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Frontiers of Rural and Microfinance

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**University of Cologne
Development Research Center
Universität zu Köln
Arbeitsstelle für Entwicklungsländerforschung**

**Frontiers of Rural and Microfinance
By
Hans Dieter Seibel**

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**A. Introduction:
From directed credit to inclusive financial systems development**

Due to the overall failure of capital transfer and government-directed credit during the 1960s and 1970s, the emphasis in development policy has shifted:

- (i) from targeting bigger farmers and SMEs to inclusive finance including microentrepreneurs, women and the poorer segments of the population;
- (ii) from development banks and credit NGOs to (rural) financial system development with a conducive policy framework and the building self-reliant, sustainable institutions;
- (iii) in rural areas from agricultural credit to rural financial services for a diversified economy;
- (iv) from development banking to microfinance.

Microfinance is that part of the financial sector which comprises formal and informal financial institutions, small and large, that provide small-size financial services to the lower segments of the population. Size of financial services is relative and varies widely by the economic development of a country or area; rigid definitions of size can lead to exclusion and unintended consequences. Microfinance covers a wide array of microfinance institutions (MFIs), ranging from indigenous rotating savings and credit associations (RoSCAs) and financial cooperatives to rural or community banks, non-bank financial institutions (NBFIs) including credit NGOs, development banks as well as commercial banks; they may also comprise moneylenders and private deposit collectors. In contrast to microcredit, microfinance proper refers to a system of financial intermediation between microsavers and microborrowers; it may further include micro-insurance and other financial services such as money transfer. Given the recent popularity of the concept of microfinance, many players have redefined the concept for their own purposes, bringing it close to the point of meaninglessness.

History has shown that, regardless of ownership, type of institution, and rural or urban sphere of operation, to be sustainable MFIs ultimately have to:

- mobilize their own resources through savings and shares, augmented by other domestic resources;
- recover their loans;
- cover their costs from their operational income;
- finance their expansion from their profits;
- acquire an appropriate legal status;
- submit to prudential regulation and effective supervision.

There are three worlds of finance, each with a great potential to increase outreach to the microeconomy, in which donors may intervene in different ways:

- The old world of donor-driven development finance comprising development banks, state cooperatives and credit NGOs which all need to be transformed into sustainable institutions
- A new world of microfinance, comprising viable formal and semiformal institutions with a commercial orientation, which do not, or not fully, rely on donor support for survival and expansion
- An ancient or indigenous world of informal finance including recent innovations, based on principles of self-reliance and viability, with a potential for innovation and mainstreaming.

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 the old and the new world; but there is an overall move

from the *old world of supply-driven development finance to the new world of demand-driven commercial finance*. The ancient or indigenous world of informal finance has been largely ignored.

Table 1: From the old to the new world of rural and microfinance

	<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/MFs
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

Formal and semiformal R/MFIs are in the hundreds of thousands; informal institutions are in the tens of millions. Large numbers of them exist in relative isolation. It is therefore recommended:

- not to focus solely on capital transfer and credit NGOs, as many donors do;
- to include among the institutions eligible for support formal, semiformal and informal financial institutions - in private, cooperative, public, community or mixed ownership;
- to promote horizontal networking and vertical linkages between the various types of institutions, including linkages with small institutions in remote areas;
- to devise systems of prudential regulation and effective supervision appropriate to the type of institution;
- to provide incentives-driven schemes for upgrading institutions in terms of legal status, supervision, and outreach;
- to place a special emphasis on support to institutions which include people from the lower segments of the population as owners or customers;
- to seek for innovative approaches to inclusive finance by integrating the vast numbers of member-owned, and perhaps other, informal financial institutions into the financial sector and including them among the institutions eligible for institutional strengthening.

B. 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.

Linkages matter: Through linkages with self-help groups or MFIs banks may provide the following services:

- Safe-keeping of deposits & excess liquidity
- Access to bank credit; channelling donor funds
- Liquidity balancing
- Equity participation
- Money transfer, check clearing, payments
- Capacity building
- Monitoring

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

Agricultural development banks (AgDBs) matter:

- AgDBs are the largest providers of RMF services
- Unreformed AgDBs waste public resources, lack growth and outreach, undermine rural finance
- Reform may lead to sustainable outreach to all segments of the rural population through retail or wholesale services (*linkages*)

Donors may support:

- Regional reform policy seminars with fin. authorities
- AgDB reform workshops through Regional Agricultural Credit Associations with FAO & other donors
- Regular state-of-the-art reporting on AgDB reform

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

8. General 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, community and public 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
- credit lines for bridging temporary liquidity gaps (*no credit lines for other purposes!*).
- assistance for the transformation of MFIs into regulated bank or non-bank institutions
- assistance for the promotion of ownership of financial institutions by the poor
- making good use of the comparative advantages of multilateral and bilateral donors.

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

- NGOs helping to identify and promote existing, or establish new, SHGs as local financial intermediaries
- networks or federations of SHGs
- linkages of SHGs with regulated financial institutions.

C. Frontier issues and recommendations to the Ford Foundation

1. Local resource mobilization matters: Donor-driven vs. local initiatives

The importance of local resource mobilization vs. capital transfer for self-financing, self-reliance, and growth

Source of funds:	External vs. internal (local savings, equity, retained earnings)
Risks:	1. Donor funds discourage local resource mobilization & growth 2. Inadequate equity curtails growth
Opportunities:	Donor equity leverages savings mobilization and credit expansion
Proposals:	1. Capacity building in savings-driven local financial institutions 2. Comparative study of savings vs. grant-driven RMFIs

2. Equity matters

Domestic resources can be effectively mobilized through equity instead of deposits by shareholder-driven RMFIs under various forms of ownership

Equity-driven RMFIs	Resource mobilization through equity mobilized by local shareholders motivated by profit sharing and access to credit
Risks:	Fraudulent equity mobilization (eg, pyramid schemes) if not properly supervised
Opportunities:	1. Massive mobilization of unequally distributed local capital in private hands 2. Mobilization of public resources as start-up capital combined with profit-driven growth
Proposals:	1. Study of equity-driven RMFIs (eg, BKK in Central Java, IFAD's Financial Service Associations in Benin, UNDP's sanadiq in Syria) 2. Support private or public initiatives to build equity-driven local RMFIs

3. Legal framework for local financial institutions matters

The importance of a legal framework for establishing deposit-taking local financial institutions (microbanks): as self-reliant institutions which grow dynamically on the basis of local resource mobilization (savings, equity, retained earnings)

Legal form	Regulated financial institution as part of the formal financial sector vs. non-formal legal status
Risks:	1. <i>Non-formal</i> : lack of deposit mobilization and supervision 2. <i>Formal</i> : Inappropriate regulation and interference by rogue

Opportunities:	governments Institutional sustainability and unlimited growth of saver and borrower outreach
Proposals:	1. Comparative study of legal frameworks for local RMFIs (eg, BPR law in Indonesia, MFI law in Uganda, cooperative banking law in Germany) 2. Preparation of model legal frameworks for RMFIs in private, cooperative and community/public ownership 3. Support projects in which a model legal framework is adopted and adapted

4. Ownership matters: Ownership and governance in local financial institutions

Ownership:	NGO vs. local (private, cooperative, communal)
Risks:	Donor ownership (as in credit NGOs) creates dependency and a lack of profit and performance orientation; curtails growth
Opportunities:	Local ownership if properly supervised is geared to profit-making, sustainability and growth of outreach
Proposals:	1. Support comparative studies of privately, cooperatively and communally owned local financial institutions (eg, in Bali and Aceh, Indonesia) 2. Support the transformation of credit NGOs into locally owned RMFIs

5. Effective supervision matters

The growth of sustainable RMFIs and sustainable financial services is contingent upon effective supervision

Supervision:	Supervision of RMFIs, whether deposit-taking or equity-driven, is crucial; supervision must be effective, ie, able and willing to suspend or close nonperforming RMFIs
Risks:	1. Ineffective supervision creates false confidence 2. Inappropriate supervision curtails the emergence of RMFIs
Opportunities:	Appropriate and effective supervision is conducive to the emergence and growth of a healthy RMFI sector
Proposals:	1. Support studies of direct and delegated supervision of RMFIs in developing and developed countries (eg, cooperatives in Vietnam, rural banks in the Philippines, BPR in Indonesia, cooperative and savings banks as former RMFIs in Germany) 2. Support mandatory auditing of RMFIs by auditing apexes of RMF federations

6. Agricultural development banks (AgDBs) matter:

AgDBs	AgDBs are the largest providers of RMF services
Risks:	Unreformed AgDBs waste public resources, lack growth and outreach, undermine rural finance
Opportunities:	Reform may lead to sustainable outreach to all segments of the rural population through retail or wholesale services (<i>linkages</i>)
Proposals:	1. Regional reform policy seminars with fin. authorities 2. AgDB reform workshops through Regional Agricultural Credit Associations with FAO & other donors 3. Regular state-of-the-art reporting on AgDB reform

7. Informal finance matters

Informal group-based financial institutions (IFI) of ancient indigenous or recent origin are ubiquitous in much of Asia and Africa, but in contrast to microfinance origins in some European countries have rarely provided a basis for financial sector development

Informal finance:	IFI are widespread and fulfil important functions; but their modern adaptations and their potential in RMF sector development is rarely recognized
Risks:	<ol style="list-style-type: none">1. Ignoring IFI as indigenous social capital leads to a continual existence of a dual financial sector and misses the chance of building an inclusive financial sector2. State interference may disrupt a well-functioning informal financial sector
Opportunities:	Building a culturally integrated, inclusive RMFI sector through strategies such as upgrading IFI, linking IFI with banks, downgrading banks linked to IFI
Proposals:	<ol style="list-style-type: none">1. Study upgrading and linkages of IFI (eg, esusu and ajo in Nigeria, anago susu in Ghana, ekub and edir in Ethiopia, chit funds in India, dhikuti in Nepal, arisan in Indonesia, sanduq in Syria)2. Support pilot projects of upgrading and linking IFI

8. Moneylenders matter: What role for the moneylender?

Moneylenders are an ancient and ubiquitous informal financial institution. Historically, they have frequently turned into organizers of rotating savings and credit associations (eg, formal and informal chit funds in India), indigenous bankers (eg, India), modern bankers (eg, rural banks in the Philippines, Bank Dagang Bali in Indonesia). They were also given the option of registering with the central bank (eg, as lending investors in the Philippines); this has increased their outreach, depth of service and efficiency while bringing down interest rates. Yet, they are widely regarded as evil; and their potential is ignored.

Moneylenders	An ancient and ubiquitous institutions which has proven adaptable to widely varying socioeconomic conditions
Risks:	Ignoring moneylenders drives them into illegality; this deprives clients of efficient services and more favourable terms
Opportunities:	Registration and legalization may greatly improve their outreach and the quality and terms of their financial services
Proposals:	<ol style="list-style-type: none">1. Support studies of registering and legalizing moneylenders and the impact on quality and terms of financial services2. Support pilot projects of transforming moneylending into legally recognized client-friendly agencies

9. Islamic RMF matters, to some

Islamic banking, with sharia-based financial products, has been spreading in various countries for about 40 years, variously driven by state command, religious leaders, selective financial institutions, or popular demand. Islamic RMF, provided by banks or MFIs, is a more recent innovation. Experience varies widely among formal and nonformal Islamic FIs, such as the People's Credit Banks (BPRS), commercial banks and cooperatives (BMT, Baitul Qirad) in Indonesia, banks in Sudan, banks and SHGs in Iran, village funds/sanadiq in Syria. Outreach and sustainability are hampered by lack of familiarity with the new paradigm in RMF, lack of experience with Islamic financial products and higher transaction costs.

Islamic RMF	The challenge of mainstreaming
Risks:	Political and religious pressure may undermine outreach and sustainability
Opportunities:	Adapting the new paradigm in RMF to sharia requirements may have a great impact on outreach and sustainability
Proposals:	1. Support comparative studies of formal and nonformal, mandatory and voluntary Islamic RMF 2. Support studies of transaction costs of Islamic financial products and the feasibility of adopting lessons learned by conventional RMF

10. Linkages matter

Linkages	Between banks and SHGs or MFIs (start-up: by AgDBs)
Risks:	Discouraging savings mobilization, growth
Opportunities:	Safe-keeping of deposits & excess liquidity Access to bank credit; channelling donor funds Liquidity balancing Equity participation Money transfer, check clearing, payments Capacity building Monitoring and supervision
Proposal:	Support model projects of horizontal networking among non-formal MFIs, incl. SHGs in remote areas (with incentives-driven upgrading), and vertical linkages with banks (with downgrading)

11. Good practices matter; best practices risk turning into worst practices

The notion of best practices (like the Technical Services Package of World Bank-financed area development projects) in RMF may lead to mechanical replication and to strategies which are not adapted to the cultural or economic conditions at a given time. Evidence is needed of the range of more variable and adaptable good practices and the process of their transformation over time.

Best vs. good practices:	Only <i>good practices</i> may have the adaptability required in development situations widely varying over space and time
Risks:	Insistence on <i>best practices</i> may lead to mechanical replication and inappropriate practices
Opportunities:	Appropriate <i>good practices</i> may permit the development of viable RMFIs in rapidly changing or widely varying situations or in nonconductive policy environments
Proposals:	Support studies of varying good practices (eg, group lending, individual lending, joint liability, capital injection in undermonetised rural economies) contingent upon situation and policy environment

12. Development matters

Given the emphasis on poverty alleviation, development has become the *forgotten half* of RMF. Does RMF lead to development and poverty alleviation; or does development as the result of good policy create an environment in which RMF will thrive and effectively contribute to poverty alleviation? Does RMF finance the sector in which value-added is created? Does RMF with its emphasis on the poor and the poorest sustain the poor in poverty or lead to sustainable poverty alleviation and development? *Good finance may not lead to growth; but bad finance definitively does, albeit in a negative way.*

RMF and development:	The relationship between RMF, development and poverty alleviation is complex
Risks:	A sole emphasis on the poor and poorest undermines both development and the growth of outreach to the poor
Opportunities:	Establishing a strong RMF sector for all segments of the population will in due course contribute to poverty alleviation once broader market-driven development processes set in
Proposals:	Support studies of the impact of development on RMF vs. the impact of RMF on development and poverty alleviation

13. Co-financing of studies matters

Co-financing of studies with research funding agencies and international development agencies would not only increase the flow of funds; it would also bridge the gap between basic and applied research; this would lead to more relevant and more systematic research as well as better communication and coordination between the worlds of research and development.

Co-financing of studies:	Cooperation and coordination among research funding agencies and international development agencies
Risks:	Lack of coordination undermines the effectiveness of both research and development approaches and fosters uncritical and ineffective replications
Opportunities:	Learning-based innovations in RMF
Proposals:	1. Initiate cooperation between research funding and development agencies in RMF 2. Joint funding of longitudinal studies of the impact of SHG-bank linkages in India

14. Conclusions

- Support the development of appropriate legal frameworks, conducive regulation and effective (delegated) supervision of self-reliant and sustainable RMFIs in private, cooperative and community or public ownership.
- Support the injection of equity into RMFIs for bridging and leveraging purposes only.
- Support linkages of informal and semiformal RMFIs, including SHGs in remote and marginal areas, with the banking sector and their upgrading to recognized or regulated institutions as seen fit.
- Support RMFIs in establishing business associations with apex services to member institutions.
- Examine the feasibility of support to sustainable BDS apex organizations of business associations. BDS to date have been largely ineffective or unsustainable; they belong into the hands of (cooperative) business associations or federations of area- or trade-based business associations, eg, of farmers, microentrepreneurs.
- Do not support temporary or ad-hoc solutions with no chance of institutional sustainability.
- Initiate cooperation between research funding and development agencies in RMF; provide funding for longitudinal impact studies, eg, of linkages and upgrading of RMFIs.
- Activities to be funded may include studies, exploratory projects and the dissemination of results.