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# STRATEGIES FOR DEVELOPING VIABLE MICROFINANCE INSTITUTIONS WITH SUSTAINABLE SERVICES

## - THE ASIAN EXPERIENCE -

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# MICROFINANCE STRATEGIES:

## STRATEGIES FOR DEVELOPING VIABLE MICROFINANCE INSTITUTIONS WITH SUSTAINABLE SERVICES

### - The Asian Experience -

### I. Sustainable Microfinance for All

### The role of the state: deregulation and prudential regulation

In most developing countries, access to financial services by all segments of the population, including low-income people, is a matter of growing concern. Many governments have responded positively to this concern by embarking on financial system reform. They have attempted to match people's demand for adequate financial services with the government's responsibility for macroeconomic stability and a sound financial infrastructure. This endeavor includes:

- deregulating the interest rate (or profit-sharing) regime;
- adjusting the legal environment and create appropriate legal forms for MFIs;
- transforming financial institutions into profitable intermediaries between savers and investors;
- providing opportunities for local people to establish their own local financial institutions;
- encouraging sound banking practices.

However, these noble objectives have not been always pursued with the necessary vigor. This, at least, is the chief lesson from the Asian financial crisis, which is rooted in:

- hazardous, politically instigated lending;
- inadequate internal resource mobilization and unhedged external debts; and, above all,
- inadequate regulation and supervision of financial institutions.

As a result of soaring inflation rates, many poor people have lost their savings and, due to the illiquidity of financial institutions, their access to credit has been curtailed. The devasting effects of the recent financial crisis in East and Southeast Asia have lent additional emphasis to **the crucial question of how to promote and prudentially regulate viable financial institutions with sustainable financial services with an outreach to all segments of the population including low-income people**, in order to prevent such a financial crisis in other countries.

### Key concepts in microfinance

**Microfinance** is defined as a sector of formal, semiformal and informal financial institutions, providing financial services to the microeconomy. These services consist of microsavings and microcredit (and perhaps other financial services such as microinsurance, leasing, transfer services), thereby allocating scarce resources to microinvestments with the highest marginal rates of return. Two types of institutions are involved:

- in a narrow sense, small local financial institutions;
- in a wider sense, national or regional banks and development finance institutions (DFIs) with microfinance services for small savers and borrowers.

**The Microeconomy** is the primary market of MFIs and includes target populations such as microentrepreneurs, small farmers and the landless, women and low-income people. It does not necessarily exclude other segments of the population.

### Viability, sustainability and outreach

**Viability** refers to the extent to which an institution covers its costs, has its loans repaid, and makes a profit; whereas **sustainability** refers to the extent to which an institution, in addition to being viable, mobilizes its own financial resources internally (equity, savings deposits, and retained profits) instead of depending on government or donor resources. Finally, **outreach** refers to the extent to which all segments of the population, including low-income people, have access to financial institutions and their services.

### Development goal

The greatest challenge for MFIs lies in the combination of viability and sustainability with outreach. The **core development issue** to be addressed, however, is how best to develop the financial system:

- in the interest of all segments of the population including low-income people; and
- in the interest of institutional viability and sustainability,

as only viable and sustainable MFIs belonging to a sound financial system will be able to guarantee adequate access to financial services for all segments of the population.

### Strategic approaches to the development of microfinance

There are three principal approaches for enhancing the effectiveness of the financial system and its services to the microeconomy:

- **the regulatory reform approach:**
  to improve the policy and regulatory environment, including the framework of bank and MFI supervision, in which MFIs operate;

- **the institutional transformation approach:**
  to improve the financial infrastructure and the microeconomy's access to it; and

- **the sound practices[1] approach:**
  to improve the effectiveness of financial institutions with microfinancial services.

While the various approaches are interrelated within an overall financial systems context, each one can be chosen as a separate entry point for development interventions. Even in a repressive regulatory environment, sound practices such as appropriate loan sizes and instalment periods or positive incentives to repay on time, can be feasible. However, the ultimate effectiveness of interventions focussing on institutional transformation and sound banking practices will vary considerably, depending on the appropriateness of the policy environment.

[1] The World Bank uses the term *best practices*, which I consider as misleading as it evokes the notion of ideal and universally valid solutions. This may result in uncritical replication of models and practices which may work well in the cultural setting of their origin but not necessarily, or at least not without adaptation, in other environments.

## II. The regulatory reform approach: strategies for creating an appropriate policy and regulatory framework

Microfinance is part of a country's wider financial system. Three reform measures are of crucial importance to the development of viable institutions with sustainable microfinancial services:

(a) **the deregulation of interest or profit-sharing rates on deposits and loans:** permitting each institution to adjust its profit-sharing or interest rate structure to its costs, including the costs of serving marginal clients in remote areas, of collecting microsavings and microinstalments, and of doorstep services;

(b) **a revision of the banking law:**
facilitating the establishment of a wide branch network of banks, creating a variety of legal forms for financial institutions with different capital requirements, and permitting local people to establish their own small financial institutions, with special provisions for nonformal MFIs and their transformation into formal institutions.

In addition, the legal system should provide for alienable private land use rights or land ownership titles as a basis of collateral and for the efficient processing of claims arising from bad debts.

(c) **The provision of effective MFI supervision:**
providing guidance and supervision to institutions with microfinancial services in the interest of both the MFIs and their customers. In the case of a multitude of small local microfinance institutions, such supervision may be provided by a separate second-tier regulatory authority.

**Indonesia:**
**Financial deregulation without adequate supervision**

*1. Financial deregulation: a story of success*
In Asia, Indonesia has served as a model case for the deregulation of the policy and legal framework since 1983, paralleled by macroeconomic stability and the deregulation of the foreign trade regime. This resulted in considerable financial deepening: an upsurge of domestic savings mobilization, credit disbursement, number of banking institutions, and outreach. The upsurge has been most impressive in microfinance. Deregulation of the monetary and banking system proceeded in the following steps:

- 1983: Interest rate autonomy is given to all banks, state-owned and private. Bank Indonesia (BI) as the central bank drops direct interest rate controls and adopts market-oriented monetary policies. Between 1983 and 1990 savings mobilization increased 6.7-fold, bank loans outstanding 6.4-fold. From 1990 to 1995 savings mobilization increased 2.5-fold, bank loans outstanding 2.4-fold.
- 1988: BI deregulates the institutional framework by easing the establishment of new banks and the opening of branches. A new rural banking law permits the establishment of rural banks (BPR) with an equity capital of Rp. 50 million, requiring the existing semiformal financial institutions to be eventually transformed into banks (BPR). 1,643 rural banks (BPR) were established until 1995. The total number of registered small financial institutions grew from 8,003 in 1990 to 9,271 in 1995; the number of commercial banks from 171 to 240; and the number of their branches from 3,563 to 5,191.
- 1990: BI withdraws most of the interest rate subsidies. Commercial banks are required to allocate at least 20% of their portfolio to the microeconomy, either directly or through MFIs.
- 1991: In response to some spectacular bank failures, BI steps up bank supervision and imposes a capital adequacy ratio.
- 1992: A new banking act deregulates bank ownership. Only two types of banks are recognized: commercial banks und rural banks (BPR) with a paid-in capital of Rp10b (US$. 4.82m, at 1992 exchange rates) and Rp50m ($24,100), respectively.

*2. Inadequate supervision: a story of failure*
Weaknesses in bank supervision had been apparent all along, to which BI responded in 1991, though ineffectively. The fact of politically instigated lending was also known, but not its excessive extent. The belief was upheld that in a climate of rapid economic growth, the healthy portion of the bank's portfolio might outgrow the sick portion, but this was erroneous.

*3. Lessons learned*
Three regulatory reform measures are essential for sustained financial and economic growth: prudential deregulation, macroeconomic stability, and effective bank supervision. Indonesia performed well on deregulation and stability, but failed on bank supervison. This, in the wider framework of the Asian financial crisis of 1997, led to a bank run, the collapse of the Rupiah, soaring inflation, massive unemployment, and, last not least, political instability. Microfinance was least affected, indicating that at the local level, MFIs were more successful in sound banking and the avoidance of political influence. The chief lesson of the Indonesian experience is that financial deregulation without adequate bank supervision can be disastrous.

## III. The institutional transformation approach: Strategies for developing viable MFIs

**The financial infrastructure:** In many countries, there is a variety of financial institutions with national and local outreach, each with its own comparative advantages for microfinancial services at the local level:

- formal institutions which fall under the banking law, including agricultural banks, development

banks, commercial banks, private shareholding banks, finance companies, leasing companies, and sometimes village or rural banks;

- semiformal institutions authorized by some government agency, including savings and credit cooperatives, NGOs and various projects and programs; and
- informal institutions beyond the purview of government agencies, including rotating and non-rotating savings and credit associations, community-owned fund-raising and credit arrangements and other types of self-help groups.

**Institutional transformation strategies:** Depending on the existence and vigor of such institutions in a given area, four major institutional transformation strategies have emerged, offering strategic entry points for microfinance development:

(1) Adapting (downscaling) formal financial institutions to the needs of the microeconomy.
(2) Upgrading (upscaling) nonformal (comprising semiformal and informal) financial institutions.
(3) Linking formal and nonformal financial institutions, or banks and self-help groups.
(4) Establishing new local financial institutions with microfinancial services.

The first three strategies may be inter-connected:

- adapting banks to the requirements of the microeconomy in a first step; then
- linking them as wholesale institutions to self-help groups as retailers; and finally,
- upgrading self-help groups e.g. to the level of financial cooperatives or village banks.

Profit-sharing or interest rate fexibility as a prerequisite:The prime prerequisite and at the same time crucial policy incentive for institutional transformation is a profit-sharing or interest rate regime which allows for market oriented interest rates. Banks must be permitted to price their products appropriately to cover their fixed and variable costs and include an adequate profit margin. If banks are to serve customers which differ widely in terms of service costs and risks, the only viable inducement for them is an adequate margin, lest they exclude small farmers, -microentrepreneurs and people in remote areas. A sense of moral obligation is usually not sufficient. Only sound social banking, which combines a social mandate with profit-making, has a chance of sustainability.

In the absence of this prime prerequisite banks may pursue one of the following three courses: they may request an exemption from the central bank; they may externalize part of their costs by working through intermediaries with separate funding (e.g. NGOs); or they may set up a non-bank organization with a separate legal personality (e.g., a limited liability company) which does not fall under the interest rate regulations of the banking law. However, these approaches should only be transitory; they are no long-term substitute for interest rate deregulation.

## Formal finance and the institutional adaptation [2] strategy

Existing agricultural, development and commercial banks frequently have a potential for adjustment to the financial requirements of the microeconomy. Tapping this vast potential is a major challenge for the member institutions of NENARACA. Institutional adaptation of banks to the microfinance market and the downscaling of their operations concerns the following areas:

[2] The institutional adaptation strategy is also referred to as institutional downscaling or downgrading strategy.

(1) their delivery system; (2) their corporate culture; (3) their internal business and product policy; (4) bank procedures; (5) terms and conditions; (6) risk management; (7) crisis prevention; (8) the manpower and training system; and (9) the transformation of their ownership structure and governance.

**(1) Delivery system:**

Adapting the delivery system of a bank may comprise four major avenues towards microfinance, all geared to one tenet, ***bringing the bank to the people:***

- extending the branch and sub-branch network;
- establishing part-time offices in villages, markets or small industry sites;
- mobile services through cars, motorcycles, bicycles, or on foot;
- full-time or part-time agents providing doorstep or other decentralized services.

**(2) Corporate culture:**

Adapting the corporate culture at the local level requires:

- an adjustment of the bank's material culture (such as the appearance of the bank building and its offices, types of vehicles, facilities such as air-conditioning);
- social culture (such as social background, dress code, language and behavior of staff as well as quality of staff-customer relations); and
- the bank's value orientation system (comprising values such as honesty and reliability, diligence and hard work, innovativeness, social responsibility, being of service to the customer, making the bank grow).

This customer-oriented corporate culture must be internalized through staff training and propagated through public relations as the bank's image.

**(3) Business and product policy:**

Adapting the banks' business and product policy requires a reorientation towards savings- and demand-driven sound banking. This comprises in particular:

- an orientation of a bank towards cost coverage and institutional viability,
- market and customer-oriented banking and
- self-reliance through mobilization of its own funds of which **savings** are the most important source in the field of microfinance.

This reorientation is to be operationalized through:

- appropriate savings and credit products; and
- reciprocal savings-cum-credit schemes,

which are all designed to bring the mutual business interests of the banks and their customers into balance.

**(4) Bank procedures:**

Adapting procedures requires:

- a simplification of forms and procedures,
- convenient facilities and banking hours,
- customer-oriented services of high quality and reliability, including
- timely delivery and collection services,
- doorstep services,
- daily savings collection,
- creditworthiness examination and collateral requirements adjusted to the needs of small customers.

**(5) Terms and conditions:**

Adapting terms and conditions to the requirements of microentrepreneurs and informal sector households comprises:

- an emphasis on small sizes of savings, loans and installments (downscaling);
- a differentia tion of terms according to area or customer groups with different risk and cost structures;
- a differentiation of terms according to the length and quality of the business relationship, including a difference in terms between initial and subsequent repeat loans;
- variable but short maturities;
- frequent instalments;
- no or short grace periods.

**(6) Risk management:**

Adapting risk management comprises a comprehensive strategy for arrears prevention, including:

- appropriate loan terms;
- reliance on a borrower's track record based on savings and previous loan repayment;
- appropriate forms of collateral, if any, including nonformal collateral substitutes;
- personal guarantees; and
- various forms of joint liability in cooperation with self-help groups;
- insistence on timely (re-) payment.

**(7) Crisis prevention:**

In addition to good risk management, crisis prevention may entail the following:

- solid equity capital base and conservative capital equity ratio,
- reliance on internal resources rather than government or donor funds,
- strict adherence to principles of honoring one's obligations, including legal action against defaulters;
- monitoring of portfolio quality and of the value of collateral;
- precautions against undue influence by local authorities, politicians and the powerful on-lending decisions (e.g., repeat loans starting with small short-term loans; regular prior savings before acceptance of loan applications; insistence that funds deposited as required savings are self-generated and not borrowed; transparency of transactions).

**(8) Manpower development and training system:**

Adapting the manpower and training system requires:

- a selection of staff with particular language and social skills, which may be more important than formal certification, and
- inclusion of customer-oriented social behaviour, microloan appraisal and arrears prevention in the training curriculum.

This may further include:

- exposure training programs for bank executives and management in other banks, perhaps in neighbouring countries, which can serve as examples of successful adaptation.

**(9) Transformation into separate local institutions:**

Development banks or national agricultural bank activities which are plagued by a lack of dynamism, high costs and low repayment rates can be salvaged through privatization of their small farmer and microenterprise lending operations, e.g.:

- as member-owned local banks or semiformal financial institutions;
- as community-owned local banks or semiformal financial institutions;
- as private shareholding banks.

Experience shows that this can greatly enhance local resource mobilization, repayment behaviour, institutional viability, volume and quality of services, outreach, and people's participation.

**Limitations:** Formal financial institutions serve but a fraction of the population, which typically lies within the upper quartile of the social hierarchy. Through adaptation to the microfinance market requirements, they may gradually expand into the second-highest quartile and into segments of the lower quartiles. Within the foreseeable future they will normally not be able to fully serve that market. To reach the whole market, the institutional downscaling strategy for formal financial institutions may be complemented by an *upgrading* strategy for nonformal financial institutions, and by a linkage strategy.

**Bank Rakyat Indonesia (BRI):**
**an agricultural development bank with viable and sustainable microfinance operations**

*1. The failure of subsidized targeted credit - in a repressive policy environment*
Until 1983, century-old BRI was a major provider of subsidized targeted credit through 3,300 bank units (*unit desa*) and a staff of 14,300 in rural areas. Heavy losses resulting from poor repayment rates (around 40%), plus fiscal cuts, had made the bank unsustainable.

*2. Making microfinance viable – in a deregulated policy environment*
After the financial deregulation of June 1983, the government as the bank's owner decided to commercialize its operations by transforming the units into self-sustaining profit-centers. With TA from the Harvard Institute for International Development, the bank calculated microsavings and microcredit transaction costs and carefully crafted two commercial products: a rural savings scheme with a lottery component (SIMPEDES) which proved to be immensely attractive; and a nontargeted credit scheme (KUPEDES) open to all: with simple procedures, short maturities, regular monthly instalments, flexible collateral requirements, incentives for timely repayment, and market rates of interest amounting to 2% flat per month (equal to an effective rate of 44% p.a., minus 11% for timely repayment = 33% p.a.) to cover all costs and risks. Nominal interest rates were drastically higher than the previous subsidized rates of around 12%, but much less so in actual fact as under-the-table payments had all but disappeared. As of 1984, all of BRI's village units were turned into profit centers with profit-sharing incentives for staff and penalties for excessive arrears for managers in terms of loss of credit authority. Programs carried out on behalf of the government and of donors were kept from the village units and confined to the branch level. During 2/1984-12/1996, a total of 18.47m loans had been made, with a long term loss ratio (total overdue one day or more, including amounts written off, divided by total which has fallen due during 2/1994-12/1996) of 2.15%; and a 12-month loss ratio of 1.59% for 1-12/1996. Total payments in arrears one day or more as a percentage of total loans outstanding as of Dec. 31, 1996, excluding write-offs, amounted to 3.64%. Consolidated profits at unit level amounted in 1996 to $177m, or 10.4% of loans outstanding.

*3. Making microfinance sustainable – by responding to the demand for depositing savings*
With this model, BRI became one of the most successful rural-mandate banks in Asia-Pacific. With liquidity first provided by the World Bank, BRI broke even in 1990: fully mobilizing its loanable funds through village-level savings and generating excess resources thereafter. Since then, BRI's *unit desa* network has been completely self-reliant (mobilizing its own resources) and viable (covering its costs from the margin and making a profit). As of 31 Dec. 1996, BRI served 2.49m borrowers with a total amount of loans outstanding of US$1.71b (1996 exchange rate); and 16.17m depositors with savings balances of $2.97b. The ratio of borrowers to savers of 1:6.5 is an indication of the strong demand of rural people for deposit facilities, far in excess of the demand for credit.

*4. Outreach of national BRI vs. local MFIs*
BRI, with 3,482 village units as of 12/1995, outperformed the totality of 1,948 formal (BPR) and 7,413 semiformal MFIs, mobilizing Rp6.02tr from 14.48m savers compared to Rp1.45tr mobilized by 9,361 MFIs from 4.60m savers; and providing Rp 3.19tr to 2.26m borrowers, compared to Rp1.88tr provided by MFIs to 2.45m borrowers. BRI has demonstrated that in a deregulated policy environment, a government-owned agricultural development bank is capable of serving vast numbers of microsavers and microborrowers at market rates, mobilizing its resources internally, covering its costs, and financing its own expansion. In a more theoretical vein: BRI has proven that institutional viability, sustainability and outreach are compatible.

### Nonformal finance and the institutional upgrading strategy

**Approaches with or without legal status:** Nonformal finance mostly rests on local institutions which are directly accessible to all segments of the population. There are two principal approaches: (1) organizational development without the adoption of legal status; (2) transition of an institution to a higher order legal form, such as a credit cooperative, finance company, rural bank or private development bank.

These two approaches may be directed at enhancing the capacity of (1) grassroots financial institutions including self-help groups or *people's organizations;* (2) self-help promoting institutions like non-governmental development organizations (NGDOs) or governmental development organizations (GDOs).

**(1) Self-help groups (SHGs):**

SHGs are member-owned and member-controlled local institutions. They may either be financial groups, with financial intermediation as their primary purpose, such as savings and credit associations; or nonfinancial groups, with financial intermediation as a secondary purpose, such as vendors' associations, craft guilds, family planning groups and numerous other types of voluntary associations.

**Functions of SHGs:**

Functions that may be enhanced through development assistance may include:

- providing guidance to members
- collecting savings from members
- building up an internal loan fund
- loan appraisal and creditworthiness examination
- financial consultancy services to members
- arranging for nonformal collateral or guarantees including joint liability
- granting loans to members
- size and term transformation
- collecting instalments
- applying social control mechanisms to enforce repayment
- granting emergency loans
- granting nonfinancial emergency assistance
- providing insurance services
- communication and exchange of experience
- providing linkages with banks, NGOs or donors
- supporting the loan applications of individual members to banks through recommendations.

**Weaknesses:** While the activities of SHGs are usually well-adapted to local conditions, they frequently lack technical skills, networking capacities and access to sources of refinance.

**Prevention of undue political influence:** MFIs can be subject to undue influence on lending decisions by local politicians or the powerful. This may be prevented by some of the following means:

- insistence on minimum length of membership of one year;
- regular participation in monthly meetings;
- repeat loans starting with very small short-term loans;
- regular prior savings before acceptance of loan applications;
- transparency in all transactions.

**The feasibility of bank status for SHGs:** The possibility and appropriateness of acquiring bank status by SHGs depends on the legal framework and on their financial and organizational maturity. In countries with an appropriate legal framework, financial SHGs may be assisted in establishing a bank owned and controlled by members. In countries without such a framework, SHGs may be assisted in establishing a non-bank institution until the law is changed. In cases where an SHG cannot immediately fulfil the conditions of the banking law, acquisition of a non-bank legal status, e.g. under cooperative law, association law, etc., may provide an interim solution which permits a SHG to undergo a process of upgrading until it is mature enough for bank status. In countries with effective savings and credit cooperatives, the feasibility of converting them into cooperative banks must be carefully examined. In countries where cooperatives have failed to mature into viable financial institutions (e.g., as a result of credit conducting on behalf of the government), rehabilitation with the objective of transforming them into viable institutions under the supervision of the central bank may provide a feasible alternative. This would in turn require massive technical assistance.

**(2) Governmental and non-governmental development organizations:**
GDOs and NGDOs may be established and supported by government or humanitarian organizations, relying on donor support and working for the benefit of others such as self-help groups and microentrepreneurs or small farmers. Or they may be apex or umbrella organizations of financial self-help groups, business associations and the like working for the benefit of their own members. The latter are, or may be, member-owned and member-directed, the former are not. Examples of the latter are regional and national federations of credit cooperatives, craft unions or market vendors associations. While their start-up phase may be donor-supported, they are to be financially self-reliant in the long run, drawing on their own resources or those of their members.

**Functions of development organizations as financial intermediaries:**
GDOs and NGDOs acting directly as financial intermediaries or working through financial self-help groups may have two basic functions: (i) guidance, training and consultancy in financial and nonfinancial matters; (ii) acting as a financial intermediary between microentrepreneurs or their self-help groups and donors or banks.

The activities of GDOs and NGDOs as financial intermediaries may include any of the following:

- financial extension services
- bookkeeping training
- financial management training
- providing innovative savings schemes, e.g. daily or doorstep savings collection in the informal sector, withdrawable voluntary savings as well as time deposits in self-help groups (SHGs), etc.
- mediating contacts with a bank or donor
- collecting and safekeeping savings
- depositing savings of microentrepreneurs of SHGs in a bank
- examining the creditworthiness of microentrepreneurs or SHGs
- negotiating bank loans for microentrepreneurs or SHGs
- onlending to microentrepreneurs or SHGs
- collecting installments from microentrepreneurs or SHGs
- bearing the credit risk
- repaying bank loans

**Functions of development organizations as nonfinancial intermediaries:** GDOs

and NGDOs not acting as financial intermediaries may still carry out several of these functions, except concluding loan contracts and bearing the credit risk. For NGDOs acting directly or indirectly as financial intermediaries it is mandatory to possess an adequate accounting system, financial management skills and financial reserves to absorb arrears and bear the risk. For DOs which strengthen financial capacities of microentrepreneurs or SHGs it is mandatory to possess adequate training and consultancy capacities. This in turn requires major institutional enhancement inputs from donors, as most DOs lack the required skills and capacities.

**Bank status for development organizations acting as financial intermediaries:** DOs acting as financial intermediaries are strongly encouraged to opt for banking status or otherwise formalize their financial operations. In actual fact, they may:

(1) contribute to the bankability of their target group (individuals or SHGs) and turn their financial operations over to suitable banks;
(2) establish their own bank operating along sound banking principles;
(3) establish a bank jointly with the SHGs or microentrepreneurs under their guidance. In the latter case, the DO may either consider its engagement in banking permanent or transitory, with the intention of eventually turning ownership and management over to the SHGs or microentrepreneurs.

**Upgrading assistance:** The upgrading of nonformal financial institutions or operations of DOs and SHGs into member-based banks operating along sound banking criteria may be a major field of technical assistance.

**Nepal:**
**From informal to formal finance – from RoSCA to finance company**

*1. From RoSCA...*

Rotating savings and credit associations (RoSCAs) are, next to the moneylender, the most prevalent type of informal finance around the world. A group of people contribute a fixed amount each and, in a monthly, weekly, daily or other rotation, turn the total amount over to (mostly) one member at a time. At the end of a cycle, the group dissolves and may reorganize with a new membership. In many countries RoSCAs have turned into permanent nonrotating credit associations with their own loan funds. Most have stayed informal; but some have adopted the legal status of a cooperative society. In Nepal, however, the dhikur (sg.) or dhikuti (pl.) as they are called here, took a different course. Centuries ago, they first originated among the Thakali as a social insurance institution to protect these trading communities against the vicissitudes of the trans-Himalaya trade. During the past fifty years, they turned into small enterprise financing institutions and spread to virtually all cities of Nepal. In some dhikuti, monthly collections amount to thousands of dollars. With a growing demand for scarce financial resources, funds were allocated by bidding; e.g., the lowest bidder may accept a pot of $1000 at $600, returning the balance of $400 to the participants. In recent years, improvident speculation has led to cases of defaulting and greatly damaged the reputation of the dhikuti.

*2. ...with daily savings collection at doorsteps...*

In 1989, H. B. Pradhananga, then a government employee, organized three dhikuti of 25 members each. He introduced several innovations: a long-term contractual savings scheme, with daily contributions of Rp10 (appr. US$0.16 at the 4/1998 exchange rate of US$1 = Rp63) for three years, which attracted low-income people; daily collection at doorsteps through a collector rather than at regular meetings; and access to credit at any time. Despite the absence of legal status, the number of groups rose to 200 with 5,000 participants within a year.

*3. ...to finance company...*

Deregulation after 1990 created a fertile ground for financial innovations in Nepal. After the enactment of the Finance Company Act in 1992, H B. Pradhananga took a big step on the evolutionary scale of organizational morphogenesis: he registered his business as the *Himalaya Finance and Savings Company Ltd., HFSC*. The new legal status created enough confidence for the participants to abandon the group structure. By May 1996, HFSC comprised 49 branches all over the country and with 600 daily deposit collectors, each serving 125-400 clients. Due to new regulation, the number of branches, including the headoffice, was subsequently reduced to six, and the remaining units were transformed into collection offices, covering 43 of 75 districts in Nepal. By converting salaries into commissions of 3% and increasing the daily collections to Rp10-500 (further increased to Rp50-500 as of 4/1998), H. B. Pradhananga was able to reduce the number of collectors to 98, collecting Rs10,000-15,000 each per day and serving 52,000 depositors.

*4. ...with innovative microsavings and microcredit products*

Savings contracts are for three years: a novelty in a country largely devoid of term finance. Savings products include one for savings collected at doorsteps at 7% interest p.a. and one of savings deposited at the office at 11%. Loan products comprise collateral-free loans for saving-participants and collateralized loans for others: 2-year business loans of Rp100,000-2m at 21% interest; 2- to 5-year agricultural loans of Rp10-500,000 at 15-19% p.a.; 2- to 5-year housing loans of Rp0.1-3m at 20-21%; 2-year vehicle hire-purchase loans of Rp50-150,000 at 24% p.a.; and personal loans up to 50% of accumulated savings at interest rates 3% above the respective savings interest rates. The share capital of HSFC as of 4/1998 is Rp100m ($1.6m): earned within a 10-year period. As savings mobilization in finance companies is limited to ten times the share capital, H.B.P. plans to transform the finance company into a bank for which no such restrictions exist.

## Formal and Nonformal Finance and the Linkage Banking Strategy

**Reducing transaction costs through linkages:** The linkage strategy focuses on self-help groups as grassroots financial intermediaries between banks and the vast numbers of microentrepreneurs and small farmers to cut down on transaction costs for both banks and customers. The linkage strategy usually encompasses measures of upscaling nonformal financial institutions and the downscaling of banks as well as the adoption of sound practices.

**Guiding principles:** The following guiding principles have emerged from the implementation in an increasing number of Asian countries, among them India, Indonesia, the Philippines and Thailand:

- Working through existing formal and nonformal institutions
- Respecting the autonomy of participating institutions
- Promoting savings mobilization
- Promoting credit delivery at market rates
- Linking savings and credit
- Repeat loans growing in size with each successful repayment cycle
- Using appropriate forms of collateral and collateral substitutes, incl. group liability and nonformal collateral
- Ensuring institutional viability
- Covering the risk from the margin
- Promoting sound banking practices

**Participative process resulting in differentiated schemes:** The linkage strategy is designed to participatively initiate linkage processes, rather than prescribe specific models. Any specific schemes are to be the outcome of participative processes among the respective participants. Each bank, GO and self-help group is free to negotiate their own scheme with their business partners. This may result in a multitude of schemes in a given country.

**The evolution of linkage schemes:** Institutional linkages between banks and SHGs may proceed in an evolutionary sequence of three steps: from indirect linkages mediated by NGOs to direct linkages and ultimately to direct access of microentrepreneurs to banking services. Between these stages, there may be intermediate steps, with NGOs or SHGs, respectively, in a consultative role.

**World Bank assessment:** In the 1989 World Development Report linkage banking was recommended as a promising strategy of financial system development: *Informal financial institutions have proved able to serve the household, agricultural, and microenterprise sectors on a sustained basis. Measures that link informal institutions to the formal financial system will improve that service and ensure a competitive environment* (p. iv; cf. p. 119). Through APRACA and AFRCA, the approach has spread to an increasing number of countries in Asia and Africa.

**India:**
**Linking banks and self-help groups**

*1. The unsustainability of subsidized targeted credit*
Rural finance in India has been the mandate of NABARD, the National Bank for Agriculture and Rural Development. Since 1980 NABARD has provided $2b in subsidized targeted credit through 150,000 primary lending institutions for 49 million rural household. Repayment performance was dismal. Well into the 1980s the rural interest rate structure was inverted, with deposit rates exceeding interest rates on loans, undermining savings mobilization and institutional self-reliance. In the early 1990s Regional Rural Banks charged 10% on loans under the NABARD program: 13.9% below the average break-even rate of interest, thus undermining institutional viability. Despite massive subsidies, vast numbers of the rural poor remained beyond the reach of the government programs. In addition it was found that large volumes of credit were obtained by the wrong people at the wrong time for the wrong purpose. During the 1990s the Indian government has been revamping its development policies in the direction of a market economy.

*2. Formal and nonformal financial institutions establish commercial business relations*
In this context, NABARD, together with the Reserve Bank of India, RBI, decided to experiment with linkage banking, which APRACA had been propagating among its member institutions since 1987. Inspired by the design of the linkage banking project in Indonesia, NABARD adopted its chief principles of working through existing institutions (banks, self-help groups and NGOs, with NABARD in the role of lender of last resort), institutional autonomy (with participating institutions working out their own business terms and conditions), institutional viability (through cost coverage from the interest rate margin for all participating institutions) and self-reliance (through savings mobilization). During the test phase, the number of participating self-help groups (SHGs) grew from 255 in 1992/93 to 620 in 1993/94 and 2,112 in 1994/95. During the first two years of national implementation, the number of SHGs grew to 4,757 in 1995/96 and 8,598 in 1996/97: 13% of them linked directly with banks without facilitation by NGOs, another 45% linked with banks with NGOs as facilitators, and 42% linked with NGOs as financial intermediaries. As of 31 March 1997, 120 banks and 220 NGOs were involved: still a minute fraction of the banking and NGO sectors in India. Presumably due to NGO influence, 76% of the SHGs are women's groups.

*3. Linkage banking: a commercially viable program*
RBI has declared linkage banking a regular banking program in India, authorizing banks to lend to unregistered SHGs, and SHGs to accept savings deposits from their members. RBI has also moved away from interest rate regulation. The interest spread of participating banks and NGOs averages 5.5% p.a. SHGs charge around 2% per month to end-users, with some going as high as 3-4% per month. Questioned about what appears as exorbitant interest rates by preferential credit standards, SHG members cited the standard moneylender interest rate of 10% per month and indicated that the interest earnings are ploughed back into the SHG loan fund, thus increasing access to credit from their own internal resources on an increasing scale. With bank loans disbursed amounting to $3.38m and a volume of $3.04m of NABARD refinancing, the scheme is still of a modest size by Indian standards. Yet NABARD considers some of the program's features remarkably successful and worth emulating: a considerable increase in rural savings; a reduction in bank transaction costs by 40%; a substantial reduction in borrower transaction costs; and a near-100% repayment rate.

## The strategy of establishing new institutions

**Infrastructural innovation as a residual strategy:** Infrastructural innovation, i.e. the establishment of new local financial institutions, can be an appropriate approach where no suitable institutions exist or existing institutions cannot be adjusted to local requirements. If approaches of institutional adaptation, upgrading or linkage banking are found inadequate in coping with local demands, infrastructural innovation can also serve as a complementary or competitive strategy and contribute to institutional differentiation.

**Requirements:** There are three basic requirements for viable and sustainable institutional innovations in microfinance on a competitive market:

- they should be demand-driven, i.e. respond to felt needs and articulated demands for financial services by microentrepreneurs, small farmers, women and the poor;
- they should be savings-driven, both in the interest of institutions and their customers as savers;
- they should cover their costs from the margin.

Great care is to be taken that governments or donors do not subvert any of these principles. There are three types of institutions which are likely to meet these requirements: (1) community-based financial institutions which are owned and controlled by a local community; (2) member-based financial institutions which are cooperatively owned and controlled by their members; and (3) privately owned financial institutions, such as local shareholding banks. Mixed ownership is also possible.

**Initiatives:** Depending on national and local circumstances new institutions may be established in the formal, semiformal or informal financial sectors. New formal financial institutions may be initiated by the central bank or by major national, regional or provincial banks, including development banks and banks with a rural mandate, as facilitators or intermediaries. They may be seconded by well-prepared NGOs in their capacity as training and consultancy agencies. New semiformal financial institutions which include cooperatives and GO and NGO-supported financial programs, may be established through cooperative or NGO networks and apex organizations which need to be adequately qualified for that task. Group-based informal financial institutions may be set up in cooperation with NGOs and cooperatives, usually through their respective networks and apexes, which in turn have to provide adequate training and facilities to their member institutions. Under favorable conditions government institutions may also succeed in establishing financial self-help groups. Private financial institutions may be set up by any number of private local people with variable share capital contributions; among their co-owners may also be self-help groups.

**Phasing:** In any of these cases, infrastructural innovation should be planned and implemented with a view towards the other three institutional strategies as complementary or successive strategies:

(1) In countries with an inappropriate policy environment and deplete of adaptable institutions intervention may start with infrastructural innovations at the informal or semiformal level;
(2) to be followed in another phase by upscaling within the nonformal framework;
(3) next by infrastructural upgrading of the most successful institutions to semiformal institutions or banks;
(4) then by linkages between nonformal and formal institutions;
(5) and eventually by a transition to formal institutions.

## The sound practices[3] approach: Strategies for providing sustainable microfinancial services

**Scope and applicability in inappropriate environments:** The sustainability of microfinancial services hinges on two factors: (1) the mobilization of internal resources and (2) the soundness of financial practices. To some extent, sound practices can be applied in any policy environment and by any type of financial institution, be it formal or nonformal. A successful institutional adaptation strategy must encompass a sound practices strategy. This comprises improved or new financial products, good procedures and effective contractual terms and conditions. Certain, but not all sound practices such as cost coverage from the margin, will depend on the policy environment; but in government-approved niches or in the nonformal sector virtually *any* practice can be implemented regardless of the regulatory environment.

**Internal resource mobilization:** Own internal resource mobilization makes microfinance institutions independent of government and donor funding. It provides a solid basis for the sustainability of microfinancial services. Major resources include share capital, savings deposits and retained profits. For MFIs operating in the microeconomy, high interest or profit-sharing rates on loans are sometimes more effective an instrument of internal resource mobilization than savings deposits.

[3] The World Bank has introduced the term *best practices.* This term evokes the notion of optimal practices applicable anywhere. In contract, experience has shown that sound practices vary by environment and must be adjusted to a given situation. What is sound in one situation may be unsound in another.

**Nepal:**
**Transforming an unsustainable credit program into viable microfinance institutions**

*1. From unsustainable agricultural development banking operations...*
Since 1975 the Agricultural Development Bank of Nepal, ADBN, has built up its Small Farmer Development Project, SFDP: a subsidized credit program targeted at the poor: 70% of the population. Major donors were IFAD ($27.5m) and ADB-Manila ($30m). By mid-1996 SFDP had reached 189,000 heads of households in some 23,000 small farmer groups. Credit disbursement and technical support were administered through 422 SFDP offices. With repayment rates since its inception barely above 40% and loss ratios fluctuating in the 20-30% range, the program incurred substantial losses. With a savings mobilization rate of less than 1% throughout is existence, it fully depended on donor resources. As a subsidized targeted credit program, SFDP turned out to be unviable and unsustainable.

*2. ...to local MFIs*
With TA from GTZ, ADBN started an experiment in 1993, turning the SFDP operations of four offices in Dhading, one of the poorest districts of Nepal, into four Small Farmers Cooperatives Ltd., SFCLs, owned and managed by their members. Each comprises on average 709 small farmers in 100 groups (73% of them male or mixed and 27% female) organized in turn in 11 intergroups. This transformation has achieved a miracle: The SFCLs started mobilizing their own resources, which reached 20% of all loans outstanding within the first two years of their existence; the repayment rate of ADBN channeling loans virtually doubled to 79%; and the repayment rate of loans from internal resources jumped to 98% as of 7/1995. When I visited one of them, SFCL Chatredeurali, in early 1998, 70% of the loans outstanding had been disbursed from internal resources.

*3. The challenge of institutional autonomy and sustainability*
After the successful completion of the experiment, ADBN has now entered into the phase of national implementation of the transformation program. By January 1998 the operations of 53 SFDP offices had been converted into autonomous SFLCs, with a total outreach of 31,481 families (representing a population of about 200,000), Rs23.6m ($0.37m at the current exchange rate) internal resources and Rs271.0m ($4.3m) loans outstanding. While ADBN continues to establish new small farmer groups through its existing network of SFDP offices which will eventually be converted into SFCLs, it is planned that within six years about 4-500 SFCLs will have been established with an outreach of more than 200,000 predominantly poor families (i.e.,. a population of 1.2 million). Given their low level of transaction costs and the excellent repayment performance, their viability seems to be secure. However, full institutional autonomy, independence from local political interference, self-reliance (including the cessation of loan channeling on ADBN's terms), appropriate supervision and the establishment of an apex structure are among the many issues that need to be assured if the SFCL are to fully evolve into a self-sustained movement with an ever-increasing deepening of financial services to the rural poor. The significance of this experiment extends far beyond SFDP. Many government-owned agricultural development banks in the region might want to take a close look at it during an exposure program.

**Microsavings:** Savings products and innovations to be promoted may comprise convenient deposit facilities for the accumulation and safeguarding of savings for microenterprise self-financing, consumption and emergencies; positive real returns to prevent erosion by inflation; savings products that differ in yield, maturity and incentive structure, such as voluntary savings withdrawable at any time or fixed deposits vs. regular compulsory savings that are non-withdrawable, lottery savings, raffles, etc.; and collection services organized by institutions or customers, such as doorstep daily savings collection, which differentially distribute transaction

costs. In small local MFIs, high interest rates on loans may serve as a major mechanism of self-imposed compulsory savings mobilization.

In subsistence agriculture and marginal informal sector activities, where virtually any type of credit may be inappropriate, **savings promotion that strengthens the self-financing capacity** of small farmers and microentrepreneurs may be the only responsible financial strategy.

**Microcredit:** Microcredit products may be appropriately differentiated in terms of maturities, instalments, services and collateral requirements (ranging from joint liability and personal guarantees to tangible collateral and pawning), rather than in terms of loan purpose, which is costly to appraise and, for fungibility reasons, difficult to control. Viable and sustainable microcredit schemes require: prudent adjustment to household savings, investment and repayment capacities; small loan sizes, with ceilings growing over a cycle of repeat loans up to a level determined by the absorptive capacity of the microenterprise and household economy; dynamically growing savings-to-credit ratios; market rates of interest autonomously determined by financial institutions and differentiated according to costs and services provided; loan maturities and repayment modalities according to customer needs and differentiated, in case of wholesaling, according for each level of intermediation; short maturities, no grace periods and short instalment periods in case of initial loans; insistence on, and incentives for, timely repayment; and the development and provision of cost-effective monitoring systems.

**Microinsurance:** Microinsurance is the most underdeveloped part of microfinance. Yet various schemes exist that are viable, benefiting both the institutions and their clients. Such schemes have generally served two major purposes: (1) they have contributed to loan security; and (2) they have served as instruments of resource mobilization.

On a modest scale, various forms of life and health insurance have been successfully practiced by different institutions in different countries, particularly as part of loan protection schemes (e.g., by credit unions). There are also successful examples of accident insurance and cattle insurance (e.g. by ADBN-SFDP, Nepal). There are virtually no cases of viable crop insurance schemes.

**Product reciprocity:** Product reciprocity, ties credit to savings and insurance. It lessens moral hazard and improves financial discipline. For otherwise unbankable customers, it establishes a track record. To banks, it offers a cost-effective solution to the information problem.

**Collection reciprocity:** Through collection reciprocity an institution may combine the collection of savings with the collection of instalments, which can be crucial to arrears prevention in the informal sector where incomes are daily or irregular, but not monthly, and are likely to escape collection without appropriate timing and collection techniques.

**Tied lending:** Recovery rates can be further improved by tied lending, which interlinks credit with commodity transactions, which are widespread in the nonformal sector but may also be successfully applied by formal institutions.

**Microfinance procedures and services:** They should be set by financial institutions rather than government; be customer-oriented, i.e. simple, fast and on time; be market-oriented and in competition with those by other formal or nonformal institutions; and cover their cost. Appropriate procedures and services should be applied to attain (1) sound financial management, (2) convenient and safe savings collection and deposit facilities, (3) appropriate loan appraisal

and processing procedures, (4) adequate risk management (including collateral substitutes, nonformal collateral, loan protection schemes and prudent loan disbursement), (5) timely repayment collection, (6) monitoring and (7) effective information gathering, all of which may include cooperation between different formal and nonformal intermediaries in fields where each is most effective.

**Terms and conditions:** Financial contracts must be sound from both an institution's and its customers' viewpoints. To arrive at balanced loan contracts, an exchange of experience and mutual learning may be required between the various types of nonformal and formal institutions including: (1) informal financial institutions with their wide range of contractual terms concerning interest rates, loan sizes, maturities, grace periods, loan purposes, reciprocities, collateral requirements, services, transaction cost sharing arrangements and unbounded innovations; (2) semiformal financial institutions including projects and programs, which tend to be influenced by governmental or non-governmental donors and frequently combine comprehensive services with a lack of commercial orientation; (3) formal institutions on tightly regulated markets, with a narrow and usually inflexible range of contractual terms; and (4) formal institutions on deregulated markets with their much wider range of terms, transaction cost sharing arrangements and innovations.

Ultimately savers and borrowers must be regarded as a market for financial institutions: with the institutions as intermediaries, and savers and borrowers as customers rather than beneficiaries. Contractual terms and conditions on that market are the result of negotiation and competition rather than administrative imposition and convenience.