidarity groups as a special type of risk management, which allows Grameen to lend without collateral
- strict credit discipline with absolute insistence on timely repayment (except during natural disasters)
- weekly center meetings with compulsory punctual attendance, where a pledge is sung and payments are transacted with a Grameen branch officer in the presence of all members
- special conditions of financial contracts, comprising a series of one-year repeat loans to individual borrowers at market rates of interest, starting small (around \$50) and, contingent upon the group members' repayment performance, growing bigger in predetermined steps and amounts, repayable in weekly instalments, with a five percent up-front deduction to be paid into the group's emergency loan fund
- adoption of Grameen's *Ten Decisions* of personal discipline to be followed in one's daily life, such as growing fruits and vegetables in the backyard; abstention from drinking, smoking and gambling; improving one's housing; building latrines; safe drinking water for better health; investing in the children's education
- intensive training of members and staff to adopt the attitudes, practices and underlying norms and values of the Grameen approach.

Many NGOs in various countries have replicated Grameen, none with Grameen's national scale and legal status of a national bank; only few have achieved satisfactory outreach and sustainability. Grameen replication in the Philippines during the first half of the 1990s was largely a failure. This changed after PCFC, with support from ADB and IFAD, provided liquidity amounting to \$34.1m to replicators, comprising NGOs, cooperatives, rural banks, rural cooperative banks and thrift banks. 162 MFIs have adopted GBA as a financial product, on-lending funds at widely varying commercial interest rates designed to cover all costs and allow for a profit. For 436,000 microenterprise clients – 98% of them women, –, they provide access to financial services. Most collection rates of participating MFIs are in the range of 94%-100%, averaging 96.2%. The original emphasis on NGOs and cooperatives has shifted to banks, particularly rural banks, while some of the major NGOs involved have themselves established banks. Much of the success is due to three factors: the professionalism of the two original NGO disseminators, CARD and Negros Women for Tomorrow (NWFT); the

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<sup>19</sup> From CARD Operations Manual. CARD Research Unit, San Pablo City, The Philippines, 4/1998



insistence on profitability resulting from high interest rates, high repayment rates and large outreach; and flexibility and innovation.

An example is Producers Rural Banking Corporation with 12 branches. In four years, it built up a clientele of 12,519 Grameen borrowers with loans outstanding (73% of its total borrowers; 13% of total loans outstanding) and 21,000 Grameen depositors (41% of its depositors; 4% of total deposits). Producers Bank is one of the few which has calculated the profitability of the Grameen product: its ROA on Grameen operations is 5.3%, and on non-Grameen 1.5%; its ROE on Grameen is 105.6% and on non-Grameen 11.2%. Producers Bank uses Grameen banking as an instrument for the vigorous expansion of its branch network and has proposed *Franchising Grameen* as a BOT strategy.

An interesting test case is Enterprise Bank, with 8 branches and 10 satellite offices. Like New Rural Bank of Victorias, it has experimented with both individual lending under USAID/MABS and Grameen lending under PCFC, but with different results:

- ✓ Among its 20,944 borrowers are 14,540 under GBA (69%; 41% of loans outstanding) and 842 under MABS (4%; 5% of loans outstanding).
- ✓ Past-due rates are 1.0% under Grameen and 5.6% under MABS (3.2% consolidated);
- ✓ In 2001, 60% of profit were derived from microlending, virtually all of this from Grameen banking;
- ✓ during the first half of 2002 (*preliminary figures*), 90% of profit were derived from Grameen banking.

The spectacular success of Grameen banking in the Philippines in terms of repayment and profitability has convinced the central bank (BSP) to exempt Grameen replicators from collateral requirements (accepting group guarantees as a substitute) and from restrictions on branching out. (IFAD 7/2002)

**Beyond ideology:** The evidence from various developing countries shows that both individual and group technologies can either fail or succeed; each one can be well or poorly done, depending on the commitment of an institution's management and staff to rigorously implement sound practices. To a certain considerable extent, the two technologies are complementary, as each has its own weakness:

- in the case of Grameen banking (not necessarily linkage banking) limitations of loan size and resistance against joint liability for other than very small loans;
- in the case of individual lending limited outreach.

The most striking example for the limited outreach potential of individual lending among the rural poor is BRI in Indonesia, with 2.7m borrowers, 26m savings accounts and annual amounts of excess liquidity between \$1bn and \$1.5bn (depending on the exchange rate), which the Microbanking Division is unable to lend with its individual technology.<sup>20</sup> In contrast, the banks involved in Grameen banking in the Philippines have tripled or quadrupled their borrower outreach within just 3-4 years.

Group technologies with joint liability function only at the level of small loan sizes. A way out found by banks and cooperatives in the Philippines is graduation, combining initial group lending with opportunities for graduating to larger-scale individual loans for the more enterprising poor.

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<sup>20</sup> Two factors have militated against the adoption of group lending by the BRI Microbanking Division: the disastrous experience with directed group lending during the 1970s; and the adamant insistence of the HIID advisory team on individual lending. BRI was involved in the GTZ-supported linkage banking project, but not through the Microbanking Division at village level, but through the Retail Division at district branch level.

**Innovation and flexibility matter**

No single product and strategy works everywhere. Eg, group and individual strategies work differently for different countries and institutions. BRI Microbanking Division in Indonesia has done well with a single loan product and a single major deposit product; while Bank Keshavarzi in Iran has done well with more than 70 financial products.

Blind and rigid replication without adjustment to culture and environment is a recipe for failure. Eg, Grameen banking with groups of five poor women has worked well in Bangladesh, where SHGs are largely absent, but failed in Indonesia where dozens of much larger SHGs exist in every village; instead, linking such pre-existing groups to banks has proven to be culturally far more appropriate. In contrast, the rural poor in India lack SHGs, but have been most receptive to NABARD's initiative of helping them, mostly through NGOs, to establish new SHGs, but of an average size of 18. In Indonesia, both men and women organize in SHGs; in Bangladesh and in India, it is mostly women. In Africa, there is great variety between ethnic groups in terms of mixed vs. women-only or men-only SHGs; depending on the society, donor pressure on all-women's groups may not be welcomed. Penalties work relatively well in parts African societies, as expressed in the bye-laws of many informal financial institutions. In southeast Asia, penalties lead to a loss of face; incentives such as interest rate rebates for timely repayment as in the case of BRI are far more effective.

## 5. What matters at the operational level?

### **Good practices matter (not *best* practices)**

Under World Bank influence, CGAP and the microfinance community have decided that *best practices* matter. This is dangerous. It evokes the notion that *optimal solutions* exist in rural and microfinance and that they can be replicated as *best practices* around the world. This is similar to the TSP of the 1970s, a *Technical Services Package* promoted by the World Bank with mathematical precision, including rapid dissemination through an 8x8x8 formula. If only these farmers had listened! Just as organizations rest on their own *satisficing solutions* (sic!), (Thompson 1967), each country and each financial institution has to discover for itself which good practices suit them. There is no replicable package of best practices! As shown above, Grameen banking for example is for some a *best practice* and for others a *worst practice*.

### **Institutional size matters, but...**

Institutions benefit from economies of scale; yet there is no *best practice* in terms of size. CGAP propagates that MFIs should strive for a minimum outreach of 3,000 clients (probably meaning borrowers, not depositors). This would be a worst rather than a best practice. BRI, with 26m savings accounts and excess liquidity above \$1bn should strive for doubling or tripling its outreach to 2.7m borrowers. Some financial institutions have opted for infinite growth; others adhere to a house banking concept are satisfied with local outreach. In many countries, savings and credit cooperatives are village based and may a few thousand or a few hundred members; while financial self-help groups may have a few hundred or a few dozen members. In Germany, before the recent consolidation, there were numerous village-based Raiffeisen banks; with a few hundred clients they were viable, sustainable and self-reliant. Most rural banks in the Philippines have hundreds, not thousands of borrowers. In marginal and remote areas, sound cooperatives or SHGs may have just a few dozen or hundred members.

### **Profits matter, but not absolutely**

Profits are a source of capital and loanable funds and therefore a major determinant of growth of outreach. It is only through profits and retained earnings that, under conditions of inflation, the value of the capital can be preserved. Profits are also an important indicator of success: of individual institutions, types of institutions, lending technology and financial products. At the institutional level, profits are calculated as rates of return on assets and equity; measuring the profitability of particular financial products – a rare but very important sound practice! - requires more refined calculations. Profits are also an indicator of the success or failure of management, staff and the board and a source of performance incentives.

### **Incentives matter**

While profits are the source of incentive payments, incentives are at the same time a major factor bringing about profits. This requires decentralization of a financial institution and the transformation of branches into profit centers with their own profit and loss calculations. Incentives must be carefully chosen and well-balanced, lest they turn into perverse incentives, as in the case of disbursement-based incentives. There are no best practices in determining incentives. Each institution has to decide which variables enter into the calculation and what their relative weight is. Eg, incentives for individual performance may be based on the (additional) number of depositors and amount of deposits, on the (additional) number and amount of loans disbursed or outstanding and on the repayment rate; alternatively, they may be based on the profit of a branch, particularly when there is only a small number of staff; or on a combination of institutional, branch and individual performance criteria. The impact of incentives has to be carefully monitored.

Eg, Centenary RDB in Uganda, in an effort to boost repayment, put the greatest weight on repayment; staff takes immediate action when instalments are late, shifting their efforts from disbursement of new loans to the repayment of existing loans. The result has been an excellent repayment performance, but a slow growth of disbursement relative to deposits, which implies a loss of profits from loans foregone. In this case, the costs of a high repayment exceed the benefits. An adjustment would be in order, increasing the weight of disbursement incentives.

### **Repayment matters**

A high repayment rate is a result of sound practices. There are now so many institutions with either group or individual technologies with very high repayment rates (98%-100%) that it has become an art that can be taught and mastered. Two major factors are involved:

- appropriate loan terms including size, instalments, grace periods, purpose and time of disbursement, which are of foremost importance; and
- sound practices of loan enforcement, insisting on timely repayment.

In the case of group lending and lending through solidarity groups, peer pressure is applied to enforce repayment on time; no repayment is accepted from any of the 30 members of a center in their weekly meetings unless the total amount due is transmitted. In individual lending, techniques are more complex and more variegated. They may be based on incentives as in the case of repeat loans and interest rate rebates in BRI, on penalties, or on a combination. Centenary RDB is one of the institutions which has found its own perfection in loan recovery (**Box B10**).

Of course, there is also a place for rescheduling, but without causing moral hazard. In a number of countries, repayment morale among borrowers of public banks has been undermined by loan forgiveness before elections and by rescheduling across the board, regardless of individual ability to repay, as in the case of ACC in Jordan and ACB in Syria. Such action is a worst practice and does great harm to borrowers: not only are they customers of a weak and possibly insolvent bank; they are also ineligible for further loans unless the rescheduled loan is repaid.

### **Information matters**

There are two types of information: computerized data and personal knowledge as part of a direct relationship between staff and clients, also between management and staff. Information on branches, financial products, clients and loans must be provided on a timely basis. This requires an efficient MIS, which is normally computer-based; but in small institutions and remote areas, manual processing of information can be far more effective. Cost and benefits of information processing have to be balanced. In rural and microfinance, personal relations with clients can be very important and cannot easily be replaced by a computer. Again, there is no *best* practice.

### **Delivery systems matter**

Many financial institutions rely on customers coming to the bank, thereby transferring transaction costs to the clients and decreasing overall efficiency of financial intermediation. *Bringing the bank to the people* can be more efficient, eg, through decentralization, doorstep services and mobile services. The costs of such services must be covered by the interest rate; they are normally far lower than the extra costs to the borrower who has to go to the bank for every savings or instalment deposit. Economies of scope – combining savings and instalment collection – may further reduce costs. In Bank Dagang Bali in Indonesia and Equity Building Society in Kenya, both the institutions and their clients benefit from such economies of scope.

**Box 10: Centenary RDB, Uganda: Sound practices of loan enforcement**

The Bank uses four instruments to achieve high repayment rates: incentives to repay on time; instant arrears information and delinquency tracking; immediate action to enforce repayment; and rigorous recovery in case of defaulting.

A powerful **incentive** is built into timely repayment: As processing speed and loan appraisal costs decline rapidly for repeat loans, a customer qualifies after three satisfactory loan cycles for an *automatic loan* that may be granted within a day; the increment in loan size is 25% instead of 15%; and the monthly interest rate drops from 2.0% to 0.5% (fees and commissions remain constant), bringing down the effective rate from 48% to 30%.

Clients are **rated** on the basis of their repayment performance on a scale of 1 (repayment within three days) to 5 (repayment after two weeks). Willful defaulters and delinquents with a rating of 5 are not eligible for a new loan. With a rating of 3, the volume of the follow-up loan is being reduced. With a rating of 2: the same loan amount may be granted again. With a rating of 1, the loan may be increased by 15% annually or more if justified.

The loan officers have **daily information** on arrears and discuss this on a daily basis. In the afternoon of each day, they receive a list of those who paid their dues and, at any time thereafter, the list of delinquents and arrears. After one day, each loan officer follows up his delinquents and provides the information twice a week to the Recovery Committee, comprised of the branch manager, the head loan officer and the loan officers. Simple cases are presented but handled the individual loan officers; more difficult cases are handled jointly, particularly when enforcement action is to be taken.

**Recovery action** is in the hands of a specialized recovery team of five as a group, comprising the head of loans and four loans officer. In extreme cases, they may request the assistance of the police. The recovery team goes into action for loans overdue 30 days and longer. Collateral can be seized by the loan officers or the recovery team on the spot in collaboration with the chairperson of the Local Council (LC) of each village. Seizure of collateral is either on the basis of a land title or, in the case of land possession without a title, in cooperation with LC chairperson. He writes a letter confirming possession of land and signs the mortgage agreement. The latter includes the land and the movable property on it, such as cows, crops and household items, all listed on the mortgage form. In the absence of land, movable collateral is entered into a chattel mortgage form signed only by the client. All the information is entered into the IMS.

In the case of fraud committed by management or staff, rigorous action is taken, up to imprisonment.

**Financial products matter**

Financial products have to be demand-oriented and cost-effective. This requires market research, testing, innovation and cost calculations per product. Care has to be taken that studies and calculations are not confined to loan products, but include savings, insurance, leasing, money transfer and other products. Only few MFIs exhaust the potential of economies of scope; but institutions with credit only are farthest from that potential.

**Loan protection matters**

Insurance is not only a service to the customers, which may be offered cost-effectively by MFIs. They are also part of loan protection. In a number of countries, credit unions, reinsured by CUNA Madison, offer a compulsory life insurance package (avoiding adverse selection!), which is so attractive that in Indonesia it has become a major marketing instrument for new members. On Mindanao in the Philippines, several associated rural banks have established a cooperative hospital as a subsidiary and offer health insurance to their clients. Micro-insurance is presently attracting increasing interest in the international microfinance community.

In areas with a **high incidence of AIDS**, compulsory life insurance among borrowers or registered clients may be highly effective in spreading the risk, for financial institutions as well as for family members who are liable for the debts of the deceased. Much research and experimentation are required and need donor support to work out sound practices.<sup>21</sup>

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<sup>21</sup> In Uganda, IFAD, among other donors has supported UWESO, a credit NGO with 8,000 women borrowers in Grameen groups, with special attention to AIDS orphans. With an operational self-sufficiency ratio of 17%, no cost-effective sound practice is in sight.

## 6. What matters to the poor?

### Access to savings and credit matters

All the poor at all times need a safe place where they can accumulate their savings. All the poor should also have the opportunity of accessing credit; but only a limited number of the poor will at any given time actually avail of credit. Savings and credit also have insurance functions.

Only financial institutions provide access to financial services on a sustainable basis. The unsafest place for savings is under the mattress or elsewhere in the house, where they are accessible to the family at any time. Thus, the poor not only need access to savings, but to savings institutions. This is why in West Africa, many of the poor hand their daily savings over to anonymous deposit collectors, who collect their savings at doorsteps against payment of a fee at minimal additional depositor transaction costs. Cooperatives, rural banks and similar MFIs are safer places; while depositor transaction costs may be higher there, these institutions may be able to pay interest rates above the inflation rate, thereby preserving the value of the savings of the poor.

There may be times where access to their savings is not sufficient, as in cases of emergency, during lean periods or when profitable investment opportunities turn up. Therefore, the poor need access to financial intermediaries with both savings and credit services and, in a more advanced stage, other financial services such as insurance, leasing or money transfer.

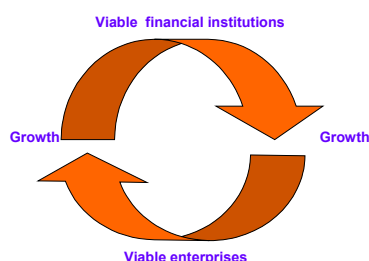
Whether access to savings-first or credit-first is more appropriate depends on the rate of return as shown above. Under conditions of a subsistence economy and activities with low returns, savings are more appropriate than credit.

### Rural enterprise viability matters

The viability of rural financial institutions and rural farm and non-farm enterprises are closely interrelated and mutually reinforcing: Viable rural enterprises need viable rural financial institutions with sustainable financial services; while rural financial institutions need viable rural enterprises who are able to make profitable investments and repay their loans.

**Graph 3**

**The virtuous circle  
of institutional and enterprise viability**



12

### Household portfolio diversification matters

As a risk management strategy, portfolio diversification matters for both, rural and microfinance institutions and their clients, including their self-help groups. The rural poor tend to invest their small-scale loans in a variety of agricultural and non-agricultural activities, with the double objective of livelihood security and asset or income growth. Members of Grameen centers in the Philippines were advised to group together along a single activity

and borrow for that activity, as they do in fact – but only on paper. In reality, they found the advice very unwise and diversified their portfolio as illustrated below. This strategy pays off handsomely. Even if one activity fails, the next one succeeds, permitting experimentation without putting the borrower under undue risk. The increase in assets over a two- or three year period is usually a multiple of the total amount of loans received, indicating that what matters to the poor is access to loans, combined with the freedom to invest them in whatever is most appropriate to them (not the donor!).

**Table 4:** Loan use and increase in assets of members of a Grameen center, People's Bank, San Francisco Branch, Mindanao, after 28 months, 3/1999-7/2002 ('000 P)

<i>IGA &amp; loan purpose</i>	<i>3/1999</i>	<i>7/2002</i>	<i>Increase</i>
Vegetable selling, 2 goats, 2 pigs	0	20	20
2 motorized tricycles (1 new, 1 second-hand)	0	50	50
Ducks, chicken, pigs, deep well	5	60	55
Motorized tricycle, sari sari, 2 pigs	3	70	67
Snack selling, motorized tricycle, 3 pigs	0	40	40
Jewellery selling, 1 pig	0	75	75
Jewellery selling, food processing, snack selling	0	?	?
Pottet plants, motorized tricycle, shoe selling	0	40	40
Sari sari, eatery, tricycle	0	25	25

**Table 5:** Loan uses and net profits of Chipangano Women's Cooperative members, Zambia (registered 3/2001)

<i>No</i>	<i>Loan</i>	<i>Use</i>	<i>Net profit</i>	<i>Use of profit</i>
1	508,000	Cotton trading; profits invested in sunflower cake to be sold in Lusaka, but prices fell	150,000	Second-hand clothes trading
2	300,000	Cotton trading	1,640,000	Shoe trading
3	320,000	Baking	940,000	Medical and school expenses; 450,000 invested in business
4	600,000	Cotton trading	2,500,000	Maize trading
5	615,000	Second-hand clothes trading, sewing	950,000	House renovation; 350,000 invested in business
6	1,435,000	Trading in welding equipment, clothes, shoes, kitchen utensils	1,400,000	830,000 invested in same business, 570,000 in maize trading
7	1 <sup>st</sup> : 700,000 2 <sup>nd</sup> : 2,000,000	Second-hand clothes trading Maize processing into flour (at the wrong season); cotton trading, won losses back	2,200,000 700,000	House building Invested in business
8	870,000	Trading in table cloth, shows, kitchen utensils; knitting sweaters	1,200,000	Investing in business; 1 cow
9	1 <sup>st</sup> 300,000 2 <sup>nd</sup> 1,000,000	Baking, sewing Same business	3,800,000 4,600,000	Saved 2m at Barclays 0.6m house repair; saved 4m at Barclays
10	0 1 <sup>st</sup> 800,000 2 <sup>nd</sup> 2,000,000	1m investment from husband's retirement benefits in grocery and clothes store Same business Cross-border fish trade	4,800,000 p.a. 2,500,000 ?	Business problems after 4 m. Still experimenting and learning

*Information from:* 1 Fanni Ngome, 2 Iris Banda, 3 Loveness, 4 Irene More, 5 Mary Banda, 6 Malis, 7 Vestina, 8 Dorothy, 9 Imelda, 10 Gladys Mawere

### **The poor themselves matter**

Whether the poor prefer access to financial services as a separate group depends on culture and the financial infrastructure. In a culture of oppression and exploitation or neglect of the



poor by financial institutions catering for the rich only, the poor need their own financial institutions, such as SHGs or cooperatives or MFIs targeting the poor. In India, when given access to banking services through NABARD's SHG banking project, millions of people have preferred, through self-selection, to organize in self-help groups of very poor women.

### **The non-poor matter**

In other cultures, which are more oriented to mutual assistance, as in parts of West Africa, and social harmony, as in parts of Indonesia, people prefer to organize in socially mixed groups or cooperatives. Wealthier people may be included because of their larger capital contribution (without availing of microloans), their skills and leadership qualities. In the Grameen replication project of PCFC in the Philippines, ADB and IFAD have insisted on targeting the ultra-poor; but both the poor and the local financial institutions have preferred a less rigid approach, in order to make better use of the personal and financial potential of the less poor.

Indirectly, local financial institutions with financial services to the non-poor, in addition to the poor, grow faster and are therefore able to increase their outreach to the poor. This is definitely the case among the rural banks involved in the Grameen replication project in the Philippines. CARD, formerly an NGO, is a prominent case. It lends only to poor women, but collects savings also from the non-poor. It now realizes that larger numbers of the non-poor will only deposit larger amounts of savings if they also have access to credit. So, if it wants to double or triple its outreach to poor women-borrowers (presently 52,000), it will have to do what all rural banks do: provide a full range of financial services to all segments of the rural population. If financial services in a given area are only available to the poor, this will hold back development, with negative impact on both employment and investment opportunities for the poor.

### **Market segments and differentiated financial products matter**

Consequently, it is market segments that matter, not targeting the poor. The poor, together with all segments of the population, benefit most in terms of sustainable development and poverty alleviation from institutions with different financial products for the poor (eg, through solidarity groups) and non-poor (eg, doorstep collection services of savings and instalments from individual clients). Self-targeting must replace targeting by donors and government agencies!

### **Culture of labor division matters:**

Similarly, men and women as well as local financial institutions have to be given the freedom of deciding for themselves whether they prefer separate or mixed institutions. Much depends on the culture of relations between the sexes and traditions of sexual labor division. In India, poor women have decided to form separate groups under NABARD's SHG banking project; while very few men decided to have SHGs of their own, preferring to leave money matters to their wives as in many Asian cultures (eg, Laos, where women are the holders of the family purse). In Nepal, women decided to join the Small Farmers Cooperatives Ltd (SFCL) as ordinary members, arguing that their household economies were also integrated. In Jabal al-Hoss in Syria, women opted against separate sanadiq in their respective villages, but established their own management and loan committees in each sanduq.

### **Autonomy matters**

In all these cases, donors and governments should abstain from targeting and other impositions. Instead, the autonomy of the poor, of women and of local financial institutions and their owners should be respected. This includes the autonomy of the poor to establish their own financial institutions such as cooperatives or SHGs, with or without participation of

the non-poor. However, donors may support experimentation with particular financial products and services which, through self-selection, appeal more to particular market segments such as the poor. But sustainability will only be achieved if these products are accepted by the clients and the institutions independent of external support.

## 7. Donor policy and coordination matter

### 7.1 Transmitting policy to operational departments

**Consensus on policy:** A comprehensive approach to financial systems development, also called financial market development, must be based on coordination, coordination and co-financing between donors: both to prevent damaging interventions and to create synergies. This requires congruous donor policies. Since the end of the Cold War, a convergence has taken place among donors: there is general agreement about the fundamentals of financial market development. There is an overall consensus, with CGAP and other donor committees as consensus builders, that rural and microfinance must be integrated into the overall development of the financial system.

**The challenge of transmitting policy to operational departments:** This convergence pertains only to policy. To transmit policy from the technical advisory units to the operational units of donor organizations remains a major challenge. It is sometimes easier to coordinate the activities of different donors in a developing country than the activities of policy advisers and operational staff within the same donor organization.

### 7.2 Cooperation, coordination and co-financing among donors

The effectiveness of development assistance is infinitely increased by cooperation, coordination and co-financing among donors. Donors with a focus on a limited number of countries may have the opportunity of acting as a lead agency in some of them.

**IFAD**, a special agency of the UN, focuses on poverty alleviation in rural areas as its mandate; and it has a special focus on rural finance. Of 236 projects with a volume of \$2.98bn, 156 projects (66%) are rural finance projects or have a rural finance component. Of its total active loan portfolio of \$2.98bn, \$630.5m (21%) are in rural finance (2001). IFAD faces two problems: it has no presence in its developing member countries; and its main instrument are loans to countries. Close cooperation between IFAD and bilateral donors or technical assistance agencies would lead to synergies and more effective development assistance:

#### **IFAD's rural finance policy:**

Upon the initiative of its Board, IFAD has prepared a rural finance policy, which was adopted by the Board in May 2000. This policy is part of the consensus which emerged during the 1990s in microfinance and may provide a basis for cooperation between IFAD and other donors. (see Box ). In its policy, IFAD is unequivocal about the crucial importance of sustainable financial institutions to provide sustainable financial services to the rural poor, as summarized in Box below and condensed in a single sentence:

*IFAD will strengthen the capacity of rural financial institutions to mobilize savings, have their costs covered and loans repaid, and make a profit to increase their saver and borrower outreach.*

For a comprehensive approach to the joint planning of rural finance projects in a financial systems perspective, IFAD has also developed a Participatory Planning Framework, which donors may use for their own purposes (**Annex 5**).

#### **Box 11: IFAD Rural Finance Policy (Abstract)**

Rural finance is one of several essential tools to be used in combating rural poverty. The purpose of IFAD's rural finance policy is to increase the productivity, income and food security of the rural poor by promoting access to sustainable financial services. ***IFAD will strengthen the capacity of rural financial institutions to mobilize savings, have their costs covered and loans repaid, and make a profit to increase their saver and***

**borrower outreach.** It may also assist in bridging gaps in equity or loanable funds until institutions are fully self-sustained. Creating rural finance systems is not a panacea. Nor is it without its challenges, among them: assuring the participation of all stakeholders; building rural financial infrastructures that are diversified, according to local conditions; enhancing institutional sustainability with outreach to the poor; and fostering a conducive policy and regulatory environment. IFAD's policy will support solutions to these challenges and promote a diversity of strategies, among them: networking among microfinance institutions and establishing apex services; upgrading and mainstreaming informal finance; linking banks with local financial institutions and self-help groups; and transforming agricultural development banks. Through its policy and strategies, IFAD confirms its commitment to continually seeking more effective ways of enabling – and empowering – the rural poor to create a sustainable means of livelihood for themselves and for the generations to come.

**Standardized reporting:** Reporting on rural and microfinance projects is frequently uneven and sometimes absent altogether. It is proposed to make use of a *Financial Data Reporting Sheet* for banks and MFIs as prepared by MIXMarket.

### 7.3 Opening markets...

The total effect of development assistance is small compared to the importance of opening markets in the EU and elsewhere for products from developing countries:

- Donors should make every effort in the EU and elsewhere for abolishing agricultural subsidies and opening up markets for developing countries

### III

## Conclusions, recommendations and options

### **(1) Sustainable development requires:**

- continual growth and diversification of the rural economy;
- access of all segments of the population including rural microentrepreneurs, farmers and the poor to sustainable financial services such as savings, credit and insurance;
- provided by self-reliant, sustainable financial institutions,
- adjusted to the cultural and socio-economic conditions in their area of operation,
- in a conducive macroeconomic policy environment.

### **(2) Sustainable rural microfinance requires local initiative and careful donor support for the development of institutions, enabling them to:**

- offer both savings and credit services,
- mobilize their own resources,
- have their loans repaid,
- cover their costs from their operational income
- finance their expansion to the poor and non-poor from their profits.

### **(3) Governments, with prudent donor assistance, have to provide,**

- a conducive policy framework with deregulated interested rates,
- an appropriate legal framework for competitive local and national financial institutions with different forms of ownership, including private, cooperative, community and also government ownership
- a system of prudential regulation and effective direct or delegated supervision.

### **(4) Donors may contribute to the development of rural financial systems through:**

- experts for R/MF units in central banks, R/MF networks and leading R/MFIs
- regional R/MF experts for consultancy, training, information exchange and supervision of donor-supported projects and MFIs
- policy dialogue
- social and human capacity building in financial authorities, R/MFI networks and R/MFIs
- equity investments with leverage through deposit-taking, clear ownership and an exit option
- no credit lines, except for bridging temporary liquidity gaps of (emerging) sustainable R/MFIs
- financial and technical assistance for the transformation of MFIs into regulated financial institutions such as rural banks, community banks, thrift banks, commercial banks, finance companies or similar institutions;
- technical and financial assistance for the promotion of ownership of financial institutions by the poor as shareholders, particularly in the process of transforming credit NGOs into regulated institutions;
- donor coordination of financial and technical assistance, cooperation and co-financing making good use of the comparative advantages of multilateral and bilateral donors.

### **(5) Supporting self-help groups as autonomous local financial institutions in marginal areas**

If a donor decides to promote rural finance in marginal areas with a focus on the poor, **two basic strategies** are suggested, both directed at indigenous or new SHGs as autonomous local financial institutions:

- Through networks or federations of SHGs, implying that both SHGs and their networks are being promoted in the framework of a project
- Through linkages of SHGs with regulated financial institutions like AgDBs, rural banks or other types of deposit-taking financial institutions.

This option would require a thorough feasibility study in each case, a long-term perspective or support, long-term experts, the willingness to work, in the longer run, towards a legal status for the SHGs or their networks or federations, and cooperation with other donors and regional organizations.

Appropriate partners for the first approach may comprise AgDBs and development NGOs, which will eventually transfer their institution-building and –maintenance functions to networks of SHGs<sup>22</sup>. Partners for the second approach may include AgDBs, rural banks or other types of deposit-taking financial institutions. Manuals exist, but would have to be adjusted.<sup>23</sup>

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<sup>22</sup> An example are the federations of SHGs (promoted by Nabard) in India with the legal status of MACS, a new type of cooperative status. As of end-2002, Nabard has established 500,000 autonomous SHGs with access to bank services, comprising some 40 million family members of very poor rural population segments.

<sup>23</sup> Cf. Seibel 1992; more recent manuals are available from Nabard, Mumbai.