“Micro-Finance --- Globally and in Pakistan”

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RAWALPINDI PAKISTAN

2005

Executive Summary

Globally, 1.2 billion people are extremely poor — surviving on less than $1 a day — and three-quarters live in rural areas. Poverty is predominantly a rural phenomenon. Extremely poor people spend more than half of their income to obtain (or produce) staple foods, which account for more than two-thirds of their caloric intake. Most of these people suffer from nutritional deficiencies, and many go hungry at certain times of the year.

Among the major interventions for alleviating poverty has been the direction of credit to the poor. This paper deals with this methodology. It talks about the widely used models of micro-finance, their advantages and concerns. Each model has been analyzed with respect to its impact and efforts have been made to highlight claims through case studies. The paper then devotes itself to a study of Pakistan with specific reference to its Micro-finance industry.

The number of poor, those living below a dollar a day, more than doubled in Pakistan during the 1990s to reach 45 million in 1999. The Government, therefore, prioritized the implementation of a comprehensive poverty reduction strategy that included improvements in social indicators, employment generation, safety nets, and access to microfinance (MF).

The microfinance sector in Pakistan is relatively young and dynamic. Each year new players enter the arena while the existing ones adapt to their changing environment. This trend has been on the rise in recent years, resulting in a sector characterized by a diversity of micro-finance players ranging from large and small conventional development organizations to commercial financial institutions involved either partially or exclusively in reaching the 'un-banked'.

The paper analyzes Pakistan and its various micro-finance players in terms of their performance and suggests ways for Pakistan to improve its Micro-Finance industry with specific focus on agricultural micro-finance since the greatest demand for micro-finance in the country is generated by this sector.

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Table of Abbreviations

ADB	Asian Development Bank
BI	Bank Indonesia
BKKBN	National Family Planning Coordinating Board
BPD	Regional Development Banks
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
CARD	Center for Agriculture and Rural Development
CFF	Central Finance Facility
CFI	Commercial Financial Institution
CU	Credit Union
DEG	German Development Company
DFI	Development Financial Institutions
GTZ	German Agency for Technical Cooperation
IDF	Integrated Development Foundation
IGA	Income-Generating Activities
IICA	Inter-American Institute of Agricultural Cooperation
KSP	Savings and Credit Cooperatives
KUD	Village Cooperative Unit (Indonesia)
LMSE	Leasing to Small and Micro Scale Enterprises Program
MFB	Micro-Finance Bank

MFI	Micro-Finance Institution
MFP	Micro-Finance Provider
NABARD	National Bank for Agriculture and Rural Development
NACSCU	National Association of Savings and Credit Cooperatives
NATCCO	National Association of Philippines Credit Cooperatives
NCBA	National Cooperative Business Association
NGO	Non-Governmental Organization
PHBK	Program linking Banks with Self-Help Groups
PMN	Pakistan Micro-finance Network
PPAF	Pakistan Poverty Alleviation Fund
ProFI	Promotion of Small Financial Institutions
RDI	Rural Development Institute
RSP	Rural Support Programme
SBP	State Bank of Pakistan
SDC	Swiss Agency for Development Cooperation
SHARE	Society for Helping Awakening Rural Poor through Education
SHG	Self-Help Group
SHGI	SHG promoting Institution
SME	Small and Medium Enterprises
USAID	U.S. Agency for International Development
VBI	Village Banking Institution
WB	World Bank
WOCCU	World Council of Credit Unions

CHAPTER 1: Introduction

Despite changes in development paradigms in the last half of the 20th century, the promise to bring wellbeing to all human being remained unfulfilled. As it stands more than 1.2 billion people in the world are struggling to survive - at the margins of human existence – on under a dollar a day. Even the country like USA which has experienced a long and steady boom has not been able to benefit the life of its every citizen. According to an estimate, roughly one out of every eight Americans still lives below poverty line. The situation in Asia is more desperate than many other regions in the world.

The presence of about 50 million poor in Bangladesh, 90 million poor in China, 300 million poor in India, 90 million poor in Indonesia, 52 million poor in Pakistan, 27 million poor in the Philippines and many other millions in other countries of Asia and Africa is the testimony of the fact that the poor people have very little enjoyed the benefit of the development programs implemented during last decades.

Poverty is predominantly a rural phenomenon. Extremely poor people spend more than half of their income to obtain (or produce) staple foods, which account for more than two-thirds of their caloric intake. Most of these people suffer from nutritional deficiencies, and many go hungry at certain times of the year.

Among the major interventions for alleviating poverty has been the direction of credit to the poor. Majority of people in poor countries are very poor, mostly engaged in small agriculture. They lack assets: do not get credit to invest; are victims of "usurious" moneylenders.

Money begets money. Adam Smith said "Money, says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little" ("The Wealth of Nations" 1937, p. 93). It is very difficult for the poor to get small working capital from formal banking system for various reasons. A collateral free working capital loan is the requirement at the door steps of the poor at the right time to help them facilitate and start feasible intended income generating activities (IGAs). It is with this background that, micro-finance is seen as one of the significant approaches to poverty alleviation.

In recent years, micro-credit, in its wider dimension known as microfinance, has become a much favored intervention for poverty alleviation in the developing countries and least developed countries. There is scarcely a poor country and development oriented donor agency (multilateral, bilateral and private) not involved in the promotion (in one form or other) of a microfinance program. Many achievements are claimed about the impact of microfinance programs, and an outside observer can not but wonder at the range of diversity of the benefits claimed.

While accepting that growth is essential for poverty alleviation, this paper asserts that the participation of the poor in economic recovery and growth will be facilitated by their access to micro-financial services. The crude 'trickle-down' analogy for the diffusion of the benefits of growth may be discredited. But if, for heuristic purposes, we were to adopt that analogy and pursue its implications, micro-financing could be described as a process by which capillary systems are opened to enable the benefits of growth to flow to the poor, and to facilitate their participation in it.

The financial service needs of the poor are simple but their satisfaction can be life-enhancing. The poor need access to convenient, liquid and safe deposit services which are protected against inflation by positive real rates of interest. With savings in reserve the poor are able to smooth their consumption expenditures in the face of uncertain income streams. Savings provide a shield against catastrophic events which, by forcing the vulnerable to divest productive assets, would otherwise tip them over the dividing line between meager sufficiency and poverty. "Micro"-insurance is a related financial product with potentially profound welfare benefits. Similarly, the poor who make their living in a myriad of activities in the informal sectors of the region, many of them either landless or with insufficient agricultural land, need access to credit to increase the productivity of their labor or to free them from exploitative financial relationships.

1.1 Defining Micro-finance

Having established the significance of the subject, I proceed to the definition. "Micro-financing" is the provision of financial services to poor and low income households without access to formal financial institutions. In most of the countries to be considered in this paper, such households form a clear majority. Using the definition of microfinance used in the ADB microfinance development strategy for the Asia-Pacific region (ADB 2000a, 1):

"Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises."

Having said that, it is nonetheless important to remember that there is a clear distinction between the economic activities and financial service needs of the SME (small and medium enterprise) sector and those of the clients of microfinance institutions. The latter operate on a much smaller scale and exclusively in the informal sector of the economy. While there may be some overlap between the bottom end of the SME sector and the poor and lower income people who form the constituency of microfinance, it is the needs of the latter to which this paper is directed.

'Microfinance' encompasses access to savings and other financial services, as well as credit. The term has come into greater currency since the early 1990s and has largely (but not entirely) supplanted the term 'micro-credit' in the professional literature. The latter term is now recognized as unfortunate because its use has focused attention on a single aspect of micro-financial services, lending to the poor, and diverted attention from the need to develop systems of financial intermediation to which the poor have access. Savings is often described, in a memorable phrase, as 'the forgotten half of rural finance' (Vogel 1984). Using the term micro-credit perpetuates this amnesia.

Microfinance Institutions (MFIs) are developing forms of 'micro-insurance' to protect the vulnerable from misfortunes, such as ill-health, which can tip them over the edge into poverty. Estimating the potential demand for insurance services by the poor as quite substantial, Kunkel and Seibel (1997) refer to micro-insurance as 'the forgotten third of microfinance'. In addition, Microfinance practitioners are working to introduce newer services, such as money transfers (given the high degree of spatial mobility of the working poor and the difficulties and expense they may experience in remitting funds to their families).

1.2 Models of Micro-Finance

1.2.1 Grameen Bank

Among the proliferation of microfinance institutions (MFIs) in developing and even some industrial countries, a number of distinguishable models have emerged. The **Grameen Bank** model has been applied in many countries in a wide variety of settings. The Grameen model requires careful targeting of the poor through means tests, usually with a focus on women and intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other's loans. Some compulsory saving requirements are imposed, but in general quite limited voluntary saving occurs. Sustainability is achieved by increasing the scale of operations, and by decentralising control and carefully managing costs. While some other models have as their goal the creation of autonomous institutions, this is not expected of the individual borrower groups. In Bangladesh, where the greatest numbers of Grameen-

inspired institutions exist, considerable innovation is occurring; only the basic model is described here.

1.2.2 Village Bank

The **Village Bank** is a widely replicated model, found mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications. Typically, an implementing agency establishes individual village banks with between 30 and 50 members and provides capital (called the 'external account') for on-lending to individual members. Individual loans are repaid at weekly intervals over 16 weeks, at which time the village bank returns the principal with interest to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of loan capital, and also encourages savings. Savings accumulated in a village bank can be loaned out to members (the 'internal' account). The standard business plan calls for a village bank to accumulate sufficient capital in its internal account to enable 'graduation' after three years, by which time loan capital has been accumulated entirely from internal sources. Hence village banks are intended to become autonomous institutions.

1.2.3 Credit Unions (CUs)

Somewhat less structured than village banks (and a good deal less so than Grameen banks) are **Credit Unions** (CUs). These are democratic, non-profit financial cooperatives owned and controlled by their members. CUs mobilise savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. The memberships of CUs is likely to be more heterogeneous than that of Grameen banks, although various CUs differ in the extent to which they include poorer and low-income households. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance. In Asia, rural credit unions have been successful in some countries, both in terms of sustainability and of reaching out to the poor (notably Sri Lanka). But they have been less successful in most other countries of the region.

1.2.4 Self-Help Groups (SHGs)

A fourth model, based on **'self-help' groups** (SHGs) is somewhat similar to the village bank concept, although less structured. Most prominent in India, SHGs have around 20 members who should be relatively homogeneous in terms of income. Their primary principle is the lending of members' savings but SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become freestanding institutions. Some NGOs act as financial intermediaries for SHGs, while others act solely as 'social' intermediaries seeking to facilitate linkages of SHGs with either licensed financial institutions or other funding agencies. The SHG model is a good

platform for combining micro-finance with other sectoral activities and their implementing agencies (maternal and child health and adult literacy, among others). However the relatively loose structure of groups makes rapid expansion of outreach and tight monitoring of performance more difficult than, say, with the Grameen Bank model.

1.2.5 Rural Financial Systems Approach

In a quite different category from the four models discussed above, each of which has strong voluntary elements involving the action of NGOs or community-based entities, is what might be called a **'rural financial systems approach'**. As practiced in Indonesia, this model exhibits a diversity of regulated financial institutions providing rural financial services. These range from a national-level institution with substantial outreach and extensive networks to small, local institutions occupying particular market niches. Also, depending on the regulatory environment in a particular country it may be possible for an NGO to transform a successful MFI into a regulated financial institution. The rural financial systems approach to micro-financing will be discussed later, with particular reference to Indonesia. The "transformation" process in which NGOs evolve to become regulated financial institutions will be also be described, in the context of Cambodia and the Philippines.

CHAPTER 2: Grameen Bank

The Grameen Bank operation is committed to the cause of poverty alleviation. It is poverty focused banking, provides collateral free credit to the poor and has a preference for the poorest women. Grameen Bank (Grameen) was started with a new paradigm, a new definition and new approach towards development.

2.1 Grameen Approach to Development

According to Muhammad Yunus, the founder of Grameen Bank, development should mean the development of the bottom 50% of population, especially bottom 50% of those who live below the poverty line. A poor person, like anyone else, has an immense potential for growth. Given the access to credit, the poor can become the architect of their destiny. They can overcome poverty. The experiences of Grameen in Bangladesh and that of Grameen replications in Asia can be taken into consideration to see how this happens.

2.1.1 Grameen Philosophy and Objectives

Poverty eradication is a doable proposition. It can be reduced and eradicated with credit as the instrument. Credit is a human right. It provides command over other resources. Given the access to it, the poor can generate income through self-employment and meet their basic needs. They can do more provided they are properly motivated and organized,

enabling conditions are created to use their potentials and they have continuous access to financial services.

Grameen was created to:

i. Extend collateral-free banking facilities to very poor men and women.

ii. Eliminate the exploitation of the poor by moneylenders.

iii. Create new opportunities for self-employment for the vast unutilized and underutilized manpower resources.

iv. Bring disadvantaged people into the folds of some organizational structure which they can understand and operate, and in which they can find socio-political and economic strength through mutual support.

v. Reverse the age-old vicious circle of "low income, low savings, low investment," into an expanding system of "low income, credit, investment, more income, more credit, more investment, more income."

2.1.2 Grameen Essentials

To achieve its objectives, Grameen has developed its own system of targeting, credit delivery and recovery, financial products and services, training program and institutional support. The essential features of the Grameen system may be summarized as the following:

i. *Exclusive targeting on the bottom poor:* As a bank for the poor, Grameen has developed its own criteria for identifying and selecting the bottom poor. These include land ownership, housing conditions and household assets of targeted persons. It has a definite preference for the poorest women. Ninety-four percent of Grameen members are women.

ii. *Organization of the borrowers into homogeneous community based groups:* The entire Grameen system is built on peer-support within the framework of a five-member group and the broader framework of a centre.

iii. *Close rapport between lender and borrower:* In Grameen, all bank transactions are transparent and close to the customers. The poor do not come to the bank, but the bank goes to the poor.

iv. *Professional Staff:* Grameen requires well-motivated professional staff to provide financial services to its members. In order to develop and maintain a hardworking

and well-meaning staff, it has designed introductory as well as in-service training for the staff.

v. *Special loan conditionalities:* Grameen has always taken into consideration the potential and capacity of its borrowers, their affordability and viability. It has developed loan products and conditionalities according to their needs. 'Borrowers know best' is the principle of Grameen. One can borrow more and more as subsequent loans as one grows in confidence and skill. Grameen regards women as the effective agents of greater family welfare and social change.

vi. *Problem-solving culture:* Grameen promotes a problem-solving culture and puts total trust in the creative potential of its staff and clientele in crisis management.

vii. *Obligatory savings:* Grameen has an obligatory savings system. It considers saving mobilization as an integral part of its lending program.

viii. *Sustainability:* Grameen aims at building a sustainable credit delivery system by charging the borrowers an affordable rate of interest. It remains cautious to avoid charging a price which makes the borrowers pay for any inefficiency of the system.

ix. *Strong Monitoring:* Grameen monitors all its activities continuously and thoroughly. It tries to reach out even to the remote and dark corners of the system to keep them clean.

x. *Decentralization:* Grameen is a decentralized system. It always delegates decision-making powers to the lower levels-- to the branch, centre and group. It operates a transparent system so that everything remains visible to everyone.

2.2 Grameen Lending Model

Surely the Grameen model cannot be blamed for its complexity: its appeal lies in the simple yet effective method of dispersing loans to those who demonstrate a need and desire for self-motivated entrepreneurship. Understanding that the poorest of the poor have been excluded from access to financial services, Grameen's Solidarity Group Lending model uses social collateral to ensure repayment of small loans approximately (in size). Essentially, small loans are distributed individually to women organized in groups of five; it is the job of this group to ensure that weekly loan repayments are met.

Believing that credit is an essential human right, the system operates on a premise of trust and a vehement conviction that poverty is not created by the poor, but rather the institutions and policies which surround them. Pitt and Khandker (1998) underscore this notion in their examination of individual and household outcomes in Bangladesh; they

conclude that access to credit is a significant determinant of many household outcomes, allowing for increased labor supply and asset holding.[1]

Grameen credit aims to promote the skills of the poor which remain "unutilized or under-utilized", in order to bring them out of poverty by "unleashing [their] energy and creativity to answer poverty". It is due to this belief that Grameen does not offer job training or career building services. Rather, the emphasis is on building social capital in the impoverished women by incorporating them into a system which gives them the ability to exercise leadership (through group or center leadership) and self-initiative (through proactive entrepreneurship).[2]

2.2.1 Who is Eligible?

Grameen caters to the rural landless who qualify as the poorest of the poor: this means that their lack of collateral has disqualified them from traditional financial services. Qualifying as landless means that one possesses less than half an acre of land or assets that amount to less than the value of an acre of medium quality land: this definition thus makes eligible approximately half of the rural population[3]. Less than this established quantity of land indicates that the potential client has few resources which can be effectively used for income generation; as such, they will benefit greatly from financial assistance. Grameen's unique model addresses the issue of collateral when dealing with the destitute. This demographic has been denied access to financial institutions because they have no collateral with which to ensure repayment of a traditional loan. The high opportunity cost of the meeting and the small amount of loan makes the Grameen system unappealing to large farmers and the rural rich, effectively dismissing them from the program.[4] The demographic targeted then is inherently narrowed to the landless and the destitute.

To guarantee payment, Grameen developed a Solidarity Group Lending model in which groups of five are assembled to use peer monitoring and social collateral to enforce repayment and efficient monitoring of the business. High risk borrowers are screened out of the process, as in a village environment one's reputation as unreliable would prevent others from joining with in a group with that individual. Furthermore, joint liability is imposed upon the group. If one member of the group defaults on a loan, all are penalized for such a behavior. Group members are thus given a strong motivation to not only help

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[1] Khandker, Shahidur and Faruquee, Rashidur. "Impact of Farm Credit in Pakistan." World Bank. pg 18.

[2] Yunus, Muhammad. "Expanding Microcredit Outreach to Reach the Millenium Development Goals". Presented at the International Seminar on Attacking Poverty with Microcredit. Dhaka, Bangladesh. 9 January 2003.

[3] Hashemi, Syed M. & Schuler, Sidney Ruth. "Sustainable Banking With the Poor: A Case Study of Grameen Bank." 2 July 1997.

[4] Goheer, Nabeel. "Microfinance: A Prescription for Poverty and Plight of Women in Rural Pakistan." Rural Finance for Growth and Poverty Alleviation.

one another, but also ensure repayment and proper conduct as per the rules of Grameen Bank. Peer monitoring reduces transaction costs incurred by the primary institution by placing it in the hands of the social pressure mechanism.

The groups are self-selected and must be homogenous in their gender composition. Although men and women both have opportunities to join, women have dominated the process and now take 94% of all distributed loans. Group members cannot be related in any manner, must have similar social and economic backgrounds to prevent unequal bargaining strength, and must be from the same village. Upon selecting a suitable group, the members are sorted into a center consisting of five groups each. The process of screening now begins: members are subjected to fourteen days of meetings in which they must learn to sign their name, learn about Grameen's objectives, and memorize Grameen's Sixteen Decisions for proper social conduct. Discipline is highly emphasized during this month of training, with the assigned loan officer testing and quizzing members to ensure their suitability for the program. Furthermore, the training also fosters a closer relationship among women not only in the group but also in the center; this creates a strong social network in which women can support each other as they embark on what will be for many their first entrepreneurial venture. Loans are disbursed only when the loan officer is satisfied with the knowledge of all members of each group.

Self-selection and peer pressure are the two salient features which allow the Solidary Group Lending model to work. The former, however, may interestingly work to the detriment of what Syed Hashemi terms the "hard core poor". Though most studies of Grameen Bank laud the institution for its remarkable ability to target the poor, the issue of differentiation within the ranks of the poor problematizes an effective targeting of this demographic. The "hard core poor" are those who are "forced to subsist on a per capita income that is less than half that of the poverty line[5]; this group often self-selects itself out of Grameen participation only because they consider themselves to be not credit-worthy. In Hashemi's words, they "do not feel they have enough resources to generate incomes to pay back loans…and thus self-select themselves out of membership". Out of 313 target group households interviewed in Rangpur and Faridpur, 120 women had chosen not to participate: 55 thought they would not be able to manage the money and thus would incur more debt; 35 thought that leaving home for Grameen meetings with males present would violate social norms; 11 were rejected for being high-risk or having high-risk husbands; and 19 said the rules were too complicated to understand and they were unable to memorize the Sixteen Decisions[6]. This observation of the self-selection bias is important in that it indicates that microfinance must be tailored to suit the individual perceptions of the target groups: encouraging confidence and optimism in the ability to help oneself is a necessary prerequisite for the success of a microfinance program hinged upon self-initiative.

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[5] Rahman, A. (1999). "Micro-credit Initiatives for Equitable and Sustainable Development: Who Pays?" World Development **27**

[6] Syed M Hashemi, "Those Left Behind: A Note on Targeting the Hardcore Poor" in Geoffrey Wood and Iffath Sharif editors, Who Needs Credit? Poverty and Finance in Bangladesh, (Dhaka: University Press Ltd, 1997).

2.2.2 Services Offered

i. *General Loan:* The General Loan is a loan of Tk 1000 dispersed to women for entrepreneurial activities. There is a 20% declining interest rate on these loans. The loans are entirely financed from the banks own deposits, with over 64% of the deposits coming from the bank's own borrowers.

ii. *Housing Loan:* Housing loans are provided for the construction of sanitary and stable housing. The maximum amount dispersed is Tk 15000, with the amount to be repaid over a period of 5 years in weekly installments at 8% interest. The average housing loan is approximately Tk 13000. To date, 627058 houses have been built with the assistance of this loan, with Tk 8.33 billion dispersed to that end.

iii. *Emergency Loan:* The Emergency Loan can be granted in times of distress.

iv. *Struggling Members Program:* Notably, Grameen has expanded its services to include what is called the Struggling Members Program, which disperses small loans to beggars with a completely flexible and optional repayment term. No interest is charged, and members are covered under life insurance and loan insurance programs. The intention is to increase the self-esteem of beggars and allow them to sell small goods as they beg, in the hopes of stimulating some form of entrepreneurial spirit. To an extent, the Program targets those who self-select out of participation in Grameen's more mainstream programs because of a lack of resources or of confidence in one's entrepreneurial abilities. Approximately 63000 beggars have already joined the program, with disbursed amount standing at Tk. 45.92 million.

v. *Micro-enterprise Loan:* These larger loans are granted to borrowers with significant business savvy, with no maximum amount specified. The funds are used to purchase merchandise such as irrigation pumps, transport vehicles, and other equipment not accessible due to restrictions of the smaller loan. Thus far, 668,389 members have taken these larger loans, with Tk 14.50 billion dispersed.

vi. *Education Loans:* Children of parents who are involved with Grameen are given education loans which cover tuition, maintenance, and other school expenses, provided that they have reached the tertiary level of education. As of December 2005, almost 9000 students had received these loans.

2.3 Organizational Model

Grameen's efficiency lies in its decentralization. The transparent, simple system of loan disbursement delegates decision-making powers to the lowest relevant level, whether that is the branch, center, or group. The group-lending process dismisses the often high transaction costs associated with targeting a lower socio-economic demographic.

Grameen is able to maintain a large target size because the group-lending process not only encourages peer pressure as a means of repayment enforcement, but also because the screening process is no longer concentrated in the hands of the bank, as it is in the traditional financial sector. Shifting the time-intensive burden of the screening process to the client reduces quite a bit of transaction cost and labor intensity[7].

Weekly meetings also enhance the transparency of the loan disbursement, emphasizing their regular and public nature, as well as cuts down on adverse selection problems by encouraging discussion of any issues facing a group or center. Furthermore, the regularity of the weekly meeting creates an organizational structure in which loans are paid regularly, loans can be received continuously and simultaneously, and the loans are monitored consistently and transparently. This cuts down on messy, time-consuming efforts of repayment enforcement, as the group and center inherit this responsibility rather than Grameen as an institution. Corruption is also kept to a minimum by the weekly meeting: financial transactions take place in front of all borrowers and the rationale for granting or rejecting loan applications are openly discussed, so the potential for bribery and preferential treatment is limited. Suspicion that such corrupt practices may occur is also defeated, and encourages those relationships of mutual trust which are so vital to the function of the Group Lending Model[8].
The weekly visits of the loan officer to the center develop a close, personal rapport between lender and borrower, facilitating problem solving and enhancing consistent transparency[9]. Constant contact with the clients in the clients' own communities also ensures a high level of familiarity with socio-cultural demands on and the economic needs of particular borrowers, and allows a tailor-made response to any obstacles that may arise as a result of these particular situations. The design of the system allows for a certain amount of flexibility in implementation, and as such the procedures of the program become "fine-tuned" by the staff in order to best suit their clients[10]. Minor problems, such as issues of interference by husbands and family members, can be addressed by the field staff effectively and quickly as a result of this decentralized system. Furthermore, the transparency of the operating procedures instills a trust in the system that could not be earned were there not a decentralized, personalized system of monitoring.

Grameen's emphasis on self-sufficiency and initiative is visible even on the organizational level: branches are encouraged to become self-sufficient as soon as

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[7] Goheer, Nabeel. "Microfinance: A Prescription for Poverty and Plight of Women in Rural Pakistan." Rural Finance for Growth and Poverty Alleviation

[8] Hashemi, Syed M. & Schuler, Sidney Ruth. "Sustainable Banking With the Poor: A Case Study of Grameen Bank." 2 July 1997.

[9] Latifee, H.I. "Microfinance and Poverty Reduction: Experiences of Grameen Operation in Asia." Presented at Asian Regional Conference, 27-30 November 2000. Grameen Trust publication.

[10] Hashemi, Syed M.

possible. Branches monitor the center's behavior and offer day-to-day contact with members. Area offices manage the branches, and function under the auspices of zonal managers. According to Hashemi, almost all major policy decisions are taken at zonal manager conferences in which "extensive critical assessments" of performance and intensive deliberations occur. Each zone policy is thus geared towards managing the problems that occur in its own jurisdiction according to norms and cultural nuances in each. The ability of the staff to familiarize themselves and target the issues in their jurisdiction is reinforced by an intensive introductory training program as well as in-service staff training, intended to support "a problem-solving culture [which] puts total trust in the creative potential of its staff and clientele in crisis management"[11].

2.4 Grameen Operations and Poverty Reduction

Poverty can be observed in many forms. It may be a lack of income or of resources, a lack of coping capacity, a lack of basic human capabilities, a lack of institutional defenses or in extreme cases a lack of all of these. In a broader sense, it may be a combination of economic, social and political deprivations. Amartya Sen argues that economic poverty is not the only kind of poverty that impoverishes human lives. He says that the linkage between economic, political and social deprivation should not be ignored.

Grameen Bank is the largest specialized bank for the poor. It has nearly 2.4 million borrowers. It lends about $ 30 million every month. It is operating in more than 40,000 villages of Bangladesh. Its cumulative loan disbursement has already crossed the 3 billion dollar mark. Grameen households have reaped significant economic and social gains from the financial services provided by Grameen. They have become politically more conscious.

i. Economic Impact

Grameen has been widely researched and recognized for making a difference in the lives of its members. According to a study based on a household survey in an area where Grameen has been operating for more than a decade, about 50% of the Grameen households have crossed the poverty line. Another 25% was about to cross it and the rest was struggling mainly because of health reasons.

Another study examining the economic effects of Grameen on the life of its borrowers, compared the situations 'before' and 'after', 'with' and 'without' Grameen. It considered the effects of Grameen operation on capital accumulation, employment, income and poverty alleviation.

The study found that without any capital base at the beginning, the Grameen borrowers started accumulating capital as they joined Grameen. Grameen loan is required to be paid back in small installments every week. The borrowers pay the installment from generated

[11] Latifee, H.I. "Microfinance and Poverty Reduction: Experiences of Grameen Operation in Asia." Presented at Asian Regional Conference, 27-30 November 2000. Grameen Trust publication.

income, leaving the original capital intact. Their capital base usually increases in large amounts as they go for subsequent loans. They go for medium and long term investments, such as the purchase of cattle, machinery, tools or equipment with their expanded capital base.

The study also found that 31 percent of the borrowers reported themselves as unemployed before joining Grameen. Grameen created new employment for them and specially for the female members who were earning nothing before. The effect of Grameen loans on reducing unemployment is impressive. The borrowers were found less underemployed than before. More than 91 percent of the borrowers in the survey area reported that Grameen had made a positive contribution to their standard of living. The bank has been able to lift a significant proportion of its borrowers and their household members out of poverty.

A World Bank study found that profits from Grameen-financed businesses were increasing borrowers' consumption by 18% per year, and that the percentage of Grameen borrowers living in extreme poverty was reduced by 70% within 4.2 years of joining. The Grameen operation not only reduced poverty and improved welfare of participating households, but also enhanced households' capacity to sustain their gains overtime.

Grameen borrowers have been found to improve their conditions in terms of housing and clothing too. They can afford warm clothes during winter seasons. Till the end of June 2005, they have built 528385 houses with housing loans from Grameen. Women are the owners of 92% of these houses. They hold the title for the land on which houses are built. This was unthinkable for them before they joined Grameen.

a. Coping Capacity

If increasing capacity to cope with calamities is considered to be an indicator of improving poverty situation, the experiences of Grameen shows that microfinance members are in better positions to cope with such situations. During two and a half month of devastating flood which hit Bangladesh in 1998, it was found that Grameen borrowers were relatively less vulnerable and more capable to deal with the situation during and after the flood. They had their savings, they had their institutional back-up and they had their peer support. They were able to go for rehabilitation immediately after the flood water receded. The crisis management capacity of Grameen households was found to be higher than others.

In fact, the severe flood, provided both a challenge and an opportunity for microfinance programs in Bangladesh. The challenge was to recover from the losses caused by the flood and to bring the poor back onto the path of sustainable development. The opportunity was to consolidate and improve upon the existing modalities in order to bring the most affected families within the fold of microfinance program and to have more impact on the socio-economic condition of the poor. Grameen and other such programs could do more under such disastrous situations if they had access to more funds. Such funds are needed to replenish their cash flow which gets depleted due to withdrawal of

savings by members, fresh loans to old borrowers, new loans to new borrowers and non-recovery of loans from flood affected borrowers.

b. Saving

Saving has always been an integral part of the Grameen program. It is designed to address production and other risks as well as market imperfections. Compulsory Savings are mobilized in group funds under Grameen system. Grameen members made cumulative savings of US$ 249 million in their group funds by September 2005 which they use for any purposes they like.

ii. Social Impact

The poor have little access to education, health, sanitation and other social services. They are socially condemned, rejected and powerless. In the case of poor women the situation is worse. In many societies including Bangladesh, women are generally confined to their homes. They are not supposed to be seen outside their household environment. Their sphere of work is largely restricted.

Under these circumstances Grameen provides them a forum where they are organized into groups and federated into centres. They become decision makers, leaders and a social force. They become group and centre leaders and also members of the Board of Directors of Grameen Bank, which they own. In the Board of Directors they are nine out of twelve members in total. The Grameen borrowers go for implementation of social development programs under the 16 decisions that they have taken. They take loans from group funds and also from Grameen loan portfolio for different purposes including tubewells, sanitary latrines and education. The Grameen borrowers who became village phone ladies by leasing cellular phones for providing village pay phone (VPP) services to the neighborhood, are not only earning more but also enjoying a gracious social status. They brought the world closer.

Grameen women have become mobile. They are exposed to the outside world and are active participants in the process of globalization by attending centre meetings, workshops, interacting with national and international dignitaries, producing, selling and buying different products. The handloom product of Grameen borrowers known as Grameen check is now exported to European and American markets.

Grameen borrowers become more conscious about their family size and family welfare and determined to improve their quality of life. Studies show that infant mortality among Grameen families has decreased by 34%, and the adoption of family planning among them is more than the national average for Bangladesh.

Whatever indicators such as respect from neighbors and spouses, self-esteem, self-confidence, self-expression, ability to protest social injustice, capacity to solve social issues are applied to measure changes in social conditions of women, the Grameen borrowers are found better off than others. The process is continuing and progress is visible.

Grameen's approach to social reform is embodied in the Sixteen Decisions: these are an example of a social development program intertwined with micro-credit delivery. Developed in 1984, the Sixteen Decisions are an integral part of Grameen Bank's mission: all potential and current borrowers are expected to memorize them, and adherence to the Decisions is monitored by the Loan Officer. Additionally, the loan officer is to explore one decision per week in-depth, and reinforce its applicability to the borrower's lives and answer their questions to that end. The decisions are:

1. We shall follow and advance the four principles of the Grameen Bank (discipline, unity, courage, and hard work) in all walks of our lives.

2. We shall bring prosperity to our families.

3. We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest possible.

4. We shall grow vegetables all the year round. We shall eat plenty of them and sell the surplus.

5. During the planting seasons, we shall plant as many seedlings as possible.

6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.

7. We shall educated our children and ensure that they can earn to pay for their education.

8. We shall always keep our children and the environment clean.

9. We shall build and use pit-latrines.

10. We shall drink tube-well water. If it is not available, we shall boil water or use alum.

11. We shall not take any dowry in our sons' weddings, neither shall we give any dowry in our daughters' weddings. We shall keep the center free from the curse of dowry. We shall not practice child marriage.

12. We shall not inflict any injustice on anyone, neither shall we allow anyone to do so.

13. For higher income, we shall collectively undertake bigger investments.

14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help them.

15. If we come to know of any breach of discipline in any center, we shall all go there and help restore discipline.

16. We shall introduce physical exercise in all our centers. We shall take part in all social activities collectively.

The Sixteen Decisions are a social development agenda that places primary responsibility on members rather than on Grameen Bank for implementation; as such, the expenditure incurred by Grameen for this social development program is minimal. The simple approach is easily understood by the participants, and reinforced through regular recitation and discussion. Furthermore, they are closely tailored to the setting of rural Bangladesh by having tangible and specific demands, rather than nebulous, ambiguous statements of principle.

iii. Political Rights

Poverty alleviation does not only mean meeting basic food and non-food requirements but also exercising political rights and enjoying political freedom. Freedom of speech, freedom of choice, freedom of enjoying human rights, freedom of casting and seeking votes for public office and other posts are some of the indicators by which it may be measured whether the poor organized under Grameen have a better understanding of their political rights and obligations.

Although it is a modest beginning, it is significant to note that Grameen borrowers and their household members are taking part in larger numbers as voters and candidates in local and central government elections. They are encouraged to discuss their rights at their centre meetings before elections and to take decision to vote for candidates who according to their judgement will advocate for and serve their cause.

During the local government elections held in 1997 many Grameen borrowers contested and became elected. According to reports, in the 1997 Local Government election 23 Grameen members including 21 women contested for the post of chairman and only 2 members were elected. They were male. In the same election 5,828 Grameen members including 4,877 women contested for membership and 1,753 of them were elected including 1,485 women candidates. The percentage of Grameen members in the local government bodies is about 7 percent.

2.5 Grameen Partners

Grameen partners worldwide believe in the great power of microfinance. There are more then 400 replication partners operating in 66 countries of different continents including 169 partners operating in 19 countries of Asia. The total outreach of Asian partners who have received both financial and technical assistance or only technical support form Grameen Trust is 630,772. About 98% of their borrowers are poor women. The amount of loan disbursement by them is $ 156.47 million and the amount of saving mobilized by

them is $ 11.19 million. They are enjoying a repayment rate of about 96%. They are trying to serve the poorest and at the sametime operate on a sustainable basis. The mature and leading ones among them have already attained operational or financially self-sufficiency at many of their branches including a few that have attained institutional self-sufficiency. They have been able to change the attitude of their borrower households and improve the quality of life of their members.

To see the impact of Grameen operation on poverty situation in different parts of Asia we discuss below the experiences of 5 Grameen partners in 5 countries of Aisa. These are IDF in Bangladesh, RDI in China, SHARE in India, KASHF in Pakistan and CARD in the Philippines.

2.5.1 IDF, Bangladesh

Integrated Development Foundation (IDF) started it operation in Bandarban Hill District of Bangladesh in 1993. It is now working in all the districts of Chittagong Hill Tracts and also in the urban areas of Chittagong city. Its total outreach is 19,476. All of them are women. At the time of entry, 44% of IDF members belonged to bottom 25% of poverty line and 56% of them belonged to bottom 25-50% of poverty line.

The total disbursement of loan made by IDF is $ 3.86 million. The repayment rate is 100%. The total amount of saving generated by IDF members is $ 0.32 million.

According to an evaluation report about 31% of IDF members crossed the poverty line by the end of 1999. To examine the impact of IDF a case study of an IDF member is presented below.

Ms. Ching Kwoyai Marma is a member of the centre number 3 of IDF Shoalok Branch in the Chittagong Hill Tracts. She has taken loan for 7 times. She is one of the oldest members of IDF. She has fully utilized her loan. She never failed in her repayment installment. Before joining IDF her family lived in absolute poverty and had no income generating activities. They had no house of their own. But after receiving credit facilities from IDF for last 7 years, she has now a house of their own, her family can afford to take 3 meals a day, they have enough clothes and blankets for winter, they use mosquito nets, they drink pure water and use sanitary latrines. They grow vegetables round the year for their own consumption as well as for selling in the market. They are now happy.

2.5.2 RDI, China

Rural Development Institute (RDI) is serving about 14,000 members in the rural areas of Henan and Hebei provinces of China. They are all poorest women. RDI has made a loan disbursement of about 5 million US$ to its borrowers and mobilized savings of about US$ 1.5 million from them. It has already achieved operational self-sufficiency. It is enjoying repayment rate of 99%.

According to a study, there has been a significant increase in income and asset ownership of its borrowers. To cite an example, Ms. Zhang Xiuqin of Yucheng, China received her first loan of 1,000 Yuan from RDI for her husband's furniture making business. With her second loan of 2,000 Yuan she bought a pregnant pig for 700 Yuan, which has since given birth to eleven piglets, some feed and wood for her husband's business. Xiuqin's family farms four mu of land. She sells the vegetables in the market at a profit of approximately 1,000 Yuan per year. Her husband makes an average of 500 Yuan per month in selling furniture. Xiuqin expects sold the 11 piglets for 3,000 Yuan. They have built a new home for about 3,000 Yuan in which she, her husband and their four children are living. All her children are going to school. She reports that she has had no difficulty in repaying her loans and would like to continue in the project and eventually expand her activities. With the increasing income the family's diet has also improved. Whereas corn and wheat have previously been the main food, their meals now include more vegetables, sweet potatoes, meat (two or three times per month) and some rice in addition to wheat.

2.5.3 SHARE, India

Society for Helping Awakening Rural Poor through Education (SHARE) has grown into a major microfinance institution in India that provides financial services to more than 61,000 poorest women in the rural areas of Andhra Pradesh. It started its operation in 1992. It has different loan products including loan for housing. More than 50% of its loans has gone for animal husbandry projects. Up to September 2000, SHARE has disbursed over $ 13 million to its borrowers and mobilized an amount of more than $ 1.3 million as savings. It is enjoying 100% repayment of its loans.

According to a study conducted by IFPRI/NIRD, 85% of SHARE clients constitute the bottom 20% of the individuals living below poverty line. A recent impact study on women who have been borrowing from SHARE showed very positive results of SHARE operation on the life of its borrowers in terms of increase in income, improved nutrition, increased expenditure on non-food basic needs, shift from wage employment to self-employment, increased access to agricultural land, increase in savings, better housing, women empowerment, etc. The study indicates that about 50% of the SHARE households have already crossed the poverty line. SHARE has already achieved operating self-sufficiency. It hopes to achieve financial self-sufficiency soon.

2.5.4 Kashf, Pakistan

Kashf Foundation is one of the pioneering organizations that is providing financial services to the poorest women in Punjab in Pakistan. It has more than 4,000 borrowers. The total amount of loan disbursed by it is about $ 600,000. It has mobilized more than $64,000 as savings from its members. Its repayment rate is 100%. It has achieved 35% operating self-sufficiency. An impact study of the Kashf revealed that 94% of its borrowers have experienced positive economic and social changes in their households and 75% of them feel that without Kashf's loans it would not have been possible for them to take business activities and to generate employment and income.

2.5.5 CARD, Philippines

Center for Agriculture and Rural Development (CARD) is one of the leading micro-finance institutions in the Philippines. It is serving more than 34,000 poorest women. By the end of September 2000, it has disbursed about $ 17.25 million to its borrowers as loans and mobilized over 1$ .4 million as savings from them. Its repayment rate is 100%. It has already achieved institutional viability. According to an evaluation study, CARD has largely succeeded in reaching very low income households and generating the self-employment and significantly increasing their income. At the time of joining 100% of CARD members belonged to the bottom 50% of the population living under poverty line. As per CARD impact study 50% of its borrowers have already crossed the poverty line.

CHAPTER 3: Village Bank

3.1 What Village Banking Offers?

Village banking offers several important services:

i. Credit — in the form of a loan to a group of approximately 15-30 individuals

ii. Savings services — both forced and voluntary

iii. Non-financial services — informal and sometimes formal as well

iv. The internal account — offered by some VBIs, the internal account provides additional credit, savings, and non-financial services.

Each of these services is now briefly discussed. Readers already familiar with village banking may wish to skip to the next section.

i. *Credit:* Village banking starts with a loan from the village banking institution (VBI) to a group of approximately 15-30 individuals. In this way it resembles solidarity group lending, only the group size is larger than the 3-7 individuals who commonly receive a solidarity group loan. The 15-30 individuals form a village bank, adopt bylaws, and learn how to keep records of all financial transactions. They elect a president, treasurer, and perhaps other officers to run meetings, collect and disburse money, and generally manage the affairs of the village bank

in receiving and providing services. Analogous to the case of solidarity group lending, all village bank members are responsible for the repayment of the loan that has been granted by the VBI to the village bank and divided among its members. If the village bank fails to repay its loan to the VBI, it typically faces the cutoff of all VBI-provided services. Therefore, village bank members have strong incentives to admit only responsible individuals to the village bank, who are likely to repay their loans on time. Since it is fundamentally the village bank that decides the size of the loan each village bank member receives—with some input, perhaps, from the VBI loan officer, who is the VBI's representative to the village bank—all village bank members also have incentives to make sure that no individual borrows more than she is capable of repaying.[12]

ii. *Forced savings:* VBIs typically require each village bank member to save. These *forced savings* are often a significant percentage of the amount the member has borrowed from the VBI. For example, forced savings range from 10 to 32 percent of the amount borrowed in the four leading Latin American VBIs analyzed in this study. Forced savings serve at least two major purposes. First, they act as cash collateral, to deter the complete failure of village banks and lessen the effects of such failures on the VBI. Forced savings are also used to cover the more routine cases of individual loan delinquency that do not threaten the village bank's existence. The second purpose of forcing village bank members to save is to introduce them to the discipline and habit of saving and to the possibilities that having a sizable savings balance could open up for them. For example, a sizable pool of savings could be used for emergencies, to pay school fees and other large household expenditures, to buy tools or machinery, or to start another business.

Because they act as cash collateral, forced savings are undoubtedly useful to the VBI. However, the utility of forced savings to clients is more open to debate. This is because of the compulsion that *all* clients must save *all* of the time regardless of the business or other uses that they might have for these savings. In addition, these savings are often made quite inaccessible to the client. Many clients might be able to more quickly increase their incomes and escape poverty if they were allowed to take some or all of their forced savings contributions and invest them in their own businesses, either as additional working capital or to buy tools and equipment. VBIs differ in the degree of inaccessibility they impose: some allow clients to withdraw their forced savings at the end of every loan cycle (typically, every 16-24 weeks), while other VBIs allow clients to access these savings only when they leave the village banking program or perhaps in cases of severe emergency, such as a hospitalization. While requiring all clients to save all of the time appears to have important drawbacks, advocates of forced savings argue that many clients lack the willpower to save on their own. Moreover, if clients are allowed easy access to their savings, they might spend these savings on relatively trivial consumption items or feel pressured to help relatives and friends in financial need.

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[12] Since village bank clients are overwhelmingly women, we adopt the convention of referring to them using the feminine pronouns, such as "she" and "her."

iii. *Voluntary savings:* VBIs typically also provide their clients the opportunity to save voluntarily, over and above the amounts they are forced to save. One of the great advantages of village banking is that it provides a way not only to offer its clients credit, but also savings services. By pooling all of their forced and voluntary savings together in a single deposit account, members of a village bank can often overcome the deposit minimums and low balance fees imposed by many banks and other deposit-taking financial institutions. When members are located some distance from the financial institution, using this single village bank savings account can also drastically reduce transactions costs for the savers. One or two village bank members can make the trip for many, combining deposits and withdrawal requests along with VBI loan repayments in a single journey. VBIs that permit internal account lending provide savers with the added possibility of earning much higher interest rates than those normally paid by banks, on both voluntary and forced savings (see the discussion of the internal account, later).

iv. *Informal non-financial services:* Village banks meet regularly (generally weekly or biweekly, sometimes monthly) to collect each member's loan payment, take savings and pay out savings withdrawal requests, and transact other business. While these meetings take members away from their own businesses for a significant period of time (a meeting typically lasts 1½ -2 hours), they are the vehicle through which village bank credit and savings services are delivered. These regular meetings also provide members with a number of other benefits, which include what may be called informal non-financial services. Among these services are the networking, informal technical assistance, empowerment, enjoyment from socializing, and the sense of belonging that can all come with participation in a village bank. Pro Mujer emphasizes the last two of these benefits when they describe why many of their Bolivian clients refuse to leave their village banks and take individual loans even though the individual loans are often larger and have much more flexible repayment terms. Opportunity International underscores the importance of the networking that takes place among the businesswomen in many of their village banks. Because of this phenomenon, Opportunity International believes that it is important to offer the alternative of solidarity group loans, not just individual loans, to village bank members needing larger or more flexible loans. Informal technical assistance and empowerment are also important benefits of village banking. The former refers to village bank members sharing knowledge and ideas to help one another with business problems. Empowerment is a widely-cited benefit of village banking and is particularly relevant to women.

Freedom from Hunger (1996, p. 3) offers an excellent explanation of the meaning of empowerment and the role of village banking in empowering its members. "By helping the poor to successfully manage their own self-help groups and help each other to use credit to increase their incomes and begin saving, these [village banking] programs engage them in vital activities that improve their confidence, self-esteem, and control of their environment. They undergo a profound

psychological transformation that many writers today call 'empowerment'—a transformation of attitude from 'I can't' to 'I can.' Reinforced by their successful use of credit and their solidarity with others in their village bank, the poor expand their awareness of the possibility of improvements in their lives."

It is particularly empowering for village bank members to see their income and savings grow since members play such a large role in managing their own village bank. For example, members decide who will be allowed to join and remain in the village bank and what size loan each person will receive during each loan cycle. Members also elect officers, serve as officers (on a rotating basis), run meetings, keep the books, and set their own rules such as levying fines for missing loan payments or arriving late to meetings. If the VBI permits an internal account, the village bank members decide who will be allowed to take out an internal account loan and what size loan they will be granted. Village banks that are divided into several solidarity groups offer additional leadership opportunities to those who serve as the head of each solidarity group.

Village banking focuses almost entirely on women because women so often need the empowerment that village banking provides. Freedom from Hunger (2002, p. 6) explains this in eloquent terms. "The education of girls is [often] treated as a low priority and, although mothers are the primary caretakers of young children, their status in the community is perilously low. In the face of such enduring obstacles, a woman's doubt in her ability to create positive change becomes ingrained. Yet hope and strength spring from the collective courage of women who gather together."

v. *Formal non-financial services :* Some VBIs offer formal non-financial services and some do not. For example, of the four VBIs examined in detail in this paper, CRECER and Pro Mujer Bolivia offer formal non-financial services and Compartamos and FINCA Nicaragua do not. CRECER and Pro Mujer Bolivia take 20-30 minutes during each village bank meeting to provide all village bank members with education in how to improve their businesses and in a number of basic health areas. Pro Mujer Bolivia also provides primary health care services such as vaccinations, breast examinations, and counselling using nurses and other trained professionals. It also argues that under certain circumstances offering non-financial services to very poor clients should not disqualify a VBI from being able to become a licensed, deposit-taking financial institution.

vi. *Internal account:* Perhaps no subject in village banking elicits such heated debate among practitioners as the question of whether to offer internal account loans. The reason for this is that there are many strong advantages and disadvantages associated with offering these loans.

Money is collected from several sources in the internal account, and then used to make loans to village bank members. In addition to being a source of

supplemental credit, the village bank internal account also provides members with savings and non-financial services.

The internal account is primarily funded from the following sources: the forced and possibly voluntary savings of village bank members (savings usually account for most internal account funds), fees and fines levied by the village bank on its members, interest income earned by lending out internal account funds to members, and interest earned by placing funds in a commercial bank account. In addition, while VBIs generally insist that each member repay her VBI loan on a regular basis (e.g., weekly or biweekly), a few VBIs, such as CRECER, allow these payments to remain in the village bank's internal account for many weeks at a time. For example, in its 16-week loan cycle, CRECER only removes member loan repayments from the village bank internal account in weeks 12 and 15. This allows the village banks to use these funds for additional internal account lending during most of the loan cycle.

The internal account funds are used to make supplemental loans to village bank members, including loans for emergencies, consumption, and additional business needs. Generally, these internal account loans can begin and end at any time during a single loan cycle. Thus, in both purpose and timing, internal account loans are more flexible than the external account loans members have with the VBI. Members also like internal account loans because they are normally repaid in bullet fashion, that is, with a single repayment of both principal and interest at the end of the loan term. This allows members additional time to work with all of the money they have borrowed and may reduce the effective interest rate they pay. On the other hand, internal account loans are often much smaller in size than the member's external account loan—either because of the limited amount of funds available in the internal account or because the VBI's rules require them to be so. Thus, while internal account loans may reduce the demand for external account loans, they rarely eliminate the need for external funds.

The internal account also provides an important savings vehicle. Instead of village banks earning only a few percent per year by placing their forced and voluntary savings in a commercial bank deposit account (an interest rate that is typical now in many Latin American countries, with their low inflation rates), the internal account often yields 2.5-5 percent per *month* on savings that are loaned out to other village bank members. This is because internal account loans normally carry an interest rate that is at least as high as the rate the VBI charges on its own (external account) loans to village bank members. These high internal account loan rates are generally mandated by VBIs in order to avoid further reducing the demand for their external account loans.

The village bank decides which of its members will receive internal account loans and how much they will be granted, and also does all of the bookkeeping. By acting as a vehicle for village bank members to manage and invest their own money, the internal account provides members with an additional source of

empowerment, business skills training, and group solidarity. While these are valuable non-financial services, the internal account also gives rise to several new problems: issues of favoritism in granting internal account loans, internal account loan delinquency, and fraud problems arising from village bank officers or other members stealing or misusing internal account funds.

3.2 The Inflexibility of Village Banking

This section argues that village banking needs to continue becoming more flexible and client-oriented in order to increase client satisfaction, retention, and impact. By improving client satisfaction and retention, VBIs will also tend to increase their own scale and sustainability through a number of channels. For example, with a greater percentage of village bank members satisfied and remaining in the program, client growth rates will increase, not only because there are fewer dropouts but also because new clients will likely become easier to attract. Portfolio growth will be fueled by the growth in the client base and also because, with clients tending to remain in the program longer, many will take out larger loans. VBI scale and sustainability will be increased for all of these reasons and because VBIs will avoid the high costs of replacing dropouts with new clients who must be given initial training in the village banking methodology and started off with tiny loans.

Compared to individual loans, village bank loans are very inflexible. Each member of a village bank receives a loan from the VBI that starts on exactly the same date and has the same term and the same repayment frequency (usually weekly or biweekly). Although different members are normally allowed to have different size loans, there is generally a cap imposed on the maximum size of the loan to any single village bank member. This is done so that small borrowers in a village bank are not required to guarantee loans that are much larger than their own since a default on even one of these large loans could be very burdensome for the small borrower. In contrast, micro-entrepreneurs who take out individual loans from a micro-finance institution (MFI) are normally able to start their loans on a date of their own choosing. These micro-entrepreneurs are also likely to have much greater flexibility to request the loan term and repayment frequency that best suit their individual needs within the range of what is offered by the MFI and perhaps after successfully repaying one or more loans (to establish their creditworthiness). Finally, micro-entrepreneurs with individual loans are not likely to face as low a ceiling on maximum loan size as they would with a village bank loan since there are no considerations of risk to small borrowers to take into account.

Village banking imposes other important inflexibilities on its clients that individual lenders normally do not. The most important of these is the forced savings requirement discussed above. Unlike the inflexibilities imposed by village banking on its loans, however, the village bank forced savings requirement appears to be inherently useful to at least some of the village bank clients, though it may be detrimental to others.

Finally, village banking also imposes important transactions costs and risks on its clients. However, it is unclear whether these transactions costs and risks are more onerous on the

whole than the transactions costs and risks imposed on clients by the individual lending methodology. Village banking clients must attend frequent and lengthy meetings, with village banks in Latin America typically meeting every week or two and the village bank meetings normally lasting 1½-2 hours. By contrast, individual loan clients do not have to attend weekly or biweekly meetings, but each individual loan client must instead carry his or her loan repayments to the lender—often once a month, but sometimes every week or two, depending on the MFI and client. Village banks must maintain bookkeeping records of all financial transactions and most are required to take member loan repayments and savings to town for deposit after each meeting. On the other hand, the village bank meetings and the bookkeeping requirements also offer the possibility of imparting important non-financial services, as discussed earlier. Finally, village bank members must bear the risks of guaranteeing the loans of everyone in the village bank, a risk that is avoided under the individual loan technology.

In summary, although village banking offers important savings and non-financial services that individual lending does not provide, many village banking clients may not value these services enough to be worth the inflexibilities, costs, and risks that the village banking methodology imposes on them. These clients may try out village banking for a while but then drop out once the program's rigidities and demands become clear to them. Some VBIs are aware that they have a problem in this area, as revealed both in conversation and in the literature. For example, Natilson (2000, p. 21) refers to Pro Mujer Bolivia's "low client retention rates" and McCord (2000, p. 19) cites "relatively high dropout rates" in FINCA Uganda.

Table 1 shows that VBI client retention rates are indeed low compared to the retention rates achieved by individual and solidarity group lenders. This suggests that village banking still needs to increase the flexibility and client-orientation of its methodology in order to improve client satisfaction and retention, as well as VBI sustainability and scale. Specifically, Table 1 presents client retention rates for the years 2003-05 for a number of VBIs as well as for a comparison group of individual and solidarity group lenders. All retention rates are calculated using the same formula, so that the data shown are fully comparable. Table 1 gives retention rates for Pro Mujer Bolivia, FINCA Nicaragua, and Compartamos, that is, for each of the four VBIs analyzed in detail in this paper except CRECER, these data being unavailable for CRECER. Retention rates are also shown for the other Pro Mujer program on which comparable data could be obtained (Nicaragua) and for the seven FINCA International programs in Latin America. In addition to presenting the average retention rates for the seven FINCA programs taken together, the individual retention rates are given for Haiti and Honduras. These are the two FINCA programs with the highest and lowest average retention rates over the 2003-05 period, respectively. Finally, to serve as a basis against which all of these VBI retention rates can be compared, Table 1 presents the average of the retention rates for all of the Accion International individual and solidarity group lenders in Latin America on which data were available.[13]

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[13] The preceding paragraphs compared the flexibility, transactions cost, and risk of village banking versus individual lending. In many ways, solidarity group lending occupies an intermediate position between these two extremes because it employs a group size smaller than that used by village banking but larger than the

The Table 1 data shows that, with the exception of Compartamos and FINCA Haiti, VBI retention rates are generally 10-15 percentage points below the average retention rates of the Accion International solidarity group and individual lenders.[14] Because most VBIs serve the lowest income segment of the micro-finance market, they arguably face less competition in this market than the Accion International affiliates face in the segment they serve, which generally consists of more mainstream micro-finance clients. This would suggest even more strongly that village banking needs to improve its product since it has lower client retention rates despite quite possibly facing less competition.

This call to increase the flexibility and client-orientation of the village banking product is really a call to continue an ongoing process. Village banking was introduced in the 1980s as an even more rigid product than it is today, a product in which everyone in the village bank had the same size starting loan, the loan size ceiling was set at a very low $300, all meetings and loan repayments were weekly, the loan term was always a very short 16 weeks, and forced savings were only available once the member left the village bank or perhaps in cases of serious emergency.

Table 1: Client Retention Rates

MFI	Country	2003	2004	2005	Average 2003-05
Pro Mujer	Bolivia	60	61	73	65
FINCA	Nicaragua	71	55	61	62
Compartamos	Mexico	87	97	92	92
Pro Mujer	Nicaragua	59	61	67	62
FINCA	Honduras	77	31	47	52
FINCA	Haiti	100	100	99	100
FINCA	Latin America – average of 7 programs[15]	65	52	58	58
Accion International	Average of 15-17 Latin American affiliates[16]	75	73	71	73

group size of one employed in individual lending. Thus, for example, solidarity group borrowers must negotiate the loan starting date, term, and repayment frequency with a smaller group than must village bank borrowers, and so flexibility to meet each individual's needs should generally be greater in the solidarity group than the village bank. Similarly, solidarity groups should require less meeting time than village banking.

[14] The very high client retention rates obtained by Compartamos and FINCA Haiti reflect, at least in part, the fact that these two VBIs face little or no competition over most of their service areas. The remaining VBIs do not enjoy such monopolistic positions.

[15] The seven FINCA Latin American programs are: Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, and Nicaragua.

Note: All client retention rates (CRR) are calculated using the same formula:

CRR = C_1 / (C_0 + NC), where C_1 is the number of clients at the end of the year, C_0 is the number of clients at the beginning of the year, and NC is the number of new clients (that enter the program during the year). For example, if all clients present at the start of the year (C_0) and all the new clients (NC) remain in the program until the end of the year, then $C_1 = C_0 + NC$, and the client retention rate equals 1 (or 100%). If only half of each group remains at the end of the year, then $C_1 = .5 (C_0 + NC)$, and the client retention rate equals 0.5 (or 50%).

3.3 Leading VBIs of Latin America

i. *Compartamos:* As a Mexican SOFOL (*financiera*), Compartamos is one of the few VBIs in Latin America that is regulated by its country's banking superintendency, and the only one of the four VBIs examined here with this characteristic. Despite its designation as a SOFOL, Compartamos is not licensed to mobilize deposits from the public. With 145,000 borrowers in December 2002, Compartamos serves the largest number of loan clients of any MFI in Latin America. Compartamos began operations in 1990 as the lending arm of *Gente Nueva,* a Mexican NGO, and became regulated in 2001. It is an affiliate of Accion International.

ii. *CRECER:* is an NGO working primarily in the rural areas of Bolivia, including many rural areas that are remote even by village banking standards. CRECER began operations in 1990, using the "Credit with Education" methodology of Freedom from Hunger. Freedom from Hunger is a U.S.-based international NGO that operates numerous village banking programs in Latin America, Africa, and Asia. CRECER became legally independent of Freedom from Hunger in the year 2001, though Freedom from Hunger still provides CRECER with technical assistance and sits on CRECER's board of directors.

iii. *FINCA Nicaragua:* is the largest of FINCA International's seven Latin American affiliates in terms of number of clients served. It is second (after Haiti) in terms of

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[16] The averages given are based on all of Accion International's Latin American affiliates that have the data needed to calculate client retention rates, except Compartamos. Compartamos is excluded because it is a VBI; all other affiliates are primarily individual or solidarity group lenders. The averages given are based on 17 affiliates in the years 2000 and 2002 and 15 affiliates in 2001. The following 13 affiliates provide client retention rates for all three years (country in parentheses): Acción Empresarial (Panama), Banco Solidario (Ecuador), BancoSol (Bolivia), BanGente (Venezuela), FAMA (Nicaragua), FED (Ecuador), Finamérica (Colombia), FINSOL (Honduras), Fundación Mario Santo Domingo (Colombia), Fundación Paraguaya (Paraguay), Génesis (Guatemala), Mibanco (Peru), and Propesa (Chile). The following seven affiliates provide client retention rates for some of the years (country and years in parentheses): ADMIC (Mexico, 2001, 2002), Cooperativa Emprender (Colombia, 2000, 2002), CREDIFE (Ecuador, 2002), Emprender (Argentina, 2000, 2001), FENAPE (Brazil, 2000), FUNDAP (Guatemala, 2000), and SogeSol (Haiti, 2002).

depth of outreach, as measured by average outstanding loan balance ($45 in Haiti and $109 in Nicaragua in December 2002). FINCA Nicaragua is an NGO and began operations in 1992.

iv. *Pro Mujer Bolivia:* an NGO that began operations in 1990, is the oldest and largest of the four Pro Mujer affiliates, and considered Pro Mujer's flagship program. The other Pro Mujer affiliates are in located in Nicaragua, Peru, and Mexico and began operations in 1996, 2000, and 2002, respectively. Like CRECER and the other Freedom from Hunger programs, all Pro Mujer affiliates provide formal non-financial services to their village bank members, as well as credit and savings services.

3.4 Village Banks in Mali ___ A Case Study

In three regions of Mali, village banks have been established with German assistance to mobilize savings and provide micro-credit. Refinancing is possible through the state-owned agricultural development bank so that the village banks can grant more loans than the volume of savings deposited. The network of village banks, which for 10 years was promoted from outside, has in the meantime proven its sustainability by expanding by its own efforts.

The 11 million people of the Republic of Mali are among the poorest in the world. Life expectancy is only 54 years, and the infant mortality rate at 144 deaths per 1,000 live births is correspondingly high. The average annual per capita income is DM 530 (about US$ 250). The majority of the poor people (86 per cent) live in rural areas, and the agricultural sector, mainly cotton and rice growing, accounts for 47 per cent of Mali's Gross Domestic Product.

The remote Dogon country in Northeastern Mali, one of the three project regions, is also affected by great poverty. Diseases due to poor hygiene are pandemic, and the level of education is extremely low. The inhabitants, mostly smallholders, live from onion and millet crops and livestock breeding. As the region often suffers from drought and plagues of locusts, the farmers' yields are scarcely enough to ensure them a living.

Before the project got underway, the villagers had only two options if they needed larger sums of money for purchases or emergency spending, such as in cases of sickness. They could turn only to traditional savings and loan associations, whose credit volumes are usually limited, or to private moneylenders, who charge usurious interest rates of up to 120 per cent. In addition, the modest amounts smallholders were able to save could not be deposited in a safe place (for instance as a reserve for the next sowing). Instead, the money was hoarded, or spent on consumer goods or buying cattle.

The state-owned agricultural development bank, BNDA, also was unable to offer the smallholders savings and loan options tailored to their needs. Besides that, the bank's branches were far too distant from the villages in the Dogon region.

To remedy this problem, self-administered village banks (Caisses Villageoises d'Epargne et de Crédit Autogérées, CVECA) were set up there in the mid-1980s as part of a project to promote income-generating measures such as rehabilitating small-scale dams. The project was supported by both German Financial Cooperation (FC) and Technical Cooperation (TC). The village banks were to provide the villagers with access to loans and at the same time mobilise their savings. The background was that the impact of income-generating projects, such as promoting irrigated rice growing, often was not sustainable due to a lack of local finance markets which could put the savings to more productive use.

Some of the village banks found very soon that they could no longer cover the heavy demand for loans out of the savings of their members. They were increasingly dependent on other refinancing sources. This was the starting point of something new in Germany's aid to the financial sector. The funds given to BNDA, which had been supported by the Reconstruction Loan Corporation (KfW) since 1986, were no longer to be used exclusively for the direct granting of individual agricultural credits, but also to be made available to the village banks. This concept was implemented from 1994 in Dogonland and in two other rural regions of Mali.

The village banks are based on the principle of self-administration. The villages themselves decide on the founding of a bank, and elect its "staff" - that is, the manager, the treasurer and the comptroller - from among their own people. Part of their funds is used for literacy programmes and initial and advanced training to turn the elected men and women farmers into real "village bank managers". The banks' self-perception rests on the ideal of village solidarity, which is why the villagers as a whole feel responsible for them.

The loans made available by the BNDA are passed on to individual banks by higher-level associations composed of representatives of the village banks. The interest rate for these loans is about 20 per cent, far above the national inflation rate of 2 per cent (1999). This rate is also offered for savings deposits. The village banks demand 30-40 per cent interest on their loans, so they have a margin of 10-20 per cent to cover their costs.

True, this margin may seem high. But it is quite reasonable given the time-consuming and costly processing of many micro-credits and savings accounts and comparable with similar micro-finance intermediaries around the world. The high rate of interest also does not deter borrowers because alternative sources of money, such as informal moneylenders, are much more expensive. In addition, unlike moneylenders, the village banks offer a safe place to keep savings, which for many customers is at least as important as access to loans.

The system also involves a former state-run and now privatized advisory and supervisory body ("service commun"), which is staffed by Mali specialists and for whose services the village banks and associations must pay (which also is covered by the interest margin). The body ensures an orderly handling of the financial transactions, carries out audits, and trains the village bank staff in book-keeping and financial management.

The villagers use the mostly short-term loans (3 to 6 months) to finance a great number of small-scale investments in income-generating activities and also to cover private financial needs for sickness, weddings and burials. Collateral is provided by "social pressure" and assets such as goats, bicycles and farming equipment.

3.4.1 What Was Achieved Through Village Banks?

i. *Geographical expansion:* In 1999, there were more than 150 village banks and 8 higher-level associations in the three project regions. The cooperatives have a total of almost 65,000 members, through which an estimated 500,000 people are reached. As members of their banks, about 70 per cent of the economically active villagers have access to savings and loans. That means the banks reach directly all economically active sections of the population. The remainder benefit indirectly from banks: higher incomes mean that children, the elderly and the sick can be given better care, and the traditionally strong social cohesion of rural people is further enhanced.

ii. *Orientation on poverty:* The banks mobilize savings totaling DM 4.4 million per year. These savings are the main re-financing basis (about two-thirds) for the overall annual loan volume of DM 6.7 million. The remainder is made available via BNDA credits. These figures manifest not only a far-reaching impact, but also a clear orientation on poverty. In 1998, the average loan level, which is one of the relevant indicators of the share of poor households benefiting from the project, was the equivalent of about DM 180 for all village banks, DM 160 in the Dogon region, and only DM 80 in another region. That means the project's target groups, which mainly are among Mali's poorest people, were reached to a great degree.

iii. *Social closeness:* The village banks usually have repayment rates of 95 per cent, an indication of their efficiency in allocating loans and the sustainability of their goal achievement. It shows that the cooperatives have become stable and thus reliable financing intermediaries in rural areas. In Dogonland, most of the village banks have even covered their operating costs since 1997. That includes not only their administrative costs, but also the interest on savings accounts and BNDA loans, including their repayment, and payments to the "service commun". This positive result is due to two factors. First, the village banks have a great "social closeness" to their customers not only because of their grassroots proximity, but also because they speak their customers' language. Second, their savings and loan terms are tailored to their customers' needs. Larger sums of money, be they savings or loans, are available when they are needed. What also counts is that the loan repayment burden is tolerable and that savings are safely invested, meaning family members cannot get their hands on them. In this respect, the BNDA's aim of improving the rural people's opportunities to generate or retain income in an efficient way has also worked out.

iv. *Increasing income:* The project has shown how successful financial intermediation, meaning the efficient transformation of savings into loans, and going beyond pure access to financial products, can help tackle pressing social problems. An impact analysis of the Dogon region by Ohio State University in 1997, for example, found that the economic situation of local households had improved. The members of village banks were less vulnerable to the financial consequences of illness, death and other events of the life cycle than were non-members. True, the banks' members are not among the poorest households. But the demand for loans by the latter was greater than their mobilised savings, while richer traders were net savers. This means there was a transfer of resources in favour of the economically weaker members. In addition, the study said, the project had promoted the people's readiness for self-help and self-qualification, strengthened social cohesion, and improved both food security and the empowerment of women. These successes were achieved by measures such as the literacy programmes, which were extended to include entire village populations and had raised the level of education as a whole.

v. *Linkage with the BNDA:* The partner bank made a great contribution to the project's success. The bank's efficient, professional management by an experienced Mali specialist and the good level of training and motivation of its employees proved decisive. The BNDA sees the refinancing of village banks as an attractive business field both because of the lower costs of loans to them and their repayment pattern, which is much better than that of the bank's own individual borrowers. The BNDA has not yet had a default on repayments by village banks, compared to a 50 per cent default rate for the direct loans it made earlier to end-borrowers. In the final analysis, the bank can thus better fulfil its mission of also helping poorer people to gain access to financial services than by granting traditional agricultural loans. The BNDA is currently and for the foreseeable future the only bank that is both willing and able to operate to a substantial extent in Mali's rural areas and, alongside the regional savings and loan cooperatives, to refinance the village networks as well. This linkage of formal sector institutions with informal finance intermediaries, which is now recognised internationally as a "best-practice model", not only strengthened the business activities of a state-run agricultural development bank, but also got underway a "bottom-up development".

vi. *Knock-on effect:* The village bank project had a "structure-building" effect in the sense of extending the "financial frontier". Aid from outside played an import catalyst role - without prejudice to the target groups' own efforts - not only in relation to their better access to sustainable financial services conforming to their needs (expanding the customer group), but also in terms of widening the offer of such financial products. New and similar village banks are now emerging in other parts of Mali at the people's own initiative, such as one promoted by the French in the Kayes region in the West of the country. In the Koro District of the Dogon region, the local village banks are themselves involved in selecting other villages and setting up new branches. Thus the venture is having a knock-on effect beyond

its original project region and contributing to the spread and professionalising of rural finance markets. As a whole, the village bank approach has proven that even simple ways of organising the mobilisation of savings and granting loans in Mali can function sustainably and be developed further on-site.

vii. *Framework conditions:* The project's success would have been inconceivable without improving the framework conditions in Mali's finance sector, in whose promotion other donors were involved as well. The main success factors included Mali's existing market economy system framework, the stability of its currency, and interest rates which are positive in real terms, conforming to market conditions, and cost-covering in the long term. The German development cooperation, involving inputs by the KfW, the German Agency for Technical Cooperation (GTZ) and the German Development Company (DEG), which is a BNDA shareholder, contributed to these conditions by:

- supporting and promoting the process of developing a Mali development plan, adopted in 1997, to promote micro-finance institutions;

- achieving in consultation with other donors in the Mali finance sector the raising of the interest rate ceiling for micro-finance institutions from 12 per cent to 27 per cent. This rate is still too low in terms of covering costs, but is an important step in that direction (the authorities tolerate for the time being that village banks exceed this limit); and

- cooperating closely with the Agence Francaise de Développement, including co-financing and joint evaluation of the BNDA.

The KfW has since 1989 frequently taken the initiative in this process, mainly by organising Round Table discussions with Mali partners and international donors and by deploying experts in the field. The KfW is also involved in the funding of the supranational RIECA network, an African union of decentral finance institutions.

3.4.2 Lessons Learnt and Future Challenges

Is the village bank model transferable to other countries? The building up of village networks is a lengthy process. In Mali, a promotion timeframe of more than 10 years was required. This means that staying power is needed, the amount depending on local framework conditions. In addition, based on the experiences in Mali the following minimum prerequisites should be in place to enable the transfer of the approach:

i. the people must be keen to help organize a network;

ii. the population density of the village banks catchment areas should not be less that 15 inhabitants per square kilometer; and

iii. the village banks must be able to work together with an efficient formal finance institution (either a development bank or a commercial bank).

Besides making further efforts to mobilize more savings and cut costs, the main challenge for the village networks in future will be to remain independent of external donor inputs in refinancing their growing loan portfolios due to their own borrowing.

Regional commercial banks are following the BNDA's example only hesitantly because they can neither assess the risk nor hedge it. That is why the German assistance has provided the BNDA with a guarantee to facilitate its refinancing of the village banks on the regional finance market. This path will also be a long one. At the end of the day, it will be successful only if the Mali government continues consistently to pursue its development goals of democratization, decentralization and privatization, and if the sectoral conditions also remain favorable.

CHAPTER 4: Credit Unions

4.1 Credit Unions: Models for Providing Sustainable Microfinance

"Credit unions are a self-sustainable means of reaching the poor. Their apparent neglect in the literature and in the various events associated with financial services to low-income households and micro and small enterprises disguises the real significance of credit unions in these markets."

- Carlos Cuevas, 1999, p.1, Sustainable Banking With the Poor, The World Bank

Credit unions operate in 67 developing countries to meet member demands for savings and credit. Credit unions first became legally registered entities in Western Europe at the end of the 19th century and in the United States and Canada in the early 20th century. In the latter half of the twentieth century, credit unions have developed in rural and urban areas in Africa, Asia, the Caribbean, Eastern Europe and Latin America. Membership in a credit union is based on a common bond, a linkage shared by savers and borrowers which can based on a community, organizational or religious affiliation or an employee-based relationship. Depending on a country's legal framework, credit unions are authorized either by the Superintendency of Banks and Financial Entities, the Ministry of Cooperatives, or a free-standing law to mobilize member/client savings and use these internally generated funds to finance member credit needs.

Microfinance today emphasizes scale and depth of outreach of financial services to large numbers of the working poor through financially sustainable organizations. Credit unions offer a savings-first, self-sustainable approach to microfinance that has already successfully met the needs of millions of low-income members around the world.

4.2 Credit Union Advantages for Microfinance Delivery

"Not only have credit unions been found to be second only to banks in lending and especially in providing deposit services to low-income clients, but their prevalence stems from real advantages credit unions have over other providers of financial services to marginalized clients."

- Carlos Cuevas, 1999, p. 1, Sustainable Banking With the Poor, The World Bank

Among many advantages, there are four primary strengths of credit unions for micro-finance delivery: services for lifetime asset growth, mixed outreach, savings mobilization and full service array of loan products.

4.2.1 Lifetime Asset Growth

Credit unions help micro-entrepreneurs climb a delicate ladder of modest but increasing asset or income security growth.

Credit unions help the lower income groups increase their assets via establishing a credit relationship, establishing an enterprise, accessing working capital, increasing income through business expansion, meeting housing credit needs, and increasing wealth through savings.

As new members join the credit union, they are able to access credit in small amounts, increasing with successful repayment. Members establish a good credit history, usually by taking out small personal loans, and then enter into a period where they can expand their loan activity.

Many credit union borrowers use credit to establish and expand enterprises as their primary or secondary economic activity. Credit union loans also become the initial capital for establishing micro-enterprise as the primary economic activity for other family members. Members look for ways to access increasing amounts of working capital with flexible repayment terms. Over time, they take out larger loans for housing and production needs, based on repayment capacity and real collateral.

These same members initially contribute little to deposit savings -- their focus is on borrowing. As their assets and income increase, they save more and borrow less. As they shift to larger loans or reduce their borrowing, members stop investing in shares and shift

their investment to deposit savings. Members become net savers, investing savings in withdraw-able deposit services offering market rates of return.

These patterns of member income and asset growth provide direction for credit union tailoring of lending and savings products. Credit union growth is conditional upon their ability to satisfactorily meet the savings and credit needs of members as they follow this life pattern. The credit unions that can offer an array of products designed to meet each of these needs will assist members not only with the very small poverty loans of unstable or stable survivors, but also with climbing to higher levels of income and asset performance of growth enterprises.

4.2.2 Diversity in Membership

It is scale, not exclusive focus, that determines whether significant outreach to the poor will occur.

- Christen, Rhyne and Vogel in "Maximizing Outreach", p. 28

Credit unions are "mixed outreach" financial institutions.

The credit union membership base is diversified economically. Members from the urban areas are vendors, merchants, self-employed, small manufacturers, teachers, construction workers, house-wives, private and public employees, bakers, leather workers and shoe makers. Members from the rural areas include grain farmers, citrus fruit growers, agricultural laborers, traders and cattle producers.

Diversification of membership decreases the covariance credit risk to the credit union. Community credit unions develop a membership base diversified in economic activity and socio-economic condition. Not all of the membership (and therefore the financial base) would be affected by a sectoral economic crisis.

"NATCCO's (National Association of Philippines Credit Cooperatives) primary credit cooperatives may be cited here as an example of privately initiated microfinance institutions which, on the evidence of their small loan sizes (Ps5,000 to Ps6000 or $200 to $240), certainly reach down to the poor even if not serving them exclusively."

- McGuire et al., Getting the framework right, 1998, p.238

Service to the poor is blended with service to a broader spectrum of the local population.

Credit union services are not focused exclusively on the poor. Service to the poor is blended with service to a broader spectrum of the local population. Smaller loan sizes, typical of loans to the poor, tend to involve higher costs per client. Credit unions serving the poor can better maintain sustainability by spreading their costs across loans of larger and medium sizes as well. In this manner, the credit union reaches a large absolute number of the poor on a sustainable basis.

4.2.3 Savings Mobilization

"The demand for liquidity is far more important to most rural citizens than the demand for credit. Savings mobilization is just as important as credit in meeting the financial needs of the rural population."

- J. Boomgard and K. Angell in The New World Of Microenterprise Finance, 1994, p.226.

What most distinguishes credit unions from other non-bank financial entities offering micro-finance services is the ability of the credit unions to mobilize mass numbers of small, voluntary, savings accounts.

These deposits can then be invested in rural production, housing, micro-enterprise and small business loans. Credit unions provide the low transaction costs required to offer this service to large segments of society. Credit unions offer a variety of types of savings services: voluntary withdrawable savings accounts, fixed term deposits based on either the term of the deposit or the size of the deposit, and other diverse savings programs including: savings for educational fees, savings for holidays or vacations, savings for infant delivery expenses, retirement savings, youth savings, etc.

"The financial systems approach to micro-enterprises recognizes that savings are as important a service for the poor as credit, and that savings are crucial in building self-sufficient financial institutions...To date, although many other programs have incorporated savings elements, only the credit union movement and scattered programs have embraced savings as equally important as credit for dealing with poor populations."

- Rhyne and Otero in The New World of Microenterprise Finance, 1994, p. 16

Sound institutional controls and structures need to accompany savings mobilization in order to protect the savings and to manage efficiently the increasing number of small-balance accounts. To meet prudential standards, credit unions must instill the financial management disciplines of capital accumulation, loan classification, delinquency control, loan loss provisions, capitalization, and liquidity management in credit union management procedures and practices.

4.2.4 Full Array of Loan Products

"Credit union loan portfolios are widely diversified. Since credit unions lend for a wide variety of purposes, the portfolio risk of specializing in a single type of activity is reduced."

- John H. Magill in "Credit Unions: A Formal-Sector Alternative for Financing Micro-enterprise Development" in Rhyne and Otero's New World of Micro-enterprise Finance, 1994, p. 149.

Members' financing needs determine their credit union loan product offerings.

Loan purposes often include housing construction, housing improvement, home purchase, small manufacturing, transportation business, commerce, personal service business, debt refinancing, emergency needs, education, agriculture, cattle- and chicken-raising, fish-harvesting, personal expenses and electric appliance purchases.

The sectoral activity can shape loan term preferences; for example, in agricultural areas, most members borrow with a longer-term repayment structure. Citrus producers borrow fixed, 6-month term loans which they pay at the end of harvest instead of monthly. Cattle producers often require a 2-year period for financing from when they buy the small animals until the animals are old enough to sell. Micro-entrepreneurs may require small working capital loans for short periods of 30 days or 16 weeks with weekly payments.

"With respect to the speed with which a loan can be obtained, flexibility regarding the terms of the loan, and most importantly with regard to transaction costs, the non-conventional individual-based technology is definitely superior to all kinds of group-lending technologies for small and micro entrepreneurs."

- Schmidt & Zeitinger in Strategic Issues of Microfinance, 1998, p.35

Credit unions have typically defined their individual lending methodology as a strength. Individual lending suits well the needs of the majority of credit union members. Despite this fact, perhaps the most significant impact the micro-finance industry has had upon credit unions has been to introduce them to a greater variety of methods and of credit products for low-income entrepreneurs.

Some credit unions, such as several in Bolivia and the Philippines, offer solidarity group loans for lower-income or "downscale" micro-entrepreneurs. For many low-income members or members who live in remote rural areas far from the credit union office, access to a local solidarity group provides them with a lower-cost method to access credit union services.

On one hand, solidarity group lending provides group protection for those who are reluctant to engage in the formal processes that are required of an individual member to make a loan application at a credit union. On the other hand, it provides an early stepping stone of access to small loans for those who start within the group and then leave it, or who graduate to full individual member services at the credit union as savers or as applicants for a larger loan.

Credit unions have developed new products which offer micro-entrepreneurs products that are flexible, taking into consideration their cash flow and offering increased access with performance. To satisfy the demand for working capital, some credit unions, such as those in Ecuador, offer "open-end" lines of credit or supplier credit through material suppliers for "upscale" micro-entrepreneurs.

4.3 Depth of Outreach Case: Savings in Bolivian Credit Unions

In Bolivia, 20 credit unions, serving 260,172 members as of December 2005, mobilize US$155 million in deposits and US$15 million in shares to finance US$173 million in loans.

Currently, 12 credit unions fall under the supervision of the Superintendency of Banks while others are in the process of registering. The Project assists the Superintendency in assessing, registering and preparing credit unions to meet licensing requirements.

Table 2: Data of 3/31/06 for 20 credit unions affiliated with WOCCU in Bolivia.

Deposit Size in Bolivia; GNP per capita $970	Number of Savings Accounts in this Range	% of Number of total of Deposit Accounts	Volume % of Savings Accounts in this Range	Total Amount of Deposits in this Range
$1-$500	164,335	92%	21%	$8
$501-$1000	6,104	3%	10%	$4
$1001-$5000	5,559	3%	24%	$9
$5001-$10,000	1,868	1%	23%	$9
$10,000-$15,000	204	0%	5%	$2
$15,001-$20,000	99	0%	4%	$1
$20,001-$30,000	76	0%	4%	$1
$30,001-$50,000	76	0%	4%	$1
$50,001-$100,000	16	0%	2%	$985
$100,001+	6	0%	2%	$720
TOTAL	**178,320**	**100%**	**100%**	**$40**

* This information is for withdrawable savings accounts ONLY; fixed term deposits not included.

World Council of Credit Unions has established for the Superintendency, its credit union Monitoring and Evaluation System, PEARLS, to track the progress of credit unions in applying the new financial standards and disciplines to their operations. The Superintendency uses the financial ratios generated by PEARLS to conduct analyses of all key areas of credit union operations. The project also provides examination training for credit union examiners from the Superintendency of Banks.

4.4 Micro-Enterprise Loan Expansion: Savings Led Credit Innovation in Ecuador Credit Unions

WOCCU projects increase the volume of credit union lending to micro-enterprise through savings mobilization and an improved array of credit products. The project strategy strengthens financial disciplines which protect savings mobilized.

The 19 credit unions participating in the WOCCU technical assistance program serve 681,720 member-clients as of December 31, 2005. The project credit unions mobilize US$60 million in savings and US$21 million in share equity investment to finance US$86 million in loans as of December 31, 2005.

Credit unions mobilized US$19.9 million in new deposit savings during the first two years of the project. Credit unions have introduced new savings services such as youth savings, institutional savings and programmed savings products.

Table 3: 19 Project Credit Unions Scale of Credit Union Savings Services June 2006

	Total	Women	Men
Total Deposit Savings	US$71,856,022	US$24,189,850	US$47,666,172
# of Deposit Savings Accounts	622,795	232,175	390,620
Average Deposit Savings	$115	$104	$122
Median Deposit Savings	$19	$20	$19
Total Shares	US$23,220,736	US$9,230,878	US$13,989,858
# of Share Accounts	538,485	232,175	306,310
Average Shares	$43	$40	$46
Median Shares	$17	$17	$17

In Ecuador 33% of credit union members are self-employed and more than 52% of credit union households have small or micro-businesses owned by the member or the spouse. The project credit unions provide financial services to an estimated 210,009 member-owned small and micro-enterprises.

The largest volume share of loans granted is to micro-entrepreneurs. US$35 million (38%) is to micro-entrepreneurs. Micro-enterprise loans make up 30% of the total number of loans. There were 50,998 consumer loans granted during 2005. It is estimated that approximately 20% (or 10,200) of the loans designated as consumer loans were for micro-entrepreneurs.

Credit unions have learned lessons from supplier credit to provide this group with low transaction costs and flexible amount availability of working capital on demand. Project credit unions have differentiated the loan product interest rates which they charge and have added new loan products such as the Micro-Enterprise Open-Ended Line of Credit and Supplier Credit Financing.

A pre-project review of credit union portfolios indicated that micro-enterprise loans made up 25% of credit union portfolios in 1994. The same sample of 13 credit unions in 2005 indicated that the micro-enterprise portion of the portfolio had increased to 40%. The volume of micro-enterprise loans increased from US$16.4 million to US$38.8 million — 135% during the project period. The sample of 13 credit unions demonstrates an annualized increase of 21% of the total number of loans and a 45% increase of the total volume of loans. This was an increase of 17,504 loans and of US$29,842,461.

4.5 Depth of Outreach Case: Poverty Lending in Philippines Credit Unions

WOCCU and Freedom From Hunger are working together in the Philippines on a project sponsored by the USAID Micro-enterprise Office to provide microfinance services to very poor women. The aim of this project is to have the credit union system serve as the provider of the external account for the saving and credit with education groups (SCWE). On average, 27 women form each group. As of March, 2006, 107 groups were formed and the 2,853 members had a 100% repayment rate. The average loan size per borrower was $42. Just over 1,700 educational group meetings took place from the time the groups first borrowed in July 2005 until March 2006. The majority of the sessions focused on health and nutrition (685 sessions) and group management education (548). More than 300 sessions imparted business skills.

The "borrower" groups had $116,972 in outstanding loans as of March. At that time, some group members had amassed $15,394 in total savings. After eight months of lending/training operations, the SCWEs reached a financial sustainability ratio of 16%.

Table 4: Loan Portfolio as of 3/31/06 for 12 credit unions (6 rural, 6 urban) affiliated with WOCCU.

Total number of 32,075 loans worth $8.03 million

Loan Size	Loan size as % of GNP per capita ($1200)	Number of Loans in Range	% of Number of total Loans	Volume % of Loans in Range	Amount of Loans in Range
$1-$250	0% to 21%	19,057	64%	18%	$1.45 million
$251-$500	21% to 42%	6,058	19%	21%	$1.72 million
$501-750	42% to 63%	2,643	8%	15%	$1.21 million
$751-?	NA	4,643	14%	46%	$3.65 million

The percentage of female credit union members in the Philippines has grown from 41.5% in 12/04 to 64.3% in 3/06. Included in this table are the 107 savings and credit with education associations composed of 2,853 women.

4.6 Sustainability: Guatemala Private Ratings and Certification Agency

In the FENACOAC Guatemala credit union system, there are 39 affiliated credit unions which serve 262 thousand members. Credit unions have mobilized US$32 million in shares and US$89 million in deposits which funded US$92 million in loans in 2005.

Survey data from credit union communities offer strong evidence that credit unions fill a major niche in local financial markets by mobilizing household savings and making loans to households engaged in small to medium-scale agricultural and commercial enterprises.

i. 75% of the number of formal sector loans and 60-75% of the formal loan volume to the sample households were made by credit unions;

ii. credit unions mobilized about 33% of the financial savings from this population.

Union Popular credit union provides 74% of the number of loans received by residents in the Tiquisate/Nueva Concepción area, and about 55% of the total amount. In San Juan and Tactic communities, the credit unions provide 56% and 42% shares of total loan amounts, respectively.

For small business loans, the credit union is the only formal source to the sample households in Tiquisate and Tactic, even though a number of private banks have branches in Tiquisate. In San Juan Sacatepequez, credit unions supplied 75 percent of micro and small business loans. Input suppliers, are the principle alternative source of short-term merchandise credit, especially to small commerce operators. The average size of input supplier loans is significantly smaller than the average credit union loan. Credit union loans are usually small in comparison to commercial bank loans. The difference in average loan size between the credit unions and the banks is particularly apparent in lending for commerce and agriculture.

Approximately 60% percent of the number of commerce loans are to women members while the same loans account for 45% of the volume of commerce loans. Women are most active in borrowing for housing and commerce. They account for 63% of credit union members who report commerce as their primary source of income.

Under a grant provided by CGAP, WOCCU and FENACOAC are currently establishing a private sector mechanism to rate and certify credit union soundness and by offering specific economic and marketing benefits for those credit unions which meet the soundness criteria.

4.7 Moving to Market Rates: Kenya Micro-Enterprise Project

In Kenya, over 1.1 million members had savings of over US$338 million and loans outstanding of US$179 million. The average size of Kenyan credit unions is about 5,000 members.

Most of the larger credit unions are located in Nairobi, frequently affiliated with single employers where payroll deduction systems are in place. Payroll deduction systems provide an on-going flow of funds coming into the credit union. Payroll deduction systems are dependable and are used for savings mobilization and loan repayment. This allows the credit union to manage its cash flow better, permitting it to hold smaller cash reserves due to the regularity of its funds flow. Another advantage is low delinquency. During WOCCU's recent field study in Kenya, delinquency rates were frequently found to be under 1%. Kenyan credit unions are also located in rural areas throughout the country. Even in these rural credit unions, there is some presence of regular inflows of cash.

While loans are made for a variety of purposes, micro-enterprise loans are considered to make up large proportions of Kenyan credit unions' loan portfolios. It is very common for a salaried employee at a company to be involved in a micro-enterprise, which is either operated on a part-time basis by the employee, or more likely, by a family member on a full-time basis. In 1993, 69% of Kenyan households depended on micro-enterprises for at least half their household income. In urban areas, the percentage jumped to 80%. This heavy reliance on microenterprise income applies also to credit union members. Credit union general managers estimates of micro-lending activity range from 40% to 60% of loans disbursed.

WOCCU provides technical assistance and training to a select group of 15 credit unions to mobilize savings and expand microfinance lending. The credit unions are a combination of urban and rural institutions that are now serving, or have a substantial opportunity to serve a variety of microentrepreneurs. Currently, the program has initiated with 10 credit unions with 37,542 members. The 10 credit unions have a total of US$22 million in assets.

WOCCU transfers sound business skills to credit unions in the areas of: (1) financial management, (2) standardization, (3) policy formation, (4) marketing, (5) human resource development, (6) credit administration, and (7) member service development.

4.8 Nicaragua Rural Credit Union Project

In Nicaragua, credit unions offer poor, rural entrepreneurs access to loans and saving mechanisms. The USAID/WOCCU Rural Credit Union Project expands 20 Nicaragua rural credit unions' financial services to provide permanent access to credit and financial services to rural agricultural and micro-entrepreneur producers.

A study of six project credit unions indicated that these credit unions, serving 2,833 members, were actively engaging in micro-enterprise development, and were reaching, proportionately, more women borrowers. (Mahon, 2006)

An analysis of the loan portfolios reveals that 52.6% of all loans originated by the credit unions are for non-agricultural micro-enterprise activities. Six credit unions studied had 695 micro-enterprise loans. Through micro-enterprise lending, credit unions are reaching

proportionately more women borrowers. More than 56% of micro-enterprise loans were made to women, compared to 48% of all credit union loans.

Table 5: Breakdown of micro-enterprise loans by size and gender for 6 Credit Unions March 2006

Size of Loan	Male	Female	Totals	Overall	Male	Female
< 300	94	149	242	35%	31%	38%
301-500	64	82	146	21%	21%	21%
501-1000	57	67	125	18%	19%	17%
1001-2000	52	67	119	17%	17%	17%
2001-3000	12	24	36	5%	4%	6%
> 3000	22	4	26	4%	7%	1%
Total	**301**	**393**	**694***	**100%**	**100%**	**100%**

* The total number of micro-enterprise loans is 695, one loan did not report gender.

The majority of credit union loans for micro-enterprise are very small loans (<$500). Of the micro-enterprise loans originated, 56% of the loans originated are for amounts less than $500 with 35% with amounts less than $300.

Loans to women are proportionately focused in lower loan amounts. In fact, 38% of all loans to women are less than $300 and 59% of all loans to women are less than $500.

Credit union financing assisted credit unions members to diversify their income generating activities and helped them to recover from the effects of Hurricane Mitch. Members in rural and agricultural communities were most affected by the Hurricane. Those members who had more than one income-generating activity in the household appeared to be recovering more quickly than those reliant on one activity (i.e., agriculture). Assisting households to diversify their income-generating activities helped limit the risk of losses and helped increase household financial stability.

4.9 Financial Performance: Self Sustainability of El Salvador Credit Unions

WOCCU began working in El Salvador in 1996 on a USAID financed project in partnership with Chemonics, the Inter-American Institute of Agricultural Cooperation (IICA) and National Cooperative Business Association (NCBA). WOCCU's efforts focus on developing rural financial enterprises. WOCCU has worked with thirteen affiliated credit unions.

By the end of 2005, each of the thirteen savings and credit cooperatives had achieved operational self-sufficiency. Three of the thirteen achieved full financial self-sustainability by 12/31/05. At that date, five other credit unions were between 75% and 99.2% financially self-sustainable and three had reached between 55.08% and 63.5% financial self-sufficiency. Only two of the credit unions affiliated with the WOCCU technical assistance project had attained less than 32% financially self-sufficient.

The operationally self-sufficient and primarily financially self-sufficient credit unions are serving El Salvador's rural poor with financial services. The average loan size on 3/31/05 was $854, approximately 47% of El Salvador's GNP. One third (7,762) of the total number of current borrowers (23,119) borrowed amounts of less than $300. The average deposit size of 55,783 members on 3/31/06 was $308.

4.10 Financial Performance: Self Sustainability Of Poland's National Credit Union Association (NACSCU)

At Polish request, the World Council of Credit Unions (WOCCU) provided technical assistance funded by the U.S. Agency for International Development (USAID) to help create a credit union system after the fall of Communism in Poland. Prior to 1992, there were no operating credit unions in Poland; however that year, the project helped to establish the National Association of Savings and Credit Cooperatives (NACSCU) and created a Central Finance Facility (CFF), a Stabilization Fund, and an Insurance Company. This technical assistance project did not focus on strengthening a number of primary level credit unions at the base, but instead had a top-down approach that has not had a replicable success anywhere else that WOCCU has worked. NACSCU has directed and implemented most of the project initiatives.

In many traditional credit union movements around the world, the second tier level of credit unions, National Associations or Federations are notoriously weak in the area of financial sustainability and depend upon subsidies for their continued survival. Poland provides a striking contrast: the Polish National Association has made remarkable progress on its own road to financial self-sufficiency. NACSCU received financial assistance from USAID up until September 2004, when it arrived at full operational self-sufficiency. Since that time, NACSCU has continued to increase its revenues. The following table illustrates NACSCU's self-sustaining capacity for 2004 and 2005:

Table 6: NACSCU Profit and Loss Statements
(in U.S. Dollars, 1 USD = 3.5 PLZ)

Line Items	As of 12/31/04	As of 12/31/05
Total Gross Income	$1,927,249	$3,284,961
Total Financial Costs	$1,247,442	$2,278,758
Total Administrative Costs	$651,950	$955,628
Net Income	$27,857	$50,575

NACSCU's overall success and financial independence are largely due to its ability to attain: legal significance, commercial significance (as evidenced by income-generating services including central finance facility, stabilization fund, training seminars, credit union computer software, equipment services, supervisory/audit services, insurance products), political significance, and supervisory significance.

The total cost of the entire seven years (1992-99) of USAID sponsored WOCCU project assistance to Poland was $3.9 million. For every one US Dollar that was spent on this project, over $40 USD of new assets was generated. Assets of $158 million USD render the Polish credit union system the fourth largest financial network in Poland.

CHAPTER 5: Self-Help Groups (SHGs)

5.1 What are Self-Help Groups (SHGs)

Self-Help Groups (SHGs) or Thrift and Credit Groups are mostly informal groups whose members pool savings and re-lend within the group on rotational or needs basis. These groups have a common perception of need and impulse towards collective action. Many of these groups got formed around specific production activity, promoted savings among members and used the pooled resources to meet emergent needs of members, including consumption needs. Sometimes the internal savings generated were supplemented by

external resources loaned/donated by the Voluntary Agency which promoted the SHGs. Since SHGs were able to mobilize savings from the poor who were not expected to have any savings and could also recycle effectively the pooled savings among members, they succeeded in performing/providing banking services to their members, may be in a primitive way, but in a manner which was cost effective, simple, flexible at the door step of the members and above all without any defaults in repayment by borrowers.

Involvement of SHGs with banks could help in overcoming the problem of high transaction costs in providing credit to the poor, by passing on some banking responsibilities regarding loan appraisal, follow-up and recovery etc. to the poor themselves. In addition, the character of SHGs and their relations with members offered ways of overcoming the problem of collateral, excessive documentation and physical access which reduced the capacity of formal institutions to serve the poor.

Based on local conditions and requirements, the SHGs have evolved their own methods of working. Some of the common characteristics of functioning of these groups are indicated below:

i. The groups usually create a common fund by contributing their small savings on a regular basis.

ii. Most of the groups themselves, or with help of NGOs, evolve flexible systems of working and managing their pooled resources in a democratic way, with participation of every member in decision-making.

iii. Request for loans are considered by the group in their periodic meetings and competing claims on limited resources are settled by consensus.

iv. Loaning is done mainly on trust with a bare minimum documentation and without any security.

v. The amounts loaned are small, frequent and for short duration.

vi. The loans cover a variety of purposes, some of which are non-traditional and rather un-conventional.

vii. Rate of interest differs from group to group and even with purpose. Interest charged is generally higher than that charged by banks and lower than that charged by money lenders.

viii. Periodic meetings of members also serve as a forum for collecting dues from members.

ix. Defaults are rare mainly due to group pressure and intimate knowledge of end use of credit.

5.2 The Linkage of SHGs with Banks

The linkages of SHGs with banks aims at using the intermediation of SHGs between banks and the rural poor for cutting down the transaction costs for both banks and their rural clients. The objective of the linkage programme could be:

i. to evolve supplementary credit strategies for meeting the credit needs of the poor by combining the flexibility, sensitivity and responsiveness of the informal credit system with the strength of technical and administrative capabilities and financial resources of the formal financial institutions.

ii. to build mutual trust and confidence between bankers and the rural poor.

iii. to encourage banking activity, both on the thrift and credit sides, in a segment of the population that formal financial institutions usually find difficult to reach.

There could be different models of the linkage between SHG and banks:

i. *Model 1:* The simplest and most direct is a model in which the banks deal directly with the individual SHGs, providing financial assistance for on-lending to the individual members.

ii. *Model 2:* Another model, a slight variant of the first, is where the bank gives direct assistance to the SHG and the SHG promoting instituion (SHGI), usually an NGO, provides training and guidance to the SHG and generally keeps a watch to ensure its satisfactory functioning.

iii. *Model 3:* The third model places the NGO or SHGI as a financial intermediary between the bank and a number of SHGs. The linkage between the bank and the SHGs in this case is indirect. The NGO accepts contractural responsibility for repayment to the bank.

iv. *Model 4:* The fourth model envisages bank loans directly to individual members of SHGs upon recommendations of the SHG and NGO. In this case, the NGO assists the bank in monitoring, supervising and recovery of loans.

It is possible that the linkage may follow an evolutionary process and move from model three to model two and to model one and finally to model four where individuals get direct access to the bank. However, the adoption or acceptance of a particular model would depend on the perception of the bank and the strength of the SHGs and the NGO. Where the banker is able to have a first hand information on the working of a SHG which is functioning satisfactorily and has rotated its pooled resources two/three times, he may well start with model two or even model one. However, a more conservative banker may like to start with model three and rely on the NGO or SHGI.

5.2.1 The Financial Scheme

The financial scheme under the Linkage Programme could be based on the following broad principles:

i. Savings first, no credit without saving.

ii. Saving as partial collateral.

iii. Bank loans to the group, for on-lending to members.

iv. Credit decisions for on-lending to members by the group.

v. Interest rates and other terms and conditions for loans to members to be decided by the group.

vi. Joint liability as a substitute for physical collateral.

vii. Ratio between savings and credit contingent upon credit worthiness of the group; increasing with good repayment record.

viii. Small loans to begin with.

5.3 The Linkage Project in India

Despite the vast expansion of the formal credit system in India[17], the dependence of the rural poor on money lenders continues especially for meeting emergent credit requirements. Such dependence is more pronounced in resource poor areas and in the case of marginal farmers, landless laborers, petty traders and artisans belonging to the socially and economically backward classes and the tribal population. With a view to developing a supplementary credit delivery mechanism to reach the poor in a cost effective and sustainable manner, the National Bank for Agriculture and Rural Development (NABARD) introduced a pilot project for linking 500 SHGs with banks in 1998 after thorough discussion with the Reserve Bank of India (the central banking authority for India), commercial banks and NGOs.

The operational guidelines from NABARD were deliberately kept flexible to enable the prticipating banks and field level bankers to innovate and contribute to building and

[17] There are nearly 150,000 credit outlets of the formal banking sector in rural areas, including cooperatives. The total outstanding bank loans for agricultural purposes in 2005 amounted to nearly Rs. 560 billion.

strengthening the project concept. Stating the advantages of linkages to the bank, the guidelines observed:

"A recognition by the formal credit structure of self-management capabilities of the poor through SHGs and a link up between the two is expected to result in specific advantages to both systems. Under the linkage project, the main advantage to banks would be externalisation of a part of the work items of the credit cycle - assessment of credit needs, appraisal, disbursal, supervision and repayment, reduction in the formal paperwork involved and a consequent reduction in transaction costs. Improvement in recoveries and also in the margins would lead to a wider coverage of the target group. A larger mobilization of small savings would be equally advantageous. For the groups, advantages lie in the access to a larger quantum of resources as compared to their corpus generated through thrift, access to better technology and skill upgradation through different schemes of banking sector and a general improvement in the nature and scale of operations that would accelerate economic development."

Besides providing policy input, coordination and 100% refinance facility at 6.5% interest p.a. to the banks, NABARD has been organizing exposure and dialogue programmes in the linkage project for banks and NGO officials. These exposure programmes, which invariably include field visits, have helped in disseminating the concept and convincing bank officials to participate in the project. So far, 17 such programmes, covering around 350 officials have been organized in collaboration with NGOs and reputed bankers training institutes like the College of Agricultural Banking (CAB) and the National Institute of Banking Management (NIBM).

The pilot project has made progress during the last few years. As of 30 June 2005, 637 groups had established credit links with 16 commercial banks and 12 RRBs; the total loan sanctioned by banks amounting to Rs.7.9 million and refinance released by NABARD amounted to Rs.7.6 million. Progress has been good in the states of Karnataka, Andra Predesh and Orissa. The project has been picking up in other states too. The list of state-wise number of SHGs linked with banks and loan sanctioned is given below:

Table 7: Pilot Project on SHG - Summary Progress Report
Figures in Thousand Rupees

State	No. of SHGs	No. of Women SHGs	Bank Loan Sanctioned	NABARD Refinance
Gujarat	19	-	398	310
Karnataka	172	97	1232	1232
Madhya Pradesh	14	14	168	148
Orissa	180	180	1906	1906
Assam	2	-	75	-
Andhra Pradesh	139	131	2660	2553
Rajasthan	16	5	224	222
Tamil Nadu	74	63	881	864
Bihar	2	2	20	-

Maharastra	17	15	376	376
Kerala	2	2	32	32
Total	637	509	7971	7643

In order to assess the results of the linkage project, quick studies were taken up by NABARD in three states viz. Karnataka, Andhra Pradesh and Tamil Nadu and certain trends in the implementation of this innovative concept have emerged. They are:

i. Larger participation in the project is of women savings and credit management groups, particularly in resource poor regions.

ii. Membership of SHGs has come mostly from the poorest sections of the society.

iii. Demand for credit is frequent and for small amounts, at unpredictable times and sometimes not necessariy for purchase of income generating assets.

iv. Even the very poor are able to save and their savings increased with addition to their incomes.

Further, some good features have come to light such as shift in credit from consumption purposes to acquisition of income generating assests, use of credit for non-traditional economic activities, increase in income levels of group members, development of thrift and self-help among members, reduction in transaction cost for both banks and SHG members and an almost 100% recovery of loans.

5.3.1 Transaction Costs

The high transaction cost for rural credit is a core problem and viability of the system is critically affected by it. NABARD has recently conducted a study to quantify the effect of intermediation by NGOs/SHGs on transaction cost. The initial findings are:

i. The intermediation of SHG led to reduction in time spent by bank staff on identification of borrowers, documentation, follow-up and recoveries. This resulted in 40% reduction in transaction cost which could increase further with increase in loan sizes.

ii. The intermediation also significantly reduced transaction costs for the borrower due to elimination of cumbersome documentation procedure and time spent and cost incured on repeated visits to banks etc. The reduction was place at 85%.

CHAPTER 6: Rural Financial Systems Approach

6.1 Indonesia

The pattern of microfinance service provision in Indonesia differs from that observed in almost all other countries in which the sector has achieved any significant outreach. There are two major differences. The first is that certain regulated financial institutions in Indonesia, both public and private, have been able to extend sustainable financial services deep into the countryside, reaching many of the poor. The second, closely related, difference concerns the role and status of NGOs, which in other countries underpin much micro-finance activity. In Indonesia, prior to the fall of the New Order government in 1998, the Department of Home Affairs and line agencies operated a comprehensive system of local administration. This gave the central government considerable capacity to implement its policies and programs in the provinces. Coupled with the suspicions harbored by officials at all levels about NGOs, this meant that there was less scope in Indonesia for the spontaneous emergence of private NGO initiatives than in, say, the Philippines.

The position of NGOs changed substantially in 1998, when in the wake of the financial crisis the Habibie Government and the international community gave responsibility for relief and reconstruction under the “Social Safety Net” program to the Indonesian NGO community. NGOs continue to enjoy a more positive status although the Indonesian NGO movement is still a minor player in the provision of microfinance services.

Methods of delivering microfinance services found in Indonesia cover a wide range. Solidarity group-based lending approaches are commonly used by NGOs. However most micro-finance services are delivered on an individual basis, due to the dominance of the sector by regulated financial institutions, following normal banking practice. The poor also manage their own financial service provision using *arisan*, traditional ROSCAs which are very common in Indonesia. Cooperatives also provide financial services to their members, traders provide credit for the poor as an element in transactions, and the State operates pawnshops. Patron/client financing relationships are widespread and tenacious outside the formal sector.

6.1.1 Bank Indonesia: The Central Bank

Bank Indonesia (BI) has regulatory oversight of most of the major institutions engaged in microfinance and has participated actively in shaping them. In this it is unlike its counterparts in other countries with strong microfinance sectors, such as Bangladesh for example, where the central bank has been largely irrelevant to microfinance. Following the emergence of the New Order government, a new central bank law was enacted in 1968. This law gave Bank Indonesia a strong “developmental” mandate. However, in 1983 a process of financial sector deregulation and liberalization commenced. A longer-term consequence of these reforms was the successful turnaround of the village-level financial operations of Bank Rakyat Indonesia (BRI), the state bank whose primary focus was the agricultural sector. The Pakto financial deregulation “package” in 1988 continued the liberalization process. Among other measures, it freed-up entry of new banks to the so-called “rural bank”, or BPR, sector.

A new central banking law was enacted in 1999 by the Habibie government (Law No. 23 of 1999 on Bank Indonesia) at the urging of the IMF. Among other measures, BI’s previous role as an “agent of development,” responsible for channeling credit to priority sectors and groups, was abolished. These credit functions were to be transferred to other entities, the continuation of credit subsidies thus transferred was to be time-bound, and the costs of continuing credit subsidies were to be approved as part of the government budgetary process, rather than being funded by BI.

During the short Presidency of Abdurrahman Wahid political opposition to the new law began to swell. There was some support for reviving the role of BI as an “agent of development”, together with calls for the restoration of liquidity financing by the Bank. Under IMF pressure, in 2001 the matter was referred by the new Government of President Megawati to an independent expert panel for advice. A ‘Letter of Intent’ transmitted by the Government to the IMF in August 2001 (IMF 2001) committed the GOI to maintaining a ‘strong, independent and accountable central bank’.

6.1.2 The Banking System

The banking institutions regulated by BI are the commercial banks and the BPRs, or 'rural banks'. Among commercial banks we give particular attention to Bank Rakyat Indonesia and its Units and also consider the Regional Development Banks (BPDs). This account also considers the several categories of BPRs (Bank Perkreditan Rakyat), literally, people's credit banks. The BPRs are generally very much smaller than commercial banks and offer a more restricted range of services.

As is well known, the Indonesian commercial banking system was devastated by the financial crisis. With few exceptions, commercial banks were little involved in micro-financing prior to the crisis. They are even less inclined to become so under current circumstances. However, under the New Order government, a number of commercial banks were involved as channeling agencies in official credit schemes implemented by Bank Indonesia. To some extent the rhetoric of these official schemes included micro-finance but their performance in outreach to the poor did not match the rhetoric. A number of commercial banks have been involved in another government micro-finance program, the PHBK (Program linking Banks with Self-Help Groups).

Prior to the crisis some larger commercial banks had begun to explore the market potential of lower-end financial services, by means including the acquisition of small banks (BPRs) and setting up their own micro-banking divisions. The financial crisis put an end to this tentative expansion of financial services to low-income people. However, several small commercial banks had developed niche activities in micro-finance which have continued unabated. They have strong microfinance customer bases, although their outreach is small.

Table 8: Indonesia: Regulated Financial Institutions and Microfinance, 2005

Institution	Loan Accounts: Numbers. (million)	Mean Balance Outstanding per Account Rp. Mn/$US)	Deposit Accounts: Numbers (million)	Mean Balance Per Account (Rp. Mn/$US)
BRI Units	2.60	Rp2.55m/$340	16.7	Rp0.65m/$85
BPRs	1.68	Rp1.94m/$260	4.6	Rp0.25m/$33
BKDs	0.70	Rp0.22m/$29	0.6	Rp0.05m/$7
LDKPs	1.30	Rp0.28m/$35	N/A	N/A

Notes: Data for BRI relate to the Kupedes (loan) and Simpedes (deposit) accounts. Term deposits are excluded. Various dates during 2005.
Sources: BI and BRI.

6.1.3 Bank Rakyat Indonesia (BRI)

At the other end of the scale, Bank Rakyat Indonesia (BRI) is one of the largest commercial banks. Here we are concerned specifically with BRI's Unit division which operates at a retail level in rural areas and has successfully encompassed elements of

micro-finance. Units offer a restricted range of services tailored to the needs of small rural customers, including the Simpedes savings account and the Kupedes loan.

BRI's Unit (formerly Unit Desa) system, operating at village or sub-district level in rural areas, performed strongly throughout the crisis, with its Kupedes borrowers continuing to make over 97 percent of the installments that fell due in the period from mid-2003 to mid-2005. Savings mobilized through the Units grew dramatically over this period, doubling from Rp 8.3 trillion at the end of October 2003 to Rp.17.7 trillion at the end of June 2005.

The BRI Unit Division's performance in the face of the crisis put the seal on its reputation as one of the most efficient rural financial institutions in the developing world. Its strong repayment performance occurred at a time when the commercial banking system as a whole had non-performing loans estimated at 60 per cent of portfolio. BRI's deposit-taking operations, serving small and micro clients through the unit network, provided the lifeblood of liquidity for the bank as a whole throughout the crisis. This helped to prop up BRI in the face of heavy losses incurred by its corporate lending division.

In mid-2005, some 3,600 BRI Units had about 2.6 million Kupedes loans outstanding (table 8), with an unpaid balance of Rp6.7 trillion ($0.89 billion)[18]. The average outstanding loan balance was Rp2.55 million ($340) and the 12 month loss rate on the loan portfolio was at the extremely low level of 1.37 per cent. Studies of the size distribution of loans and the characteristics of borrowers indicate that at the lower end of the lending range the BRI Units do indeed reach the ranks of the poor. However, the outreach of the BRI units to low-income and poor people appears quite variable from place to place. Moreover, Kupedes loans are secured by collateral, most commonly some certification of land ownership, and are made in respect of established economic enterprises, not start-ups. These requirements constrain the capacity of Units to lend to the very poor, although less stringent requirements for loans belowRp1 million ($130) are being trialed.

On the other side of the balance sheet, the Units had 24.9 million savings accounts. These included 16.7 million Simpedes savings accounts (see Table 8) with a mean balance of around Rp650,000 ($85). Again this suggests that many depositors are likely to be poor. Clearly lack of liquidity is not a constraint on the lending of the BRI Units. With a loss rate close to 1 per cent the Units could be considered too conservative in lending.

6.1.4 Regional Development Banks (BPDs)

Another category of Indonesian commercial bank is of particular significance to microfinance. They are the BPDs (Regional Development Banks), one in each province,

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[18] A rate of Rp 7,500 is used for currency conversions. In a situation of extreme exchange rate instability such as in Indonesia since mid-1997, it is often misleading to convert to other currencies when discussing changes in rupiah values.

owned by the respective provincial governments. While they have a mandate to act as bankers to their governments, they also perform some functions analogous to those of so-called “Second Tier Institutions” operating in micro-finance in some other Asian countries (For example, PCFC in the Philippines). Some BPDs (7 out of 26) have responsibility for supervision of certain small formal financial institutions operating within the provinces. Their regulatory and supervisory responsibilities appear likely to increase as governmental devolution takes place in Indonesia.

6.1.5 The BPRs (Rural Banks or BPR Non-BKD)

The term “BPR” (people’s credit bank, but often translated simply as rural bank) is used in the Banking Act of 1992 and elsewhere to describe two categories of small regulated financial institution. The first is the “BPR non-BKD”, most commonly called simply “BPR”. There were around 2,400 of these small banks in mid-2005. Recently a number of BPRs practising banking under Islamic (Syariah) principles have emerged.

The second category is called, formally, BPR-BKD, or simply, “BKD’ (Village Credit Body). There were 5345 BKDs in mid-2005. They date back to the late nineteenth century and were formed under Dutch rule on Java and Madura islands as pioneer micro-credit institutions. For simplicity, in this paper the two categories of institutions will be called simply BPRs and BKDs. The BKDs are very much smaller institutions than the BPRs. Both are subject to the Banking Act, and are in principle regulated and supervised by Bank Indonesia.

Under the 1992 Banking Act, the BPRs may accept time and savings deposits, and provide credit. Most are limited liability companies in private ownership, operated for profit. Some are in chains associated with commercial banks or NGOs. Some are registered as co-operatives, others are organized on Islamic principles (BPR Syariah). In mid-2000, BPRs had 1.677 million accounts (table 8) with outstanding loans of Rp3.256 trillion ($430 million) and a mean outstanding balance of around Rp1.94 million ($260) per account. The comparable figure for the BRI *Kupedes*, as noted above, was $340. There were almost 4.6 million demand deposit accounts, totalling some $230 million, with a mean balance of around Rp250,000 or $33 (compared with the BRI *Simpedes* average of $85) as well as fixed deposits totalling Rp1.675 trillion ($220 million). Loan-to-deposit ratios were typically around 80 percent, and the average BPR had assets of perhaps Rp1,800 million ($240,000). The mean loan and deposit balances of the BPRs suggest they are, in general, serving a lower income stratum of the population than the BRI Units.

In May 2004, BPRs accounted for 0.65 percent of credit outstanding in the banking system and their deposits were some 0.25 percent of all deposits. While this is almost trivial if the chosen numeraire is a financial one, the number of clients who benefit from access to BPRs (almost 1.7 million borrowers) is far from trivial. Typical loans offered by a BPR are short-term micro-loans for petty traders ranging from Rp100,000 to Rp3 million, with 3-6 month maturities, daily installments, and flat rates of interest in the range 2-4 per cent per month. The BPR system withstood the crisis, in general, much

better than the commercial banks. BI strengthened prudential supervision in 1999 and liquidated 72 BPRs, while the overall level of non-performing loans rose to 37 percent[19]. Bank Indonesia and GTZ have begun a project (ProFI or Promotion of Small Financial Institutions) to address the weaknesses of the BPR system.

6.1.6 The BKDs (Village Credit Bodies, or BPR BKD)

The BKDs commenced operations more than a century ago and their status as banking institutions was affirmed by legislation in the colonial parliament in 1929. They were never subject to Bank Indonesia interest rate restrictions, which enabled them to set interest rates at sustainable levels well before the financial sector reforms of the 1980s. The 1992 Banking Act brought them under the supervisory jurisdiction of BI. They are supervised by BRI on behalf of BI. Some 5,400 of these small locally-based institutions served more than 700,000 borrowers in mid-2005. They are found primarily in the provinces of East and Central Java. As mentioned they do not offer the levels of service of the BPRs, and are normally open only one day a week, in association with local market days. In mid-2005, BKDs had loans outstanding of Rp152 billion ($20 million) (Table 8) at an average loan size of Rp217,000 ($29). The BKDs focus almost exclusively on credit provision, although a portion of each loan is held in a mandatory deposit. These mandatory balances totalled Rp32 billion in mid-2005, with more than 600,000 accounts and an average balance of around Rp50,000 or $7. These savings and loans figures suggest genuine micro-finance. Most BKD loans have a 12 week term with weekly instalments and an effective annual interest rate of 43 per cent. Management of each BKD is in the hands of a committee drawn from the village government. Loans are approved primarily on the basis of character and bank-ability. An itinerant bookkeeper employed by the district government and paid for by the BKDs serves 5 or 6 BKDs, each of which opens on a rota determined by village market days. All record-keeping is manual.

6.1.7 Non-Bank Financial Institutions

The NBFIs are a heterogeneous group, having in common (besides their activity in micro-finance) that they are not subject to BI regulation. For the purposes of micro-finance in Indonesia, they include small community-based institutions (LDKPs), pawnshops and the savings and credit cooperatives.

6.1.8 The LDKPs: Community-based Non-Bank Financial Institutions

The acronym "LDKP" is applied generically to a range of small savings and credit institutions which exist, with variations, in a number of provinces. A total of 2,272 LDKPs (table 8) were operating in mid-2005 serving more than 1.3 million borrowers

[19] By comparison, at the height of the crisis the non-performing loans of the commercial banking sector were calculated at some 60 per cent. Data for the BPR sector in mid-2004, based on CAMEL ratings, showed 42.5 per cent of BPRs as "sound", with 14.7 per cent "fairly sound", and 28.1 per cent "unsound".

with loans outstanding of some Rp360 billion ($48 million), with a mean balance outstanding of Rp275,000 ($35). The level of savings mobilised by the LDKP (Rp334 billion) was almost as great as the loans outstanding. As with the BKDs, this also suggests genuine micro-finance. A mean loan size (balance outstanding) of $55 for LDKPs puts them on roughly the same social level as the BKDs ($43) and on a very much lower level than the BPRs ($390) and the BRI Units ($510).

The lending procedures of one type of institution within the LDKP category, the BKKs of Central Java, give a sense of the nature of these small village-based institutions:

> *BKKs apply the now typical instruments of micro-credit: loans are unsecured and character-based, relied on references from local officials rather than based on feasibility studies … Initial loans are small and gradually increased, based on repayment performance. This mechanism functions as the primary repayment incentive. Loans are paid in equal installments, carrying maturities from 22 days to 12 months, according to six different repayment plans with monthly effective interest rates ranging from 2.2 per cent to 10.8 per cent. Savings are mandatory for every loan and are treated as cash collateral, becoming accessible only after full loan repayment.*
>
> **- (BI and GTZ 1999)**

6.1.9 Savings and Credit Co-operatives

Co-operatives were a primary instrument of state policy under Suharto and independent initiatives were discouraged. Essentially the only cooperatives in rural areas were those within the official KUD (Village Cooperative Unit) system. A new cooperative law in 1992 attempted to entrench the official cooperatives in certain areas of the economy. However since 1998, independent entities are now free to obtain licenses under the Act of 1992 to set up KSP (Savings and Credit Cooperatives). Some NGOs have taken advantage of the new situation to set up financial services cooperatives. Islamic self-help savings and loan groups (the BMT) are in many cases adopting the cooperative legal form, while a long-running government microfinance program (P4K) is working towards having its self-help groups adopt cooperative status. There is also a proliferation of unregistered cooperatives, and some moneylenders have adopted these (referred to as Kosipa) as a front for their high-cost lending. Many USPs which originated within the KUD movement continue actively, although less tightly linked into the official system than before.

Some 36,000 cooperative savings and loan entities were registered in Indonesia in October 2000. These comprised around 1,200 KSPs and some 5,200 USPs (the latter rural, and associated with the KUD cooperative system). In addition there were some 29,600 urban USPs, mostly associated with workplace arrangements. The KSPs had perhaps 0.7 million members and the rural and urban USPs around 3 million and 7 million, respectively. A Bank Indonesia/GTZ assessment of the credit union activities of the USP units of the KUD is that:

[they] have so far played a minor role as financial intermediaries due to repressive regulation and excessive government interference under the New Order regime of former President Suharto. However, the more than 5,335 government-sponsored KUDS are established throughout the country and would in fact possess a tremendous microfinance potential if properly stimulated and regulated.

6.1.10 Informal Financial Institutions

NGOs conducting microfinance require no permission to extend credit, and there are no reporting requirements or supervisory arrangements for such activities. However, they are forbidden to mobilize the savings of members unless these are deposited directly in a regulated financial institution. In practice, some savings mobilisation appears to be tolerated as long as the amount is small. Some larger NGOs have set up their own BPRs to overcome the problem. Also, the new freedom to set up savings and loan cooperatives under the Act of 1992 offers another solution to this problem. However, for NGOs unable to take either of these paths, the inability to mobilize even compulsory savings in conjunction with lending is a constraint on their activities. NGOs have been involved in mass poverty alleviation programs of the GOI which involve elements of microfinance, especially the IDT (or 'backward villages' program, of 1993-1997). Their function in such schemes has been to act as social intermediaries, preparing "self-help groups" of the poor to participate. Relatively few NGOs in Indonesia are specialist microfinance providers. Most have microfinance as only one among a range of development activities. By contrast, Grameen replications have not been particularly successful in Indonesia and the outreach of this category of NGO is insignificant.

Self-help groups (SHGs) are completely informal organisations. Hundreds of thousands of informal SHGs with savings and credit activities exist in Indonesia. Many are spontaneous groupings, based on traditional forms of association, such as the *arisan*. This is the Indonesian version of the ROSCA. Many other SHGs have been founded by government and community organisations in connection with government programs, or have been created by NGOs, and some are organised on Syariah principles.

An unknown number of SHGs continue in operation on the basis of revolving funds which they have been able to preserve from one or another of the mass programs operated by government from time to time (described below). As many as 400,000 groups were formed during the 1990s in connection with one program or another, involving perhaps 10 million individual members and touching the lives of perhaps another 40 million family members. This is enormous outreach, mostly to the poor and very poor, but financial sustainability has been elusive.

6.1.11 The Role of Government

Since the advent of the new Order, successive governments, acting through the central bank and a number of line departments, have supported activities now categorised as micro-finance. Initiatives have been dedicated either to financial sector development in some broader sense, or to nurturing particular microfinance projects. There has often

been significant donor involvement in these activities and the overall record, as exemplified by the performance of BRI, has been good. Initiatives styled specifically as 'micro-credit' or 'micro-finance' became more important over time during the Suharto period, as the overall incidence of poverty fell and the need was felt for a more targeted approach to eliminating the residual. To some extent this reflected a realization by the New Order government that, despite the successes of BRI units and small bank and non-bank financial institutions in extending sustainable financial services to lower strata of the population, there remained a core group of the poor untouched by this progress.

6.1.12 Mass Poverty Alleviation Programs

By contrast with the government's achievements in financial sector development for the benefit of lower-income and rural people, there was a parallel development of mass credit schemes, in which neither institutional sustainability nor financial sector development have been objectives. Indeed, these have often operated at odds with the sustainable programs already described. These mass schemes reflected political concern with the problem of the hardcore poor. The first was the IDT (Presidential instruction relating to backward villages) which commenced in 1993. A second, the UEDSP (village economic activities with savings and loans), commenced in 1995, also with the benefit of presidential funding. A third campaign, the Prosperous Family Program, was introduced as an emergency measure in 1996. Donors have avoided entanglement in unsustainable mass schemes of the GOI, although they did support microfinance in the context of "social safety net" programs as a response to the crisis.

Some sense of the character of these mass government programs may be gained by considering the most meteoric scheme of this genre, the "Prosperous Family Program'. In 1996 as an emergency response to political concerns about income inequality, President Suharto launched this program using the National Family Planning Coordinating Board (BKKBN) as the implementing agency. Some 9.8 million Indonesian families received highly subsidized funding under this program in just 12 months. The program was financed by a levy of 2 percent on the incomes of corporations and high income individuals, channeled through a Suharto family foundation. It became one of the "social safety net" programs after the commencement of the crisis in 1997. Cumulative disbursements by the various micro-credit programs implemented by the Family Planning Board rose from Rp317 billion in December 1997 to Rp768 billion in December 2004 and Rp900 billion in March 2005. This last figure is equivalent to approximately $100 million at an exchange rate of Rp9000. The Prosperous Family and other programs in this category, such as the UEDSP, were retrogresive in their influence on financial sector development in Indonesia. They often acted to undercut legitimate microfinance institutions attempting to achieve sustainability with realistic interest rates and they were a negative influence on the rural credit culture.

6.2 Philippines

Leading Philippine NGOs are concerned to improve this situation. Micro-finance NGOs have been active in dialogue with the National Credit Council (discussed below) and in

self-regulation. The Micro-finance Coalition for Standards (now the Micro-finance council), set up in 1996 with USAID assistance, is an organization of MFIs and other micro-finance stakeholders (including the central bank) which documents best practice and sets benchmark standards for MFI performance, as well as conducting training activities.

Commercial banks have had limited engagement with micro-finance in the Philippines; only government-owned financial institutions have had any substantial involvement. The Development Bank of the Philippines, the LandBank and the People's Credit and Finance Corporation (PCFC) have provided wholesale loans to MFIs for on-lending to micro-finance clients. In this way they have financed rural banks, cooperatives and NGOs to serve as conduits for credit. However this involvement has often been on unsustainable terms, with subsidized credit delivered at government direction.

Private commercial banks, on the other hand, have been extremely tentative in their approach to micro-finance. A study of *The Role of Commercial Banks in Micro-finance* (Goodwin-Groen 1998) discusses the quite limited record of commercial bank micro-financing in Asia and the Pacific. While there is a long tradition of government subsidized loans channeled through banking systems, micro-finance conducted as a profitable business is comparatively rare. Goodwin-Groen identified BRI and another small private commercial bank in Indonesia, together with one small private commercial bank in each of Sri Lanka and India, as comprising the four commercial banks in the Asia-Pacific region which treat micro-finance as a profitable core business.

In the Philippines, Ms Goodwin identified some cases where private commercial banks have made lines of credit available to particular MFIs. However, in one case this occurred at a sub-market rate of interest and in another the bank concerned channeled the money through its charitable foundation to allow for a tax write-off should the loans fail. Good performance by certain NGOs had encouraged the bank to convert this lending to a fully commercial basis, but the crisis in 1997 cut short this experiment. At that time a single NGO, TSPI Development Corporation, had eight loans from three leading commercial banks and its financial performance was exemplary. Despite this, interviews suggested that personal relationships between board members of TSPI and senior bank executives were the primary motivation for these arrangements (Goodwin-Groen 1998, 27).

The experience of this and several other well-performing NGOs in the Philippines suggests that there are barriers of culture and perception in the banking community which must crumble before traditional bankers will consider funding even the best-performed of MFIs. This has led some MFI leaders to conclude that the only feasible path to expansion and mobilization of the funding necessary to meet the demand for micro-credit is to transform their organizations into small regulated banks. Several MFIs have followed the ‘transformation’ strategy so far, including CARD Bank and Opportunity Microfinance Bank.

6.3 Cambodia

Cambodia has adopted what might be called a 'transformation' model of micro-finance service provision. This is one where microfinance services originate in the voluntary sector and government's role is seen as providing an appropriate policy and regulatory environment and financial infrastructure (specifically, a second-tier institution, the RDB, to act as a wholesaler for and nurturer of MFIs). Micro-finance institutions are then expected to follow a linear path on which they transform themselves from informal revolving funds to NGOs to licensed MFIs and then to specialist micro-finance banks. Only ACLEDA has made the transition to bank status, and at present only a couple of institutions are licensed MFIs. A number of other NGOs are in process of achieving licenced MFI status, including CCB, Prasac Credit Association and ANS. The ability to incorporate a small specialist bank such as ACLEDA Bank under Cambodian law is an essential part of the supportive regulatory environment. Cambodia is one of a relatively small number of countries in the Asian region (Indonesia and the Philippines being others) where this is possible.

CHAPTER 7: Pakistan --- Country Context

7.1 The Country Profile

Pakistan is a country with a population of 146 million & an average growth rate of 2.8 % per annum. Women form 48% of the total population and 52 % are men.

According to the estimates 97 million people live in rural areas whereas 49 million in the urban areas. The total labor force is estimated at 41.5 million, of which 28.1 million (67.7%) is in rural areas and 13.4 million (32.3%) in urban areas. Agriculture is the mainstay of economy with sustaining 48.4 % of the employed labor force. The other main sectoral employers are services 15.02 %, trade 13.87 and manufacturing 11.25 %. Per capita income is estimated at US$ 480.

Exports in 2005-06 were estimated at US$ 8925 million or 15.7% of GDP. Exports mainly comprise of primary commodities 11%, semi-manufactures 14% and manufactured goods 75%. The main export items are cotton, leather, rice, synthetic textiles, sports goods etc.

Imports in 2005-06 were US$ 10,171 million reflecting a trade gape of US$ 1,246 million. Major imports include petroleum, machinery, edible oil, chemical and fertilizers.

Persistent fiscal deficit is a major economic issue with fiscal deficit in 2006-07 estimated at 5.7 % of GDP. This led to unsustainable growth in public debt, and the current level of domestic debt rests at US$ 27 billion (PKR 1.6 trillion) and foreign debt at US$ 36 billion. The unsustainable levels of public debt and resulting debt servicing liabilities together with regional security needs leave limited fiscal space for servicing social development in Pakistan.

7.2 The Present Policy Context

After the relatively difficult phase for Pakistan's economy during the 90's the far reaching structural reforms initiated and accelerated in particular over the past six years have now started to pay off and Pakistan has witnessed a modest rebound in growth, its vulnerability to external shocks has reduced and its key economic fundamentals have improved. The current growth rates however need to be strengthened to arrest the current growth in poverty levels. Macro-stabilization, governance reforms and re-profiling of external debt stock have created prospects for robust growth in future.

The Government has indicated its willingness to speed up the pace of structural reforms to meet the major challenges of:

i. reducing poverty,

ii. improving governance and administration,

iii. improving the fiscal and balance of payments positions,

iv. restoring investor confidence,

v. achieving higher growth on a sustainable basis, and

vi. improving social indicators.

The reform agenda includes structural changes in major economic sectors, fiscal reforms, financial sector reforms, provincial finance reforms, judicial reforms, and private sector development.

7.3 The Microfinance Industry in the Country

7.3.1 Background

The number of poor people in Pakistan nearly doubled during the 1990s and as mentioned earlier this incidence of poverty will continue to increase if economic performance is not accelerated, directed poverty reduction interventions are not enhanced, and delivery of pro-poor services not improved.

Therefore, the Government has made poverty reduction its prime objective and identified micro-finance (MF) as a critical element of its poverty reduction strategy.

7.3.2 Sector Description and Recent Performance

i. Overview

A conservative estimate suggests that the micro-finance sector in Pakistan has grown substantially over the last 6 years on the back of huge social investments made by donors and investors. This growth has been on all fronts; increase in retail micro-finance players, entry of green field MFBs, diversification of products (credit as well as non-credit), growth in active borrowers, and development of branch infrastructure as delivery conduits for future growth.

It is important to highlight however, that in micro-finance, as an industry, paybacks are generally deferred. Thus, this huge investment has generated momentum and created a conducive policy environment as well as the enabling infrastructure that has brought focus and attracted private sector investment to the sector, which has enabled the industry to operate at a low cost. However, all agree that maintaining future growth and sustainability requires rationalizing existing price structures in order to raise the level of returns to make the sector attractive for private risk capital.
With a legislative (Micro-finance Institutions Ordinance 2001) and regulatory (Prudential Regulations) framework in place, micro-finance in Pakistan is a sector in its own right, rather than just a tool for poverty alleviation. The sector in Pakistan represents a diverse set of institutions including 20-25 non-governmental organizations (NGOs), 06 microfinance banks (MFBs), 4-5 commercial financial institutions (CFIs), and 04-06 rural support programmes (RSPs).

Pakistan's micro-finance sector is in its growth curve. One manifestation of this development is the micro-finance providers' recent move to start diversifying their product base. This includes the addition of a menu of credit products in addition to loans for productive purposes (e.g., consumption loans, personal loans, and freedom' loans), voluntary saving products (both demand and time deposits), insurance products (largely credit life but some have moved towards health insurance) and money transfer services.

Credit technology has also begun to change in response to market demand and an expansion in the market segments served can be observed. The sector has started shifting from predominantly group-based lending towards individual and smaller group lending as it moves from rural to urban finance. Innovative use of technology has started to change service delivery: recently a micro-finance bank (MFB) has set up biometric ATM machines in its peri-urban branches, and some MFIs have started providing mobile banking services.

The SBP has recently issued guidelines for commercial banks to enter micro-finance. This, with most of the sector highly capitalized, could help MFPs leverage growth as well

as help diversify funding portfolios and reduce MFPs' reliance on only one or two sources of funding currently available to them.

The micro-finance sector in Pakistan is also supported by avibrant meso-sector that services micro-finance providers. A corporate rating firm recently rated two MFBs and an NGO MFI. The rating firm is accredited by CGAP to access its rating fund and plans to enter into partnership with a specialized rating agency for micro-finance to build its knowledge of the sector. The 'Big 4' audit firms have a much better understanding of the microfinance business and its intricacies-evidence is the CGAP financial transparency award received by The First MicroFinanceBank Ltd. (FMFB) for the last hvo years.

Recently, the MF sector in Pakistan has also seen the arrival of two high quality technical assistance providers: ShoreBank International (SBI) and Grameen Foundation, USA. Both specialize in the micro-finance business.

There is awareness that a credit bureau is necessary for the credit market to flourish and the PMN is working with its members and strategic partners to improve the information symmetry and transparency environment of the micro-finance sector.

ii. Demand for Micro-finance

The average size of loan taken by households as microfinance is about US$ 295 (PKR l6, 540) at an interest rate of 18-20 % per annum. Considering these, the estimated potential demand for micro-credit is about US$ 2 billion per annum based on the number of poor households (6.6 million) or about US$ 3 billion based on half the adult poor population (10 million).

Similarly, the estimates for deposit possibilities range from US$ 225 million to US$ 350 million per annum. Based on population distribution, two thirds of this demand is considered to emanate from the rural poor. The NGO-MFIs experience reflects that depositors out-number borrowers by 2-4 times. The poor emphasize the safety and accessibility of savings facilities as many lost their savings in the past due to failures of cooperatives and finance companies.

Most of the demand for MF in rural areas is for agriculture production (50 %), livestock (25 %), and the balance for other household-based income-generating activities (IGAs). In urban areas, most of the demand is for small business and self-employed ventures. Households are extended families and the pool of labor within a family unit creates potential for a diverse range of income-earning opportunities. Demand attributes include (i) small and frequent loans; (ii) flexible terms compatible with the nature of activity; (iii) preference of women, due to restricted mobility, (iv) simple and speedy delivery procedures placed within the community; (v) service proximity, and (vi) significant and sustained social preparation to familiarize the poor with managing IGAs. Interest rate sensitivity is high in rural areas due to the general low level of economic activity. The

apprehension of becoming indebted, particularly among women, due to failed enterprises (e.g., death of livestock, failure of business, crop failures) is widespread.

7.3.3 Financial Sector Reforms and Micro-finance

The Government of Pakistan considers an efficient financial system necessary for macro-economic stability. Therefore, the banking system is being strengthened by (i) fundamentally changing norms for governance; (ii) restructuring to conserve assets, downsizing staff and branches, and reducing bad debts; (iii) implementing debt recovery measures; (iv) strengthening the prudential and supervisory framework; (v) improving legal and judicial enforcement of banking courts; and (vi) privatizing all but one state-owned Commercial Bank (CB's). State Bank of Pakistan (SBP), the country's central bank, has been empowered in all matters concerning monetary and banking policies, as well as for governance and management of the financial institutions. These reforms have been extended to the Development Financial Institutions (DFIs) that are presently in restructuring and re-capitalization phase.

Interest rates have been deregulated and loans up to US$ 1,785 (PKR 100,000) may not be collateralized. In general, the reforms constitute a positive financial environment. Enforcing SBP's authority in banking supervision and greater transparency requirements has significantly strengthened good governance.

The banking reforms have now been extended to cover the specific needs of MF, which include:

i. Conducive policy to encourage emergence of MFIs as depository institutions;

ii. Corresponding creation of a supervisory and regulatory system for orderly sector development;

iii. Flexibility to adopt practices and procedures for banking with the poor, such as mobile banking and group collateral;

iv. Free limit to accumulate a non-collateralized loan portfolio; and

v. Insulation from political interference.

The MF sector can now seamlessly integrate with the broader financial sector of the country.

i. Microfinance Sector Development

In the 1960s and 1970s, subsidized micro-credit was provided in rural areas, but failed to reach the poor due to an unsustainable system, which was prone to abuse and diversion of funds to higher income groups. In the 1980s, the Aga Khan Rural Support Program (AKRSP) was established in the northern region to build community-based organizations

and infrastructure, and assist in resource mobilization through credit and savings. The success of the AKRSP led to the creation of Pakistan's other RSPs, which formed the primary approach to microfinance during the 1980s and part of the 1990s. Those RSPs made a major contribution to the micro-finance sector by accessing lines of credit from commercial banks to provide micro-credit to low-income people living in rural areas. Similarly, the Orangi Pilot Project (OPP) developed an individual lending methodology adapted to urban slums, by targeting entrepreneurs in Karachi region. In the 1990s, learning from international best practices, NGOs specialized in microfinance started their operations, such as Kashf Foundation, Taraqee and Damen. The outreach of microfinance institutions and other rural organizations providing financial services has been limited due to a narrow institutional base, slow progress on sustainability and efficiency benchmarks.

Since 2000, the micro-finance landscape in Pakistan has changed considerably. This change can be credited primarily to the government's growing interest in the microfinance sector. It was this interest that resulted in:

a. The creation of the apex funding body, the Pakistan Poverty Alleviation Fund (PPAF)

b. The formulation of the MFIs ordinance 2001, regulating the creation of commercial micro-finance banks, such as The First MicroFinanceBank (created by the AKRSP) and the Khushhali Bank, a retail microfinance bank issued from a public-private partnership.

In the last two years, Pakistan micro-finance providers have posted faster growth in terms of outreach, with 'transformed' or 'created' dedicated micro-finance organizations starting to realize their full potential through a conducive regulatory environment. Other organizations are also benefiting from the dissemination of best practices and the availability of funds to finance their expansion.

ii. Regulations and government initiatives

The MFIs Ordinance 2001 was promulgated by the Government of Pakistan to support the development of the micro-finance sector by introducing the concept of micro-finance banks. Under this ordinance, micro-finance banks created with the necessary amount of capital, can offer micro-finance services, including savings deposits, to the general public. In addition, the State Bank of Pakistan (SBP) introduced additional prudential regulations related to micro-finance operations. This ordinance and the relevant prudential regulations of the BSP, regulate The First MicroFinanceBank and the Khushhali Bank.

The government, with the lending support of the Asian Development Bank, also supported the creation of the Khushhali Bank. This was the first retail microfinance bank in Pakistan, owned by a group of private and public commercial banks. In addition to this project, ADB support has resulted in the establishment of several funds available to

regulated micro-finance banks, such as the Social Development Fund, the Community Investment Fund, a Risk Mitigation Fund and a Deposit Protection Fund.

7.3.4 Practices and Innovations

i. Practices

The majority of micro-finance organizations operating in Pakistan, particularly RSPs, use community-based organizations as conduits for their financial services. This methodology produces the highest outreach. The largest micro-finance provider is the NRSP, with national coverage. However, RSPs find it difficult to view micro-finance activities as anything other than a supporting component of their larger, integrated program, resulting in difficulties to separate costs specific to micro-finance.

Other organizations use the solidarity group model, adapted from the Grameen Bank to the Pakistan context, the best example being Kashf Foundation. Organizations such as this are the fastest growing providers of micro-finance in Pakistan and post the best 'portfolio quality' ratios.

Finally, some organizations use a mix of individual lending and partnerships with community-based organizations. It seems that the organizations using this methodology are the most viable programs, if self-sufficiency ratios are compared.

ii. Innovations

The PPAF, a wholesale window for MFIs and the micro-finance banks (Khushhali Bank and First Micro-finance Bank) could be seen as innovative ventures breaking away from the traditional financing windows and vehicles in Pakistan. In addition, the State Bank of Pakistan has established a conducive legislative framework, which features the inclusion of micro-finance funds as wholesale facilities and protection mechanisms for borrowers. Some micro-finance providers have started to offer innovative products, such as skills training, emergency loans, and life insurance, while adopting innovative management practices in scaling up their operations or establishing partnerships between commercial bank and MFIs. Adaptations of the Grameen Bank model have been innovative and very successful, as demonstrated by the Kashf Foundation and UPAP.

The Performance Indicators report compiled by the Pakistan Micro-financing Network (PMN) provides a benchmarking tool to share best practices and standards in Pakistan, which also includes individual analysis of each member's performance.

The Swiss Agency for Development Cooperation (SDC) takes a sectoral approach to strengthening microfinance in Pakistan. The FSSP offers unique technical and financial assistance to the whole microfinance sector, with the objectives of: developing human and institutional capacity within all types of microfinance institutions; building the capacity of local expertise providers; supporting market oriented approaches and creating an enabling environment. In addition, SDC has provided support to the development of

micro-leasing products and providers through support to Network Leasing, Orix Leasing and other leasing companies operating in Pakistan. The Leasing to Small and Micro Scale Enterprises Program (LMSE) project aims to increase earning and employment in the MSE sector in NWFP and Northern Areas through an improvement in access to leasing services on a sustainable basis.

7.4 Performance of MF Providers

Conservative estimates suggest a huge potential market for MFPs. With 10 million as the absolute minimum, the current outreach of 600,000 clearly indicates that Pakistan's micro-finance sector has a long way to go. In spite of exceptional growth rates over the last few years, albeit with a low starting base, the future of this sector depends upon robust, profitable, and viable organizations that can access diversified sources of capital, including commercial capital (debt, equity, and hybrid) and deposits. Achieving growth and profitability is possible given that Pakistan is globally competitive when we look at its cost structure and operational efficiency[20].

In the following sections we will look at the performance of MFPs with regard to scale, growth, financial structure, profitability, efficiency, productivity, and asset risk and utilization. For ease of analysis reporting organizations have been categorized into five peer groups:

i. **MFIs:** non-governmental organizations that are specialized microfinance institutions

ii. **MFBs:** microfinance banks licensed by the SBP

iii. **RSPs:** rural support programmes running microfinance operations as a part of their integrated rural development programmes

iv. **NGOs:** non-governmental organizations running microfinance operations as a part of their integrated development programmes

v. **CFIs:** commercial financial institutions involved in microfinance

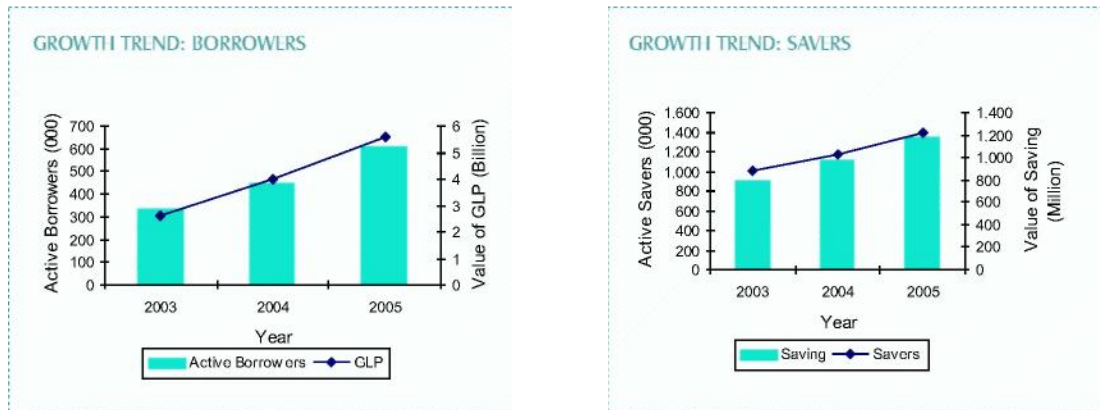
7.4.1 Outreach and Growth

The most important indicators to look at in this section are growth in outreach as measured by the number of active borrowers; the extent to which growth, in terms of gross loan portfolio (GLP), is a factor of increase in clients, and the extent to which it is a factor of larger loan/deposit size; the proportion of total growth coming from sustainable institutions; and finally, the proportion of total outstanding loans going to female clients.

[20] Trends Report (2006) by SBI and PMN

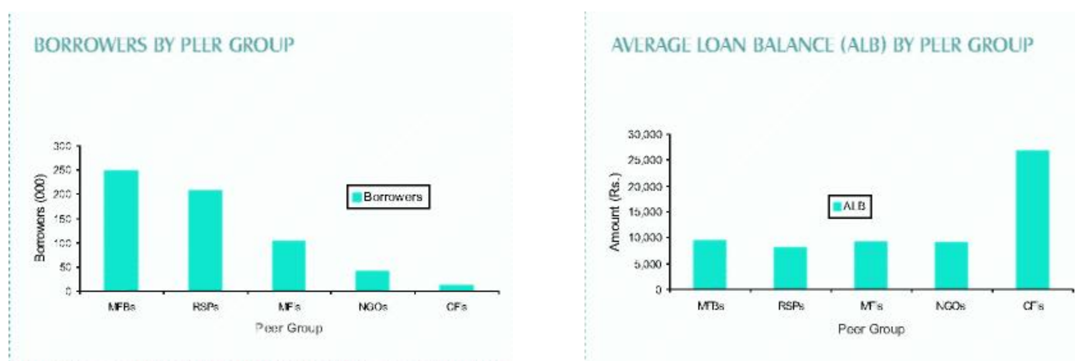
Figures 1A and 1 B indicate that over the past three years (2003-2005), the number of active borrowers increased by 85% while total outstanding loans grew by 115%. In comparison, the growth in the number of savers and the value of savings has been more gradual, at 38% and 49%, respectively. This growth is led by a large upfront investment from two multilateral donors - the Asian Development Bank (ADB) and the World Bank (WB).

Figures 1A and 1B



MFBs as a peer group account for the largest share, in terms of total active borrowers, of Pakistan's microfinance market. MFBs are closely followed by the rural support programmes (RSPs), with MFIs coming in a distant third in terms of market share. Each of the three largest peer groups however, is dominated by a single player (Khushhali Bank accounts for 92%; NRSP accounts for 59%, and Kashf Foundation for 73%, of the respective market share of the peer group to which they belong). These three players together cover 70% of the micro-finance market in terms of total active borrowers.

Figures 2A and 2B

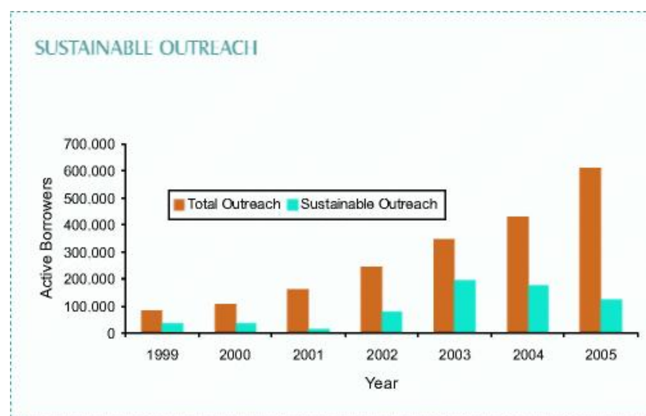


Figures 2A and 2B above also show that average loan sizes for all peer groups hover around Rs. 10,000, except in the case of CFIs, where it is as high as Rs. 27,000. However, the MFB peer group has an outlier - KB - whose sheer size has skewed the percentage for the entire group; if KB is removed from the MFB group, the average loan balance (ALB) would stand at Rs. 20,000. This indicates a move towards market segmentation among micro-finance players and a case of either larger loans, or enterprise lending by MFBs.

The data indicates that gender targeting is skewed in favor of male credit clients. At 44.6%, the micro-finance sector in Pakistan has the lowest global proportion of female borrowers (all MFIs reporting to the MBB: 63%; all financially self-sufficient MFIs reporting to the MBB: 62%; all MFIs in Asia reporting to the MBB: 85%). The low targeting of female clients could be one of the reasons that the microfinance sector has not been able to achieve scale as has happened in other parts of the world.

Figure 3 below illustrates the biggest challenge faced by the micro-finance sector in Pakistan. This brings forth not just the issue of the financial viability of the industry but also the issue of the sector's ability to provide access to financial services in perpetuity, without support from donors and the government.

Figure 3



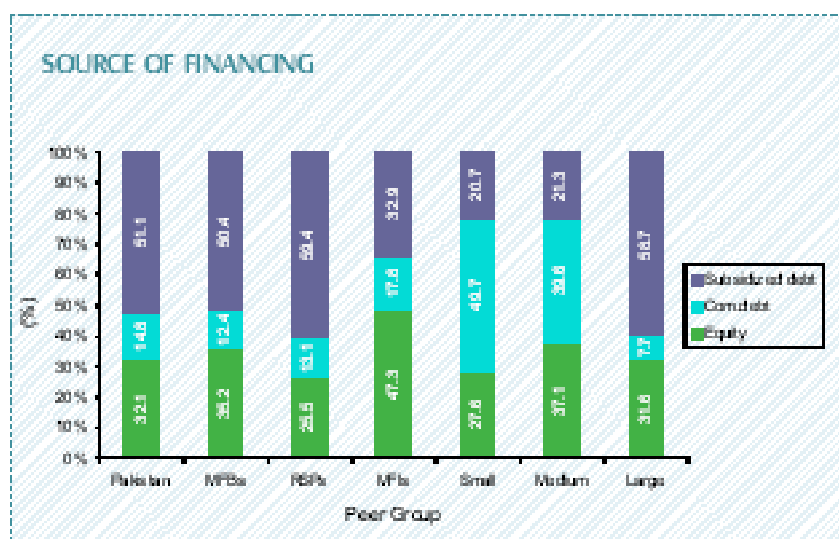
Although the graph clearly shows growth in outreach, the provision of micro-finance services is still heavily subsidy dependent.

7.4.2 Financial Structure

This section sheds light on the financial structure of MFPs in terms of sources used to finance assets and the degree of leverage, as indicated by the debt-to-equity ratio.

The three major sources of funds available to MFPs in Pakistan are equity, non-commercial liabilities at subsidized prices, and commercial liabilities at market price. Another source, largely untapped but available to MFBs, is public deposits. The sources of finance for microfinance players, are compared in Figure 4 below.

Figure 4

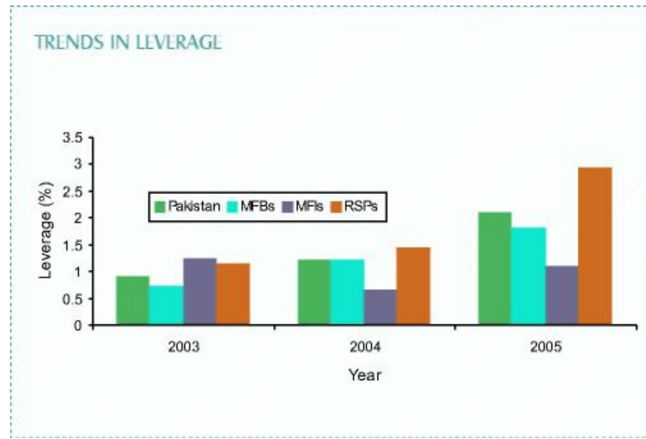


The substantial equity base of Pakistan's micro-finance sector (sector-wide equity-to-asset ratio of 32%) indicates that MFPs have the potential to attract debt finance and thus grow by leveraging their capital on the balance sheet. The fact that this potential or opportunity to attract commercial debt has not been used yet is evident from the fact that commercial debt makes up the smallest proportion in the capital structure of the largest MFPs combined. Two of the largest organizations (NRSP and Khushhali Bank) in terms of active borrowers, finance their portfolio largely by accessing either debt from the apex or from a multilateral, at less than market price.

If we map the trend of leverage over the last year, what we find is that the sector as a whole is using leverage to grow its portfolio. Within the sector the RSPs use the most leverage, followed by the MFBs. Within the peer groups, KB (2.1) has the highest debt

among the MFBs, TRDP among the RSPs (10.4), and Asasah among the MFIs (negative equity).

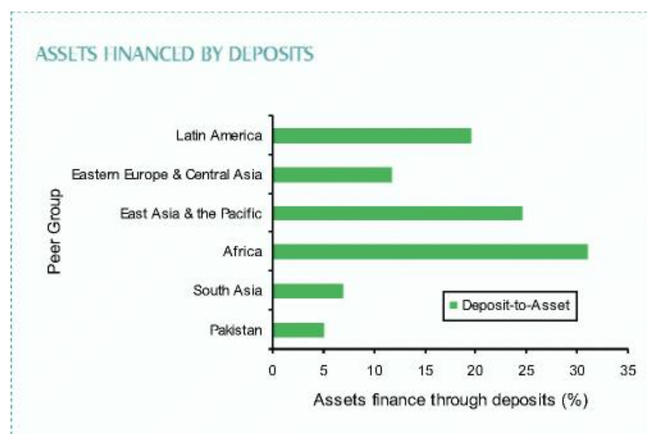
Figure 5



Another factor reflected in the low share of commercial liability as a source of funding is that public deposits as a source of funds remains significantly untapped. This is because the SBP only allows licensed banking institutions to intermediate deposits. As a result NGOs, RSPs and MFIs can only facilitate savings and deposit them with financial institutions. In the MFB peer group also, only FMFB has an aggressive policy to fund by raising deposits, whereas the largest MFB, Khushhali Bank, has made a strategic decision to grow quickly through a single product and build infrastructure before developing and offering deposit services.

Figure 6 compares Pakistan against regional benchmarks in terms of public deposits being used as a source of funding assets.

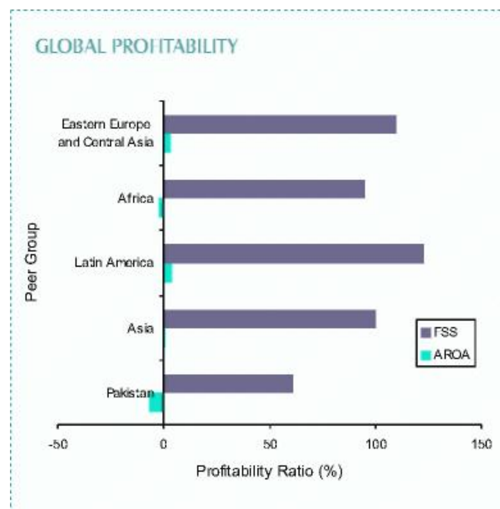
Figure 6



7.4.3 Financial Performance

This section examines two key indicators of profitability: Adjusted Return on Assets (AROA) and Financial Self Sufficiency (FSS). In the absence of adjusted data, to see where it stands in its own region, Pakistan is compared with other South Asian countries using Operational Self Sufficiency (OSS) as the core indicator. A positive AROA and an FSS above 100% indicates the ability of an organization to generate profits to fund growth. Indicators below the two thresholds indicate that the organization is at a risk of de-capitalization. Factors contributing to profitability include portfolio yield, asset yield, operating cost, financial cost, and loan loss cost ratios.

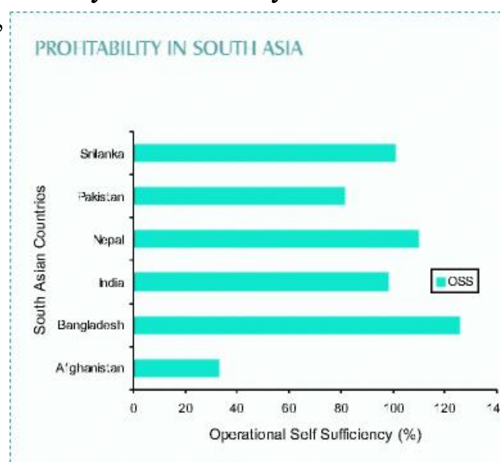
Figure 7



At -7.2% AROA and 61% FSS, the micro-finance sector in Pakistan has one of the lowest profitability ratios globally. What we can see from Figure 7 is that all other regional peers show much better performance with regard to profitability; they either have a positive AROA, or are on the cusp of profitability.

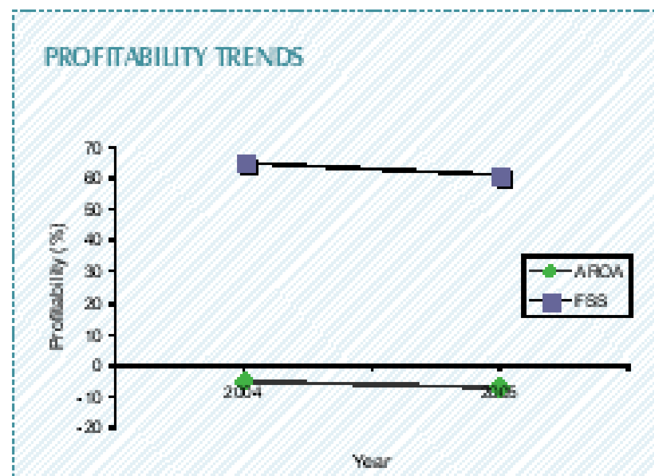
Barring Afghanistan, which is only in its third year of micro-finance, Pakistan has the lowest OSS in South Asia, as shown in Figure 8.

Figure 8



Despite having one of the lowest levels of profitability globally, over the last year the profitability in Pakistan has declined even further from an AROA of -5% to -7.2% and an FSS of 65% to 61%, as shown in Figure 9.

Figure 9



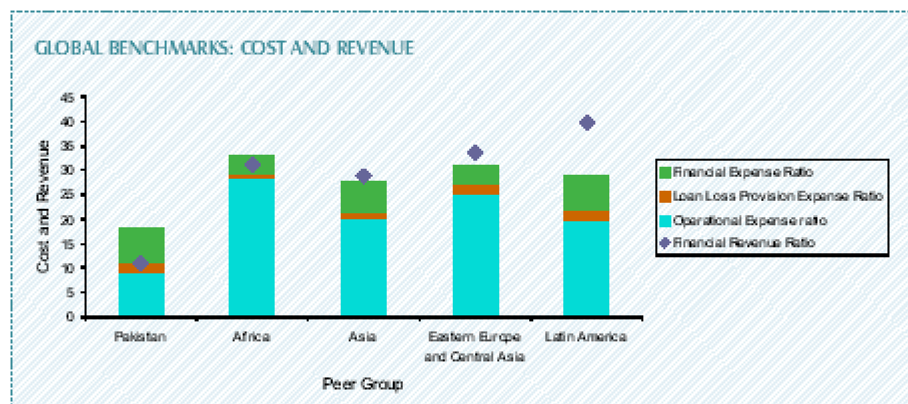
Some of the causes of this low profitability are:

i. *Low Yields on Portfolio and Assets*

Despite the fact that the costs are globally competitive, MFPs in Pakistan continue to charge prices that do not cover total costs (see Figure 10). In fact, in Pakistan, MFIs are only able to cover their operational costs and a portion of their loan losses.

Figure 10

ii. *Eff ect ive*

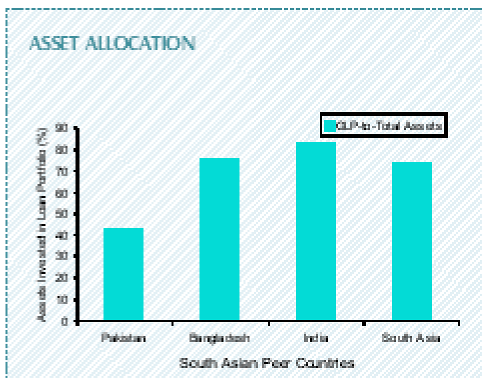


Utilization of Assets

Another area of concern is the ineffective rate at which the assets of the sector as a whole are translated into active micro-loans. A good benchmark to measure effective utilization of assets is the percentage of assets invested in loan portfolio. MFPs in Pakistan translate only 42.5% of their total assets into loan portfolio, which amounts to only half the rate at which other countries in the region do, as shown in Figure11.

Asset utilization has a significant impact on the overall profitability of the industry. The lower the investment in terms of loan portfolio, the greater the opportunity cost for the sector in terms of yield foregone. The rate at which assets are utilized as active loans is a factor of the institutional ability of the sector to disburse loans, and the concerned organizations' willingness to use their resources as active loans against their decision to earn income from idle investment. It is important for the sector to acknowledge that the core business of a MFP is to increase access to financial services for the un-banked. Therefore, utilization of assets in building loan portfolio will help MFPs in both improving their profitability, and increasing outreach of financial services to the un-banked.

Figure 11

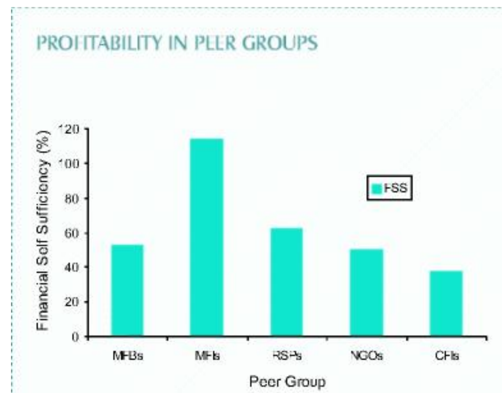


iii. *Investment in Capacity Building and Infrastructure*

MFPs have started growing and the increase in branches and staff has been much faster than the increase in borrowers or gross loan portfolio (GLP), which brings in revenue. Thus, there has been a massive upfront investment, with a gestation period required to translate this into revenues.

Within the peer groups the most profitable is the MFI group, which has a positive AROA and FSS. The RSPs and the MFBs follow as less un-profitable amongst the peer groups in that order. The MFI group is led by Kashf at 4.1% AROA and Orangi Pilot Project (OPP) at a 2.9% AROA. Within this group the dispersion from the average is also low, indicating that all, except one MFI, is either profitable or is on the cusp of profitability.

Figure 12



Primary factors for the profitability of MFIs are:

a. A GLP-to-total assets ratio (63.2%) that is almost 1.5 times the national average (42.5%)

b. A high portfolio yield (27.8%) which again is almost 1.55 times the national average (18%)

c. Higher operating efficiency (MFIs at 16.1%; national at 22.4%)

7.4.4 Efficiency and Productivity

The analysis looks at how efficiently MFPs are performing and at their productivity. The important indicators to consider are: operating expense-to-GLP; operating expense-to-average borrowers[21], staff productivity, and personnel allocation.

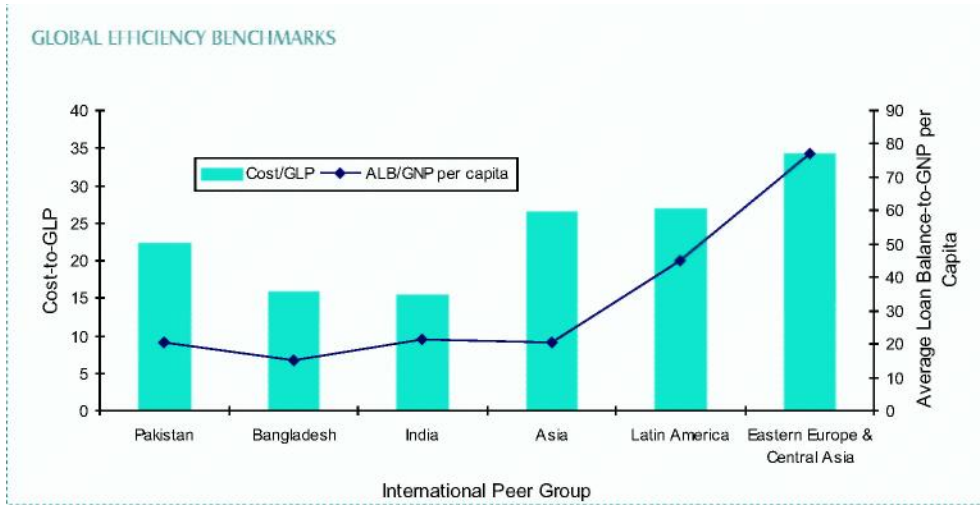
As shown in Figure 13, at 20.2% operating cost-to-average GLP, the micro-finance sector in Pakistan is very efficient, both in the South Asia region and globally. This is so in spite of the two factors that keep efficiency low:

i. Low average loan balance-to-GNP per capita

ii. Inefficient allocation of resources: 42.5% GLP-to-total assets

[21] For MFBs mobilizing and intermediating deposits, average clients is used.

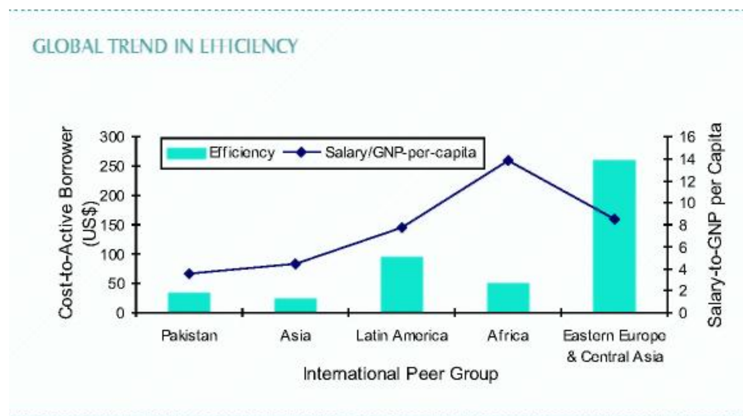
Figure 13



This however, indicates the fact that there is room for MFPs to become more profitable if they invest more of their assets in loan portfolio.

It is also important to note that even when the data is adjusted for loan size, MFPs in Pakistan prove to be efficient. This indicates that efficiency is not a factor of loan size but of decentralized decision-making and of distribution channels. Another reason is staff productivity and lower salaries as a percentage of CNP-per-capita, as shown in Figure 14.

Figure 14



Efficiency trends in Pakistan have remained flat over the last year, as shown in Table 9. This is expected to change as organizations begin to utilize their current investment in infrastructure and human resource development over the next years.

Table 9: Efficiency Trends

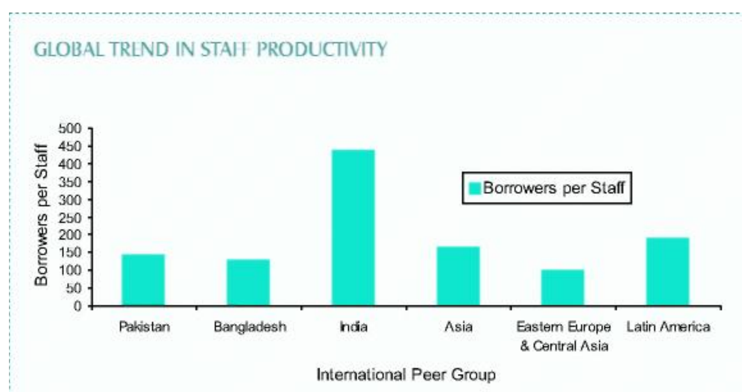
Indicator	2004	2005

Operating Expense-to-Average CLP	22.50%	22.40%
Operating Expense-to-Average Clients (PRS)	1,939/-	1,938/-

CFIs make up the most efficient peer group, followed by MFIs, RSPs, and NGOs and finally MFBs. This is on the back of higher investments in loan portfolio, since most MFPs are older than MFBs. This is also because the staff salaries paid by MFPs generally as a multiple of GNP-per capita, are lower than those paid by MFBs. Interestingly, when we look at efficiency in terms of scale, the most efficient peer group is the small MFPs largely because two of the organizations are CFIs and they have high loan sizes.

Another area to look into is the productivity of staff, shown in Figure 15 below, since this could be one of the drivers to attain operating efficiencies. At 147 borrowers per staff, Pakistan stands on the margins of global benchmarks, with India being an outlier.

Figure 15



Again, if we look attends in Pakistan we see productivity remaining flat (2005: 143; 2004: 153). One of the possible reasons for this could be that investments in infrastructure and personnel have increased tremendously over the last couple of years, as shown in Table 10, with expected deferred benefits. This is again expected to improve further with trained loan officers being optimally utilized and organizations moving towards urban and semi-urban areas.

Table 10: Growth in Infrastructure

Indicator	2004	2005	2005 Increase (%)

Number of personnel	157600%	294800%	42961.73
Number of branches	277	388	5701.06

7.4.5 Portfolio Quality and Liquidity

This section analyzes the credit risk MFPs are holding on the asset side of their balance sheets. The aged Portfolio at Risk (PAR) (>30 and > 90 days) is evaluated and the write-off ratios are also examined. By writing off portfolios organizations can improve their PAR, though that does make a dent in their bottom line, unless their risk has been adequately covered through provisioning.

At 3.2% and 2% PAR > 30 and 90 days, respectively, Pakistan's micro-finance sector has a globally competitive credit risk (see Figure 16). Although it is marginally higher than that of the country's international peers, it is still within the normal range of 3-5%. Also, this is at a discount from credit risks in India and Bangladesh.

Figure 16

Figure 17, which shows a comparison of the risk within different peer groups in Pakistan, reveals that the smaller organizations have higher risk, large ones have medium risk, and medium-size ones have the lowest risk. Again, in terms of institutional peers, the lowest risk is carried by MFIs and the highest risk by CFIs. Risk is concentrated in a few institutions (BOK, Khushhali Bank and Sungi Foundation) and also geographically in the North West Frontier Province (NWFP). There are number of factors that differentiate high credit risk players from low credit risk players:

i. Exponential growth with little investment in systems and staff capacity

ii. A 'zero tolerance' policy towards delinquency

iii. Clear focus on micro-finance as a commercial business[22] with focus on the poor

[22] Commercial business means that institutions are providing demand-based high quality financial products on a sustainable basis. This also means MFPs are moving towards efficient operations and accessing diversified sources of both social and commercial capital to grow their balance sheets.

iv. or un-banked

Figure 17

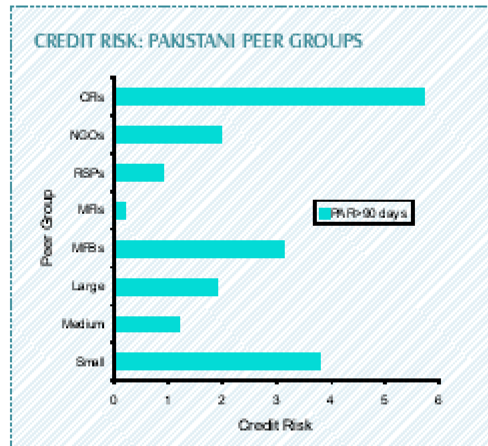
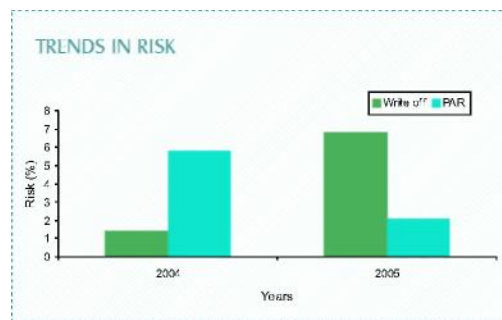


Figure 18

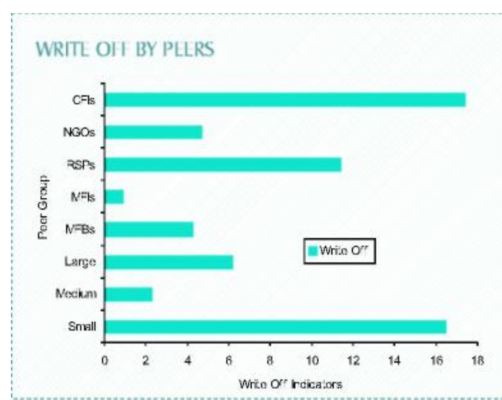


As shown in Figure 18, the risk faced by microfinance providers has declined from 5.8% (>90 days) in 2004 to 2% in 2005.

The biggest reason for this decline is a very high write-off rate that was less than 1.5% in 2004 but reached 6.8% during 2005. This write-off has largely been done by the PMN analyst to match international standards, but the organizations continue to hold high levels of bad loans on their balance sheets. The PMN urges them to clean all loans that are above 360 days past due in their next financial statement.

Again the risk profile of the sector depicts higher concentration of risk with old loans than with new loans. This is because organizations have started investing on both systems and human resources.

Figure 19



Similarly, some organizations have begun following practices of sharing negative lists of clients in competitive areas, an indication that managers have understood the importance of monitoring and evaluating risk to remain competitive in the micro-finance industry.

As shown in Figure 19, the biggest write-off within different peer groups comes from CFIs followed by the RSPs and the smallest percentage from MFIs. Again the smaller organizations have the largest write-offs, whereas the medium ones have the smallest.

CHAPTER 8: Conclusion and Recommendations

It is evident from the above discussion that micro-finance can effectively used as a tool for poverty reduction. The question however remains whether all categories of poor can overcome poverty if they have access to credit, whether microfinance programs can serve the poorest on a sustainable basis, whether credit alone is the answer to poverty reduction, whether viability of both borrowers and lenders can be simultaneously taken care of in such programs, whether microfinance organizations with different scales of operations are equally able to meet the disastrous situations and absorb the shock of irregular payment and default situations. Although these and many other issues remain to be sufficiently attended and adequately explained, microfinance industry continues to grow through a process of learning by doing. Grameen and Grameen partners are facing new challenges with their strong commitment and creativity. They are confidently marching forward with new strategies and products.

The experiences of Grameen and Grameen partners worldwide and also the experiences of other MFIs indicate sufficiently that poverty can be reduced and even eradicated if MFIs have access to adequate amount of funds from both internal and external sources, if they are able to develop and retain a professional staff and if they are able to motivate their clientele to do their best to overcome poverty. The process is on. It will continue until the mission is fulfilled.

The micro-finance sector in Pakistan continues to pursue a low-cost low-yield strategy. This, on the back of efficient operations, low delivery costs, competitive credit risk, high capital adequacy, higher investment in human resources, and system improvement should lead to a sustainable industry, which is not the case currently.

The micro-finance sector in Pakistan is poised for growth, product diversification, and market segmentation. There are also very clear signs that both MFIs and MFBs will need to build linkages where they share the same market niche and will soon be competing both, amongst themselves and with each other. With this possibility, there is an increased need for high quality service providers that can build the necessary infrastructure, and reduce the business risk faced by MFPs.

The recent 'Guidelines for Commercial Banks to do Microfinance' issued by the State Bank of Pakistan will on the one hand build awareness amongst commercial banks to move down market for direct lending, and on the other, open avenues for existing MFPs

to leverage their balance sheets by entering into commercial transactions with banks. This will build confidence between micro-finance players and the commercial sector and will diversify the funding options available to the sector. However, for MFPs to achieve this, they will need to improve their performance by showing a positive bottom line, a healthy balance sheet, and strong cash flows. The MFB will also be required to provide hard numbers through improved disclosures, audits by high quality firms, and credit ratings in the future.

The availability of different kind of products and value-added services is also becoming increasingly important. The use of technology and value addition in products will help MFPs pursue product differentiation and increase outreach.

Some further guidelines are presented below. Most of these address issues specific to financing agriculture, some respond to the general challenges of operating in rural areas, and some reflect good practice in delivering small unsecured loans.

i. *Repayments are not linked to loan use.* Lenders assess borrower repayment capacity by looking at all of a household's income sources, not just the income (e.g., crop sales) produced by the investment of the loan proceeds. Borrowers understand that they are obliged to repay whether or not their particular use of the loan is successful. By treating farming households as complex financial units, with a number of income-generating activities and financial strategies for coping with their numerous obligations, agricultural micro-finance programs have been able to dramatically increase repayment rates.

ii. *Character-based lending techniques are combined with technical criteria in selecting borrowers, setting loan terms, and enforcing repayment.* To decrease credit risk, successful agricultural micro-lenders have developed lending models that combine reliance on character-based mechanisms — such as group guarantees or close follow-up on late payments — with knowledge of crop production techniques and markets for farm goods.

iii. *Savings mechanisms are provided.* When rural financial institutions have offered deposit accounts to farming households, which helps them to save funds for lean times before harvests, the number of such accounts has quickly exceeded the number of loans.

iv. *Portfolio risk is highly diversified.* Micro-finance institutions that have successfully expanded into agricultural lending have tended to lend to a wide variety of farming households, including clients engaged in more than one crop or livestock activity. In doing so, they have ensured that their loan portfolios and the portfolios of their clients are better protected against agricultural and natural risks beyond their control.

v. *Loan terms and conditions are adjusted to accommodate cyclical cash flows and bulky investments.* Cash flows are highly cyclical in farming communities.

Successful agricultural micro-lenders have modified loan terms and conditions to track these cash-flow cycles more closely without abandoning the essential principle that repayment is expected, regardless of the success or failure an any individual productive activity — even that for which the loan was used.

vi. *Contractual arrangements reduce price risk, enhance production quality, and help guarantee repayment.* When the final quality or quantity of a particular crop is a core concern — for example, for agricultural traders and processors — contractual arrangements that combine technical assistance and provision of specified inputs on credit have worked to the advantage of both the farmer and the market intermediary.

vii. *Financial service delivery piggybacks on existing institutional infrastructure or is extended using technology.* Attaching delivery of financial services to infrastructure already in place in rural areas, often for non-financial purposes, reduces transaction costs for lenders and borrowers alike, and creates potential for sustainable rural finance even in remote communities. Various technologies show enormous promise for lowering the costs of financial services in rural areas, including automated teller machines (ATMs), point-of-sale (POS) devices linked to "smart cards", and loan officers using personal digital assistants.

viii. *Membership-based organizations can facilitate rural access to financial services and be viable in remote areas.* Lenders generally face much lower transaction costs when dealing with an association of farmers as opposed to numerous individual, dispersed farmers — if the association can administer loans effectively. Membership-based organizations can also be viable financial service providers themselves.

ix. *Area-based index insurance can protect against the risks of agricultural lending.* Although government-sponsored agricultural insurance schemes have a poor record, area-based index insurance — which provides payouts linked to regional levels of rainfall, commodity prices, and the like — holds more promise for protecting lenders against the risks involved in agricultural lending.

x. *To succeed, agricultural micro-finance must be insulated from political interference.* Agricultural micro-finance cannot survive in the long term unless it is protected from political interference. Such political interference includes not just the meddling of funds intended for micro-financial purposes but also political influence by feudal leaders who are desirous of keeping the rural population suppressed. They do so by providing credit with outrageous conditions and interest rates which the rural poor are unable to pay. Therefore the feudals and rural rich strongly condemn any alternative source of credit to the poor in their regions and they ensure that micro-finance cannot be practiced in their area. Even the best-designed and best-executed programs wither in the face of government moratoriums on loan repayment or other such meddling in well-functioning systems of rural finance.

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Executive Summary

Globally, 1.2 billion people are extremely poor — surviving on less than $1 a day — and three-quarters live in rural areas. Poverty is predominantly a rural phenomenon. Extremely poor people spend more than half of their income to obtain (or produce) staple foods, which account for more than two-thirds of their caloric intake. Most of these people suffer from nutritional deficiencies, and many go hungry at certain times of the year.

Among the major interventions for alleviating poverty has been the direction of credit to the poor. This paper deals with this methodology. It talks about the widely used models of micro-finance, their advantages and concerns. Each model has been analyzed with respect to its impact and efforts have been made to highlight claims through case studies. The paper then devotes itself to a study of Pakistan with specific reference to its Micro-finance industry.

The number of poor, those living below a dollar a day, more than doubled in Pakistan during the 1990s to reach 45 million in 1999. The Government, therefore, prioritized the implementation of a comprehensive poverty reduction strategy that included improvements in social indicators, employment generation, safety nets, and access to microfinance (MF).

The microfinance sector in Pakistan is relatively young and dynamic. Each year new players enter the arena while the existing ones adapt to their changing environment. This trend has been on the rise in recent years, resulting in a sector characterized by a diversity of micro-finance players ranging from large and small conventional development organizations to commercial financial institutions involved either partially or exclusively in reaching the 'un-banked'.

The paper analyzes Pakistan and its various micro-finance players in terms of their performance and suggests ways for Pakistan to improve its Micro-Finance industry with specific focus on agricultural micro-finance since the greatest demand for micro-finance in the country is generated by this sector.

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Table of Abbreviations

ADB	Asian Development Bank
BI	Bank Indonesia
BKKBN	National Family Planning Coordinating Board
BPD	Regional Development Banks
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
CARD	Center for Agriculture and Rural Development
CFF	Central Finance Facility
CFI	Commercial Financial Institution
CU	Credit Union
DEG	German Development Company
DFI	Development Financial Institutions
GTZ	German Agency for Technical Cooperation
IDF	Integrated Development Foundation
IGA	Income-Generating Activities
IICA	Inter-American Institute of Agricultural Cooperation
KSP	Savings and Credit Cooperatives
KUD	Village Cooperative Unit (Indonesia)
LMSE	Leasing to Small and Micro Scale Enterprises Program
MFB	Micro-Finance Bank
MFI	Micro-Finance Institution
MFP	Micro-Finance Provider
NABARD	National Bank for Agriculture and Rural Development
NACSCU	National Association of Savings and Credit Cooperatives
NATCCO	National Association of Philippines Credit Cooperatives
NCBA	National Cooperative Business Association
NGO	Non-Governmental Organization
PHBK	Program linking Banks with Self-Help Groups
PMN	Pakistan Micro-finance Network
PPAF	Pakistan Poverty Alleviation Fund
ProFI	Promotion of Small Financial Institutions
RDI	Rural Development Institute
RSP	Rural Support Programme
SBP	State Bank of Pakistan
SDC	Swiss Agency for Development Cooperation

SHARE	Society for Helping Awakening Rural Poor through Education
SHG	Self-Help Group
SHGI	SHG promoting Institution
SME	Small and Medium Enterprises
USAID	U.S. Agency for International Development
VBI	Village Banking Institution
WB	World Bank
WOCCU	World Council of Credit Unions

CHAPTER 1: Introduction

Despite changes in development paradigms in the last half of the 20th century, the promise to bring wellbeing to all human being remained unfulfilled. As it stands more than 1.2 billion people in the world are struggling to survive - at the margins of human existence – on under a dollar a day. Even the country like USA which has experienced a long and steady boom has not been able to benefit the life of its every citizen. According to an estimate, roughly one out of every eight Americans still lives below poverty line. The situation in Asia is more desperate than many other regions in the world.

The presence of about 50 million poor in Bangladesh, 90 million poor in China, 300 million poor in India, 90 million poor in Indonesia, 52 million poor in Pakistan, 27 million poor in the Philippines and many other millions in other countries of Asia and Africa is the testimony of the fact that the poor people have very little enjoyed the benefit of the development programs implemented during last decades.

Poverty is predominantly a rural phenomenon. Extremely poor people spend more than half of their income to obtain (or produce) staple foods, which account for more than two-thirds of their caloric intake. Most of these people suffer from nutritional deficiencies, and many go hungry at certain times of the year.

Among the major interventions for alleviating poverty has been the direction of credit to the poor. Majority of people in poor countries are very poor, mostly engaged in small agriculture. They lack assets: do not get credit to invest; are victims of "usurious" moneylenders.

Money begets money. Adam Smith said “Money, says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little” (“The Wealth of Nations” 1937, p. 93). It is very difficult for the poor to get small working capital from formal banking system for various reasons. A collateral free working capital loan is the requirement at the door steps of the poor at the right time to help them facilitate and start feasible intended income generating activities (IGAs). It is with this background that, micro-finance is seen as one of the significant approaches to poverty alleviation.

In recent years, micro-credit, in its wider dimension known as microfinance, has become a much favored intervention for poverty alleviation in the developing countries and least developed countries. There is scarcely a poor country and development oriented donor agency (multilateral, bilateral and private) not involved in the promotion (in one form or other) of a microfinance program. Many achievements are claimed about the impact of microfinance programs, and an outside observer can not but wonder at the range of diversity of the benefits claimed.

While accepting that growth is essential for poverty alleviation, this paper asserts that the participation of the poor in economic recovery and growth will be facilitated by their access to

micro-financial services. The crude ‘trickle-down’ analogy for the diffusion of the benefits of growth may be discredited. But if, for heuristic purposes, we were to adopt that analogy and pursue its implications, micro-financing could be described as a process by which capillary systems are opened to enable the benefits of growth to flow to the poor, and to facilitate their participation in it.

The financial service needs of the poor are simple but their satisfaction can be life-enhancing. The poor need access to convenient, liquid and safe deposit services which are protected against inflation by positive real rates of interest. With savings in reserve the poor are able to smooth their consumption expenditures in the face of uncertain income streams. Savings provide a shield against catastrophic events which, by forcing the vulnerable to divest productive assets, would otherwise tip them over the dividing line between meager sufficiency and poverty. “Micro”-insurance is a related financial product with potentially profound welfare benefits. Similarly, the poor who make their living in a myriad of activities in the informal sectors of the region, many of them either landless or with insufficient agricultural land, need access to credit to increase the productivity of their labor or to free them from exploitative financial relationships.

1.1 Defining Micro-finance

Having established the significance of the subject, I proceed to the definition. “Micro-financing” is the provision of financial services to poor and low income households without access to formal financial institutions. In most of the countries to be considered in this paper, such households form a clear majority. Using the definition of microfinance used in the ADB microfinance development strategy for the Asia-Pacific region (ADB 2000a, 1):

“Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises.”

Having said that, it is nonetheless important to remember that there is a clear distinction between the economic activities and financial service needs of the SME (small and medium enterprise) sector and those of the clients of microfinance institutions. The latter operate on a much smaller scale and exclusively in the informal sector of the economy. While there may be some overlap between the bottom end of the SME sector and the poor and lower income people who form the constituency of microfinance, it is the needs of the latter to which this paper is directed.

‘Microfinance’ encompasses access to savings and other financial services, as well as credit. The term has come into greater currency since the early 1990s and has largely (but not entirely) supplanted the term ‘micro-credit’ in the professional literature. The latter term is now recognized as unfortunate because its use has focused attention on a single aspect of micro-financial services, lending to the poor, and diverted attention from the need to develop systems of financial intermediation to which the poor have access. Savings is often described, in a

memorable phrase, as ‘the forgotten half of rural finance’ (Vogel 1984). Using the term micro-credit perpetuates this amnesia.

Microfinance Institutions (MFIs) are developing forms of ‘micro-insurance’ to protect the vulnerable from misfortunes, such as ill-health, which can tip them over the edge into poverty. Estimating the potential demand for insurance services by the poor as quite substantial, Kunkel and Seibel (1997) refer to micro-insurance as ‘the forgotten third of microfinance’. In addition, Microfinance practitioners are working to introduce newer services, such as money transfers (given the high degree of spatial mobility of the working poor and the difficulties and expense they may experience in remitting funds to their families).

1.2 Models of Micro-Finance

1.2.1 Grameen Bank

Among the proliferation of microfinance institutions (MFIs) in developing and even some industrial countries, a number of distinguishable models have emerged. The **Grameen Bank** model has been applied in many countries in a wide variety of settings. The Grameen model requires careful targeting of the poor through means tests, usually with a focus on women and intensive fieldwork by staff to motivate and supervise the borrower groups. Groups normally consist of five members, who guarantee each other’s loans. Some compulsory saving requirements are imposed, but in general quite limited voluntary saving occurs. Sustainability is achieved by increasing the scale of operations, and by decentralising control and carefully managing costs. While some other models have as their goal the creation of autonomous institutions, this is not expected of the individual borrower groups. In Bangladesh, where the greatest numbers of Grameen-inspired institutions exist, considerable innovation is occurring; only the basic model is described here.

1.2.2 Village Bank

The **Village Bank** is a widely replicated model, found mainly in Latin America and Africa, but with substantially less total outreach than the many Grameen Bank replications. Typically, an implementing agency establishes individual village banks with between 30 and 50 members and provides capital (called the ‘external account’) for on-lending to individual members. Individual loans are repaid at weekly intervals over 16 weeks, at which time the village bank returns the principal with interest to the implementing agency. A bank repaying in full is eligible for subsequent loans, with loan sizes linked to the performance of village bank members in accumulating savings. Peer pressure operates to maintain full repayment, thus assuring further injections of loan capital, and also encourages savings. Savings accumulated in a village bank can be loaned out to members (the ‘internal’ account). The standard business plan calls for a village bank to accumulate sufficient capital in its internal account to enable ‘graduation’ after three years, by which time loan capital has been accumulated entirely from internal sources. Hence village banks are intended to become autonomous institutions.

1.2.3 Credit Unions (CUs)

Somewhat less structured than village banks (and a good deal less so than Grameen banks) are **Credit Unions** (CUs). These are democratic, non-profit financial cooperatives owned and controlled by their members. CUs mobilise savings, provide loans for productive and provident purposes and have memberships which are generally based on some common bond. The memberships of CUs is likely to be more heterogeneous than that of Grameen banks, although various CUs differ in the extent to which they include poorer and low-income households. CUs generally relate to an apex body that promotes primary credit unions and provides training while monitoring their financial performance. In Asia, rural credit unions have been successful in some countries, both in terms of sustainability and of reaching out to the poor (notably Sri Lanka). But they have been less successful in most other countries of the region.

1.2.4 Self-Help Groups (SHGs)

A fourth model, based on **'self-help' groups** (SHGs) is somewhat similar to the village bank concept, although less structured. Most prominent in India, SHGs have around 20 members who should be relatively homogeneous in terms of income. Their primary principle is the lending of members' savings but SHGs also seek external funding to supplement internal resources. The terms and conditions of loans differ among SHGs, depending on the democratic decisions of members. Typical SHGs are promoted and supported by NGOs, but the objective (as with village banks) is for them to become freestanding institutions. Some NGOs act as financial intermediaries for SHGs, while others act solely as 'social' intermediaries seeking to facilitate linkages of SHGs with either licensed financial institutions or other funding agencies. The SHG model is a good platform for combining micro-finance with other sectoral activities and their implementing agencies (maternal and child health and adult literacy, among others). However the relatively loose structure of groups makes rapid expansion of outreach and tight monitoring of performance more difficult than, say, with the Grameen Bank model.

1.2.5 Rural Financial Systems Approach

In a quite different category from the four models discussed above, each of which has strong voluntary elements involving the action of NGOs or community-based entities, is what might be called a **'rural financial systems approach'**. As practiced in Indonesia, this model exhibits a diversity of regulated financial institutions providing rural financial services. These range from a national-level institution with substantial outreach and extensive networks to small, local institutions occupying particular market niches. Also, depending on the regulatory environment in a particular country it may be possible for an NGO to transform a successful MFI into a regulated financial institution. The rural financial systems approach to micro-financing will be discussed later, with particular reference to Indonesia. The "transformation" process in which NGOs evolve to become regulated financial institutions will be also be described, in the context of Cambodia and the Philippines.

CHAPTER 2: Grameen Bank

The Grameen Bank operation is committed to the cause of poverty alleviation. It is poverty focused banking, provides collateral free credit to the poor and has a preference for the poorest women. Grameen Bank (Grameen) was started with a new paradigm, a new definition and new approach towards development.

2.1 Grameen Approach to Development

According to Muhammad Yunus, the founder of Grameen Bank, development should mean the development of the bottom 50% of population, especially bottom 50% of those who live below the poverty line. A poor person, like anyone else, has an immense potential for growth. Given the access to credit, the poor can become the architect of their destiny. They can overcome poverty. The experiences of Grameen in Bangladesh and that of Grameen replications in Asia can be taken into consideration to see how this happens.

2.1.1 Grameen Philosophy and Objectives

Poverty eradication is a doable proposition. It can be reduced and eradicated with credit as the instrument. Credit is a human right. It provides command over other resources. Given the access to it, the poor can generate income through self-employment and meet their basic needs. They can do more provided they are properly motivated and organized, enabling conditions are created to use their potentials and they have continuous access to financial services.

Grameen was created to:

i. Extend collateral-free banking facilities to very poor men and women.

ii. Eliminate the exploitation of the poor by moneylenders.

iii. Create new opportunities for self-employment for the vast unutilized and underutilized manpower resources.

iv. Bring disadvantaged people into the folds of some organizational structure which they can understand and operate, and in which they can find socio-political and economic strength through mutual support.

v. Reverse the age-old vicious circle of "low income, low savings, low investment," into an expanding system of "low income, credit, investment, more income, more credit, more investment, more income."

2.1.2 Grameen Essentials

To achieve its objectives, Grameen has developed its own system of targeting, credit delivery and recovery, financial products and services, training program and institutional support. The essential features of the Grameen system may be summarized as the following:

i. *Exclusive targeting on the bottom poor:* As a bank for the poor, Grameen has developed its own criteria for identifying and selecting the bottom poor. These include land ownership, housing conditions and household assets of targeted persons. It has a definite preference for the poorest women. Ninety-four percent of Grameen members are women.

ii. *Organization of the borrowers into homogeneous community based groups:* The entire Grameen system is built on peer-support within the framework of a five-member group and the broader framework of a centre.

iii. *Close rapport between lender and borrower:* In Grameen, all bank transactions are transparent and close to the customers. The poor do not come to the bank, but the bank goes to the poor.

iv. *Professional Staff:* Grameen requires well-motivated professional staff to provide financial services to its members. In order to develop and maintain a hardworking and well-meaning staff, it has designed introductory as well as in-service training for the staff.

v. *Special loan conditionalities:* Grameen has always taken into consideration the potential and capacity of its borrowers, their affordability and viability. It has developed loan products and conditionalities according to their needs. 'Borrowers know best' is the principle of Grameen. One can borrow more and more as subsequent loans as one grows in confidence and skill. Grameen regards women as the effective agents of greater family welfare and social change.

vi. *Problem-solving culture:* Grameen promotes a problem-solving culture and puts total trust in the creative potential of its staff and clientele in crisis management.

vii. *Obligatory savings:* Grameen has an obligatory savings system. It considers saving mobilization as an integral part of its lending program.

viii. *Sustainability:* Grameen aims at building a sustainable credit delivery system by charging the borrowers an affordable rate of interest. It remains cautious to avoid charging a price which makes the borrowers pay for any inefficiency of the system.

ix. *Strong Monitoring:* Grameen monitors all its activities continuously and thoroughly. It tries to reach out even to the remote and dark corners of the system to keep them clean.

x. *Decentralization:* Grameen is a decentralized system. It always delegates decision-making powers to the lower levels-- to the branch, centre and group. It operates a transparent system so that everything remains visible to everyone.

2.2 Grameen Lending Model

Surely the Grameen model cannot be blamed for its complexity: its appeal lies in the simple yet effective method of dispersing loans to those who demonstrate a need and desire for self-motivated entrepreneurship. Understanding that the poorest of the poor have been excluded from access to financial services, Grameen's Solidarity Group Lending model uses social collateral to ensure repayment of small loans approximately (in size). Essentially, small loans are distributed individually to women organized in groups of five; it is the job of this group to ensure that weekly loan repayments are met.

Believing that credit is an essential human right, the system operates on a premise of trust and a vehement conviction that poverty is not created by the poor, but rather the institutions and policies which surround them. Pitt and Khandker (1998) underscore this notion in their examination of individual and household outcomes in Bangladesh; they conclude that access to credit is a significant determinant of many household outcomes, allowing for increased labor supply and asset holding.[1]

Grameen credit aims to promote the skills of the poor which remain "unutilized or under-utilized", in order to bring them out of poverty by "unleashing [their] energy and creativity to answer poverty". It is due to this belief that Grameen does not offer job training or career building services. Rather, the emphasis is on building social capital in the impoverished women by incorporating them into a system which gives them the ability to exercise leadership (through group or center leadership) and self-initiative (through proactive entrepreneurship).[2]

2.2.1 Who is Eligible?

Grameen caters to the rural landless who qualify as the poorest of the poor: this means that their lack of collateral has disqualified them from traditional financial services. Qualifying as landless means that one possesses less than half an acre of land or assets that amount to less than the value of an acre of medium quality land: this definition thus makes eligible approximately half of

[1] Khandker, Shahidur and Faruquee, Rashidur. "Impact of Farm Credit in Pakistan." World Bank. pg 18.

[2] Yunus, Muhammad. "Expanding Microcredit Outreach to Reach the Millenium Development Goals". Presented at the International Seminar on Attacking Poverty with Microcredit. Dhaka, Bangladesh. 9 January 2003.

the rural population[3]. Less than this established quantity of land indicates that the potential client has few resources which can be effectively used for income generation; as such, they will benefit greatly from financial assistance. Grameen's unique model addresses the issue of collateral when dealing with the destitute. This demographic has been denied access to financial institutions because they have no collateral with which to ensure repayment of a traditional loan. The high opportunity cost of the meeting and the small amount of loan makes the Grameen system unappealing to large farmers and the rural rich, effectively dismissing them from the program.[4] The demographic targeted then is inherently narrowed to the landless and the destitute.

To guarantee payment, Grameen developed a Solidarity Group Lending model in which groups of five are assembled to use peer monitoring and social collateral to enforce repayment and efficient monitoring of the business. High risk borrowers are screened out of the process, as in a village environment one's reputation as unreliable would prevent others from joining with in a group with that individual. Furthermore, joint liability is imposed upon the group. If one member of the group defaults on a loan, all are penalized for such a behavior. Group members are thus given a strong motivation to not only help one another, but also ensure repayment and proper conduct as per the rules of Grameen Bank. Peer monitoring reduces transaction costs incurred by the primary institution by placing it in the hands of the social pressure mechanism.

The groups are self-selected and must be homogenous in their gender composition. Although men and women both have opportunities to join, women have dominated the process and now take 94% of all distributed loans. Group members cannot be related in any manner, must have similar social and economic backgrounds to prevent unequal bargaining strength, and must be from the same village. Upon selecting a suitable group, the members are sorted into a center consisting of five groups each. The process of screening now begins: members are subjected to fourteen days of meetings in which they must learn to sign their name, learn about Grameen's objectives, and memorize Grameen's Sixteen Decisions for proper social conduct. Discipline is highly emphasized during this month of training, with the assigned loan officer testing and quizzing members to ensure their suitability for the program. Furthermore, the training also fosters a closer relationship among women not only in the group but also in the center; this creates a strong social network in which women can support each other as they embark on what will be for many their first entrepreneurial venture. Loans are disbursed only when the loan officer is satisfied with the knowledge of all members of each group.

Self-selection and peer pressure are the two salient features which allow the Solidary Group Lending model to work. The former, however, may interestingly work to the detriment of what Syed Hashemi terms the "hard core poor". Though most studies of Grameen Bank laud the institution for its remarkable ability to target the poor, the issue of differentiation within the

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[3] Hashemi, Syed M. & Schuler, Sidney Ruth. "Sustainable Banking With the Poor: A Case Study of Grameen Bank." 2 July 1997.

[4] Goheer, Nabeel. "Microfinance: A Prescription for Poverty and Plight of Women in Rural Pakistan." Rural Finance for Growth and Poverty Alleviation.

ranks of the poor problematizes an effective targeting of this demographic. The "hard core poor" are those who are "forced to subsist on a per capita income that is less than half that of the poverty line[5]; this group often self-selects itself out of Grameen participation only because they consider themselves to be not credit-worthy. In Hashemi's words, they "do not feel they have enough resources to generate incomes to pay back loans…and thus self-select themselves out of membership". Out of 313 target group households interviewed in Rangpur and Faridpur, 120 women had chosen not to participate: 55 thought they would not be able to manage the money and thus would incur more debt; 35 thought that leaving home for Grameen meetings with males present would violate social norms; 11 were rejected for being high-risk or having high-risk husbands; and 19 said the rules were too complicated to understand and they were unable to memorize the Sixteen Decisions[6]. This observation of the self-selection bias is important in that it indicates that microfinance must be tailored to suit the individual perceptions of the target groups: encouraging confidence and optimism in the ability to help oneself is a necessary prerequisite for the success of a microfinance program hinged upon self-initiative.

2.2.2 Services Offered

i. *General Loan:* The General Loan is a loan of Tk 1000 dispersed to women for entrepreneurial activities. There is a 20% declining interest rate on these loans. The loans are entirely financed from the banks own deposits, with over 64% of the deposits coming from the bank's own borrowers.

ii. *Housing Loan:* Housing loans are provided for the construction of sanitary and stable housing. The maximum amount dispersed is Tk 15000, with the amount to be repaid over a period of 5 years in weekly installments at 8% interest. The average housing loan is approximately Tk 13000. To date, 627058 houses have been built with the assistance of this loan, with Tk 8.33 billion dispersed to that end.

iii. *Emergency Loan:* The Emergency Loan can be granted in times of distress.

iv. *Struggling Members Program:* Notably, Grameen has expanded its services to include what is called the Struggling Members Program, which disperses small loans to beggars with a completely flexible and optional repayment term. No interest is charged, and members are covered under life insurance and loan insurance programs. The intention is to increase the self-esteem of beggars and allow them to sell small goods as they beg, in the hopes of stimulating some form of entrepreneurial spirit. To an extent, the Program targets those who self-select out of participation in Grameen's more mainstream programs because of a lack of resources or of confidence in one's entrepreneurial

[5] Rahman, A. (1999). "Micro-credit Initiatives for Equitable and Sustainable Development: Who Pays?" World Development **27**

[6] Syed M Hashemi, "Those Left Behind: A Note on Targeting the Hardcore Poor" in Geoffrey Wood and Iffath Sharif editors, Who Needs Credit? Poverty and Finance in Bangladesh, (Dhaka: University Press Ltd, 1997).

abilities. Approximately 63000 beggars have already joined the program, with disbursed amount standing at Tk. 45.92 million.

v. *Micro-enterprise Loan:* These larger loans are granted to borrowers with significant business savvy, with no maximum amount specified. The funds are used to purchase merchandise such as irrigation pumps, transport vehicles, and other equipment not accessible due to restrictions of the smaller loan. Thus far, 668,389 members have taken these larger loans, with Tk 14.50 billion dispersed.

vi. *Education Loans:* Children of parents who are involved with Grameen are given education loans which cover tuition, maintenance, and other school expenses, provided that they have reached the tertiary level of education. As of December 2005, almost 9000 students had received these loans.

2.3 Organizational Model

Grameen's efficiency lies in its decentralization. The transparent, simple system of loan disbursement delegates decision-making powers to the lowest relevant level, whether that is the branch, center, or group. The group-lending process dismisses the often high transaction costs associated with targeting a lower socio-economic demographic. Grameen is able to maintain a large target size because the group-lending process not only encourages peer pressure as a means of repayment enforcement, but also because the screening process is no longer concentrated in the hands of the bank, as it is in the traditional financial sector. Shifting the time-intensive burden of the screening process to the client reduces quite a bit of transaction cost and labor intensity[7].

Weekly meetings also enhance the transparency of the loan disbursement, emphasizing their regular and public nature, as well as cuts down on adverse selection problems by encouraging discussion of any issues facing a group or center. Furthermore, the regularity of the weekly meeting creates an organizational structure in which loans are paid regularly, loans can be received continuously and simultaneously, and the loans are monitored consistently and transparently. This cuts down on messy, time-consuming efforts of repayment enforcement, as the group and center inherit this responsibility rather than Grameen as an institution. Corruption is also kept to a minimum by the weekly meeting: financial transactions take place in front of all borrowers and the rationale for granting or rejecting loan applications are openly discussed, so the potential for bribery and preferential treatment is limited. Suspicion that such corrupt practices may occur is also defeated, and encourages those relationships of mutual trust which are so vital to the function of the Group Lending Model[8].

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[7] Goheer, Nabeel. "Microfinance: A Prescription for Poverty and Plight of Women in Rural Pakistan." Rural Finance for Growth and Poverty Alleviation

[8] Hashemi, Syed M. & Schuler, Sidney Ruth. "Sustainable Banking With the Poor: A Case Study of Grameen Bank." 2 July 1997.

The weekly visits of the loan officer to the center develop a close, personal rapport between lender and borrower, facilitating problem solving and enhancing consistent transparency[9]. Constant contact with the clients in the clients' own communities also ensures a high level of familiarity with socio-cultural demands on and the economic needs of particular borrowers, and allows a tailor-made response to any obstacles that may arise as a result of these particular situations. The design of the system allows for a certain amount of flexibility in implementation, and as such the procedures of the program become "fine-tuned" by the staff in order to best suit their clients[10]. Minor problems, such as issues of interference by husbands and family members, can be addressed by the field staff effectively and quickly as a result of this decentralized system. Furthermore, the transparency of the operating procedures instills a trust in the system that could not be earned were there not a decentralized, personalized system of monitoring.

Grameen's emphasis on self-sufficiency and initiative is visible even on the organizational level: branches are encouraged to become self-sufficient as soon as possible. Branches monitor the center's behavior and offer day-to-day contact with members. Area offices manage the branches, and function under the auspices of zonal managers. According to Hashemi, almost all major policy decisions are taken at zonal manager conferences in which "extensive critical assessments" of performance and intensive deliberations occur. Each zone policy is thus geared towards managing the problems that occur in its own jurisdiction according to norms and cultural nuances in each. The ability of the staff to familiarize themselves and target the issues in their jurisdiction is reinforced by an intensive introductory training program as well as in-service staff training, intended to support "a problem-solving culture [which] puts total trust in the creative potential of its staff and clientele in crisis management"[11].

2.4 Grameen Operations and Poverty Reduction

Poverty can be observed in many forms. It may be a lack of income or of resources, a lack of coping capacity, a lack of basic human capabilities, a lack of institutional defenses or in extreme cases a lack of all of these. In a broader sense, it may be a combination of economic, social and political deprivations. Amartya Sen argues that economic poverty is not the only kind of poverty that impoverishes human lives. He says that the linkage between economic, political and social deprivation should not be ignored.

Grameen Bank is the largest specialized bank for the poor. It has nearly 2.4 million borrowers. It lends about $ 30 million every month. It is operating in more than 40,000 villages of Bangladesh.

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[9] Latifee, H.I. "Microfinance and Poverty Reduction: Experiences of Grameen Operation in Asia." Presented at Asian Regional Conference, 27-30 November 2000. Grameen Trust publication.

[10] Hashemi, Syed M.

[11] Latifee, H.I. "Microfinance and Poverty Reduction: Experiences of Grameen Operation in Asia." Presented at Asian Regional Conference, 27-30 November 2000. Grameen Trust publication.

Its cumulative loan disbursement has already crossed the 3 billion dollar mark. Grameen households have reaped significant economic and social gains from the financial services provided by Grameen. They have become politically more conscious.

i. Economic Impact

Grameen has been widely researched and recognized for making a difference in the lives of its members. According to a study based on a household survey in an area where Grameen has been operating for more than a decade, about 50% of the Grameen households have crossed the poverty line. Another 25% was about to cross it and the rest was struggling mainly because of health reasons.

Another study examining the economic effects of Grameen on the life of its borrowers, compared the situations 'before' and 'after', 'with' and 'without' Grameen. It considered the effects of Grameen operation on capital accumulation, employment, income and poverty alleviation.

The study found that without any capital base at the beginning, the Grameen borrowers started accumulating capital as they joined Grameen. Grameen loan is required to be paid back in small installments every week. The borrowers pay the installment from generated income, leaving the original capital intact. Their capital base usually increases in large amounts as they go for subsequent loans. They go for medium and long term investments, such as the purchase of cattle, machinery, tools or equipment with their expanded capital base.

The study also found that 31 percent of the borrowers reported themselves as unemployed before joining Grameen. Grameen created new employment for them and specially for the female members who were earning nothing before. The effect of Grameen loans on reducing unemployment is impressive. The borrowers were found less underemployed than before. More than 91 percent of the borrowers in the survey area reported that Grameen had made a positive contribution to their standard of living. The bank has been able to lift a significant proportion of its borrowers and their household members out of poverty.

A World Bank study found that profits from Grameen-financed businesses were increasing borrowers' consumption by 18% per year, and that the percentage of Grameen borrowers living in extreme poverty was reduced by 70% within 4.2 years of joining. The Grameen operation not only reduced poverty and improved welfare of participating households, but also enhanced households' capacity to sustain their gains overtime.

Grameen borrowers have been found to improve their conditions in terms of housing and clothing too. They can afford warm clothes during winter seasons. Till the end of June 2005, they have built 528385 houses with housing loans from Grameen. Women are the owners of 92% of these houses. They hold the title for the land on which houses are built. This was unthinkable for them before they joined Grameen.

a. Coping Capacity

If increasing capacity to cope with calamities is considered to be an indicator of improving poverty situation, the experiences of Grameen shows that microfinance members are in better positions to cope with such situations. During two and a half month of devastating flood which hit Bangladesh in 1998, it was found that Grameen borrowers were relatively less vulnerable and more capable to deal with the situation during and after the flood. They had their savings, they had their institutional back-up and they had their peer support. They were able to go for rehabilitation immediately after the flood water receded. The crisis management capacity of Grameen households was found to be higher than others.

In fact, the severe flood, provided both a challenge and an opportunity for microfinance programs in Bangladesh. The challenge was to recover from the losses caused by the flood and to bring the poor back onto the path of sustainable development. The opportunity was to consolidate and improve upon the existing modalities in order to bring the most affected families within the fold of microfinance program and to have more impact on the socio-economic condition of the poor. Grameen and other such programs could do more under such disastrous situations if they had access to more funds. Such funds are needed to replenish their cash flow which gets depleted due to withdrawal of savings by members, fresh loans to old borrowers, new loans to new borrowers and non-recovery of loans from flood affected borrowers.

b. Saving

Saving has always been an integral part of the Grameen program. It is designed to address production and other risks as well as market imperfections. Compulsory Savings are mobilized in group funds under Grameen system. Grameen members made cumulative savings of US$ 249 million in their group funds by September 2005 which they use for any purposes they like.

ii. Social Impact

The poor have little access to education, health, sanitation and other social services. They are socially condemned, rejected and powerless. In the case of poor women the situation is worse. In many societies including Bangladesh, women are generally confined to their homes. They are not supposed to be seen outside their household environment. Their sphere of work is largely restricted.

Under these circumstances Grameen provides them a forum where they are organized into groups and federated into centres. They become decision makers, leaders and a social force. They become group and centre leaders and also members of the Board of Directors of Grameen Bank, which they own. In the Board of Directors they are nine out of twelve members in total. The Grameen borrowers go for implementation of social development programs under the 16 decisions that they have taken. They take loans from group funds and also from Grameen loan portfolio for different purposes including tubewells, sanitary latrines and education. The Grameen borrowers who became village phone ladies by leasing cellular phones for providing

village pay phone (VPP) services to the neighborhood, are not only earning more but also enjoying a gracious social status. They brought the world closer.

Grameen women have become mobile. They are exposed to the outside world and are active participants in the process of globalization by attending centre meetings, workshops, interacting with national and international dignitaries, producing, selling and buying different products. The handloom product of Grameen borrowers known as Grameen check is now exported to European and American markets.

Grameen borrowers become more conscious about their family size and family welfare and determined to improve their quality of life. Studies show that infant mortality among Grameen families has decreased by 34%, and the adoption of family planning among them is more than the national average for Bangladesh.

Whatever indicators such as respect from neighbors and spouses, self-esteem, self-confidence, self-expression, ability to protest social injustice, capacity to solve social issues are applied to measure changes in social conditions of women, the Grameen borrowers are found better off than others. The process is continuing and progress is visible.

Grameen's approach to social reform is embodied in the Sixteen Decisions: these are an example of a social development program intertwined with micro-credit delivery. Developed in 1984, the Sixteen Decisions are an integral part of Grameen Bank's mission: all potential and current borrowers are expected to memorize them, and adherence to the Decisions is monitored by the Loan Officer. Additionally, the loan officer is to explore one decision per week in-depth, and reinforce its applicability to the borrower's lives and answer their questions to that end. The decisions are:

1. We shall follow and advance the four principles of the Grameen Bank (discipline, unity, courage, and hard work) in all walks of our lives.

2. We shall bring prosperity to our families.

3. We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest possible.

4. We shall grow vegetables all the year round. We shall eat plenty of them and sell the surplus.

5. During the planting seasons, we shall plant as many seedlings as possible.

6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.

7. We shall educated our children and ensure that they can earn to pay for their education.

8. We shall always keep our children and the environment clean.

9. We shall build and use pit-latrines.

10. We shall drink tube-well water. If it is not available, we shall boil water or use alum.

11. We shall not take any dowry in our sons' weddings, neither shall we give any dowry in our daughters' weddings. We shall keep the center free from the curse of dowry. We shall not practice child marriage.

12. We shall not inflict any injustice on anyone, neither shall we allow anyone to do so.

13. For higher income, we shall collectively undertake bigger investments.

14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help them.

15. If we come to know of any breach of discipline in any center, we shall all go there and help restore discipline.

16. We shall introduce physical exercise in all our centers. We shall take part in all social activities collectively.

The Sixteen Decisions are a social development agenda that places primary responsibility on members rather than on Grameen Bank for implementation; as such, the expenditure incurred by Grameen for this social development program is minimal. The simple approach is easily understood by the participants, and reinforced through regular recitation and discussion. Furthermore, they are closely tailored to the setting of rural Bangladesh by having tangible and specific demands, rather than nebulous, ambiguous statements of principle.

iii. Political Rights

Poverty alleviation does not only mean meeting basic food and non-food requirements but also exercising political rights and enjoying political freedom. Freedom of speech, freedom of choice, freedom of enjoying human rights, freedom of casting and seeking votes for public office and other posts are some of the indicators by which it may be measured whether the poor organized under Grameen have a better understanding of their political rights and obligations.

Although it is a modest beginning, it is significant to note that Grameen borrowers and their household members are taking part in larger numbers as voters and candidates in local and central government elections. They are encouraged to discuss their rights at their centre meetings before elections and to take decision to vote for candidates who according to their judgement will advocate for and serve their cause.

During the local government elections held in 1997 many Grameen borrowers contested and became elected. According to reports, in the 1997 Local Government election 23 Grameen members including 21 women contested for the post of chairman and only 2 members were elected. They were male. In the same election 5,828 Grameen members including 4,877 women contested for membership and 1,753 of them were elected including 1,485 women candidates. The percentage of Grameen members in the local government bodies is about 7 percent.

2.5 Grameen Partners

Grameen partners worldwide believe in the great power of microfinance. There are more then 400 replication partners operating in 66 countries of different continents including 169 partners operating in 19 countries of Asia. The total outreach of Asian partners who have received both financial and technical assistance or only technical support form Grameen Trust is 630,772. About 98% of their borrowers are poor women. The amount of loan disbursement by them is $ 156.47 million and the amount of saving mobilized by them is $ 11.19 million. They are enjoying a repayment rate of about 96%. They are trying to serve the poorest and at the sametime operate on a sustainable basis. The mature and leading ones among them have already attained operational or financially self-sufficiency at many of their branches including a few that have attained institutional self-sufficiency. They have been able to change the attitude of their borrower households and improve the quality of life of their members.

To see the impact of Grameen operation on poverty situation in different parts of Asia we discuss below the experiences of 5 Grameen partners in 5 countries of Aisa. These are IDF in Bangladesh, RDI in China, SHARE in India, KASHF in Pakistan and CARD in the Philippines.

2.5.1 IDF, Bangladesh

Integrated Development Foundation (IDF) started it operation in Bandarban Hill District of Bangladesh in 1993. It is now working in all the districts of Chittagong Hill Tracts and also in the urban areas of Chittagong city. Its total outreach is 19,476. All of them are women. At the time of entry, 44% of IDF members belonged to bottom 25% of poverty line and 56% of them belonged to bottom 25-50% of poverty line.

The total disbursement of loan made by IDF is $ 3.86 million. The repayment rate is 100%. The total amount of saving generated by IDF members is $ 0.32 million.

According to an evaluation report about 31% of IDF members crossed the poverty line by the end of 1999. To examine the impact of IDF a case study of an IDF member is presented below.

Ms. Ching Kwoyai Marma is a member of the centre number 3 of IDF Shoalok Branch in the Chittagong Hill Tracts. She has taken loan for 7 times. She is one of the oldest members of IDF. She has fully utilized her loan. She never failed in her repayment installment. Before joining IDF her family lived in absolute poverty and had no income generating activities. They had no house of their own. But after receiving credit facilities from IDF for last 7 years, she has now a house of their own, her family can afford to take 3 meals a day, they have enough clothes and blankets for winter, they use mosquito nets, they drink pure water and use sanitary latrines. They grow vegetables round the year for their own consumption as well as for selling in the market. They are now happy.

2.5.2 RDI, China

Rural Development Institute (RDI) is serving about 14,000 members in the rural areas of Henan and Hebei provinces of China. They are all poorest women. RDI has made a loan disbursement of about 5 million US$ to its borrowers and mobilized savings of about US$ 1.5 million from them. It has already achieved operational self-sufficiency. It is enjoying repayment rate of 99%.

According to a study, there has been a significant increase in income and asset ownership of its borrowers. To cite an example, Ms. Zhang Xiuqin of Yucheng, China received her first loan of 1,000 Yuan from RDI for her husband's furniture making business. With her second loan of 2,000 Yuan she bought a pregnant pig for 700 Yuan, which has since given birth to eleven piglets, some feed and wood for her husband's business. Xiuqin's family farms four mu of land. She sells the vegetables in the market at a profit of approximately 1,000 Yuan per year. Her husband makes an average of 500 Yuan per month in selling furniture. Xiuqin expects sold the 11 piglets for 3,000 Yuan. They have built a new home for about 3,000 Yuan in which she, her husband and their four children are living. All her children are going to school. She reports that she has had no difficulty in repaying her loans and would like to continue in the project and eventually expand her activities. With the increasing income the family's diet has also improved. Whereas corn and wheat have previously been the main food, their meals now include more vegetables, sweet potatoes, meat (two or three times per month) and some rice in addition to wheat.

2.5.3 SHARE, India

Society for Helping Awakening Rural Poor through Education (SHARE) has grown into a major microfinance institution in India that provides financial services to more than 61,000 poorest women in the rural areas of Andhra Pradesh. It started its operation in 1992. It has different loan products including loan for housing. More than 50% of its loans has gone for animal husbandry projects. Up to September 2000, SHARE has disbursed over $ 13 million to its borrowers and

mobilized an amount of more than $ 1.3 million as savings. It is enjoying 100% repayment of its loans.

According to a study conducted by IFPRI/NIRD, 85% of SHARE clients constitute the bottom 20% of the individuals living below poverty line. A recent impact study on women who have been borrowing from SHARE showed very positive results of SHARE operation on the life of its borrowers in terms of increase in income, improved nutrition, increased expenditure on non-food basic needs, shift from wage employment to self-employment, increased access to agricultural land, increase in savings, better housing, women empowerment, etc. The study indicates that about 50% of the SHARE households have already crossed the poverty line. SHARE has already achieved operating self-sufficiency. It hopes to achieve financial self-sufficiency soon.

2.5.4 Kashf, Pakistan

Kashf Foundation is one of the pioneering organizations that is providing financial services to the poorest women in Punjab in Pakistan. It has more than 4,000 borrowers. The total amount of loan disbursed by it is about $ 600,000. It has mobilized more than $64,000 as savings from its members. Its repayment rate is 100%. It has achieved 35% operating self-sufficiency. An impact study of the Kashf revealed that 94% of its borrowers have experienced positive economic and social changes in their households and 75% of them feel that without Kashf's loans it would not have been possible for them to take business activities and to generate employment and income.

2.5.5 CARD, Philippines

Center for Agriculture and Rural Development (CARD) is one of the leading micro-finance institutions in the Philippines. It is serving more than 34,000 poorest women. By the end of September 2000, it has disbursed about $ 17.25 million to its borrowers as loans and mobilized over 1$ .4 million as savings from them. Its repayment rate is 100%. It has already achieved institutional viability. According to an evaluation study, CARD has largely succeeded in reaching very low income households and generating the self-employment and significantly increasing their income. At the time of joining 100% of CARD members belonged to the bottom 50% of the population living under poverty line. As per CARD impact study 50% of its borrowers have already crossed the poverty line.

CHAPTER 3: Village Bank

3.1 What Village Banking Offers?

Village banking offers several important services:

i. Credit — in the form of a loan to a group of approximately 15-30 individuals

ii. Savings services — both forced and voluntary

iii. Non-financial services — informal and sometimes formal as well

iv. The internal account — offered by some VBIs, the internal account provides additional credit, savings, and non-financial services.

Each of these services is now briefly discussed. Readers already familiar with village banking may wish to skip to the next section.

i. *Credit:* Village banking starts with a loan from the village banking institution (VBI) to a group of approximately 15-30 individuals. In this way it resembles solidarity group lending, only the group size is larger than the 3-7 individuals who commonly receive a solidarity group loan. The 15-30 individuals form a village bank, adopt bylaws, and learn how to keep records of all financial transactions. They elect a president, treasurer, and perhaps other officers to run meetings, collect and disburse money, and generally manage the affairs of the village bank in receiving and providing services. Analogous to the case of solidarity group lending, all village bank members are responsible for the repayment of the loan that has been granted by the VBI to the village bank and divided among its members. If the village bank fails to repay its loan to the VBI, it typically faces the cutoff of all VBI-provided services. Therefore, village bank members have strong incentives to admit only responsible individuals to the village bank, who are likely to repay their loans on time. Since it is fundamentally the village bank that decides the size of the loan each village bank member receives—with some input, perhaps, from the VBI loan officer, who is the VBI's representative to the village bank—all village bank members also have incentives to make sure that no individual borrows more than she is capable of repaying.[12]

ii. *Forced savings:* VBIs typically require each village bank member to save. These *forced savings* are often a significant percentage of the amount the member has borrowed from

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[12] Since village bank clients are overwhelmingly women, we adopt the convention of referring to them using the feminine pronouns, such as "she" and "her."

the VBI. For example, forced savings range from 10 to 32 percent of the amount borrowed in the four leading Latin American VBIs analyzed in this study. Forced savings serve at least two major purposes. First, they act as cash collateral, to deter the complete failure of village banks and lessen the effects of such failures on the VBI. Forced savings are also used to cover the more routine cases of individual loan delinquency that do not threaten the village bank's existence. The second purpose of forcing village bank members to save is to introduce them to the discipline and habit of saving and to the possibilities that having a sizable savings balance could open up for them. For example, a sizable pool of savings could be used for emergencies, to pay school fees and other large household expenditures, to buy tools or machinery, or to start another business.

Because they act as cash collateral, forced savings are undoubtedly useful to the VBI. However, the utility of forced savings to clients is more open to debate. This is because of the compulsion that *all* clients must save *all* of the time regardless of the business or other uses that they might have for these savings. In addition, these savings are often made quite inaccessible to the client. Many clients might be able to more quickly increase their incomes and escape poverty if they were allowed to take some or all of their forced savings contributions and invest them in their own businesses, either as additional working capital or to buy tools and equipment. VBIs differ in the degree of inaccessibility they impose: some allow clients to withdraw their forced savings at the end of every loan cycle (typically, every 16-24 weeks), while other VBIs allow clients to access these savings only when they leave the village banking program or perhaps in cases of severe emergency, such as a hospitalization. While requiring all clients to save all of the time appears to have important drawbacks, advocates of forced savings argue that many clients lack the willpower to save on their own. Moreover, if clients are allowed easy access to their savings, they might spend these savings on relatively trivial consumption items or feel pressured to help relatives and friends in financial need.

iii. *Voluntary savings:* VBIs typically also provide their clients the opportunity to save voluntarily, over and above the amounts they are forced to save. One of the great advantages of village banking is that it provides a way not only to offer its clients credit, but also savings services. By pooling all of their forced and voluntary savings together in a single deposit account, members of a village bank can often overcome the deposit minimums and low balance fees imposed by many banks and other deposit-taking financial institutions. When members are located some distance from the financial institution, using this single village bank savings account can also drastically reduce transactions costs for the savers. One or two village bank members can make the trip for many, combining deposits and withdrawal requests along with VBI loan repayments in a single journey. VBIs that permit internal account lending provide savers with the added possibility of earning much higher interest rates than those normally paid by banks, on both voluntary and forced savings (see the discussion of the internal account, later).

iv. *Informal non-financial services:* Village banks meet regularly (generally weekly or biweekly, sometimes monthly) to collect each member's loan payment, take savings and

pay out savings withdrawal requests, and transact other business. While these meetings take members away from their own businesses for a significant period of time (a meeting typically lasts 1½ -2 hours), they are the vehicle through which village bank credit and savings services are delivered. These regular meetings also provide members with a number of other benefits, which include what may be called informal non-financial services. Among these services are the networking, informal technical assistance, empowerment, enjoyment from socializing, and the sense of belonging that can all come with participation in a village bank. Pro Mujer emphasizes the last two of these benefits when they describe why many of their Bolivian clients refuse to leave their village banks and take individual loans even though the individual loans are often larger and have much more flexible repayment terms. Opportunity International underscores the importance of the networking that takes place among the businesswomen in many of their village banks. Because of this phenomenon, Opportunity International believes that it is important to offer the alternative of solidarity group loans, not just individual loans, to village bank members needing larger or more flexible loans. Informal technical assistance and empowerment are also important benefits of village banking. The former refers to village bank members sharing knowledge and ideas to help one another with business problems. Empowerment is a widely-cited benefit of village banking and is particularly relevant to women.

Freedom from Hunger (1996, p. 3) offers an excellent explanation of the meaning of empowerment and the role of village banking in empowering its members. “By helping the poor to successfully manage their own self-help groups and help each other to use credit to increase their incomes and begin saving, these [village banking] programs engage them in vital activities that improve their confidence, self-esteem, and control of their environment. They undergo a profound psychological transformation that many writers today call ‘empowerment’—a transformation of attitude from ‘I can’t’ to ‘I can.’ Reinforced by their successful use of credit and their solidarity with others in their village bank, the poor expand their awareness of the possibility of improvements in their lives.”

It is particularly empowering for village bank members to see their income and savings grow since members play such a large role in managing their own village bank. For example, members decide who will be allowed to join and remain in the village bank and what size loan each person will receive during each loan cycle. Members also elect officers, serve as officers (on a rotating basis), run meetings, keep the books, and set their own rules such as levying fines for missing loan payments or arriving late to meetings. If the VBI permits an internal account, the village bank members decide who will be allowed to take out an internal account loan and what size loan they will be granted. Village banks that are divided into several solidarity groups offer additional leadership opportunities to those who serve as the head of each solidarity group.

Village banking focuses almost entirely on women because women so often need the empowerment that village banking provides. Freedom from Hunger (2002, p. 6) explains this in eloquent terms. “The education of girls is [often] treated as a low priority and,

although mothers are the primary caretakers of young children, their status in the community is perilously low. In the face of such enduring obstacles, a woman's doubt in her ability to create positive change becomes ingrained. Yet hope and strength spring from the collective courage of women who gather together."

v. *Formal non-financial services :* Some VBIs offer formal non-financial services and some do not. For example, of the four VBIs examined in detail in this paper, CRECER and Pro Mujer Bolivia offer formal non-financial services and Compartamos and FINCA Nicaragua do not. CRECER and Pro Mujer Bolivia take 20-30 minutes during each village bank meeting to provide all village bank members with education in how to improve their businesses and in a number of basic health areas. Pro Mujer Bolivia also provides primary health care services such as vaccinations, breast examinations, and counselling using nurses and other trained professionals. It also argues that under certain circumstances offering non-financial services to very poor clients should not disqualify a VBI from being able to become a licensed, deposit-taking financial institution.

vi. *Internal account:* Perhaps no subject in village banking elicits such heated debate among practitioners as the question of whether to offer internal account loans. The reason for this is that there are many strong advantages and disadvantages associated with offering these loans.

Money is collected from several sources in the internal account, and then used to make loans to village bank members. In addition to being a source of supplemental credit, the village bank internal account also provides members with savings and non-financial services.

The internal account is primarily funded from the following sources: the forced and possibly voluntary savings of village bank members (savings usually account for most internal account funds), fees and fines levied by the village bank on its members, interest income earned by lending out internal account funds to members, and interest earned by placing funds in a commercial bank account. In addition, while VBIs generally insist that each member repay her VBI loan on a regular basis (e.g., weekly or biweekly), a few VBIs, such as CRECER, allow these payments to remain in the village bank's internal account for many weeks at a time. For example, in its 16-week loan cycle, CRECER only removes member loan repayments from the village bank internal account in weeks 12 and 15. This allows the village banks to use these funds for additional internal account lending during most of the loan cycle.

The internal account funds are used to make supplemental loans to village bank members, including loans for emergencies, consumption, and additional business needs. Generally, these internal account loans can begin and end at any time during a single loan cycle. Thus, in both purpose and timing, internal account loans are more flexible than the external account loans members have with the VBI. Members also like internal account loans because they are normally repaid in bullet fashion, that is, with a single repayment

of both principal and interest at the end of the loan term. This allows members additional time to work with all of the money they have borrowed and may reduce the effective interest rate they pay. On the other hand, internal account loans are often much smaller in size than the member's external account loan—either because of the limited amount of funds available in the internal account or because the VBI's rules require them to be so. Thus, while internal account loans may reduce the demand for external account loans, they rarely eliminate the need for external funds.

The internal account also provides an important savings vehicle. Instead of village banks earning only a few percent per year by placing their forced and voluntary savings in a commercial bank deposit account (an interest rate that is typical now in many Latin American countries, with their low inflation rates), the internal account often yields 2.5-5 percent per *month* on savings that are loaned out to other village bank members. This is because internal account loans normally carry an interest rate that is at least as high as the rate the VBI charges on its own (external account) loans to village bank members. These high internal account loan rates are generally mandated by VBIs in order to avoid further reducing the demand for their external account loans.

The village bank decides which of its members will receive internal account loans and how much they will be granted, and also does all of the bookkeeping. By acting as a vehicle for village bank members to manage and invest their own money, the internal account provides members with an additional source of empowerment, business skills training, and group solidarity. While these are valuable non-financial services, the internal account also gives rise to several new problems: issues of favoritism in granting internal account loans, internal account loan delinquency, and fraud problems arising from village bank officers or other members stealing or misusing internal account funds.

3.2 The Inflexibility of Village Banking

This section argues that village banking needs to continue becoming more flexible and client-oriented in order to increase client satisfaction, retention, and impact. By improving client satisfaction and retention, VBIs will also tend to increase their own scale and sustainability through a number of channels. For example, with a greater percentage of village bank members satisfied and remaining in the program, client growth rates will increase, not only because there are fewer dropouts but also because new clients will likely become easier to attract. Portfolio growth will be fueled by the growth in the client base and also because, with clients tending to remain in the program longer, many will take out larger loans. VBI scale and sustainability will be increased for all of these reasons and because VBIs will avoid the high costs of replacing dropouts with new clients who must be given initial training in the village banking methodology and started off with tiny loans.

Compared to individual loans, village bank loans are very inflexible. Each member of a village bank receives a loan from the VBI that starts on exactly the same date and has the same term and

the same repayment frequency (usually weekly or biweekly). Although different members are normally allowed to have different size loans, there is generally a cap imposed on the maximum size of the loan to any single village bank member. This is done so that small borrowers in a village bank are not required to guarantee loans that are much larger than their own since a default on even one of these large loans could be very burdensome for the small borrower. In contrast, micro-entrepreneurs who take out individual loans from a micro-finance institution (MFI) are normally able to start their loans on a date of their own choosing. These micro-entrepreneurs are also likely to have much greater flexibility to request the loan term and repayment frequency that best suit their individual needs within the range of what is offered by the MFI and perhaps after successfully repaying one or more loans (to establish their creditworthiness). Finally, micro-entrepreneurs with individual loans are not likely to face as low a ceiling on maximum loan size as they would with a village bank loan since there are no considerations of risk to small borrowers to take into account.

Village banking imposes other important inflexibilities on its clients that individual lenders normally do not. The most important of these is the forced savings requirement discussed above. Unlike the inflexibilities imposed by village banking on its loans, however, the village bank forced savings requirement appears to be inherently useful to at least some of the village bank clients, though it may be detrimental to others.

Finally, village banking also imposes important transactions costs and risks on its clients. However, it is unclear whether these transactions costs and risks are more onerous on the whole than the transactions costs and risks imposed on clients by the individual lending methodology. Village banking clients must attend frequent and lengthy meetings, with village banks in Latin America typically meeting every week or two and the village bank meetings normally lasting 1½-2 hours. By contrast, individual loan clients do not have to attend weekly or biweekly meetings, but each individual loan client must instead carry his or her loan repayments to the lender—often once a month, but sometimes every week or two, depending on the MFI and client. Village banks must maintain bookkeeping records of all financial transactions and most are required to take member loan repayments and savings to town for deposit after each meeting. On the other hand, the village bank meetings and the bookkeeping requirements also offer the possibility of imparting important non-financial services, as discussed earlier. Finally, village bank members must bear the risks of guaranteeing the loans of everyone in the village bank, a risk that is avoided under the individual loan technology.

In summary, although village banking offers important savings and non-financial services that individual lending does not provide, many village banking clients may not value these services enough to be worth the inflexibilities, costs, and risks that the village banking methodology imposes on them. These clients may try out village banking for a while but then drop out once the program's rigidities and demands become clear to them. Some VBIs are aware that they have a problem in this area, as revealed both in conversation and in the literature. For example, Natilson (2000, p. 21) refers to Pro Mujer Bolivia's "low client retention rates" and McCord (2000, p. 19) cites "relatively high dropout rates" in FINCA Uganda.

Table 1 shows that VBI client retention rates are indeed low compared to the retention rates achieved by individual and solidarity group lenders. This suggests that village banking still needs to increase the flexibility and client-orientation of its methodology in order to improve client satisfaction and retention, as well as VBI sustainability and scale. Specifically, Table 1 presents client retention rates for the years 2003-05 for a number of VBIs as well as for a comparison group of individual and solidarity group lenders. All retention rates are calculated using the same formula, so that the data shown are fully comparable. Table 1 gives retention rates for Pro Mujer Bolivia, FINCA Nicaragua, and Compartamos, that is, for each of the four VBIs analyzed in detail in this paper except CRECER, these data being unavailable for CRECER. Retention rates are also shown for the other Pro Mujer program on which comparable data could be obtained (Nicaragua) and for the seven FINCA International programs in Latin America. In addition to presenting the average retention rates for the seven FINCA programs taken together, the individual retention rates are given for Haiti and Honduras. These are the two FINCA programs with the highest and lowest average retention rates over the 2003-05 period, respectively. Finally, to serve as a basis against which all of these VBI retention rates can be compared, Table 1 presents the average of the retention rates for all of the Accion International individual and solidarity group lenders in Latin America on which data were available.[13]

The Table 1 data shows that, with the exception of Compartamos and FINCA Haiti, VBI retention rates are generally 10-15 percentage points below the average retention rates of the Accion International solidarity group and individual lenders.[14] Because most VBIs serve the lowest income segment of the micro-finance market, they arguably face less competition in this market than the Accion International affiliates face in the segment they serve, which generally consists of more mainstream micro-finance clients. This would suggest even more strongly that village banking needs to improve its product since it has lower client retention rates despite quite possibly facing less competition.

This call to increase the flexibility and client-orientation of the village banking product is really a call to continue an ongoing process. Village banking was introduced in the 1980s as an even more rigid product than it is today, a product in which everyone in the village bank had the same size starting loan, the loan size ceiling was set at a very low $300, all meetings and loan repayments were weekly, the loan term was always a very short 16 weeks, and forced savings

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[13] The preceding paragraphs compared the flexibility, transactions cost, and risk of village banking versus individual lending. In many ways, solidarity group lending occupies an intermediate position between these two extremes because it employs a group size smaller than that used by village banking but larger than the group size of one employed in individual lending. Thus, for example, solidarity group borrowers must negotiate the loan starting date, term, and repayment frequency with a smaller group than must village bank borrowers, and so flexibility to meet each individual's needs should generally be greater in the solidarity group than the village bank. Similarly, solidarity groups should require less meeting time than village banking.

[14] The very high client retention rates obtained by Compartamos and FINCA Haiti reflect, at least in part, the fact that these two VBIs face little or no competition over most of their service areas. The remaining VBIs do not enjoy such monopolistic positions.

were only available once the member left the village bank or perhaps in cases of serious emergency.

Table 1: Client Retention Rates

MFI	Country	2003	2004	2005	Average 2003-05
Pro Mujer	Bolivia	60	61	73	65
FINCA	Nicaragua	71	55	61	62
Compartamos	Mexico	87	97	92	92
Pro Mujer	Nicaragua	59	61	67	62
FINCA	Honduras	77	31	47	52
FINCA	Haiti	100	100	99	100
FINCA	Latin America – average of 7 programs[15]	65	52	58	58
Accion International	Average of 15-17 Latin American affiliates[16]	75	73	71	73

Note: All client retention rates (CRR) are calculated using the same formula:

CRR = C_1 / (C_0 + NC), where C_1 is the number of clients at the end of the year, C_0 is the number of clients at the beginning of the year, and NC is the number of new clients (that enter the program during the year). For example, if all clients present at the start of the year (C_0) and all the new clients (NC) remain in the program until the end of the year, then $C_1 = C_0 + NC$, and the client retention rate equals 1 (or 100%). If only half of each group remains at the end of the year, then $C_1 = .5\ (C_0 + NC)$, and the client retention rate equals 0.5 (or 50%).

[15] The seven FINCA Latin American programs are: Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, and Nicaragua.

[16] The averages given are based on all of Accion International's Latin American affiliates that have the data needed to calculate client retention rates, except Compartamos. Compartamos is excluded because it is a VBI; all other affiliates are primarily individual or solidarity group lenders. The averages given are based on 17 affiliates in the years 2000 and 2002 and 15 affiliates in 2001. The following 13 affiliates provide client retention rates for all three years (country in parentheses): Acción Empresarial (Panama), Banco Solidario (Ecuador), BancoSol (Bolivia), BanGente (Venezuela), FAMA (Nicaragua), FED (Ecuador), Finamérica (Colombia), FINSOL (Honduras), Fundación Mario Santo Domingo (Colombia), Fundación Paraguaya (Paraguay), Génesis (Guatemala), Mibanco (Peru), and Propesa (Chile). The following seven affiliates provide client retention rates for some of the years (country and years in parentheses): ADMIC (Mexico, 2001, 2002), Cooperativa Emprender (Colombia, 2000, 2002), CREDIFE (Ecuador, 2002), Emprender (Argentina, 2000, 2001), FENAPE (Brazil, 2000), FUNDAP (Guatemala, 2000), and SogeSol (Haiti, 2002).

3.3 Leading VBIs of Latin America

i. *Compartamos:* As a Mexican SOFOL (*financiera*), Compartamos is one of the few VBIs in Latin America that is regulated by its country's banking superintendency, and the only one of the four VBIs examined here with this characteristic. Despite its designation as a SOFOL, Compartamos is not licensed to mobilize deposits from the public. With 145,000 borrowers in December 2002, Compartamos serves the largest number of loan clients of any MFI in Latin America. Compartamos began operations in 1990 as the lending arm of *Gente Nueva,* a Mexican NGO, and became regulated in 2001. It is an affiliate of Accion International.

ii. *CRECER:* is an NGO working primarily in the rural areas of Bolivia, including many rural areas that are remote even by village banking standards. CRECER began operations in 1990, using the "Credit with Education" methodology of Freedom from Hunger. Freedom from Hunger is a U.S.-based international NGO that operates numerous village banking programs in Latin America, Africa, and Asia. CRECER became legally independent of Freedom from Hunger in the year 2001, though Freedom from Hunger still provides CRECER with technical assistance and sits on CRECER's board of directors.

iii. *FINCA Nicaragua:* is the largest of FINCA International's seven Latin American affiliates in terms of number of clients served. It is second (after Haiti) in terms of depth of outreach, as measured by average outstanding loan balance ($45 in Haiti and $109 in Nicaragua in December 2002). FINCA Nicaragua is an NGO and began operations in 1992.

iv. *Pro Mujer Bolivia:* an NGO that began operations in 1990, is the oldest and largest of the four Pro Mujer affiliates, and considered Pro Mujer's flagship program. The other Pro Mujer affiliates are in located in Nicaragua, Peru, and Mexico and began operations in 1996, 2000, and 2002, respectively. Like CRECER and the other Freedom from Hunger programs, all Pro Mujer affiliates provide formal non-financial services to their village bank members, as well as credit and savings services.

3.4 Village Banks in Mali ___ A Case Study

In three regions of Mali, village banks have been established with German assistance to mobilize savings and provide micro-credit. Refinancing is possible through the state-owned agricultural development bank so that the village banks can grant more loans than the volume of savings deposited. The network of village banks, which for 10 years was promoted from outside, has in the meantime proven its sustainability by expanding by its own efforts.

The 11 million people of the Republic of Mali are among the poorest in the world. Life expectancy is only 54 years, and the infant mortality rate at 144 deaths per 1,000 live births is

correspondingly high. The average annual per capita income is DM 530 (about US$ 250). The majority of the poor people (86 per cent) live in rural areas, and the agricultural sector, mainly cotton and rice growing, accounts for 47 per cent of Mali's Gross Domestic Product.

The remote Dogon country in Northeastern Mali, one of the three project regions, is also affected by great poverty. Diseases due to poor hygiene are pandemic, and the level of education is extremely low. The inhabitants, mostly smallholders, live from onion and millet crops and livestock breeding. As the region often suffers from drought and plagues of locusts, the farmers' yields are scarcely enough to ensure them a living.

Before the project got underway, the villagers had only two options if they needed larger sums of money for purchases or emergency spending, such as in cases of sickness. They could turn only to traditional savings and loan associations, whose credit volumes are usually limited, or to private moneylenders, who charge usurious interest rates of up to 120 per cent. In addition, the modest amounts smallholders were able to save could not be deposited in a safe place (for instance as a reserve for the next sowing). Instead, the money was hoarded, or spent on consumer goods or buying cattle.

The state-owned agricultural development bank, BNDA, also was unable to offer the smallholders savings and loan options tailored to their needs. Besides that, the bank's branches were far too distant from the villages in the Dogon region.

To remedy this problem, self-administered village banks (Caisses Villageoises d'Epargne et de Crédit Autogérées, CVECA) were set up there in the mid-1980s as part of a project to promote income-generating measures such as rehabilitating small-scale dams. The project was supported by both German Financial Cooperation (FC) and Technical Cooperation (TC). The village banks were to provide the villagers with access to loans and at the same time mobilise their savings. The background was that the impact of income-generating projects, such as promoting irrigated rice growing, often was not sustainable due to a lack of local finance markets which could put the savings to more productive use.

Some of the village banks found very soon that they could no longer cover the heavy demand for loans out of the savings of their members. They were increasingly dependent on other refinancing sources. This was the starting point of something new in Germany's aid to the financial sector. The funds given to BNDA, which had been supported by the Reconstruction Loan Corporation (KfW) since 1986, were no longer to be used exclusively for the direct granting of individual agricultural credits, but also to be made available to the village banks. This concept was implemented from 1994 in Dogonland and in two other rural regions of Mali.

The village banks are based on the principle of self-administration. The villages themselves decide on the founding of a bank, and elect its "staff" - that is, the manager, the treasurer and the comptroller - from among their own people. Part of their funds is used for literacy programmes and initial and advanced training to turn the elected men and women farmers into real "village

bank managers". The banks' self-perception rests on the ideal of village solidarity, which is why the villagers as a whole feel responsible for them.

The loans made available by the BNDA are passed on to individual banks by higher-level associations composed of representatives of the village banks. The interest rate for these loans is about 20 per cent, far above the national inflation rate of 2 per cent (1999). This rate is also offered for savings deposits. The village banks demand 30-40 per cent interest on their loans, so they have a margin of 10-20 per cent to cover their costs.

True, this margin may seem high. But it is quite reasonable given the time-consuming and costly processing of many micro-credits and savings accounts and comparable with similar micro-finance intermediaries around the world. The high rate of interest also does not deter borrowers because alternative sources of money, such as informal moneylenders, are much more expensive. In addition, unlike moneylenders, the village banks offer a safe place to keep savings, which for many customers is at least as important as access to loans.

The system also involves a former state-run and now privatized advisory and supervisory body ("service commun"), which is staffed by Mali specialists and for whose services the village banks and associations must pay (which also is covered by the interest margin). The body ensures an orderly handling of the financial transactions, carries out audits, and trains the village bank staff in book-keeping and financial management.

The villagers use the mostly short-term loans (3 to 6 months) to finance a great number of small-scale investments in income-generating activities and also to cover private financial needs for sickness, weddings and burials. Collateral is provided by "social pressure" and assets such as goats, bicycles and farming equipment.

3.4.1 What Was Achieved Through Village Banks?

i. *Geographical expansion:* In 1999, there were more than 150 village banks and 8 higher-level associations in the three project regions. The cooperatives have a total of almost 65,000 members, through which an estimated 500,000 people are reached. As members of their banks, about 70 per cent of the economically active villagers have access to savings and loans. That means the banks reach directly all economically active sections of the population. The remainder benefit indirectly from banks: higher incomes mean that children, the elderly and the sick can be given better care, and the traditionally strong social cohesion of rural people is further enhanced.

ii. *Orientation on poverty:* The banks mobilize savings totaling DM 4.4 million per year. These savings are the main re-financing basis (about two-thirds) for the overall annual loan volume of DM 6.7 million. The remainder is made available via BNDA credits. These figures manifest not only a far-reaching impact, but also a clear orientation on poverty. In 1998, the average loan level, which is one of the relevant indicators of the

share of poor households benefiting from the project, was the equivalent of about DM 180 for all village banks, DM 160 in the Dogon region, and only DM 80 in another region. That means the project's target groups, which mainly are among Mali's poorest people, were reached to a great degree.

iii. *Social closeness:* The village banks usually have repayment rates of 95 per cent, an indication of their efficiency in allocating loans and the sustainability of their goal achievement. It shows that the cooperatives have become stable and thus reliable financing intermediaries in rural areas. In Dogonland, most of the village banks have even covered their operating costs since 1997. That includes not only their administrative costs, but also the interest on savings accounts and BNDA loans, including their repayment, and payments to the "service commun". This positive result is due to two factors. First, the village banks have a great "social closeness" to their customers not only because of their grassroots proximity, but also because they speak their customers' language. Second, their savings and loan terms are tailored to their customers' needs. Larger sums of money, be they savings or loans, are available when they are needed. What also counts is that the loan repayment burden is tolerable and that savings are safely invested, meaning family members cannot get their hands on them. In this respect, the BNDA's aim of improving the rural people's opportunities to generate or retain income in an efficient way has also worked out.

iv. *Increasing income:* The project has shown how successful financial intermediation, meaning the efficient transformation of savings into loans, and going beyond pure access to financial products, can help tackle pressing social problems. An impact analysis of the Dogon region by Ohio State University in 1997, for example, found that the economic situation of local households had improved. The members of village banks were less vulnerable to the financial consequences of illness, death and other events of the life cycle than were non-members. True, the banks' members are not among the poorest households. But the demand for loans by the latter was greater than their mobilised savings, while richer traders were net savers. This means there was a transfer of resources in favour of the economically weaker members. In addition, the study said, the project had promoted the people's readiness for self-help and self-qualification, strengthened social cohesion, and improved both food security and the empowerment of women. These successes were achieved by measures such as the literacy programmes, which were extended to include entire village populations and had raised the level of education as a whole.

v. *Linkage with the BNDA:* The partner bank made a great contribution to the project's success. The bank's efficient, professional management by an experienced Mali specialist and the good level of training and motivation of its employees proved decisive. The BNDA sees the refinancing of village banks as an attractive business field both because of the lower costs of loans to them and their repayment pattern, which is much better than that of the bank's own individual borrowers. The BNDA has not yet had a default on repayments by village banks, compared to a 50 per cent default rate for the direct loans it

made earlier to end-borrowers. In the final analysis, the bank can thus better fulfil its mission of also helping poorer people to gain access to financial services than by granting traditional agricultural loans. The BNDA is currently and for the foreseeable future the only bank that is both willing and able to operate to a substantial extent in Mali's rural areas and, alongside the regional savings and loan cooperatives, to refinance the village networks as well. This linkage of formal sector institutions with informal finance intermediaries, which is now recognised internationally as a "best-practice model", not only strengthened the business activities of a state-run agricultural development bank, but also got underway a "bottom-up development".

vi. *Knock-on effect:* The village bank project had a "structure-building" effect in the sense of extending the "financial frontier". Aid from outside played an import catalyst role - without prejudice to the target groups' own efforts - not only in relation to their better access to sustainable financial services conforming to their needs (expanding the customer group), but also in terms of widening the offer of such financial products. New and similar village banks are now emerging in other parts of Mali at the people's own initiative, such as one promoted by the French in the Kayes region in the West of the country. In the Koro District of the Dogon region, the local village banks are themselves involved in selecting other villages and setting up new branches. Thus the venture is having a knock-on effect beyond its original project region and contributing to the spread and professionalising of rural finance markets. As a whole, the village bank approach has proven that even simple ways of organising the mobilisation of savings and granting loans in Mali can function sustainably and be developed further on-site.

vii. *Framework conditions:* The project's success would have been inconceivable without improving the framework conditions in Mali's finance sector, in whose promotion other donors were involved as well. The main success factors included Mali's existing market economy system framework, the stability of its currency, and interest rates which are positive in real terms, conforming to market conditions, and cost-covering in the long term. The German development cooperation, involving inputs by the KfW, the German Agency for Technical Cooperation (GTZ) and the German Development Company (DEG), which is a BNDA shareholder, contributed to these conditions by:

- supporting and promoting the process of developing a Mali development plan, adopted in 1997, to promote micro-finance institutions;

- achieving in consultation with other donors in the Mali finance sector the raising of the interest rate ceiling for micro-finance institutions from 12 per cent to 27 per cent. This rate is still too low in terms of covering costs, but is an important step in that direction (the authorities tolerate for the time being that village banks exceed this limit); and

- cooperating closely with the Agence Francaise de Développement, including co-financing and joint evaluation of the BNDA.

The KfW has since 1989 frequently taken the initiative in this process, mainly by organising Round Table discussions with Mali partners and international donors and by deploying experts in the field. The KfW is also involved in the funding of the supranational RIECA network, an African union of decentral finance institutions.

3.4.2 Lessons Learnt and Future Challenges

Is the village bank model transferable to other countries? The building up of village networks is a lengthy process. In Mali, a promotion timeframe of more than 10 years was required. This means that staying power is needed, the amount depending on local framework conditions. In addition, based on the experiences in Mali the following minimum prerequisites should be in place to enable the transfer of the approach:

i. the people must be keen to help organize a network;

ii. the population density of the village banks catchment areas should not be less that 15 inhabitants per square kilometer; and

iii. the village banks must be able to work together with an efficient formal finance institution (either a development bank or a commercial bank).

Besides making further efforts to mobilize more savings and cut costs, the main challenge for the village networks in future will be to remain independent of external donor inputs in refinancing their growing loan portfolios due to their own borrowing.

Regional commercial banks are following the BNDA's example only hesitantly because they can neither assess the risk nor hedge it. That is why the German assistance has provided the BNDA with a guarantee to facilitate its refinancing of the village banks on the regional finance market. This path will also be a long one. At the end of the day, it will be successful only if the Mali government continues consistently to pursue its development goals of democratization, decentralization and privatization, and if the sectoral conditions also remain favorable.

CHAPTER 4: Credit Unions

4.1 Credit Unions: Models for Providing Sustainable Microfinance

"Credit unions are a self-sustainable means of reaching the poor. Their apparent neglect in the literature and in the various events associated with financial services to low-income households and micro and small enterprises disguises the real significance of credit unions in these markets."

- Carlos Cuevas, 1999, p.1, Sustainable Banking With the Poor, The World Bank

Credit unions operate in 67 developing countries to meet member demands for savings and credit. Credit unions first became legally registered entities in Western Europe at the end of the 19th century and in the United States and Canada in the early 20th century. In the latter half of the twentieth century, credit unions have developed in rural and urban areas in Africa, Asia, the Caribbean, Eastern Europe and Latin America. Membership in a credit union is based on a common bond, a linkage shared by savers and borrowers which can based on a community, organizational or religious affiliation or an employee-based relationship. Depending on a country's legal framework, credit unions are authorized either by the Superintendency of Banks and Financial Entities, the Ministry of Cooperatives, or a free-standing law to mobilize member/client savings and use these internally generated funds to finance member credit needs.

Microfinance today emphasizes scale and depth of outreach of financial services to large numbers of the working poor through financially sustainable organizations. Credit unions offer a savings-first, self-sustainable approach to microfinance that has already successfully met the needs of millions of low-income members around the world.

4.2 Credit Union Advantages for Microfinance Delivery

"Not only have credit unions been found to be second only to banks in lending and especially in providing deposit services to low-income clients, but their prevalence stems from real advantages credit unions have over other providers of financial services to marginalized clients."

- Carlos Cuevas, 1999, p. 1, Sustainable Banking With the Poor, The World Bank

Among many advantages, there are four primary strengths of credit unions for micro-finance delivery: services for lifetime asset growth, mixed outreach, savings mobilization and full service array of loan products.

4.2.1 Lifetime Asset Growth

Credit unions help micro-entrepreneurs climb a delicate ladder of modest but increasing asset or income security growth.

Credit unions help the lower income groups increase their assets via establishing a credit relationship, establishing an enterprise, accessing working capital, increasing income through business expansion, meeting housing credit needs, and increasing wealth through savings.

As new members join the credit union, they are able to access credit in small amounts, increasing with successful repayment. Members establish a good credit history, usually by taking out small personal loans, and then enter into a period where they can expand their loan activity.

Many credit union borrowers use credit to establish and expand enterprises as their primary or secondary economic activity. Credit union loans also become the initial capital for establishing micro-enterprise as the primary economic activity for other family members. Members look for ways to access increasing amounts of working capital with flexible repayment terms. Over time, they take out larger loans for housing and production needs, based on repayment capacity and real collateral.

These same members initially contribute little to deposit savings -- their focus is on borrowing. As their assets and income increase, they save more and borrow less. As they shift to larger loans or reduce their borrowing, members stop investing in shares and shift their investment to deposit savings. Members become net savers, investing savings in withdraw-able deposit services offering market rates of return.

These patterns of member income and asset growth provide direction for credit union tailoring of lending and savings products. Credit union growth is conditional upon their ability to satisfactorily meet the savings and credit needs of members as they follow this life pattern. The credit unions that can offer an array of products designed to meet each of these needs will assist members not only with the very small poverty loans of unstable or stable survivors, but also with climbing to higher levels of income and asset performance of growth enterprises.

4.2.2 Diversity in Membership

It is scale, not exclusive focus, that determines whether significant outreach to the poor will occur.

- Christen, Rhyne and Vogel in "Maximizing Outreach", p. 28

Credit unions are "mixed outreach" financial institutions.

The credit union membership base is diversified economically. Members from the urban areas are vendors, merchants, self-employed, small manufacturers, teachers, construction workers, house-wives, private and public employees, bakers, leather workers and shoe makers. Members from the rural areas include grain farmers, citrus fruit growers, agricultural laborers, traders and cattle producers.

Diversification of membership decreases the covariance credit risk to the credit union. Community credit unions develop a membership base diversified in economic activity and socio-economic condition. Not all of the membership (and therefore the financial base) would be affected by a sectoral economic crisis.

"NATCCO's (National Association of Philippines Credit Cooperatives) primary credit cooperatives may be cited here as an example of privately initiated microfinance institutions which, on the evidence of their small loan sizes (Ps5,000 to Ps6000 or $200 to $240), certainly reach down to the poor even if not serving them exclusively."

- McGuire et al., Getting the framework right, 1998, p.238

Service to the poor is blended with service to a broader spectrum of the local population.

Credit union services are not focused exclusively on the poor. Service to the poor is blended with service to a broader spectrum of the local population. Smaller loan sizes, typical of loans to the poor, tend to involve higher costs per client. Credit unions serving the poor can better maintain sustainability by spreading their costs across loans of larger and medium sizes as well. In this manner, the credit union reaches a large absolute number of the poor on a sustainable basis.

4.2.3 Savings Mobilization

"The demand for liquidity is far more important to most rural citizens than the demand for credit. Savings mobilization is just as important as credit in meeting the financial needs of the rural population."

- J. Boomgard and K. Angell in The New World Of Microenterprise Finance, 1994, p.226.

What most distinguishes credit unions from other non-bank financial entities offering micro-finance services is the ability of the credit unions to mobilize mass numbers of small, voluntary, savings accounts.

These deposits can then be invested in rural production, housing, micro-enterprise and small business loans. Credit unions provide the low transaction costs required to offer this service to large segments of society. Credit unions offer a variety of types of savings services: voluntary

withdrawable savings accounts, fixed term deposits based on either the term of the deposit or the size of the deposit, and other diverse savings programs including: savings for educational fees, savings for holidays or vacations, savings for infant delivery expenses, retirement savings, youth savings, etc.

"The financial systems approach to micro-enterprises recognizes that savings are as important a service for the poor as credit, and that savings are crucial in building self-sufficient financial institutions...To date, although many other programs have incorporated savings elements, only the credit union movement and scattered programs have embraced savings as equally important as credit for dealing with poor populations."

- Rhyne and Otero in The New World of Microenterprise Finance, 1994, p. 16

Sound institutional controls and structures need to accompany savings mobilization in order to protect the savings and to manage efficiently the increasing number of small-balance accounts. To meet prudential standards, credit unions must instill the financial management disciplines of capital accumulation, loan classification, delinquency control, loan loss provisions, capitalization, and liquidity management in credit union management procedures and practices.

4.2.4 Full Array of Loan Products

"Credit union loan portfolios are widely diversified. Since credit unions lend for a wide variety of purposes, the portfolio risk of specializing in a single type of activity is reduced."

- John H. Magill in "Credit Unions: A Formal-Sector Alternative for Financing Micro-enterprise Development" in Rhyne and Otero's New World of Micro-enterprise Finance, 1994, p. 149.

Members' financing needs determine their credit union loan product offerings.

Loan purposes often include housing construction, housing improvement, home purchase, small manufacturing, transportation business, commerce, personal service business, debt refinancing, emergency needs, education, agriculture, cattle- and chicken-raising, fish-harvesting, personal expenses and electric appliance purchases.

The sectoral activity can shape loan term preferences; for example, in agricultural areas, most members borrow with a longer-term repayment structure. Citrus producers borrow fixed, 6-month term loans which they pay at the end of harvest instead of monthly. Cattle producers often require a 2-year period for financing from when they buy the small animals until the animals are old enough to sell. Micro-entrepreneurs may require small working capital loans for short periods of 30 days or 16 weeks with weekly payments.

"With respect to the speed with which a loan can be obtained, flexibility regarding the terms of the loan, and most importantly with regard to transaction costs, the non-conventional individual-

based technology is definitely superior to all kinds of group-lending technologies for small and micro entrepreneurs."

- Schmidt & Zeitinger in Strategic Issues of Microfinance, 1998, p.35

Credit unions have typically defined their individual lending methodology as a strength. Individual lending suits well the needs of the majority of credit union members. Despite this fact, perhaps the most significant impact the micro-finance industry has had upon credit unions has been to introduce them to a greater variety of methods and of credit products for low-income entrepreneurs.

Some credit unions, such as several in Bolivia and the Philippines, offer solidarity group loans for lower-income or "downscale" micro-entrepreneurs. For many low-income members or members who live in remote rural areas far from the credit union office, access to a local solidarity group provides them with a lower-cost method to access credit union services.

On one hand, solidarity group lending provides group protection for those who are reluctant to engage in the formal processes that are required of an individual member to make a loan application at a credit union. On the other hand, it provides an early stepping stone of access to small loans for those who start within the group and then leave it, or who graduate to full individual member services at the credit union as savers or as applicants for a larger loan.

Credit unions have developed new products which offer micro-entrepreneurs products that are flexible, taking into consideration their cash flow and offering increased access with performance. To satisfy the demand for working capital, some credit unions, such as those in Ecuador, offer "open-end" lines of credit or supplier credit through material suppliers for "upscale" micro-entrepreneurs.

4.3 Depth of Outreach Case: Savings in Bolivian Credit Unions

In Bolivia, 20 credit unions, serving 260,172 members as of December 2005, mobilize US$155 million in deposits and US$15 million in shares to finance US$173 million in loans.

Currently, 12 credit unions fall under the supervision of the Superintendency of Banks while others are in the process of registering. The Project assists the Superintendency in assessing, registering and preparing credit unions to meet licensing requirements.

Table 2: Data of 3/31/06 for 20 credit unions affiliated with WOCCU in Bolivia.

Deposit Size in Bolivia; GNP per capita $970	Number of Savings Accounts in this Range	% of Number of total of Deposit Accounts	Volume % of Savings Accounts in this Range	Total Amount of Deposits in this Range
$1-$500	164,335	92%	21%	$8
$501-$1000	6,104	3%	10%	$4
$1001-$5000	5,559	3%	24%	$9
$5001-$10,000	1,868	1%	23%	$9
$10,000-$15,000	204	0%	5%	$2
$15,001-$20,000	99	0%	4%	$1
$20,001-$30,000	76	0%	4%	$1
$30,001-$50,000	76	0%	4%	$1
$50,001-$100,000	16	0%	2%	$985
$100,001+	6	0%	2%	$720
TOTAL	**178,320**	**100%**	**100%**	**$40**

* This information is for withdrawable savings accounts ONLY; fixed term deposits not included.

World Council of Credit Unions has established for the Superintendency, its credit union Monitoring and Evaluation System, PEARLS, to track the progress of credit unions in applying the new financial standards and disciplines to their operations. The Superintendency uses the financial ratios generated by PEARLS to conduct analyses of all key areas of credit union operations. The project also provides examination training for credit union examiners from the Superintendency of Banks.

4.4 Micro-Enterprise Loan Expansion: Savings Led Credit Innovation in Ecuador Credit Unions

WOCCU projects increase the volume of credit union lending to micro-enterprise through savings mobilization and an improved array of credit products. The project strategy strengthens financial disciplines which protect savings mobilized.

The 19 credit unions participating in the WOCCU technical assistance program serve 681,720 member-clients as of December 31, 2005. The project credit unions mobilize US$60 million in savings and US$21 million in share equity investment to finance US$86 million in loans as of December 31, 2005.

Credit unions mobilized US$19.9 million in new deposit savings during the first two years of the project. Credit unions have introduced new savings services such as youth savings, institutional savings and programmed savings products.

Table 3: 19 Project Credit Unions Scale of Credit Union Savings Services June 2006

	Total	Women	Men
Total Deposit Savings	US$71,856,022	US$24,189,850	US$47,666,172
# of Deposit Savings Accounts	622,795	232,175	390,620
Average Deposit Savings	$115	$104	$122
Median Deposit Savings	$19	$20	$19
Total Shares	US$23,220,736	US$9,230,878	US$13,989,858
# of Share Accounts	538,485	232,175	306,310
Average Shares	$43	$40	$46
Median Shares	$17	$17	$17

In Ecuador 33% of credit union members are self-employed and more than 52% of credit union households have small or micro-businesses owned by the member or the spouse. The project credit unions provide financial services to an estimated 210,009 member-owned small and micro-enterprises.

The largest volume share of loans granted is to micro-entrepreneurs. US$35 million (38%) is to micro-entrepreneurs. Micro-enterprise loans make up 30% of the total number of loans. There were 50,998 consumer loans granted during 2005. It is estimated that approximately 20% (or 10,200) of the loans designated as consumer loans were for micro-entrepreneurs.

Credit unions have learned lessons from supplier credit to provide this group with low transaction costs and flexible amount availability of working capital on demand. Project credit unions have differentiated the loan product interest rates which they charge and have added new loan products such as the Micro-Enterprise Open-Ended Line of Credit and Supplier Credit Financing.

A pre-project review of credit union portfolios indicated that micro-enterprise loans made up 25% of credit union portfolios in 1994. The same sample of 13 credit unions in 2005 indicated that the micro-enterprise portion of the portfolio had increased to 40%. The volume of micro-enterprise loans increased from US$16.4 million to US$38.8 million — 135% during the project period. The sample of 13 credit unions demonstrates an annualized increase of 21% of the total

number of loans and a 45% increase of the total volume of loans. This was an increase of 17,504 loans and of US$29,842,461.

4.5 Depth of Outreach Case: Poverty Lending in Philippines Credit Unions

WOCCU and Freedom From Hunger are working together in the Philippines on a project sponsored by the USAID Micro-enterprise Office to provide microfinance services to very poor women. The aim of this project is to have the credit union system serve as the provider of the external account for the saving and credit with education groups (SCWE). On average, 27 women form each group. As of March, 2006, 107 groups were formed and the 2,853 members had a 100% repayment rate. The average loan size per borrower was $42. Just over 1,700 educational group meetings took place from the time the groups first borrowed in July 2005 until March 2006. The majority of the sessions focused on health and nutrition (685 sessions) and group management education (548). More than 300 sessions imparted business skills.

The "borrower" groups had $116,972 in outstanding loans as of March. At that time, some group members had amassed $15,394 in total savings. After eight months of lending/training operations, the SCWEs reached a financial sustainability ratio of 16%.

Table 4: Loan Portfolio as of 3/31/06 for 12 credit unions (6 rural, 6 urban) affiliated with WOCCU.

Total number of 32,075 loans worth $8.03 million

Loan Size	Loan size as % of GNP per capita ($1200)	Number of Loans in Range	% of Number of total Loans	Volume % of Loans in Range	Amount of Loans in Range
$1-$250	0% to 21%	19,057	64%	18%	$1.45 million
$251-$500	21% to 42%	6,058	19%	21%	$1.72 million
$501-750	42% to 63%	2,643	8%	15%	$1.21 million
$751-?	NA	4,643	14%	46%	$3.65 million

The percentage of female credit union members in the Philippines has grown from 41.5% in 12/04 to 64.3% in 3/06. Included in this table are the 107 savings and credit with education associations composed of 2,853 women.

4.6 Sustainability: Guatemala Private Ratings and Certification Agency

In the FENACOAC Guatemala credit union system, there are 39 affiliated credit unions which serve 262 thousand members. Credit unions have mobilized US$32 million in shares and US$89 million in deposits which funded US$92 million in loans in 2005.

Survey data from credit union communities offer strong evidence that credit unions fill a major niche in local financial markets by mobilizing household savings and making loans to households engaged in small to medium-scale agricultural and commercial enterprises.

i. 75% of the number of formal sector loans and 60-75% of the formal loan volume to the sample households were made by credit unions;

ii. credit unions mobilized about 33% of the financial savings from this population.

Union Popular credit union provides 74% of the number of loans received by residents in the Tiquisate/Nueva Concepción area, and about 55% of the total amount. In San Juan and Tactic communities, the credit unions provide 56% and 42% shares of total loan amounts, respectively.

For small business loans, the credit union is the only formal source to the sample households in Tiquisate and Tactic, even though a number of private banks have branches in Tiquisate. In San Juan Sacatepequez, credit unions supplied 75 percent of micro and small business loans. Input suppliers, are the principle alternative source of short-term merchandise credit, especially to small commerce operators. The average size of input supplier loans is significantly smaller than the average credit union loan. Credit union loans are usually small in comparison to commercial bank loans. The difference in average loan size between the credit unions and the banks is particularly apparent in lending for commerce and agriculture.

Approximately 60% percent of the number of commerce loans are to women members while the same loans account for 45% of the volume of commerce loans. Women are most active in borrowing for housing and commerce. They account for 63% of credit union members who report commerce as their primary source of income.

Under a grant provided by CGAP, WOCCU and FENACOAC are currently establishing a private sector mechanism to rate and certify credit union soundness and by offering specific economic and marketing benefits for those credit unions which meet the soundness criteria.

4.7 Moving to Market Rates: Kenya Micro-Enterprise Project

In Kenya, over 1.1 million members had savings of over US$338 million and loans outstanding of US$179 million. The average size of Kenyan credit unions is about 5,000 members.

Most of the larger credit unions are located in Nairobi, frequently affiliated with single employers where payroll deduction systems are in place. Payroll deduction systems provide an on-going flow of funds coming into the credit union. Payroll deduction systems are dependable and are used for savings mobilization and loan repayment. This allows the credit union to manage its cash flow better, permitting it to hold smaller cash reserves due to the regularity of its funds flow. Another advantage is low delinquency. During WOCCU's recent field study in Kenya, delinquency rates were frequently found to be under 1%. Kenyan credit unions are also located in rural areas throughout the country. Even in these rural credit unions, there is some presence of regular inflows of cash.

While loans are made for a variety of purposes, micro-enterprise loans are considered to make up large proportions of Kenyan credit unions' loan portfolios. It is very common for a salaried employee at a company to be involved in a micro-enterprise, which is either operated on a part-time basis by the employee, or more likely, by a family member on a full-time basis. In 1993, 69% of Kenyan households depended on micro-enterprises for at least half their household income. In urban areas, the percentage jumped to 80%. This heavy reliance on microenterprise income applies also to credit union members. Credit union general managers estimates of micro-lending activity range from 40% to 60% of loans disbursed.

WOCCU provides technical assistance and training to a select group of 15 credit unions to mobilize savings and expand microfinance lending. The credit unions are a combination of urban and rural institutions that are now serving, or have a substantial opportunity to serve a variety of microentrepreneurs. Currently, the program has initiated with 10 credit unions with 37,542 members. The 10 credit unions have a total of US$22 million in assets.

WOCCU transfers sound business skills to credit unions in the areas of: (1) financial management, (2) standardization, (3) policy formation, (4) marketing, (5) human resource development, (6) credit administration, and (7) member service development.

4.8 Nicaragua Rural Credit Union Project

In Nicaragua, credit unions offer poor, rural entrepreneurs access to loans and saving mechanisms. The USAID/WOCCU Rural Credit Union Project expands 20 Nicaragua rural credit unions' financial services to provide permanent access to credit and financial services to rural agricultural and micro-entrepreneur producers.

A study of six project credit unions indicated that these credit unions, serving 2,833 members, were actively engaging in micro-enterprise development, and were reaching, proportionately, more women borrowers. (Mahon, 2006)

An analysis of the loan portfolios reveals that 52.6% of all loans originated by the credit unions are for non-agricultural micro-enterprise activities. Six credit unions studied had 695 micro-enterprise loans. Through micro-enterprise lending, credit unions are reaching proportionately more women borrowers. More than 56% of micro-enterprise loans were made to women, compared to 48% of all credit union loans.

Table 5: Breakdown of micro-enterprise loans by size and gender for 6 Credit Unions March 2006

Size of Loan	Male	Female	Totals	Overall	Male	Female
< 300	94	149	242	35%	31%	38%
301-500	64	82	146	21%	21%	21%
501-1000	57	67	125	18%	19%	17%
1001-2000	52	67	119	17%	17%	17%
2001-3000	12	24	36	5%	4%	6%
> 3000	22	4	26	4%	7%	1%
Total	**301**	**393**	**694***	**100%**	**100%**	**100%**

* The total number of micro-enterprise loans is 695, one loan did not report gender.

The majority of credit union loans for micro-enterprise are very small loans (<$500). Of the micro-enterprise loans originated, 56% of the loans originated are for amounts less than $500 with 35% with amounts less than $300.

Loans to women are proportionately focused in lower loan amounts. In fact, 38% of all loans to women are less than $300 and 59% of all loans to women are less than $500.

Credit union financing assisted credit unions members to diversify their income generating activities and helped them to recover from the effects of Hurricane Mitch. Members in rural and agricultural communities were most affected by the Hurricane. Those members who had more than one income-generating activity in the household appeared to be recovering more quickly than those reliant on one activity (i.e., agriculture). Assisting households to diversify their income-generating activities helped limit the risk of losses and helped increase household financial stability.

4.9 Financial Performance: Self Sustainability of El Salvador Credit Unions

WOCCU began working in El Salvador in 1996 on a USAID financed project in partnership with Chemonics, the Inter-American Institute of Agricultural Cooperation (IICA) and National Cooperative Business Association (NCBA). WOCCU's efforts focus on developing rural financial enterprises. WOCCU has worked with thirteen affiliated credit unions.

By the end of 2005, each of the thirteen savings and credit cooperatives had achieved operational self-sufficiency. Three of the thirteen achieved full financial self-sustainability by 12/31/05. At that date, five other credit unions were between 75% and 99.2% financially self-sustainable and three had reached between 55.08% and 63.5% financial self-sufficiency. Only two of the credit unions affiliated with the WOCCU technical assistance project had attained less than 32% financially self-sufficient.

The operationally self-sufficient and primarily financially self-sufficient credit unions are serving El Salvador's rural poor with financial services. The average loan size on 3/31/05 was $854, approximately 47% of El Salvador's GNP. One third (7,762) of the total number of current borrowers (23,119) borrowed amounts of less than $300. The average deposit size of 55,783 members on 3/31/06 was $308.

4.10Financial Performance: Self Sustainability Of Poland's National Credit Union Association (NACSCU)

At Polish request, the World Council of Credit Unions (WOCCU) provided technical assistance funded by the U.S. Agency for International Development (USAID) to help create a credit union system after the fall of Communism in Poland. Prior to 1992, there were no operating credit unions in Poland; however that year, the project helped to establish the National Association of Savings and Credit Cooperatives (NACSCU) and created a Central Finance Facility (CFF), a Stabilization Fund, and an Insurance Company. This technical assistance project did not focus on strengthening a number of primary level credit unions at the base, but instead had a top-down approach that has not had a replicable success anywhere else that WOCCU has worked. NACSCU has directed and implemented most of the project initiatives.

In many traditional credit union movements around the world, the second tier level of credit unions, National Associations or Federations are notoriously weak in the area of financial sustainability and depend upon subsidies for their continued survival. Poland provides a striking contrast: the Polish National Association has made remarkable progress on its own road to financial self-sufficiency. NACSCU received financial assistance from USAID up until September 2004, when it arrived at full operational self-sufficiency. Since that time, NACSCU has continued to increase its revenues. The following table illustrates NACSCU's self-sustaining capacity for 2004 and 2005:

Table 6: NACSCU Profit and Loss Statements
(in U.S. Dollars, 1 USD = 3.5 PLZ)

Line Items	As of 12/31/04	As of 12/31/05
Total Gross Income	$1,927,249	$3,284,961
Total Financial Costs	$1,247,442	$2,278,758
Total Administrative Costs	$651,950	$955,628
Net Income	$27,857	$50,575

NACSCU's overall success and financial independence are largely due to its ability to attain: legal significance, commercial significance (as evidenced by income-generating services including central finance facility, stabilization fund, training seminars, credit union computer software, equipment services, supervisory/audit services, insurance products), political significance, and supervisory significance.

The total cost of the entire seven years (1992-99) of USAID sponsored WOCCU project assistance to Poland was $3.9 million. For every one US Dollar that was spent on this project, over $40 USD of new assets was generated. Assets of $158 million USD render the Polish credit union system the fourth largest financial network in Poland.

CHAPTER 5: Self-Help Groups (SHGs)

5.1 What are Self-Help Groups (SHGs)

Self-Help Groups (SHGs) or Thrift and Credit Groups are mostly informal groups whose members pool savings and re-lend within the group on rotational or needs basis. These groups have a common perception of need and impulse towards collective action. Many of these groups got formed around specific production activity, promoted savings among members and used the pooled resources to meet emergent needs of members, including consumption needs. Sometimes the internal savings generated were supplemented by external resources loaned/donated by the Voluntary Agency which promoted the SHGs. Since SHGs were able to mobilize savings from the poor who were not expected to have any savings and could also recycle effectively the pooled savings among members, they succeeded in performing/providing banking services to their members, may be in a primitive way, but in a manner which was cost effective, simple, flexible at the door step of the members and above all without any defaults in repayment by borrowers.

Involvement of SHGs with banks could help in overcoming the problem of high transaction costs in providing credit to the poor, by passing on some banking responsibilities regarding loan appraisal, follow-up and recovery etc. to the poor themselves. In addition, the character of SHGs and their relations with members offered ways of overcoming the problem of collateral, excessive documentation and physical access which reduced the capacity of formal institutions to serve the poor.

Based on local conditions and requirements, the SHGs have evolved their own methods of working. Some of the common characteristics of functioning of these groups are indicated below:

i. The groups usually create a common fund by contributing their small savings on a regular basis.

ii. Most of the groups themselves, or with help of NGOs, evolve flexible systems of working and managing their pooled resources in a democratic way, with participation of every member in decision-making.

iii. Request for loans are considered by the group in their periodic meetings and competing claims on limited resources are settled by consensus.

iv. Loaning is done mainly on trust with a bare minimum documentation and without any security.

v. The amounts loaned are small, frequent and for short duration.

vi. The loans cover a variety of purposes, some of which are non-traditional and rather un-conventional.

vii. Rate of interest differs from group to group and even with purpose. Interest charged is generally higher than that charged by banks and lower than that charged by money lenders.

viii. Periodic meetings of members also serve as a forum for collecting dues from members.

ix. Defaults are rare mainly due to group pressure and intimate knowledge of end use of credit.

5.2 The Linkage of SHGs with Banks

The linkages of SHGs with banks aims at using the intermediation of SHGs between banks and the rural poor for cutting down the transaction costs for both banks and their rural clients. The objective of the linkage programme could be:

i. to evolve supplementary credit strategies for meeting the credit needs of the poor by combining the flexibility, sensitivity and responsiveness of the informal credit system with the strength of technical and administrative capabilities and financial resources of the formal financial institutions.

ii. to build mutual trust and confidence between bankers and the rural poor.

iii. to encourage banking activity, both on the thrift and credit sides, in a segment of the population that formal financial institutions usually find difficult to reach.

There could be different models of the linkage between SHG and banks:

i. *Model 1:* The simplest and most direct is a model in which the banks deal directly with the individual SHGs, providing financial assistance for on-lending to the individual members.

ii. *Model 2:* Another model, a slight variant of the first, is where the bank gives direct assistance to the SHG and the SHG promoting instituion (SHGI), usually an NGO, provides training and guidance to the SHG and generally keeps a watch to ensure its satisfactory functioning.

iii. *Model 3:* The third model places the NGO or SHGI as a financial intermediary between the bank and a number of SHGs. The linkage between the bank and the SHGs in this case is indirect. The NGO accepts contractural responsibility for repayment to the bank.

iv. *Model 4:* The fourth model envisages bank loans directly to individual members of SHGs upon recommendations of the SHG and NGO. In this case, the NGO assists the bank in monitoring, supervising and recovery of loans.

It is possible that the linkage may follow an evolutionary process and move from model three to model two and to model one and finally to model four where individuals get direct access to the bank. However, the adoption or acceptance of a particular model would depend on the perception of the bank and the strength of the SHGs and the NGO. Where the banker is able to have a first hand information on the working of a SHG which is functioning satisfactorily and has rotated its pooled resources two/three times, he may well start with model two or even model one. However, a more conservative banker may like to start with model three and rely on the NGO or SHGI.

5.2.1 The Financial Scheme

The financial scheme under the Linkage Programme could be based on the following broad principles:

i. Savings first, no credit without saving.

ii. Saving as partial collateral.

iii. Bank loans to the group, for on-lending to members.

iv. Credit decisions for on-lending to members by the group.

v. Interest rates and other terms and conditions for loans to members to be decided by the group.

vi. Joint liability as a substitute for physical collateral.

vii. Ratio between savings and credit contingent upon credit worthiness of the group; increasing with good repayment record.

viii. Small loans to begin with.

5.3 The Linkage Project in India

Despite the vast expansion of the formal credit system in India[17], the dependence of the rural poor on money lenders continues especially for meeting emergent credit requirements. Such dependence is more pronounced in resource poor areas and in the case of marginal farmers, landless laborers, petty traders and artisans belonging to the socially and economically backward classes and the tribal population. With a view to developing a supplementary credit delivery mechanism to reach the poor in a cost effective and sustainable manner, the National Bank for Agriculture and Rural Development (NABARD) introduced a pilot project for linking 500 SHGs with banks in 1998 after thorough discussion with the Reserve Bank of India (the central banking authority for India), commercial banks and NGOs.

The operational guidelines from NABARD were deliberately kept flexible to enable the prticipating banks and field level bankers to innovate and contribute to building and strengthening the project concept. Stating the advantages of linkages to the bank, the guidelines observed:

"A recognition by the formal credit structure of self-management capabilities of the poor through SHGs and a link up between the two is expected to result in specific advantages to both systems. Under the linkage project, the main advantage to banks would be externalisation of a part of the work items of the credit cycle - assessment of credit needs, appraisal, disbursal, supervision and repayment, reduction in the formal paperwork involved and a consequent reduction in transaction costs. Improvement in recoveries and also in the margins would lead to a wider coverage of the target group. A larger mobilization of small savings would be equally advantageous. For the groups, advantages lie in the access to a larger quantum of resources as compared to their corpus generated through thrift, access to better technology and skill upgradation through different schemes of banking sector and a general improvement in the nature and scale of operations that would accelerate economic development."

Besides providing policy input, coordination and 100% refinance facility at 6.5% interest p.a. to the banks, NABARD has been organizing exposure and dialogue programmes in the linkage project for banks and NGO officials. These exposure programmes, which invariably include field visits, have helped in disseminating the concept and convincing bank officials to participate in the project. So far, 17 such programmes, covering around 350 officials have been organized in collaboration with NGOs and reputed bankers training institutes like the College of Agricultural Banking (CAB) and the National Institute of Banking Management (NIBM).

The pilot project has made progress during the last few years. As of 30 June 2005, 637 groups had established credit links with 16 commercial banks and 12 RRBs; the total loan sanctioned by banks amounting to Rs.7.9 million and refinance released by NABARD amounted to Rs.7.6

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[17] There are nearly 150,000 credit outlets of the formal banking sector in rural areas, including cooperatives. The total outstanding bank loans for agricultural purposes in 2005 amounted to nearly Rs. 560 billion.

million. Progress has been good in the states of Karnataka, Andra Predesh and Orissa. The project has been picking up in other states too. The list of state-wise number of SHGs linked with banks and loan sanctioned is given below:

Table 7: Pilot Project on SHG - Summary Progress Report
Figures in Thousand Rupees

State	No. of SHGs	No. of Women SHGs	Bank Loan Sanctioned	NABARD Refinance
Gujarat	19	-	398	310
Karnataka	172	97	1232	1232
Madhya Pradesh	14	14	168	148
Orissa	180	180	1906	1906
Assam	2	-	75	-
Andhra Pradesh	139	131	2660	2553
Rajasthan	16	5	224	222
Tamil Nadu	74	63	881	864
Bihar	2	2	20	-
Maharastra	17	15	376	376
Kerala	2	2	32	32
Total	637	509	7971	7643

In order to assess the results of the linkage project, quick studies were taken up by NABARD in three states viz. Karnataka, Andhra Pradesh and Tamil Nadu and certain trends in the implementation of this innovative concept have emerged. They are:

i. Larger participation in the project is of women savings and credit management groups, particularly in resource poor regions.

ii. Membership of SHGs has come mostly from the poorest sections of the society.

iii. Demand for credit is frequent and for small amounts, at unpredictable times and sometimes not necessariy for purchase of income generating assets.

iv. Even the very poor are able to save and their savings increased with addition to their incomes.

Further, some good features have come to light such as shift in credit from consumption purposes to acquisition of income generating assests, use of credit for non-traditional economic activities, increase in income levels of group members, development of thrift and self-help among members, reduction in transaction cost for both banks and SHG members and an almost 100% recovery of loans.

5.3.1 Transaction Costs

The high transaction cost for rural credit is a core problem and viability of the system is critically affected by it. NABARD has recently conducted a study to quantify the effect of intermediation by NGOs/SHGs on transaction cost. The initial findings are:

i. The intermediation of SHG led to reduction in time spent by bank staff on identification of borrowers, documentation, follow-up and recoveries. This resulted in 40% reduction in transaction cost which could increase further with increase in loan sizes.

ii. The intermediation also significantly reduced transaction costs for the borrower due to elimination of cumbersome documentation procedure and time spent and cost incured on repeated visits to banks etc. The reduction was place at 85%.

CHAPTER 6: Rural Financial Systems Approach

6.1 Indonesia

The pattern of microfinance service provision in Indonesia differs from that observed in almost all other countries in which the sector has achieved any significant outreach. There are two major differences. The first is that certain regulated financial institutions in Indonesia, both public and private, have been able to extend sustainable financial services deep into the countryside, reaching many of the poor. The second, closely related, difference concerns the role and status of NGOs, which in other countries underpin much micro-finance activity. In Indonesia, prior to the fall of the New Order government in 1998, the Department of Home Affairs and line agencies operated a comprehensive system of local administration. This gave the central government considerable capacity to implement its policies and programs in the provinces. Coupled with the suspicions harbored by officials at all levels about NGOs, this meant that there was less scope in Indonesia for the spontaneous emergence of private NGO initiatives than in, say, the Philippines.

The position of NGOs changed substantially in 1998, when in the wake of the financial crisis the Habibie Government and the international community gave responsibility for relief and reconstruction under the “Social Safety Net” program to the Indonesian NGO community. NGOs continue to enjoy a more positive status although the Indonesian NGO movement is still a minor player in the provision of microfinance services.

Methods of delivering microfinance services found in Indonesia cover a wide range. Solidarity group-based lending approaches are commonly used by NGOs. However most micro-finance services are delivered on an individual basis, due to the dominance of the sector by regulated financial institutions, following normal banking practice. The poor also manage their own financial service provision using *arisan*, traditional ROSCAs which are very common in Indonesia. Cooperatives also provide financial services to their members, traders provide credit for the poor as an element in transactions, and the State operates pawnshops. Patron/client financing relationships are widespread and tenacious outside the formal sector.

6.1.1 Bank Indonesia: The Central Bank

Bank Indonesia (BI) has regulatory oversight of most of the major institutions engaged in microfinance and has participated actively in shaping them. In this it is unlike its counterparts in other countries with strong microfinance sectors, such as Bangladesh for example, where the central bank has been largely irrelevant to microfinance. Following the emergence of the New Order government, a new central bank law was enacted in 1968. This law gave Bank Indonesia a strong “developmental” mandate. However, in 1983 a process of financial sector deregulation

and liberalization commenced. A longer-term consequence of these reforms was the successful turnaround of the village-level financial operations of Bank Rakyat Indonesia (BRI), the state bank whose primary focus was the agricultural sector. The Pakto financial deregulation "package" in 1988 continued the liberalization process. Among other measures, it freed-up entry of new banks to the so-called "rural bank", or BPR, sector.

A new central banking law was enacted in 1999 by the Habibie government (Law No. 23 of 1999 on Bank Indonesia) at the urging of the IMF. Among other measures, BI's previous role as an "agent of development," responsible for channeling credit to priority sectors and groups, was abolished. These credit functions were to be transferred to other entities, the continuation of credit subsidies thus transferred was to be time-bound, and the costs of continuing credit subsidies were to be approved as part of the government budgetary process, rather than being funded by BI.

During the short Presidency of Abdurrahman Wahid political opposition to the new law began to swell. There was some support for reviving the role of BI as an "agent of development", together with calls for the restoration of liquidity financing by the Bank. Under IMF pressure, in 2001 the matter was referred by the new Government of President Megawati to an independent expert panel for advice. A 'Letter of Intent' transmitted by the Government to the IMF in August 2001 (IMF 2001) committed the GOI to maintaining a 'strong, independent and accountable central bank'.

6.1.2 The Banking System

The banking institutions regulated by BI are the commercial banks and the BPRs, or 'rural banks'. Among commercial banks we give particular attention to Bank Rakyat Indonesia and its Units and also consider the Regional Development Banks (BPDs). This account also considers the several categories of BPRs (Bank Perkreditan Rakyat), literally, people's credit banks. The BPRs are generally very much smaller than commercial banks and offer a more restricted range of services.

As is well known, the Indonesian commercial banking system was devastated by the financial crisis. With few exceptions, commercial banks were little involved in micro-financing prior to the crisis. They are even less inclined to become so under current circumstances. However, under the New Order government, a number of commercial banks were involved as channeling agencies in official credit schemes implemented by Bank Indonesia. To some extent the rhetoric of these official schemes included micro-finance but their performance in outreach to the poor did not match the rhetoric. A number of commercial banks have been involved in another government micro-finance program, the PHBK (Program linking Banks with Self-Help Groups).

Prior to the crisis some larger commercial banks had begun to explore the market potential of lower-end financial services, by means including the acquisition of small banks (BPRs) and setting up their own micro-banking divisions. The financial crisis put an end to this tentative expansion of financial services to low-income people. However, several small commercial banks

had developed niche activities in micro-finance which have continued unabated. They have strong microfinance customer bases, although their outreach is small.

Table 8: Indonesia: Regulated Financial Institutions and Microfinance, 2005

Institution	Loan Accounts: Numbers. (million)	Mean Balance Outstanding per Account Rp. Mn/$US)	Deposit Accounts: Numbers (million)	Mean Balance Per Account (Rp. Mn/$US)
BRI Units	2.60	Rp2.55m/$340	16.7	Rp0.65m/$85
BPRs	1.68	Rp1.94m/$260	4.6	Rp0.25m/$33
BKDs	0.70	Rp0.22m/$29	0.6	Rp0.05m/$7
LDKPs	1.30	Rp0.28m/$35	N/A	N/A

Notes: Data for BRI relate to the Kupedes (loan) and Simpedes (deposit) accounts. Term deposits are excluded. Various dates during 2005.
Sources: BI and BRI.

6.1.3 Bank Rakyat Indonesia (BRI)

At the other end of the scale, Bank Rakyat Indonesia (BRI) is one of the largest commercial banks. Here we are concerned specifically with BRI's Unit division which operates at a retail level in rural areas and has successfully encompassed elements of micro-finance. Units offer a restricted range of services tailored to the needs of small rural customers, including the Simpedes savings account and the Kupedes loan.

BRI's Unit (formerly Unit Desa) system, operating at village or sub-district level in rural areas, performed strongly throughout the crisis, with its Kupedes borrowers continuing to make over 97 percent of the installments that fell due in the period from mid-2003 to mid-2005. Savings mobilized through the Units grew dramatically over this period, doubling from Rp 8.3 trillion at the end of October 2003 to Rp.17.7 trillion at the end of June 2005.

The BRI Unit Division's performance in the face of the crisis put the seal on its reputation as one of the most efficient rural financial institutions in the developing world. Its strong repayment performance occurred at a time when the commercial banking system as a whole had non-performing loans estimated at 60 per cent of portfolio. BRI's deposit-taking operations, serving small and micro clients through the unit network, provided the lifeblood of liquidity for the bank as a whole throughout the crisis. This helped to prop up BRI in the face of heavy losses incurred by its corporate lending division.

In mid-2005, some 3,600 BRI Units had about 2.6 million Kupedes loans outstanding (table 8), with an unpaid balance of Rp6.7 trillion ($0.89 billion)[18]. The average outstanding loan balance

[18] A rate of Rp 7,500 is used for currency conversions. In a situation of extreme exchange rate instability such as in Indonesia since mid-1997, it is often misleading to convert to other currencies when discussing changes in rupiah values.

was Rp2.55 million ($340) and the 12 month loss rate on the loan portfolio was at the extremely low level of 1.37 per cent. Studies of the size distribution of loans and the characteristics of borrowers indicate that at the lower end of the lending range the BRI Units do indeed reach the ranks of the poor. However, the outreach of the BRI units to low-income and poor people appears quite variable from place to place. Moreover, Kupedes loans are secured by collateral, most commonly some certification of land ownership, and are made in respect of established economic enterprises, not start-ups. These requirements constrain the capacity of Units to lend to the very poor, although less stringent requirements for loans belowRp1 million ($130) are being trialed.

On the other side of the balance sheet, the Units had 24.9 million savings accounts. These included 16.7 million Simpedes savings accounts (see Table 8) with a mean balance of around Rp650,000 ($85). Again this suggests that many depositors are likely to be poor. Clearly lack of liquidity is not a constraint on the lending of the BRI Units. With a loss rate close to 1 per cent the Units could be considered too conservative in lending.

6.1.4 Regional Development Banks (BPDs)

Another category of Indonesian commercial bank is of particular significance to microfinance. They are the BPDs (Regional Development Banks), one in each province, owned by the respective provincial governments. While they have a mandate to act as bankers to their governments, they also perform some functions analogous to those of so-called “Second Tier Institutions” operating in micro-finance in some other Asian countries (For example, PCFC in the Philippines). Some BPDs (7 out of 26) have responsibility for supervision of certain small formal financial institutions operating within the provinces. Their regulatory and supervisory responsibilities appear likely to increase as governmental devolution takes place in Indonesia.

6.1.5 The BPRs (Rural Banks or BPR Non-BKD)

The term “BPR” (people’s credit bank, but often translated simply as rural bank) is used in the Banking Act of 1992 and elsewhere to describe two categories of small regulated financial institution. The first is the “BPR non-BKD”, most commonly called simply “BPR”. There were around 2,400 of these small banks in mid-2005. Recently a number of BPRs practising banking under Islamic (Syariah) principles have emerged.

The second category is called, formally, BPR-BKD, or simply, “BKD’ (Village Credit Body). There were 5345 BKDs in mid-2005. They date back to the late nineteenth century and were formed under Dutch rule on Java and Madura islands as pioneer micro-credit institutions. For simplicity, in this paper the two categories of institutions will be called simply BPRs and BKDs. The BKDs are very much smaller institutions than the BPRs. Both are subject to the Banking Act, and are in principle regulated and supervised by Bank Indonesia.

Under the 1992 Banking Act, the BPRs may accept time and savings deposits, and provide credit. Most are limited liability companies in private ownership, operated for profit. Some are in chains associated with commercial banks or NGOs. Some are registered as co-operatives, others are organized on Islamic principles (BPR Syariah). In mid-2000, BPRs had 1.677 million accounts (table 8) with outstanding loans of Rp3.256 trillion ($430 million) and a mean outstanding balance of around Rp1.94 million ($260) per account. The comparable figure for the BRI *Kupedes*, as noted above, was $340. There were almost 4.6 million demand deposit accounts, totalling some $230 million, with a mean balance of around Rp250,000 or $33 (compared with the BRI *Simpedes* average of $85) as well as fixed deposits totalling Rp1.675 trillion ($220 million). Loan-to-deposit ratios were typically around 80 percent, and the average BPR had assets of perhaps Rp1,800 million ($240,000). The mean loan and deposit balances of the BPRs suggest they are, in general, serving a lower income stratum of the population than the BRI Units.

In May 2004, BPRs accounted for 0.65 percent of credit outstanding in the banking system and their deposits were some 0.25 percent of all deposits. While this is almost trivial if the chosen numeraire is a financial one, the number of clients who benefit from access to BPRs (almost 1.7 million borrowers) is far from trivial. Typical loans offered by a BPR are short-term micro-loans for petty traders ranging from Rp100,000 to Rp3 million, with 3-6 month maturities, daily installments, and flat rates of interest in the range 2-4 per cent per month. The BPR system withstood the crisis, in general, much better than the commercial banks. BI strengthened prudential supervision in 1999 and liquidated 72 BPRs, while the overall level of non-performing loans rose to 37 percent[19]. Bank Indonesia and GTZ have begun a project (ProFI or Promotion of Small Financial Institutions) to address the weaknesses of the BPR system.

6.1.6 The BKDs (Village Credit Bodies, or BPR BKD)

The BKDs commenced operations more than a century ago and their status as banking institutions was affirmed by legislation in the colonial parliament in 1929. They were never subject to Bank Indonesia interest rate restrictions, which enabled them to set interest rates at sustainable levels well before the financial sector reforms of the 1980s. The 1992 Banking Act brought them under the supervisory jurisdiction of BI. They are supervised by BRI on behalf of BI. Some 5,400 of these small locally-based institutions served more than 700,000 borrowers in mid-2005. They are found primarily in the provinces of East and Central Java. As mentioned they do not offer the levels of service of the BPRs, and are normally open only one day a week, in association with local market days. In mid-2005, BKDs had loans outstanding of Rp152 billion ($20 million) (Table 8) at an average loan size of Rp217,000 ($29). The BKDs focus almost exclusively on credit provision, although a portion of each loan is held in a mandatory deposit. These mandatory balances totalled Rp32 billion in mid-2005, with more than 600,000 accounts and an average balance of around Rp50,000 or $7. These savings and loans figures

[19] By comparison, at the height of the crisis the non-performing loans of the commercial banking sector were calculated at some 60 per cent. Data for the BPR sector in mid-2004, based on CAMEL ratings, showed 42.5 per cent of BPRs as "sound", with 14.7 per cent "fairly sound", and 28.1 per cent "unsound".

suggest genuine micro-finance. Most BKD loans have a 12 week term with weekly instalments and an effective annual interest rate of 43 per cent. Management of each BKD is in the hands of a committee drawn from the village government. Loans are approved primarily on the basis of character and bank-ability. An itinerant bookkeeper employed by the district government and paid for by the BKDs serves 5 or 6 BKDs, each of which opens on a rota determined by village market days. All record-keeping is manual.

6.1.7 Non-Bank Financial Institutions

The NBFIs are a heterogeneous group, having in common (besides their activity in micro-finance) that they are not subject to BI regulation. For the purposes of micro-finance in Indonesia, they include small community-based institutions (LDKPs), pawnshops and the savings and credit cooperatives.

6.1.8 The LDKPs: Community-based Non-Bank Financial Institutions

The acronym "LDKP" is applied generically to a range of small savings and credit institutions which exist, with variations, in a number of provinces. A total of 2,272 LDKPs (table 8) were operating in mid-2005 serving more than 1.3 million borrowers with loans outstanding of some Rp360 billion ($48 million), with a mean balance outstanding of Rp275,000 ($35). The level of savings mobilised by the LDKP (Rp334 billion) was almost as great as the loans outstanding. As with the BKDs, this also suggests genuine micro-finance. A mean loan size (balance outstanding) of $55 for LDKPs puts them on roughly the same social level as the BKDs ($43) and on a very much lower level than the BPRs ($390) and the BRI Units ($510).

The lending procedures of one type of institution within the LDKP category, the BKKs of Central Java, give a sense of the nature of these small village-based institutions:

> *BKKs apply the now typical instruments of micro-credit: loans are unsecured and character-based, relied on references from local officials rather than based on feasibility studies … Initial loans are small and gradually increased, based on repayment performance. This mechanism functions as the primary repayment incentive. Loans are paid in equal installments, carrying maturities from 22 days to 12 months, according to six different repayment plans with monthly effective interest rates ranging from 2.2 per cent to 10.8 per cent. Savings are mandatory for every loan and are treated as cash collateral, becoming accessible only after full loan repayment.*

- (BI and GTZ 1999)

6.1.9 Savings and Credit Co-operatives

Co-operatives were a primary instrument of state policy under Suharto and independent initiatives were discouraged. Essentially the only cooperatives in rural areas were those within

the official KUD (Village Cooperative Unit) system. A new cooperative law in 1992 attempted to entrench the official cooperatives in certain areas of the economy. However since 1998, independent entities are now free to obtain licenses under the Act of 1992 to set up KSP (Savings and Credit Cooperatives). Some NGOs have taken advantage of the new situation to set up financial services cooperatives. Islamic self-help savings and loan groups (the BMT) are in many cases adopting the cooperative legal form, while a long-running government microfinance program (P4K) is working towards having its self-help groups adopt cooperative status. There is also a proliferation of unregistered cooperatives, and some moneylenders have adopted these (referred to as Kosipa) as a front for their high-cost lending. Many USPs which originated within the KUD movement continue actively, although less tightly linked into the official system than before.

Some 36,000 cooperative savings and loan entities were registered in Indonesia in October 2000. These comprised around 1,200 KSPs and some 5,200 USPs (the latter rural, and associated with the KUD cooperative system). In addition there were some 29,600 urban USPs, mostly associated with workplace arrangements. The KSPs had perhaps 0.7 million members and the rural and urban USPs around 3 million and 7 million, respectively. A Bank Indonesia/GTZ assessment of the credit union activities of the USP units of the KUD is that:

> *[they] have so far played a minor role as financial intermediaries due to repressive regulation and excessive government interference under the New Order regime of former President Suharto. However, the more than 5,335 government-sponsored KUDS are established throughout the country and would in fact possess a tremendous microfinance potential if properly stimulated and regulated.*

6.1.10 Informal Financial Institutions

NGOs conducting microfinance require no permission to extend credit, and there are no reporting requirements or supervisory arrangements for such activities. However, they are forbidden to mobilize the savings of members unless these are deposited directly in a regulated financial institution. In practice, some savings mobilisation appears to be tolerated as long as the amount is small. Some larger NGOs have set up their own BPRs to overcome the problem. Also, the new freedom to set up savings and loan cooperatives under the Act of 1992 offers another solution to this problem. However, for NGOs unable to take either of these paths, the inability to mobilize even compulsory savings in conjunction with lending is a constraint on their activities. NGOs have been involved in mass poverty alleviation programs of the GOI which involve elements of microfinance, especially the IDT (or 'backward villages' program, of 1993-1997). Their function in such schemes has been to act as social intermediaries, preparing "self-help groups" of the poor to participate. Relatively few NGOs in Indonesia are specialist microfinance providers. Most have microfinance as only one among a range of development activities. By contrast, Grameen replications have not been particularly successful in Indonesia and the outreach of this category of NGO is insignificant.

Self-help groups (SHGs) are completely informal organisations. Hundreds of thousands of informal SHGs with savings and credit activities exist in Indonesia. Many are spontaneous groupings, based on traditional forms of association, such as the *arisan*. This is the Indonesian version of the ROSCA. Many other SHGs have been founded by government and community organisations in connection with government programs, or have been created by NGOs, and some are organised on Syariah principles.

An unknown number of SHGs continue in operation on the basis of revolving funds which they have been able to preserve from one or another of the mass programs operated by government from time to time (described below). As many as 400,000 groups were formed during the 1990s in connection with one program or another, involving perhaps 10 million individual members and touching the lives of perhaps another 40 million family members. This is enormous outreach, mostly to the poor and very poor, but financial sustainability has been elusive.

6.1.11 The Role of Government

Since the advent of the new Order, successive governments, acting through the central bank and a number of line departments, have supported activities now categorised as micro-finance. Initiatives have been dedicated either to financial sector development in some broader sense, or to nurturing particular microfinance projects. There has often been significant donor involvement in these activities and the overall record, as exemplified by the performance of BRI, has been good. Initiatives styled specifically as ‘micro-credit’ or ‘micro-finance’ became more important over time during the Suharto period, as the overall incidence of poverty fell and the need was felt for a more targeted approach to eliminating the residual. To some extent this reflected a realization by the New Order government that, despite the successes of BRI units and small bank and non-bank financial institutions in extending sustainable financial services to lower strata of the population, there remained a core group of the poor untouched by this progress.

6.1.12 Mass Poverty Alleviation Programs

By contrast with the government’s achievements in financial sector development for the benefit of lower-income and rural people, there was a parallel development of mass credit schemes, in which neither institutional sustainability nor financial sector development have been objectives. Indeed, these have often operated at odds with the sustainable programs already described. These mass schemes reflected political concern with the problem of the hardcore poor. The first was the IDT (Presidential instruction relating to backward villages) which commenced in 1993. A second, the UEDSP (village economic activities with savings and loans), commenced in 1995, also with the benefit of presidential funding. A third campaign, the Prosperous Family Program, was introduced as an emergency measure in 1996. Donors have avoided entanglement in unsustainable mass schemes of the GOI, although they did support microfinance in the context of “social safety net” programs as a response to the crisis.

Some sense of the character of these mass government programs may be gained by considering the most meteoric scheme of this genre, the "Prosperous Family Program'. In 1996 as an emergency response to political concerns about income inequality, President Suharto launched this program using the National Family Planning Coordinating Board (BKKBN) as the implementing agency. Some 9.8 million Indonesian families received highly subsidized funding under this program in just 12 months. The program was financed by a levy of 2 percent on the incomes of corporations and high income individuals, channeled through a Suharto family foundation. It became one of the "social safety net" programs after the commencement of the crisis in 1997. Cumulative disbursements by the various micro-credit programs implemented by the Family Planning Board rose from Rp317 billion in December 1997 to Rp768 billion in December 2004 and Rp900 billion in March 2005. This last figure is equivalent to approximately $100 million at an exchange rate of Rp9000. The Prosperous Family and other programs in this category, such as the UEDSP, were retrogresive in their influence on financial sector development in Indonesia. They often acted to undercut legitimate microfinance institutions attempting to achieve sustainability with realistic interest rates and they were a negative influence on the rural credit culture.

6.2 Philippines

Leading Philippine NGOs are concerned to improve this situation. Micro-finance NGOs have been active in dialogue with the National Credit Council (discussed below) and in self-regulation. The Micro-finance Coalition for Standards (now the Micro-finance council), set up in 1996 with USAID assistance, is an organization of MFIs and other micro-finance stakeholders (including the central bank) which documents best practice and sets benchmark standards for MFI performance, as well as conducting training activities.

Commercial banks have had limited engagement with micro-finance in the Philippines; only government-owned financial institutions have had any substantial involvement. The Development Bank of the Philippines, the LandBank and the People's Credit and Finance Corporation (PCFC) have provided wholesale loans to MFIs for on-lending to micro-finance clients. In this way they have financed rural banks, cooperatives and NGOs to serve as conduits for credit. However this involvement has often been on unsustainable terms, with subsidized credit delivered at government direction.

Private commercial banks, on the other hand, have been extremely tentative in their approach to micro-finance. A study of *The Role of Commercial Banks in Micro-finance* (Goodwin-Groen 1998) discusses the quite limited record of commercial bank micro-financing in Asia and the Pacific. While there is a long tradition of government subsidized loans channeled through banking systems, micro-finance conducted as a profitable business is comparatively rare. Goodwin-Groen identified BRI and another small private commercial bank in Indonesia, together with one small private commercial bank in each of Sri Lanka and India, as comprising the four commercial banks in the Asia-Pacific region which treat micro-finance as a profitable core business.

In the Philippines, Ms Goodwin identified some cases where private commercial banks have made lines of credit available to particular MFIs. However, in one case this occurred at a sub-market rate of interest and in another the bank concerned channeled the money through its charitable foundation to allow for a tax write-off should the loans fail. Good performance by certain NGOs had encouraged the bank to convert this lending to a fully commercial basis, but the crisis in 1997 cut short this experiment. At that time a single NGO, TSPI Development Corporation, had eight loans from three leading commercial banks and its financial performance was exemplary. Despite this, interviews suggested that personal relationships between board members of TSPI and senior bank executives were the primary motivation for these arrangements (Goodwin-Groen 1998, 27).

The experience of this and several other well-performing NGOs in the Philippines suggests that there are barriers of culture and perception in the banking community which must crumble before traditional bankers will consider funding even the best-performed of MFIs. This has led some MFI leaders to conclude that the only feasible path to expansion and mobilization of the funding necessary to meet the demand for micro-credit is to transform their organizations into small regulated banks. Several MFIs have followed the 'transformation' strategy so far, including CARD Bank and Opportunity Microfinance Bank.

6.3 Cambodia

Cambodia has adopted what might be called a 'transformation' model of micro-finance service provision. This is one where microfinance services originate in the voluntary sector and government's role is seen as providing an appropriate policy and regulatory environment and financial infrastructure (specifically, a second-tier institution, the RDB, to act as a wholesaler for and nurturer of MFIs). Micro-finance institutions are then expected to follow a linear path on which they transform themselves from informal revolving funds to NGOs to licensed MFIs and then to specialist micro-finance banks. Only ACLEDA has made the transition to bank status, and at present only a couple of institutions are licensed MFIs. A number of other NGOs are in process of achieving licenced MFI status, including CCB, Prasac Credit Association and ANS. The ability to incorporate a small specialist bank such as ACLEDA Bank under Cambodian law is an essential part of the supportive regulatory environment. Cambodia is one of a relatively small number of countries in the Asian region (Indonesia and the Philippines being others) where this is possible.

CHAPTER 7: Pakistan --- Country Context

7.1 The Country Profile

Pakistan is a country with a population of 146 million & an average growth rate of 2.8 % per annum. Women form 48% of the total population and 52 % are men.

According to the estimates 97 million people live in rural areas whereas 49 million in the urban areas. The total labor force is estimated at 41.5 million, of which 28.1 million (67.7%) is in rural areas and 13.4 million (32.3%) in urban areas. Agriculture is the mainstay of economy with sustaining 48.4 % of the employed labor force. The other main sectoral employers are services 15.02 %, trade 13.87 and manufacturing 11.25 %. Per capita income is estimated at US$ 480.

Exports in 2005-06 were estimated at US$ 8925 million or 15.7% of GDP. Exports mainly comprise of primary commodities 11%, semi-manufactures 14% and manufactured goods 75%. The main export items are cotton, leather, rice, synthetic textiles, sports goods etc.

Imports in 2005-06 were US$ 10,171 million reflecting a trade gape of US$ 1,246 million. Major imports include petroleum, machinery, edible oil, chemical and fertilizers.

Persistent fiscal deficit is a major economic issue with fiscal deficit in 2006-07 estimated at 5.7 % of GDP. This led to unsustainable growth in public debt, and the current level of domestic debt rests at US$ 27 billion (PKR 1.6 trillion) and foreign debt at US$ 36 billion. The unsustainable levels of public debt and resulting debt servicing liabilities together with regional security needs leave limited fiscal space for servicing social development in Pakistan.

7.2 The Present Policy Context

After the relatively difficult phase for Pakistan's economy during the 90's the far reaching structural reforms initiated and accelerated in particular over the past six years have now started to pay off and Pakistan has witnessed a modest rebound in growth, its vulnerability to external shocks has reduced and its key economic fundamentals have improved. The current growth rates however need to be strengthened to arrest the current growth in poverty levels. Macro-stabilization, governance reforms and re-profiling of external debt stock have created prospects for robust growth in future.

The Government has indicated its willingness to speed up the pace of structural reforms to meet the major challenges of:

i. reducing poverty,

ii. improving governance and administration,

iii. improving the fiscal and balance of payments positions,

iv. restoring investor confidence,

v. achieving higher growth on a sustainable basis, and

vi. improving social indicators.

The reform agenda includes structural changes in major economic sectors, fiscal reforms, financial sector reforms, provincial finance reforms, judicial reforms, and private sector development.

7.3 The Microfinance Industry in the Country

7.3.1 Background

The number of poor people in Pakistan nearly doubled during the 1990s and as mentioned earlier this incidence of poverty will continue to increase if economic performance is not accelerated, directed poverty reduction interventions are not enhanced, and delivery of pro-poor services not improved.

Therefore, the Government has made poverty reduction its prime objective and identified micro-finance (MF) as a critical element of its poverty reduction strategy.

7.3.2 Sector Description and Recent Performance

i. Overview

A conservative estimate suggests that the micro-finance sector in Pakistan has grown substantially over the last 6 years on the back of huge social investments made by donors and investors. This growth has been on all fronts; increase in retail micro-finance players, entry of green field MFBs, diversification of products (credit as well as non-credit), growth in active borrowers, and development of branch infrastructure as delivery conduits for future growth.

It is important to highlight however, that in micro-finance, as an industry, paybacks are generally deferred. Thus, this huge investment has generated momentum and created a conducive policy environment as well as the enabling infrastructure that has brought focus and attracted private sector investment to the sector, which has enabled the industry to operate at a low cost. However, all agree that maintaining future growth and sustainability requires rationalizing existing price structures in order to raise the level of returns to make the sector attractive for private risk capital.

With a legislative (Micro-finance Institutions Ordinance 2001) and regulatory (Prudential Regulations) framework in place, micro-finance in Pakistan is a sector in its own right, rather than just a tool for poverty alleviation. The sector in Pakistan represents a diverse set of institutions including 20-25 non-governmental organizations (NGOs), 06 microfinance banks (MFBs), 4-5 commercial financial institutions (CFIs), and 04-06 rural support programmes (RSPs).

Pakistan's micro-finance sector is in its growth curve. One manifestation of this development is the micro-finance providers' recent move to start diversifying their product base. This includes the addition of a menu of credit products in addition to loans for productive purposes (e.g., consumption loans, personal loans, and freedom' loans), voluntary saving products (both demand and time deposits), insurance products (largely credit life but some have moved towards health insurance) and money transfer services.

Credit technology has also begun to change in response to market demand and an expansion in the market segments served can be observed. The sector has started shifting from predominantly group-based lending towards individual and smaller group lending as it moves from rural to urban finance. Innovative use of technology has started to change service delivery: recently a micro-finance bank (MFB) has set up biometric ATM machines in its peri-urban branches, and some MFIs have started providing mobile banking services.

The SBP has recently issued guidelines for commercial banks to enter micro-finance. This, with most of the sector highly capitalized, could help MFPs leverage growth as well as help diversify funding portfolios and reduce MFPs' reliance on only one or two sources of funding currently available to them.

The micro-finance sector in Pakistan is also supported by avibrant meso-sector that services micro-finance providers. A corporate rating firm recently rated two MFBs and an NGO MFI. The rating firm is accredited by CGAP to access its rating fund and plans to enter into partnership with a specialized rating agency for micro-finance to build its knowledge of the sector. The 'Big 4' audit firms have a much better understanding of the microfinance business and its intricacies-evidence is the CGAP financial transparency award received by The First MicroFinanceBank Ltd. (FMFB) for the last hvo years.

Recently, the MF sector in Pakistan has also seen the arrival of two high quality technical assistance providers: ShoreBank International (SBI) and Grameen Foundation, USA. Both specialize in the micro-finance business.

There is awareness that a credit bureau is necessary for the credit market to flourish and the PMN is working with its members and strategic partners to improve the information symmetry and transparency environment of the micro-finance sector.

ii. Demand for Micro-finance

The average size of loan taken by households as microfinance is about US$ 295 (PKR l6, 540) at an interest rate of 18-20 % per annum. Considering these, the estimated potential demand for micro-credit is about US$ 2 billion per annum based on the number of poor households (6.6 million) or about US$ 3 billion based on half the adult poor population (10 million).

Similarly, the estimates for deposit possibilities range from US$ 225 million to US$ 350 million per annum. Based on population distribution, two thirds of this demand is considered to emanate from the rural poor. The NGO-MFIs experience reflects that depositors out-number borrowers by 2-4 times. The poor emphasize the safety and accessibility of savings facilities as many lost their savings in the past due to failures of cooperatives and finance companies.

Most of the demand for MF in rural areas is for agriculture production (50 %), livestock (25 %), and the balance for other household-based income-generating activities (IGAs). In urban areas, most of the demand is for small business and self-employed ventures. Households are extended families and the pool of labor within a family unit creates potential for a diverse range of income-earning opportunities. Demand attributes include (i) small and frequent loans; (ii) flexible terms compatible with the nature of activity; (iii) preference of women, due to restricted mobility, (iv) simple and speedy delivery procedures placed within the community; (v) service proximity, and (vi) significant and sustained social preparation to familiarize the poor with managing IGAs. Interest rate sensitivity is high in rural areas due to the general low level of economic activity. The apprehension of becoming indebted, particularly among women, due to failed enterprises (e.g., death of livestock, failure of business, crop failures) is widespread.

7.3.3 Financial Sector Reforms and Micro-finance

The Government of Pakistan considers an efficient financial system necessary for macro-economic stability. Therefore, the banking system is being strengthened by (i) fundamentally changing norms for governance; (ii) restructuring to conserve assets, downsizing staff and branches, and reducing bad debts; (iii) implementing debt recovery measures; (iv) strengthening the prudential and supervisory framework; (v) improving legal and judicial enforcement of banking courts; and (vi) privatizing all but one state-owned Commercial Bank (CB's). State Bank of Pakistan (SBP), the country's central bank, has been empowered in all matters concerning monetary and banking policies, as well as for governance and management of the financial institutions. These reforms have been extended to the Development Financial Institutions (DFIs) that are presently in restructuring and re-capitalization phase.

Interest rates have been deregulated and loans up to US$ 1,785 (PKR 100,000) may not be collateralized. In general, the reforms constitute a positive financial environment. Enforcing SBP's authority in banking supervision and greater transparency requirements has significantly strengthened good governance.

The banking reforms have now been extended to cover the specific needs of MF, which include:

i. Conducive policy to encourage emergence of MFIs as depository institutions;

ii. Corresponding creation of a supervisory and regulatory system for orderly sector development;

iii. Flexibility to adopt practices and procedures for banking with the poor, such as mobile banking and group collateral;

iv. Free limit to accumulate a non-collateralized loan portfolio; and

v. Insulation from political interference.

The MF sector can now seamlessly integrate with the broader financial sector of the country.

i. Microfinance Sector Development

In the 1960s and 1970s, subsidized micro-credit was provided in rural areas, but failed to reach the poor due to an unsustainable system, which was prone to abuse and diversion of funds to higher income groups. In the 1980s, the Aga Khan Rural Support Program (AKRSP) was established in the northern region to build community-based organizations and infrastructure, and assist in resource mobilization through credit and savings. The success of the AKRSP led to the creation of Pakistan's other RSPs, which formed the primary approach to microfinance during the 1980s and part of the 1990s. Those RSPs made a major contribution to the micro-finance sector by accessing lines of credit from commercial banks to provide micro-credit to low-income people living in rural areas. Similarly, the Orangi Pilot Project (OPP) developed an individual lending methodology adapted to urban slums, by targeting entrepreneurs in Karachi region. In the 1990s, learning from international best practices, NGOs specialized in microfinance started their operations, such as Kashf Foundation, Taraqee and Damen. The outreach of microfinance institutions and other rural organizations providing financial services has been limited due to a narrow institutional base, slow progress on sustainability and efficiency benchmarks.

Since 2000, the micro-finance landscape in Pakistan has changed considerably. This change can be credited primarily to the government's growing interest in the microfinance sector. It was this interest that resulted in:

a. The creation of the apex funding body, the Pakistan Poverty Alleviation Fund (PPAF)

b. The formulation of the MFIs ordinance 2001, regulating the creation of commercial micro-finance banks, such as The First MicroFinanceBank (created by the AKRSP) and the Khushhali Bank, a retail microfinance bank issued from a public-private partnership.

In the last two years, Pakistan micro-finance providers have posted faster growth in terms of outreach, with 'transformed' or 'created' dedicated micro-finance organizations starting to realize their full potential through a conducive regulatory environment. Other organizations are also benefiting from the dissemination of best practices and the availability of funds to finance their expansion.

ii. Regulations and government initiatives

The MFIs Ordinance 2001 was promulgated by the Government of Pakistan to support the development of the micro-finance sector by introducing the concept of micro-finance banks. Under this ordinance, micro-finance banks created with the necessary amount of capital, can offer micro-finance services, including savings deposits, to the general public. In addition, the State Bank of Pakistan (SBP) introduced additional prudential regulations related to micro-finance operations. This ordinance and the relevant prudential regulations of the BSP, regulate The First MicroFinanceBank and the Khushhali Bank.

The government, with the lending support of the Asian Development Bank, also supported the creation of the Khushhali Bank. This was the first retail microfinance bank in Pakistan, owned by a group of private and public commercial banks. In addition to this project, ADB support has resulted in the establishment of several funds available to regulated micro-finance banks, such as the Social Development Fund, the Community Investment Fund, a Risk Mitigation Fund and a Deposit Protection Fund.

7.3.4 Practices and Innovations

i. Practices

The majority of micro-finance organizations operating in Pakistan, particularly RSPs, use community-based organizations as conduits for their financial services. This methodology produces the highest outreach. The largest micro-finance provider is the NRSP, with national coverage. However, RSPs find it difficult to view micro-finance activities as anything other than a supporting component of their larger, integrated program, resulting in difficulties to separate costs specific to micro-finance.

Other organizations use the solidarity group model, adapted from the Grameen Bank to the Pakistan context, the best example being Kashf Foundation. Organizations such as this are the fastest growing providers of micro-finance in Pakistan and post the best 'portfolio quality' ratios.

Finally, some organizations use a mix of individual lending and partnerships with community-based organizations. It seems that the organizations using this methodology are the most viable programs, if self-sufficiency ratios are compared.

ii. Innovations

The PPAF, a wholesale window for MFIs and the micro-finance banks (Khushhali Bank and First Micro-finance Bank) could be seen as innovative ventures breaking away from the traditional financing windows and vehicles in Pakistan. In addition, the State Bank of Pakistan has established a conducive legislative framework, which features the inclusion of micro-finance funds as wholesale facilities and protection mechanisms for borrowers. Some micro-finance providers have started to offer innovative products, such as skills training, emergency loans, and life insurance, while adopting innovative management practices in scaling up their operations or establishing partnerships between commercial bank and MFIs. Adaptations of the Grameen Bank model have been innovative and very successful, as demonstrated by the Kashf Foundation and UPAP.

The Performance Indicators report compiled by the Pakistan Micro-financing Network (PMN) provides a benchmarking tool to share best practices and standards in Pakistan, which also includes individual analysis of each member's performance.

The Swiss Agency for Development Cooperation (SDC) takes a sectoral approach to strengthening microfinance in Pakistan. The FSSP offers unique technical and financial assistance to the whole microfinance sector, with the objectives of: developing human and institutional capacity within all types of microfinance institutions; building the capacity of local expertise providers; supporting market oriented approaches and creating an enabling environment. In addition, SDC has provided support to the development of micro-leasing products and providers through support to Network Leasing, Orix Leasing and other leasing companies operating in Pakistan. The Leasing to Small and Micro Scale Enterprises Program (LMSE) project aims to increase earning and employment in the MSE sector in NWFP and Northern Areas through an improvement in access to leasing services on a sustainable basis.

7.4 Performance of MF Providers

Conservative estimates suggest a huge potential market for MFPs. With 10 million as the absolute minimum, the current outreach of 600,000 clearly indicates that Pakistan's micro-finance sector has a long way to go. In spite of exceptional growth rates over the last few years, albeit with a low starting base, the future of this sector depends upon robust, profitable, and viable organizations that can access diversified sources of capital, including commercial capital (debt, equity, and hybrid) and deposits. Achieving growth and profitability is possible given that Pakistan is globally competitive when we look at its cost structure and operational efficiency[20].

In the following sections we will look at the performance of MFPs with regard to scale, growth, financial structure, profitability, efficiency, productivity, and asset risk and utilization. For ease of analysis reporting organizations have been categorized into five peer groups:

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[20] Trends Report (2006) by SBI and PMN

i. **MFIs:** non-governmental organizations that are specialized microfinance institutions

ii. **MFBs:** microfinance banks licensed by the SBP

iii. **RSPs:** rural support programmes running microfinance operations as a part of their integrated rural development programmes

iv. **NGOs:** non-governmental organizations running microfinance operations as a part of their integrated development programmes

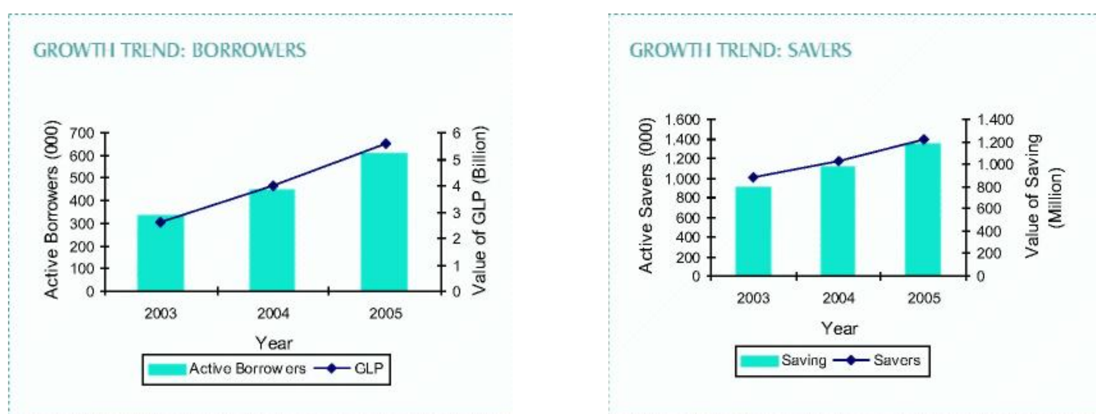
v. **CFIs:** commercial financial institutions involved in microfinance

7.4.1 Outreach and Growth

The most important indicators to look at in this section are growth in outreach as measured by the number of active borrowers; the extent to which growth, in terms of gross loan portfolio (GLP), is a factor of increase in clients, and the extent to which it is a factor of larger loan/deposit size; the proportion of total growth coming from sustainable institutions; and finally, the proportion of total outstanding loans going to female clients.

Figures 1A and 1 B indicate that over the past three years (2003-2005), the number of active borrowers increased by 85% while total outstanding loans grew by 115%. In comparison, the growth in the number of savers and the value of savings has been more gradual, at 38% and 49%, respectively. This growth is led by a large upfront investment from two multilateral donors - the Asian Development Bank (ADB) and the World Bank (WB).

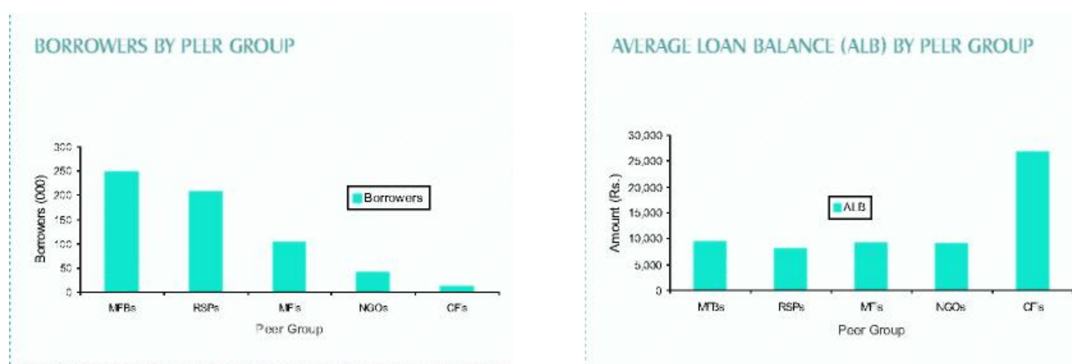
Figures 1A and 1B



MFBs as a peer group account for the largest share, in terms of total active borrowers, of Pakistan's microfinance market. MFBs are closely followed by the rural support programmes (RSPs), with MFIs coming in a distant third in terms of market share. Each of the three largest peer groups however, is dominated by a single player (Khushhali Bank accounts for 92%; NRSP

accounts for 59%, and Kashf Foundation for 73%, of the respective market share of the peer group to which they belong). These three players together cover 70% of the micro-finance market in terms of total active borrowers.

Figures 2A and 2B

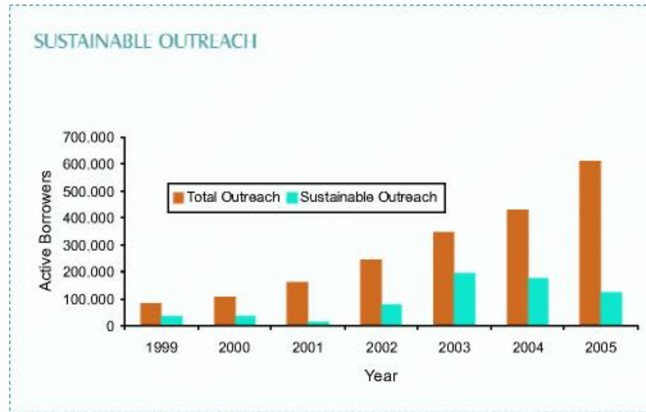


Figures 2A and 2B above also show that average loan sizes for all peer groups hover around Rs. 10,000, except in the case of CFIs, where it is as high as Rs. 27,000. However, the MFB peer group has an outlier - KB - whose sheer size has skewed the percentage for the entire group; if KB is removed from the MFB group, the average loan balance (ALB) would stand at Rs. 20,000. This indicates a move towards market segmentation among micro-finance players and a case of either larger loans, or enterprise lending by MFBs.

The data indicates that gender targeting is skewed in favor of male credit clients. At 44.6%, the micro-finance sector in Pakistan has the lowest global proportion of female borrowers (all MFIs reporting to the MBB: 63%; all financially self-sufficient MFIs reporting to the MBB: 62%; all MFIs in Asia reporting to the MBB: 85%). The low targeting of female clients could be one of the reasons that the microfinance sector has not been able to achieve scale as has happened in other parts of the world.

Figure 3 below illustrates the biggest challenge faced by the micro-finance sector in Pakistan. This brings forth not just the issue of the financial viability of the industry but also the issue of the sector's ability to provide access to financial services in perpetuity, without support from donors and the government.

Figure 3



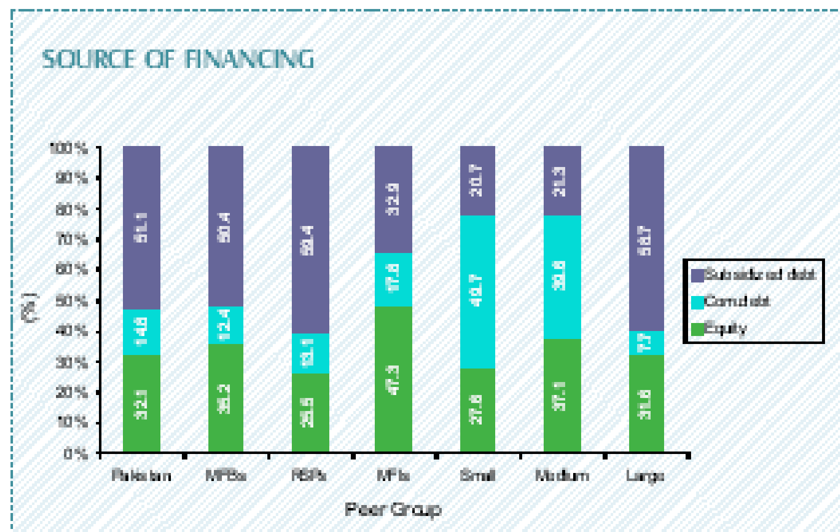
Although the graph clearly shows growth in outreach, the provision of micro-finance services is still heavily subsidy dependent.

7.4.2 Financial Structure

This section sheds light on the financial structure of MFPs in terms of sources used to finance assets and the degree of leverage, as indicated by the debt-to-equity ratio.

The three major sources of funds available to MFPs in Pakistan are equity, non-commercial liabilities at subsidized prices, and commercial liabilities at market price. Another source, largely untapped but available to MFBs, is public deposits. The sources of finance for microfinance players, are compared in Figure 4 below.

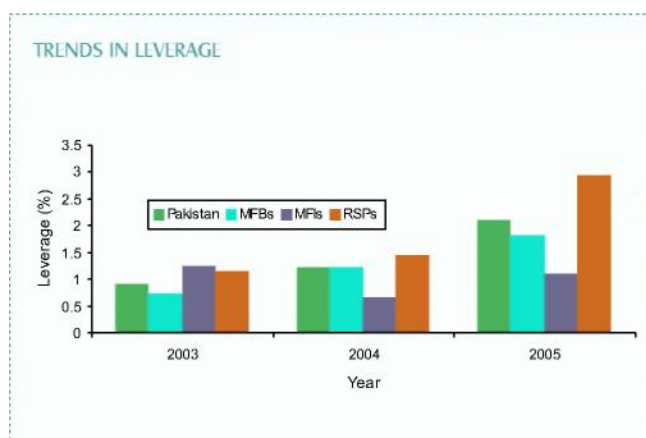
Figure 4



The substantial equity base of Pakistan's micro-finance sector (sector-wide equity-to-asset ratio of 32%) indicates that MFPs have the potential to attract debt finance and thus grow by leveraging their capital on the balance sheet. The fact that this potential or opportunity to attract commercial debt has not been used yet is evident from the fact that commercial debt makes up the smallest proportion in the capital structure of the largest MFPs combined. Two of the largest organizations (NRSP and Khushhali Bank) in terms of active borrowers, finance their portfolio largely by accessing either debt from the apex or from a multilateral, at less than market price.

If we map the trend of leverage over the last year, what we find is that the sector as a whole is using leverage to grow its portfolio. Within the sector the RSPs use the most leverage, followed by the MFBs. Within the peer groups, KB (2.1) has the highest debt among the MFBs, TRDP among the RSPs (10.4), and Asasah among the MFIs (negative equity).

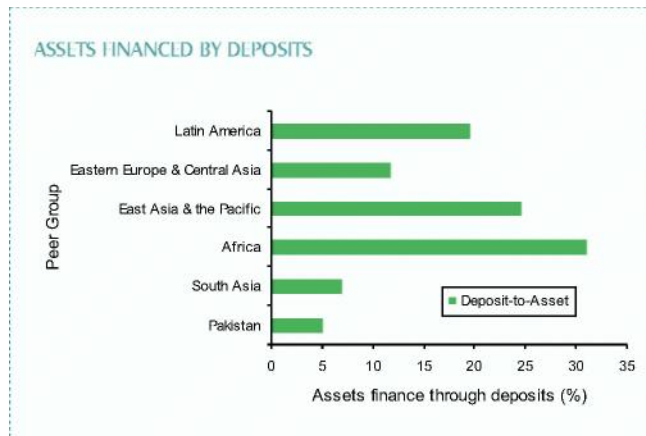
Figure 5



Another factor reflected in the low share of commercial liability as a source of funding is that public deposits as a source of funds remains significantly untapped. This is because the SBP only allows licensed banking institutions to intermediate deposits. As a result NGOs, RSPs and MFIs can only facilitate savings and deposit them with financial institutions. In the MFB peer group also, only FMFB has an aggressive policy to fund by raising deposits, whereas the largest MFB, Khushhali Bank, has made a strategic decision to grow quickly through a single product and build infrastructure before developing and offering deposit services.

Figure 6 compares Pakistan against regional benchmarks in terms of public deposits being used as a source of funding assets.

Figure 6



7.4.3 Financial Performance

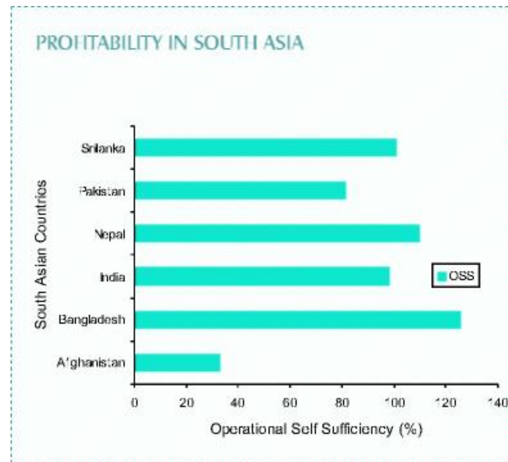
This section examines two key indicators of profitability: Adjusted Return on Assets (AROA) and Financial Self Sufficiency (FSS). In the absence of adjusted data, to see where it stands in its own region, Pakistan is compared with other South Asian countries using Operational Self Sufficiency (OSS) as the core indicator. A positive AROA and an FSS above 100% indicates the ability of an organization to generate profits to fund growth. Indicators below the two thresholds indicate that the organization is at a risk of de-capitalization. Factors contributing to profitability include portfolio yield, asset yield, operating cost, financial cost, and loan loss cost ratios.

Figure 7

At -7.2% AROA and 61% FSS, the micro-finance sector in Pakistan has one of the lowest profitability ratios globally. What we can see from Figure 7 is that all other regional peers show much better performance with regard to profitability; they either have a positive AROA, or are on the cusp of profitability.

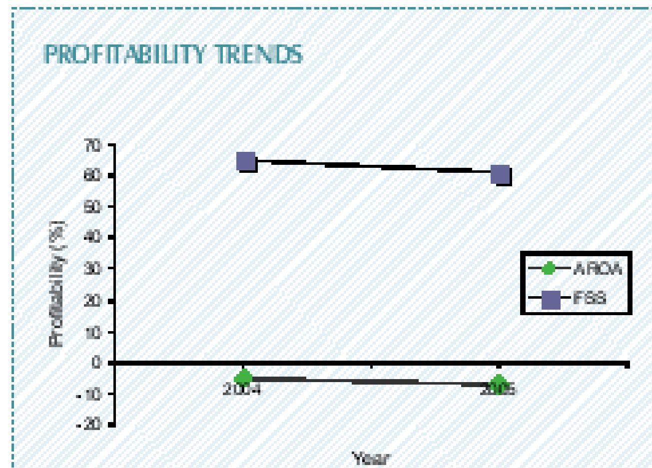
Barring Afghanistan, which is only in its third year of micro-finance, Pakistan has the lowest OSS in South Asia, as shown in Figure 8.

Figure 8



Despite having one of the lowest levels of profitability globally, over the last year the profitability in Pakistan has declined even further from an AROA of -5% to -7.2% and an FSS of 65% to 61%, as shown in Figure 9.

Figure 9

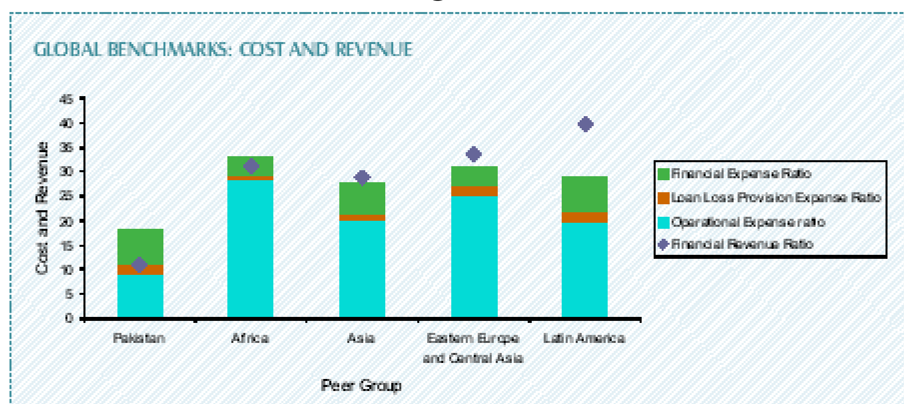


Some of the causes of this low profitability are:

i. Low Yields on Portfolio and Assets

Despite the fact that the costs are globally competitive, MFPs in Pakistan continue to charge prices that do not cover total costs (see Figure 10). In fact, in Pakistan, MFIs are only able to cover their operational costs and a portion of their loan losses.

Figure 10

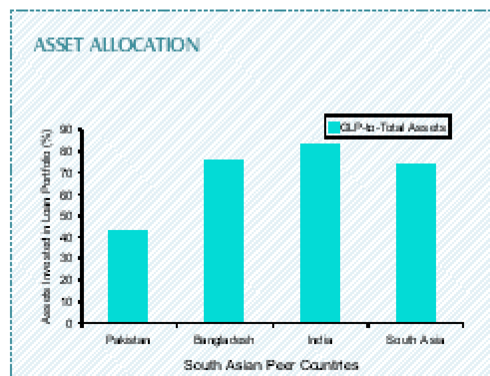


ii. Effective Utilization of Assets

Another area of concern is the ineffective rate at which the assets of the sector as a whole are translated into active micro-loans. A good benchmark to measure effective utilization of assets is the percentage of assets invested in loan portfolio. MFPs in Pakistan translate only 42.5% of their total assets into loan portfolio, which amounts to only half the rate at which other countries in the region do, as shown in Figure11.

Asset utilization has a significant impact on the overall profitability of the industry. The lower the investment in terms of loan portfolio, the greater the opportunity cost for the sector in terms of yield foregone. The rate at which assets are utilized as active loans is a factor of the institutional ability of the sector to disburse loans, and the concerned organizations' willingness to use their resources as active loans against their decision to earn income from idle investment. It is important for the sector to acknowledge that the core business of a MFP is to increase access to financial services for the un-banked. Therefore, utilization of assets in building loan portfolio will help MFPs in both improving their profitability, and increasing outreach of financial services to the un-banked.

Figure 11

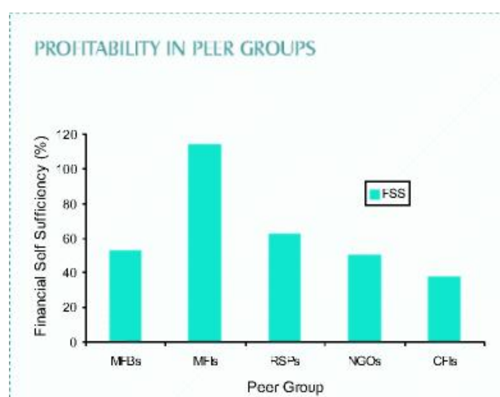


iii. Investment in Capacity Building and Infrastructure

MFPs have started growing and the increase in branches and staff has been much faster than the increase in borrowers or gross loan portfolio (GLP), which brings in revenue. Thus, there has been a massive upfront investment, with a gestation period required to translate this into revenues.

Within the peer groups the most profitable is the MFI group, which has a positive AROA and FSS. The RSPs and the MFBs follow as less un-profitable amongst the peer groups in that order. The MFI group is led by Kashf at 4.1% AROA and Orangi Pilot Project (OPP) at a 2.9% AROA. Within this group the dispersion from the average is also low, indicating that all, except one MFI, is either profitable or is on the cusp of profitability.

Figure 12



Primary factors for the profitability of MFIs are:

a. A GLP-to-total assets ratio (63.2%) that is almost 1.5 times the national average (42.5%)

b. A high portfolio yield (27.8%) which again is almost 1.55 times the national average (18%)

c. Higher operating efficiency (MFIs at 16.1%; national at 22.4%)

7.4.4 Efficiency and Productivity

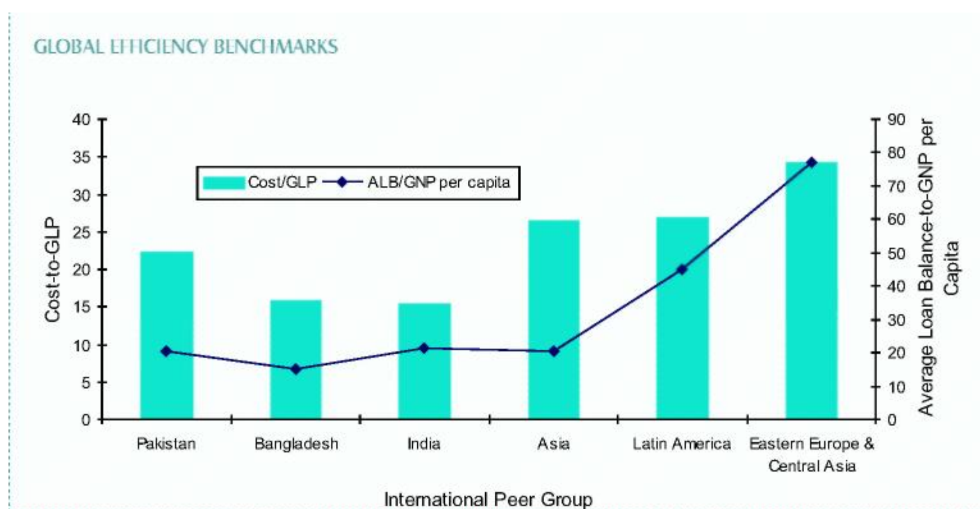
The analysis looks at how efficiently MFPs are performing and at their productivity. The important indicators to consider are: operating expense-to-GLP; operating expense-to-average borrowers[21], staff productivity, and personnel allocation.

As shown in Figure 13, at 20.2% operating cost-to-average GLP, the micro-finance sector in Pakistan is very efficient, both in the South Asia region and globally. This is so in spite of the two factors that keep efficiency low:

i. Low average loan balance-to-GNP per capita

ii. Inefficient allocation of resources: 42.5% GLP-to-total assets

Figure 13



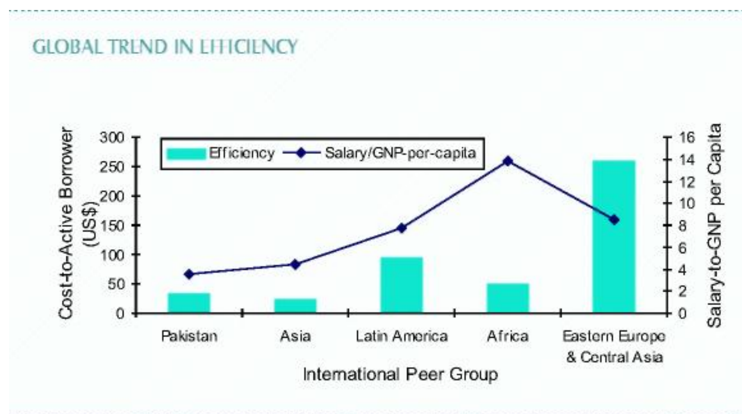
This however, indicates the fact that there is room for MFPs to become more profitable if they invest more of their assets in loan portfolio.

It is also important to note that even when the data is adjusted for loan size, MFPs in Pakistan prove to be efficient. This indicates that efficiency is not a factor of loan size but of decentralized

[21] For MFBs mobilizing and intermediating deposits, average clients is used.

decision-making and of distribution channels. Another reason is staff productivity and lower salaries as a percentage of CNP-per-capita, as shown in Figure 14.

Figure 14



Efficiency trends in Pakistan have remained flat over the last year, as shown in Table 9. This is expected to change as organizations begin to utilize their current investment in infrastructure and human resource development over the next years.

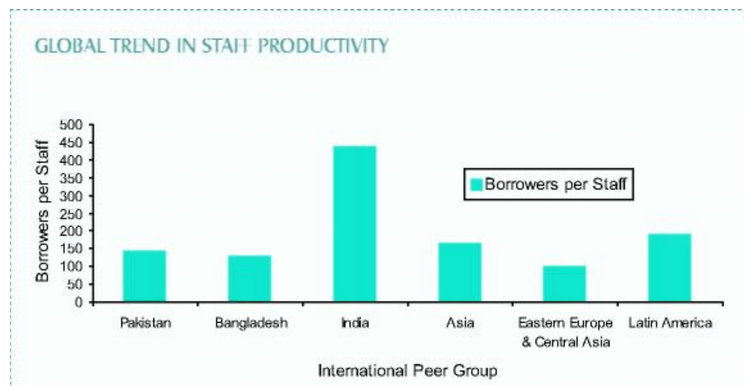
Table 9: Efficiency Trends

Indicator	2004	2005
Operating Expense-to-Average CLP	22.50%	22.40%
Operating Expense-to-Average Clients (PRS)	1,939/-	1,938/-

CFIs make up the most efficient peer group, followed by MFIs, RSPs, and NGOs and finally MFBs. This is on the back of higher investments in loan portfolio, since most MFPs are older than MFBs. This is also because the staff salaries paid by MFPs generally as a multiple of GNP-per capita, are lower than those paid by MFBs. Interestingly, when we look at efficiency in terms of scale, the most efficient peer group is the small MFPs largely because two of the organizations are CFIs and they have high loan sizes.

Another area to look into is the productivity of staff, shown in Figure 15 below, since this could be one of the drivers to attain operating efficiencies. At 147 borrowers per staff, Pakistan stands on the margins of global benchmarks, with India being an outlier.

Figure 15



Again, if we look attends in Pakistan we see productivity remaining flat (2005: 143; 2004: 153). One of the possible reasons for this could be that investments in infrastructure and personnel have increased tremendously over the last couple of years, as shown in Table 10, with expected deferred benefits. This is again expected to improve further with trained loan officers being optimally utilized and organizations moving towards urban and semi-urban areas.

Table 10: Growth in Infrastructure

Indicator	2004	2005	2005 Increase (%)
Number of personnel	157600%	294800%	42961.73
Number of branches	277	388	5701.06

7.4.5 Portfolio Quality and Liquidity

This section analyzes the credit risk MFPs are holding on the asset side of their balance sheets. The aged Portfolio at Risk (PAR) (>30 and > 90 days) is evaluated and the write-off ratios are also examined. By writing off portfolios organizations can improve their PAR, though that does make a dent in their bottom line, unless their risk has been adequately covered through provisioning.

At 3.2% and 2% PAR > 30 and 90 days, respectively, Pakistan's micro-finance sector has a globally competitive credit risk (see Figure 16). Although it is marginally higher than that of the country's international peers, it is still within the normal range of 3-5%. Also, this is at a discount from credit risks in India and Bangladesh.

Figure 16

Figure 17, which shows a comparison of the risk within different peer groups in Pakistan, reveals that the smaller organizations have higher risk, large ones have medium risk, and medium-size ones have the lowest risk. Again, in terms of institutional peers, the lowest risk is carried by MFIs and the highest risk by CFIs. Risk is concentrated in a few institutions (BOK, Khushhali Bank and Sungi Foundation) and also geographically in the North West Frontier Province (NWFP). There are number of factors that differentiate high credit risk players from low credit risk players:

i. Exponential growth with little investment in systems and staff capacity

ii. A 'zero tolerance' policy towards delinquency

iii. Clear focus on micro-finance as a commercial business[22] with focus on the poor or un-
iv. banked

Figure 17

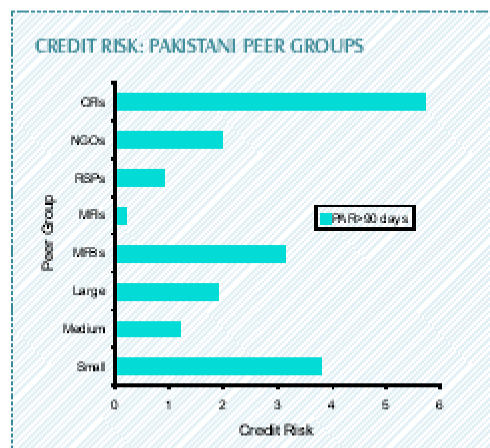
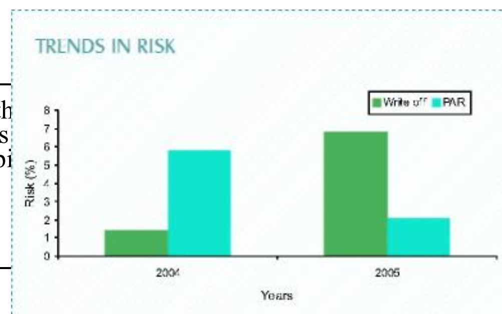


Figure 18



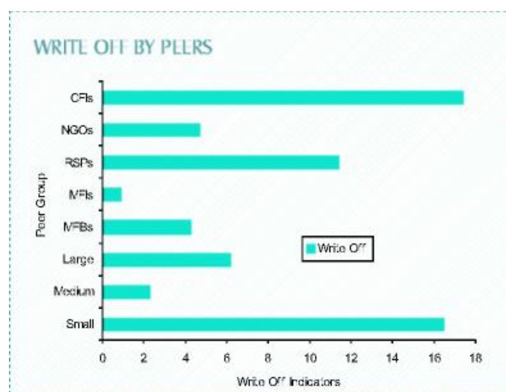
[22] Commercial business means th … gh quality financial products on a sustainable basis. This also means … and accessing diversified sources of both social and commercial capi…

As shown in Figure 18, the risk faced by microfinance providers has declined from 5.8% (>90 days) in 2004 to 2% in 2005.

The biggest reason for this decline is a very high write-off rate that was less than 1.5% in 2004 but reached 6.8% during 2005. This write-off has largely been done by the PMN analyst to match international standards, but the organizations continue to hold high levels of bad loans on their balance sheets. The PMN urges them to clean all loans that are above 360 days past due in their next financial statement.

Again the risk profile of the sector depicts higher concentration of risk with old loans than with new loans. This is because organizations have started investing on both systems and human resources.

Figure 19



Similarly, some organizations have begun following practices of sharing negative lists of clients in competitive areas, an indication that managers have understood the importance of monitoring and evaluating risk to remain competitive in the micro-finance industry.

As shown in Figure 19, the biggest write-off within different peer groups comes from CFIs followed by the RSPs and the smallest percentage from MFIs. Again the smaller organizations have the largest write-offs, whereas the medium ones have the smallest.

CHAPTER 8: Conclusion and Recommendations

It is evident from the above discussion that micro-finance can effectively used as a tool for poverty reduction. The question however remains whether all categories of poor can overcome poverty if they have access to credit, whether microfinance programs can serve the poorest on a

sustainable basis, whether credit alone is the answer to poverty reduction, whether viability of both borrowers and lenders can be simultaneously taken care of in such programs, whether microfinance organizations with different scales of operations are equally able to meet the disastrous situations and absorb the shock of irregular payment and default situations. Although these and many other issues remain to be sufficiently attended and adequately explained, microfinance industry continues to grow through a process of learning by doing. Grameen and Grameen partners are facing new challenges with their strong commitment and creativity. They are confidently marching forward with new strategies and products.

The experiences of Grameen and Grameen partners worldwide and also the experiences of other MFIs indicate sufficiently that poverty can be reduced and even eradicated if MFIs have access to adequate amount of funds from both internal and external sources, if they are able to develop and retain a professional staff and if they are able to motivate their clientele to do their best to overcome poverty. The process is on. It will continue until the mission is fulfilled.

The micro-finance sector in Pakistan continues to pursue a low-cost low-yield strategy. This, on the back of efficient operations, low delivery costs, competitive credit risk, high capital adequacy, higher investment in human resources, and system improvement should lead to a sustainable industry, which is not the case currently.

The micro-finance sector in Pakistan is poised for growth, product diversification, and market segmentation. There are also very clear signs that both MFIs and MFBs will need to build linkages where they share the same market niche and will soon be competing both, amongst themselves and with each other. With this possibility, there is an increased need for high quality service providers that can build the necessary infrastructure, and reduce the business risk faced by MFPs.

The recent 'Guidelines for Commercial Banks to do Microfinance' issued by the State Bank of Pakistan will on the one hand build awareness amongst commercial banks to move down market for direct lending, and on the other, open avenues for existing MFPs to leverage their balance sheets by entering into commercial transactions with banks. This will build confidence between micro-finance players and the commercial sector and will diversify the funding options available to the sector. However, for MFPs to achieve this, they will need to improve their performance by showing a positive bottom line, a healthy balance sheet, and strong cash flows. The MFB will also be required to provide hard numbers through improved disclosures, audits by high quality firms, and credit ratings in the future.

The availability of different kind of products and value-added services is also becoming increasingly important. The use of technology and value addition in products will help MFPs pursue product differentiation and increase outreach.

Some further guidelines are presented below. Most of these address issues specific to financing agriculture, some respond to the general challenges of operating in rural areas, and some reflect good practice in delivering small unsecured loans.

i. *Repayments are not linked to loan use.* Lenders assess borrower repayment capacity by looking at all of a household's income sources, not just the income (e.g., crop sales) produced by the investment of the loan proceeds. Borrowers understand that they are obliged to repay whether or not their particular use of the loan is successful. By treating farming households as complex financial units, with a number of income-generating activities and financial strategies for coping with their numerous obligations, agricultural micro-finance programs have been able to dramatically increase repayment rates.

ii. *Character-based lending techniques are combined with technical criteria in selecting borrowers, setting loan terms, and enforcing repayment.* To decrease credit risk, successful agricultural micro-lenders have developed lending models that combine reliance on character-based mechanisms — such as group guarantees or close follow-up on late payments — with knowledge of crop production techniques and markets for farm goods.

iii. *Savings mechanisms are provided.* When rural financial institutions have offered deposit accounts to farming households, which helps them to save funds for lean times before harvests, the number of such accounts has quickly exceeded the number of loans.

iv. *Portfolio risk is highly diversified.* Micro-finance institutions that have successfully expanded into agricultural lending have tended to lend to a wide variety of farming households, including clients engaged in more than one crop or livestock activity. In doing so, they have ensured that their loan portfolios and the portfolios of their clients are better protected against agricultural and natural risks beyond their control.

v. *Loan terms and conditions are adjusted to accommodate cyclical cash flows and bulky investments.* Cash flows are highly cyclical in farming communities. Successful agricultural micro-lenders have modified loan terms and conditions to track these cash-flow cycles more closely without abandoning the essential principle that repayment is expected, regardless of the success or failure an any individual productive activity — even that for which the loan was used.

vi. *Contractual arrangements reduce price risk, enhance production quality, and help guarantee repayment.* When the final quality or quantity of a particular crop is a core concern — for example, for agricultural traders and processors — contractual arrangements that combine technical assistance and provision of specified inputs on credit have worked to the advantage of both the farmer and the market intermediary.

vii. *Financial service delivery piggybacks on existing institutional infrastructure or is extended using technology.* Attaching delivery of financial services to infrastructure already in place in rural areas, often for non-financial purposes, reduces transaction costs for lenders and borrowers alike, and creates potential for sustainable rural finance even in remote communities. Various technologies show enormous promise for lowering the

costs of financial services in rural areas, including automated teller machines (ATMs), point-of-sale (POS) devices linked to "smart cards", and loan officers using personal digital assistants.

viii. *Membership-based organizations can facilitate rural access to financial services and be viable in remote areas.* Lenders generally face much lower transaction costs when dealing with an association of farmers as opposed to numerous individual, dispersed farmers — if the association can administer loans effectively. Membership-based organizations can also be viable financial service providers themselves.

ix. *Area-based index insurance can protect against the risks of agricultural lending.* Although government-sponsored agricultural insurance schemes have a poor record, area-based index insurance — which provides payouts linked to regional levels of rainfall, commodity prices, and the like — holds more promise for protecting lenders against the risks involved in agricultural lending.

x. *To succeed, agricultural micro-finance must be insulated from political interference.* Agricultural micro-finance cannot survive in the long term unless it is protected from political interference. Such political interference includes not just the meddling of funds intended for micro-financial purposes but also political influence by feudal leaders who are desirous of keeping the rural population suppressed. They do so by providing credit with outrageous conditions and interest rates which the rural poor are unable to pay. Therefore the feudals and rural rich strongly condemn any alternative source of credit to the poor in their regions and they ensure that micro-finance cannot be practiced in their area. Even the best-designed and best-executed programs wither in the face of government moratoriums on loan repayment or other such meddling in well-functioning systems of rural finance.

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