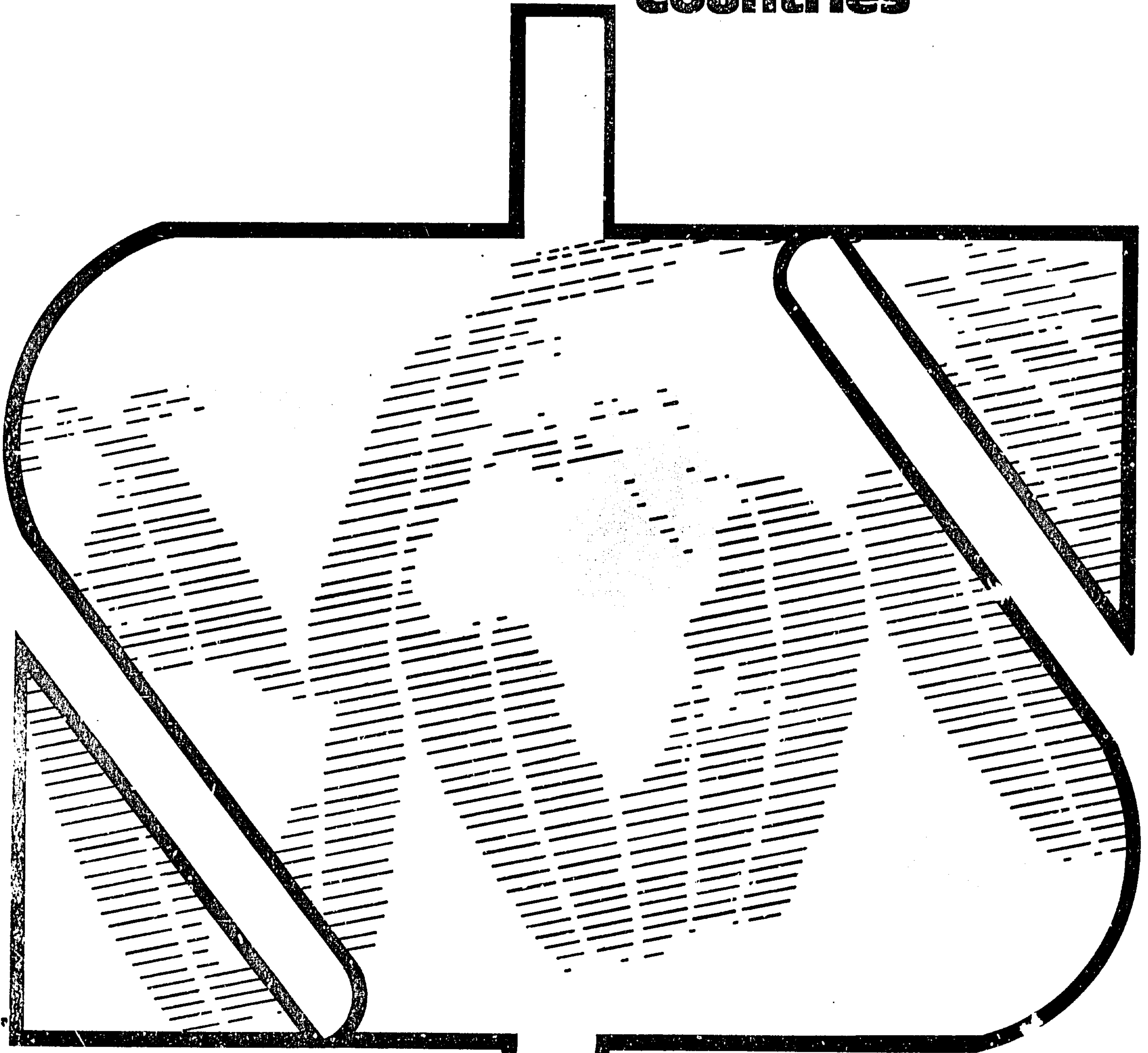
PN-AAR-974
ISN 38426

Small-Scale Bank Lending in Developing Countries



February 1985

Agency for International Development
Washington, D.C. 20523

PN AAR 974

SMALL-SCALE BANK LENDING IN DEVELOPING COUNTRIES: A COMPARATIVE ANALYSIS

by

Jason Brown

April 1984

Prepared for

Employment and Small Enterprise Division
Office of Rural and Institutional Development
Bureau for Science and Technology
U.S. Agency for International Development
Washington, D.C. 20523
Grant No. DAN-0600-G-SS-2107-00

Acknowledgements

I wish to express my appreciation to the authors of the various case studies for making this analysis fruitful. I also wish to thank Dr. Robert Young of the Employment and Small Enterprise Division, Agency for International Development, for his encouragement and support.

Jason Brown

The views and interpretations in this publication are those of the authors and should not be attributed to the Agency of International Development or to any individual acting in its behalf.

Table of Contents

Page Numbers

PART A: COMPARATIVE ANALYSIS 1

I. Introduction 1
II. Summary Findings 1
III. Background 4
IV. Description of Banking Institutions 5
  A. Types of Banking Institutions 5
  B. Loan Size and Extent of Small-Scale Business Lending 6
  C. Terms 6
V. Lending Policies and Procedures 7
  A. Increasing Volume of Lending and Velocity of Loan Turnover 8
  B. Increasing Number of Loans Managed by Each Employee 8
  C. Focusing on Lendee Selection 8
  D. Enforcing Repayment 8
  E. Controlling Employee and Other Administrative Costs 9
  F. Encouraging Savings 9
  G. Increasing the Spread 10
  H. Use of Non-Banking Intermediaries 10
VI. Profitability 10
VII. Impact on Borrowers 12
VIII. Conclusions 13
  A. Policy Environment 13
  B. Profitability 13
  C. Use of Intermediaries 14
  D. The Role of Banks and the Issue of Subsidy 15
  E. The Next Step 16

PART B: CASE STUDY SUMMARIES 18

I. Small-Scale Bank Lending in Bangladesh. 19
II. Small-Scale Bank Lending in India 23
III. Small-Scale Lending of Syndicate Bank, India. 27
IV. Small-Scale Bank Lending in Indonesia: The Badan Kredit Kecamatan 30
V. Small-Scale Bank Lending in Thailand. 33
VI. Small-Scale Bank Lending in the Cameroons 35
VII. Small-Scale Lending in Kenya 37
VIII. Small-Scale Lending of the Federation de Cajas de Credito, El Salvador 39
IX. Small-Scale Bank Lending in Ecuador 41

Part A

COMPARATIVE ANALYSIS

SMALL-SCALE BANK LENDING IN LESS DEVELOPED COUNTRIES

by

JASON BROWN

PART A

COMPARATIVE ANALYSIS

I. INTRODUCTION

In the past several years, many developing country banking institutions have initiated programs to provide small-scale loans to businesses. Data on the scale and effectiveness of these loans have been sparse or in the case of comparative data, totally non-existent. This project was therefore undertaken to obtain, within budgetary constraints, such information as would shed some light on the rationale and determinants of success for such small-scale lending. For the purpose of this project, small-scale is defined as $500 or less.

Data collection efforts focused on assembling existing secondary data. However, as so few secondary data were found to exist, original data had to be collected in some cases. Case studies were developed also to collect information on operations and impact that would allow for comparison across programs. Most programs have not been systematically evaluated. For those that have been, such as Bangladesh, resulting information fails to address certain key points. For most programs, cost information is either not available or incomplete.

It was originally intended to focus only on commercial banks. In practice, many countries have used other vehicles to achieve the same purpose. Case studies include, therefore, examples of many types of banking institutions.

The case studies, summarized in Part B of this report, include:

1. Small-Scale Bank Lending in Bangladesh.
2. Small-Scale Bank Lending in India.
3. Small-Scale Lending by Syndicate Bank, India.
4. Small-Scale Bank Lending in Indonesia: The Badan Kredit Kecamatan (BKK).
5. Small-Scale Bank Lending in Thailand.
6. Small-Scale Bank Lending in the Cameroons.
7. Small-Scale Lending in Kenya.
8. Small-Scale Lending of the Federation de Cajas de Credito, El Salvador.
9. Small-Scale Bank Lending in Ecuador.

As a result of the inadequacies of the data, the comparative analysis that follows must be viewed as incomplete. More and better information is needed before definitive conclusions can be reached on the utility of small-scale lending programs.

II. SUMMARY FINDINGS

Most small-scale lending by banking institutions for business purposes in developing countries is of recent origin, though some programs predate 1970. However, some, such as Syndicate in India, go back over 50 years. It is clear that the number and variety of such programs is growing rapidly.

There are many rationales for establishing small-scale lending programs ranging from purely political to profit maximizing. Most often a combination of intentions is present. Within the context of their particular rationale, many programs appear to be surprisingly successful.

It is not clear whether any bank studied has been able to make an unsubsidized profit purely on the basis of small lending. Some Indian banks may be doing so, but there is insufficient financial data to verify this. Banks which appear to be unsubsidized and profitable (Banco del Pacifico, Syndicate, etc.) seem to accomplish it by offering credit to large and small borrowers and keeping small lending to a modest proportion of total money lent. For some banks, such as Syndicate, small savings are a vital part of bank resources and small loans make up the majority of loans made, even if not the majority of total money lent.

Some lending institutions, such as those in India, Indonesia and Bangladesh, have been able to reach very large numbers of people. Where it is their intention to do so, banks appear to have found ways to at least cover their costs on small-scale loans. Where impact studies on borrowers have been completed, findings generally support the contention that such lending is useful (more evaluation will be necessary before this finding is conclusive). Key aspects of bank small-scale business lending are summarized in Table I.

Government policy frameworks have had a significant impact on most programs. India's supportive policy has been responsible for making Indian bank programs the largest in the world. Government support was essential to all programs studied. Inhibiting policies, such as interest rate ceilings, are viewed as a principal reason why many programs, such as the one in El Salvador, remain small.

Not surprisingly, "successful" programs seem to be characterized by:

1. Supportive government policies
2. Clarity as to objectives
3. Strong administrative structure
4. Dynamic leadership
5. Mobilization of savings as an integral part of the program

Almost all programs to date have been developed in relative ignorance of each other. However, in the few cases where information has been transferred it has been viewed as extremely helpful. Some programs, such as those in the Philippines, have been consciously modeled on those formed elsewhere. There is now enough varied experience world-wide in such programs to make it possible to find elements from other contexts which may prove appropriate in new locations. Existing programs also may benefit from the experience elsewhere.

It is hoped that this study will prove a useful first step in making such information more widely available. However, field data collection on a more systematic basis will be necessary to verify and clarify key points. In depth evaluation efforts such as that of the Indonesian Badan Keredit Kecamatan, which is included as on the case studies, should be encouraged.

Table I. Key Aspects of Small-Scale Business Lending

Country	Date[1]	# of Loans[2]	Avg. Loan[3] Size	Average Interest Rate	Administrative[4] Costs	Subsidy[5] Present?	Are Banks[6] Profitable?	Commerci Bank
Bangladesh	1981	72,000	$ 140	12-26%	4-8%	Subsidy	Yes	Yes
India	1981	15 million	$ 500	4-18%	3%	Subsidy	Yes	Yes
Indonesia	1983	2.7 million	$ 50	40-48%	4.3%	Subsidy	Yes	No
Thailand	1983	3,100	$ 4,000	16%	?	No Subsidy	Yes	Yes
Cameroon	1983	0	$40,000	11%	?	Subsidy	Yes	No
Kenya	1983	9,000	$ 572	?	?	No Subsidy	Yes	Yes
El Salvador	1981	61,177	$ 400	15%	2.5%	Subsidy	Yes	No
Ecuador	1982	3,000	$ 1,400	12%	?	Subsidy	Yes	Yes

1Date of information provided
2Known loans of this size in each country
3average loan size of known small-scale business lending
4Average percentage interest required to cover administrative costs, if known. Based on limited data Comparability questionable.
5Is the small-scale lending subsidized in some way (e.g., low interest rates, salary support)?
6Are banks profitable, even with small-scale lending included?

III. BACKGROUND

A variety of studies have repeatedly found that inadequate credit is the principal problem facing most small business people in developing countries. Few businesses are receiving credit from any formal lending institutions. Most small business lending world wide, to the extent loans are available at all, is provided by friends and relatives and, to a lesser degree, by informal sources such as money lenders.

There is some disagreement among experts as to the extent to which this concern of businesses with credit represents a genuine need as opposed to a misapplication of existing sources of capital. However, no one has concluded that the increased availability of credit is not an important element in business expansion.

Banks and other formal lending institutions have been slow to respond to the credit needs of small business for a variety of reasons. A major reason appears to be how to identify and handle a large number of small accounts at and acceptable cost.

Some banking institutions, such as Syndicate and Canara Banks in India, have long and successful histories of small-scale lending. Yet it was not until the early 1970's that interest in lending to that sector expanded.

The initial impetus was primary political. India nationalized its banks in 1969 and forced them to lend to greater numbers of small borrowers. The Philippine government in the mid-seventies developed a series of incentives and sanctions designed to encourage small-scale lending. This was done at a time when the Marcos regime was still somewhat insecure. As a result of increasing population pressure in the 1970's, Indonesia experimented with establishing a series of small-scale lending programs. The government of El Salvador developed its small-scale lending program as an overt means of mobilizing popular support. The Thai banks are involved in small-scale lending only as a result of government pressure. Political pressures on banking systems seem to be growing.

Some banking institutions become involved as a result of a combination of economic and environmental factors, such as Ecuador's Banco del Pacifico and the Syndicate Bank in India. The Banco del Pacifico was forced to focus on small lending because most larger borrowers in Ecuador already had established relationships with existing banks. Their only reasonable source of growth was clients not served by other banks. Small-scale lending was encouraged by a government policy requiring that 20 percent of the value of loan funds be utilized for development purposes.

The Syndicate Bank in India was in a similar situation. Originally established specifically to assist the Guad Saraswat Brahmin caste of South India, most of whom were small farmers and business people, they had to provide small loans to reach their intended clientele. Both banks recognized the problems of servicing small loans. They took advantage of government incentives to reduce costs and experimented with ways of cutting internal costs yet further.

Some banks become involved as a result of the requirements of a foreign loan. That is clearly the case in the Cameroons and more or less true of Bangladesh as well. The Banque Cameroonaise de Development would clearly not have made loans even as small as they have without pressure from the World Bank. The difficulty in meeting the objectives for yet smaller loans clearly stems from the Banque's perception that such loans are not viable, even if the World Bank continues to apply pressure to assure that they are made.

In Bangladesh, the banks began to provide small business lending due to the availability of various incentives developed through a loan from A.I.D. Without these incentives, they were unwilling to take the risks associated with such loans.

IV. DESCRIPTION OF BANKING INSTITUTIONS

A. Type of Banking Institutions

Small-scale lending to business is being carried out by a wide variety of banking-type institutions in developing countries. This project was most interested in looking at regular commercial banks and, therefore, these predominate in the case studies included.

Chief among the other types of banking institutions seem to be cooperative banks. Examples in the case studies include the Federation de Cajas de Credito in El Salvador and BSBL and IRDP in Bangladesh. Cooperative banks are typically developed to complement other services provided to farmers. Business lending is something in which they become involved because of increasing demand by borrowers, rather than by bank philosophy.

Other institutions are established and run by governments to achieve specific objectives. An example of this is the Badan Kredit Kecamatan (BKK) in Indonesia. This institution was set up and is subsidized by the provincial and central government to provide credit to small business. In a sense, the Federation de Cajas de Credito in El Salvador also falls in this category, since it was set up and is closely controlled by the government, even though operating on a cooperative basis.

An informal institution, at present the principal non-family source of small-scale lending to business, is the money lender. Despite their unsavory reputation, these people fill an important void. They typically charge very high interest rates, which may in some cases be as high as 100% a day, but which average 5-20% a day for urban vendors. Recent information seems to suggest however, that these high rates may in fact represent nothing more than the high risk associated with such lending. Some countries, such as India have experimented with providing bank lending to money lenders at low rates in an effort to cushion the risk and enable money lenders to pass on lower rates to borrowers. This has been successful in some cases. More such experimentation will probably occur in the future because money lenders could serve as an effective tool in assisting banks to reach large numbers of people.

Finally, there are institutions run by voluntary, non-profit, organizations. The vast majority of these at present are cooperatives tied to farmer groups. However, an increasing number, such as the ones briefly described in the Kenya case study, are being set up by local or international organizations having socio-economic objectives. Although these programs are in most cases small at present, some, such as one in the Dominican Republic (not among the case studies) have become or have the potential of becoming fairly large. Some banks are interested in using these groups as a low-cost way to identify and supervise borrowers. This has been accomplished with some success on a limited basis in India. It has also been attempted, though on a much smaller scale, in Kenya and some other African and Latin American countries. There will undoubtedly be more experimentation along these lines in the future.

B. Loan Size and Extent of Small-Scale Business Lending

The definition of small-scale lending varies considerably from bank to bank. Loans average $50.00 for the Badan Kredit Kecamatan in Indonesia, but in the Cameroons, the smallest loan yet considered was $14,285.00. This project intended to look only at programs providing loans averaging $500 or less. Since such wide variations were found from country to country, the local definition of small-scale was accepted instead.

Average small-scale loan size and the number of loans provided up to the date indicated is provided in Table 1. Several of the programs are very large and provide loans averaging well within the original maximum of $500.00. Most of the commercial banks, with the exception of Syndicate, provided a modest number of small-scale loans. For all commercial banks, including Syndicate and those in Bangladesh, small-scale lending utilizes a very small proportion of total loaned funds. Although complete data on all banks is not available, it can probably be safely assumed small-scale lending absorbs on the average less than 5 percent of bank loan value in commercial banks. This means that commercial banks can absorb unusual small-lending costs in total bank operations with relative ease.

The other small-scale lending programs with significant loan volume, such as those in El Salvador and Indonesia, are not operated by commercial banks, but are instead either governmental (Indonesia) or closely connected to government (El Salvador). This configuration of programs reflects the fact that the initial impetus for small-scale lending has been principally political, except in a few cases. Nevertheless, the exceptions, including the older Syndicate Bank and the more recent Banco del Pacifico, suggest that commercial banks, at least in particular cases, find it justifiable to become involved in small-scale lending.

C. Terms

One of the principal concerns of small-scale lenders, is to the extent feasible, to make sure loan proceeds are used for the purposes stated in the loan agreement. The theory is that if loan proceeds are used for other purposes, there is greater likelihood of default. Although actual experience of many banks corroborates this position, extensive evaluation in Bangladesh shows little difference inrepayment by those who used loans for the stated purpose and by those who used loans for numerous other purposes.

The Bangladesh research raises some questions about the effort banks make to assure compliance. In practice, only a few banks have any enforceable requirements. These are generally the banks with a smaller number of relatively larger loans, such as the Banco del Pacifico, the Banque Cameroonaise and the Thai commercial banks. These banks avoid working capital loans and write checks directly to vendors for materials, equipment or buildings. The larger programs have very limited control over loan use.

Interest rates vary considerably from country to country, depending on government policy. The lowest rates, which are set at 4 percent, are those of the Differential Interest Rate Scheme in India. All Indian banks, including Syndicate, are required to utilize 1 percent of their loan portfolio for this Scheme.

The highest rates of interest, which can range from 40-50 percent, are those of Indonesia. These rates are for unsecured business working capital loans with a maximum maturity of three months (4.8 percent per month).

Some banks are restricted by government policy from charging what they feel is the rate of interest they need to make small-scale lending profitable. This includes the Banco del Pacifico, which is restricted to a maximum of 16.25 percent. They feel they need a minimum of 18 percent to make small lending a profit center. As a result of the government position, they have taken the stance that their small-lending program is a public relations program that they will subsidize on a small scale at 12 percent interest. This stance will continue until government interest rate limits increase.

Interest rates for other programs are listed in Table 1. Although situations vary from country to country, these few cases suggest that if banks are required to charge less than an average of 18 percent for loans and have a spread between costs of funds and effective interest rate of less than 8-10 percent, small-scale lending becomes increasingly unprofitable.

The loan term varies depending on the type of business and the use of funds. Loan proceeds for use in purchasing equipment and inventory tend to be for periods of 3-4 years maximum. Working capital loans for small retailers may be for three months or less. The latter normally have the highest interest rate and are unsecured.

V. LENDING POLICIES AND PROCEDURES

Administrative procedures tend to closely reflect program objectives. For those programs which are small and intend to remain so for the foreseeable future, such as the Banco del Pacifico and the Thai banks, procedures are simply reflections of normal banking activity. This means that loan requests would typically involve extensive paperwork, several levels of approval and long waiting periods. The banks which use these procedures recognize that the associated administrative costs are impractical on a larger scale, if a bank wishes to continue to be profitable.

This reality has led the banks which operate larger programs to seek ways to reduce costs while keeping default rates within reasonable limits. Banks with larger small-scale lending programs utilize the following methods to control costs.

A. Increasing volume of lending and velocity of loan turnover

Most of the larger programs attempt to keep as much money as possible moving as rapidly as possible. Turnovers of 4-5 times a year to be most desired. Large volume has the advantage of producing a continuous flow of substantial interest income with which to cover costs. Short loan duration has a number of advantages. Usually the amounts are smaller and the bank thus has smaller risk. Problem borrowers emerge quickly and can be cut off from additional credit before losses are substantial. The various administrative charges associated with short term loans tend to move the effective interest rate up substantially. For instance, the effective rate can approach 50-100 percent a year with a turnover of 4-5 times a year, even if the nominal interest rate is relatively low.

B. Increasing number of loans managed by each employee

For larger programs, it appears that a typical loan officer is managing an average of 200 loans. Some (e.g., Krishi Bank in Gangladesh) banks approach 400 loans per loan officer. The effect of this high number is to both lower overhead costs per loan and, of course, decrease the time available for loan supervision. This means that larger programs rely on methods other than direct supervision to assure repayment.

C. Focusing on lendee selection

Smaller programs, as already indicated, follow traditional procedures in selection of loan recipients. In the case of Banco del Pacifico, for instance, the loan recipient must provide two personal references, tow commercial references, a strong credit history, a co-signer who also has a good credit history, a business plan and in most cases, invoices for goods purchased, against which the loan is drawn.

With the much larger number of very small loans provided by some other programs, such strict procedures have proven impossible. In Bangladesh, loan recipients must generally be recommended by someone in their village known to the bank, such as a village official. Most programs have one or more forms that must be completed. Other than this, few controls are apparent in client selection. However, each program which has good to significant size has developed a method of lendee selection, which while simple, seems to work in their socio-cultural environment.

D. Enforcing repayment

All programs studied have experienced problems with repayment during their start-up period. Most either have already or are in the process of bringing these under control. Arrears in the Federation de Cajas de Credito program rose from 3 percent in 1978 to 7.4 percent in 1979, before settling back to a more modest 4 percent in 1980. Arrears in the Banco del Pacifico rose from 7 percent in 1979 to 27 percent in 1980, before new controls were established which brought the rate to 0.7 percent in 1982. For the Bangladesh banks as a group, arrears stood at 33 percent in 1979, the first year of program operation, but fell to 9.86 percent by 1982.

Each program has faced different problems in increasing repayment. For all banks, it was necessary to isolate the type of lendee likely to be a problem borrower and adjust lending policies to either eliminate that category from borrowing or establish criteria that would increase the likelihood of their repaying. Some programs, such as the Banco del Pacifico, launched of highly publicized drive to enforce collection, including taking delinquent borrowers to court. It is not clear which method, stricter loan appraisal procedures or stricter enforcement of loan collection, was more critical, but repayment clearly has increased substantially in all programs for which information is available.

The age of delinquencies (the period of time the loan has been delinquent) seems to be the most important factor in determining the ability of the banks to reduce all delinquencies. Bangladesh banks which have been unable to decrease the age of delinquencies have also been unsuccessful in reducing all delinquencies.

E. Controlling employee and other administrative costs

Bank personnel in larger programs are generally paid less than other comparable people. Syndicate Bank, for instance, has historically paid 10-20 percent less than other Indian banks for people with comparable jobs. Its employees currently average $1,250.00 a year as against $1,500.00 for the Indian banking industry. In its early years, the differential was much greater. The Bandan Kredit Kecamatan pays less for its people than they would receive if hired as regular Indonesian civil servants.

Small loan programs are often administered out of local village offices or other facilities used on a part-time basis. Little is provided such offices in the way of equipment or supplies other than forms and pencils.

Total administrative costs for the Federation de Cajas de Credito were 8 percent of loan volume in 1980 and rose to 10 percent in 1981. In 1982, administrative costs averaged just under 8 percent of loan volume for the nine Bangladesh banks.

F. Encouraging savings

Most programs have put heave emphasis on savings mobilization as a relatively inexpensive source of capital for additional lending (offer less than 8 percent). Some programs have gone so far as to enforce savings. This is true of five of the nine banks in Bangladesh, which require lenders to maintain a balance in the bank at some percentage of the loan outstanding. The Syndicate Bank early began a program of encouraging small desposits by sending people door to door to collect $0.01 or $0.02 a day. Deposit collectors were paid a commission. Depositors in the early days were only paid about 3 percent and could not remove deposits for several years. More recently, competition has forced Syndicate to raise interest rates to 5-6 percent. They are no longer able to pay commissions to collectors, but small deposits continue to be encouraged.

G. Increasing the spread

Based on costs associated with providing small-scale loans in a particular location in the context of a bank's overall philosophy, the banks determine the spread necessary between their cost of money and the average interest rate earned. Bank experience seems to suggest that a much wider spread is necessary to make profits with small-scale lending. Whereas spreads of 2-4 percent are not uncommon for regular commercial loans, the average spread required in small-scale lending seems to be closer to 8-10 percent. The average spread of the nine participating banks in Bangladesh, for instance, is 10.8 percent.

H. Use of non-banking intermediaries

Although little documentation on the use of non-banking intermediaries exists, it appears that banks are increasingly using such intermediaries to identify and supervise borrowers as a means of controlling their costs. As usual, most examples of these are found in India, but it is also increasingly evident elsewhere.

One type of intermediary is the money lender. Informal information suggests that banks are providing funds to moneylenders, often at advantageous rates. The money lender, in turn, is expected to make loans to small borrowers at reduced rates. Whether interest rates received by borrowers are in fact lower is undocumented.

Another type of intermediary is the nonprofit organizations mentioned earlier. Hundreds of these organizations in India serve as conduits for low interest funds from the banks. Examples of these programs are the Working Women's Forum, the National Association of Educated Self-Employed Youth in Madras and the Calcutta "Y" Self-Employment Centere in Calcutta. The nonprofits select and supervise the borrowers. Again, documentation fo results is limited, but at least some banks have been pleased with the results. In these few cases, it is known that default rates dropped to near zero. These banks had previously experienced default rates near 50 percent when they attempted to supervise such loans themselves.

Banks are also increasingly willing to finance receivables of small stores and suppliers. This essentially permits small business operations to receive credit for which they would otherwise not qualify.

VI. PROFITABILITY

Profitability is extremely difficult to analyze systematically from a comparative standpoint. For banks where small-scale lending is a minor factor in overall banking operations, costs and income are not accounted for separately. This is true, for instance, of the Banco del Pacifico. Other banks have bookkeeping practices which make it difficult to determine profitability. This is true of Indian banks, where default rates and administrative costs tend to be closely guarded secrets.

Most programs have access to a variety of "incentives" that effectively lower costs (at least in theory), while some programs (sometimes the same ones) must operate under regulations which effectively increase costs. Again, India is a good example. For lending to "priority" sectors, banks may borrow from the Central Bank at a discount. They also have recourse to a guarantee scheme, should the borrower default. On the other side of the ledger, "priority" sector lending is required as a percentage of total lending, often forcing the banks into loans they consider too risky. They are also required to lend 1 percent of their loan portfolio at 4 percent (their cost of money here is about 2 percent). Many banks apparently do not use the guarantee scheme. To do so would require them to admit high default rates to the same body that also audits them, which they are reluctant to do. No one outside the banks knows their true costs and profits.

In Bangladesh, the AID dollar financing which established the bank small loan program created generous incentives. Participating banks would receive funds: 1) to cover all defaults or failure of interest rates to cover default; 2) to pay one-third of the value of the loan on a grant basis; 3) to pay one-third of the loan value for each fully repaid loan. Interest rates were allowed to range up to 36 percent. This policy amounted to reducing bank risk to near zero. However, loans have to be provided to very small borrowers, most of whom had no previous experience with bank credit. Therefore, although this program is profitable even when various incentives are discounted, it remains to be seen whether profitability can be maintained once the incentives are no longer in place.

The BKK in Indonesia is a governmental program. As such, its concerns are of different nature than a commercial bank. There are a number of subsidies to this program, including payment by the government of one-third of salaries and a continuous infusion of capital. Profit and loss statements do not take into account provisions for bad debt. Effective interest rates approach up to 50-100 percent. When these factors are discounted, the program is still profitable. As in the case of Bangladesh, it is unclear what effect removal of incentives will have on profitability.

As a result of various incentives and regulations, profitability of small-scale lending programs is difficult to compare across national borders. For this reason, the program in Bangladesh, which involvs nine banks, is particularly instructive. This program was extensively evaluated and important comparative data on the early years of the program are available. This is virtually the only program for which reliable interbank comparative data can be found that relate profits to different bank lending strategies.

As indicated already, this program was found to be profitable overall, even when the various subsidies were discounted. The average profit for the nine institutions was 3.3 percent of average monthly outstanding loans in March, 1983. As might be expected, however, profitability varies considerably among the institutions. Krishi had the greatest profit at 8.3 percent. Uttara had the greatest loss at 13.7 percent. Five of the nine banks were profitable.

Reference should be made to the Bangladesh case study (see pp. 19-22) for a detailed analysis of factors contributing to profitability. Significantly, no single factor was paramount. The profitable banks were able to be so, in general, by operating large programs which selected borrowers carefully, kept administrative costs low, kept arrears low (especially) those over six months), encouraged savings and maintained a healthy average spread. No bank, however, did extremely well in all areas. Profitability in fact seemed to depend on a combination of factors which was different for each bank. These factors are outlined in Table II (p. 21).

Of the Bangladesh banks, Krishi, the most profitable, had the largest loan portfolio, moderate amounts of delinquencies, low administrative expenses, moderate savings and a very healthy spread; Rupali, next most profitable, had among the smallest loan portfolios but low deliquencies, higher administrative expenses, high levels of savings and the highest spread of all; Sonali, the next, had higher delinquencies but much lower administrative expenses, savings and moderately lower spread. Uttara, the least profitable, had a very small program with moderate delinquencies (most of them over 12 months old), high administrative costs, moderate to low savings and a high spread.

Due to the paucity of reliable and complete data on other programs, it is difficult to generalize. Data on Bangladesh do suggest, however, that profitability can be achieved through a variety of factor combinations. All of the factors identified are important. Others may also be vital as a result of the particular environment in an individual country. How they are put together will vary considerably between countries and between banking institutions.

VII. IMPACT ON BORROWERS

The impact of small-scale borrowing on loan recipients has been evaluated only in Indonesia and Bangladesh.

In Indonesia, 96 percent of borrowers interviewed said that their net profits had increased. Almost without exception, they attributed this to the loan. For most, the principal source of increased profits was their ability to buy in larger quantities, thus taking advantage of supplier discounts. Only 17 percent of those interviewed had increased the number of their employees since receiving the loan. Increases averaged 1.85 persons. Only slightly more than half of the interviewees attributed such added employment to the loan. No effort was made in this evaluation to obtain actual amounts of increase in net profit. Nor was there a control group to attempt to isolate whether increases in net profit or employment were truly attributable to the loan. Therefore, it is difficult to assess the meaningfulness of the Indonesia data.

In Bangladesh, much more exhaustive evaluation was carried out. Actual increases in net worth were measured and a control group was utilized. It was found that 28 percent of borrowers showed a greater than 10 percent increase in net worth, whereas only 17 percent of non-borrows showed a similar increase. If problem borrowers are removed, the percentage showing a greater than 10 percent increase rises to 33 percent. Unfortunately, despite the amount of evaluation carried out, there seems to have been no consideration of the employment effects.

VIII. CONCLUSIONS

Small-scale lending by commercial and other banks to business in developing countries is growing very rapidly. For a variety of political or economic reasons banks apparently have overcome their fears and found ways to make such loans at acceptable costs.

The key to a successful program seems to be a commitment to undertake small-scale lending in a big way. Small programs can seldom hope to deal with the impediments to profitability. Large programs seem to find a variety of methods to spread or reduce costs.

As with many new programs, the risks seem to outweigh the advantages initially. However, our case studies have demonstrated that with sufficient careful attention many problems can be solved. More importantly, from the point of view of the banks, small-scale lending to business can be a substantial new market which can eventually contribute to growth and profit.

Several points deserve special emphasis:

A. Policy Environment.

No single factor has been more telling in the emergence of these programs than the policy environment. India is the most compelling example, with millions of loans having been made to date almost entirely due to government policy. With the exception of Syndicate, no program studied would have emerged without government encouragement. Larger programs exist only where there were, at least at the outset, clear incentives.

One of the most critical incentives is flexibile interest rate ceilings. Experience seem to suggest that where interest rate ceilings are rigidly enforced below true free market rates, programs will not grow, despite other incentives. When government policies set low ceilings, some countries have found ways to get around them. The Philippines is a good example. There, despite interest rate ceilings of 18 percent, various fees are allowed which can increase the effective interest rate to near 40 percent. Such flexibility appears to have enabled small-scale lending in the Philippines to flourish.

B. Profitability.

The most critical and most elusive issue is profitability. Many of the factors which contribute to profitability are known. It is, therefore, possible to make recommendations to a bank which may have a positive impact on profits. However, as pointed out in the case of Bangladesh, a variety of factor combinations can result in either profit or loss. Until more research is carried out, no greater precision is possible.

While there is no documented, supportive, observation in the Philippines, India and Bangladesh seems to suggest that banks should:

1. view small-scale lending as a:

   a. means for tapping new markets (long-term);

   b. means for mobilizing new resources (short-term);

   c. possible source of profit, particularly if interest rates are not unreasonably controlled, loan volume and velocity can be increased and costs can be kept down (long-term);

2. initially keep small-scale lending as a small proportion of total funds lent, until program has proven itself profitable;

3. be experimental in finding ways to get volume up and costs down, including use of intermediaries such as money lenders and nonprofit organizations.

C. Use of Intermediaries.

There is much interest in the greater use of intermediaries such as nonprofit organizations or money lenders to distribute credit. USAID and other donors are funding projects which are experimenting in this area. There is evidence that intermediaries can be helpful both to banks and to potential borrowers.

Successful use of nonprofit intermediaries to date has occurred where: (a) the nonprofit organizations were fairly large, well-organized and in significant numbers; and (b) the particular non-profit intermediaries cooperating with the bank were already fairly large and well organized.

Experience suggests that it takes many years for a nonprofit to develop to the point where it can effectively serve as an intermediary. Likewise, because non-profits typically are relatively small, banks would need to be able work with many of them if this was to be seen as a vehicle for reaching large numbers of borrowers. However, careful consideration must be given to the role the non-profit organizations should play. Unless the nonprofit is extremely strong organizationally, it would normally be wise not to ask it to actually dispense, collect or otherwise handle money. This is best done by the bank which has experience in such matters. The role of the nonprofit should be to identify borrowers, help them complete the formalities necessary to obtain the credit and then assist during the period of the loan to use the money in a manner that will assure its prompt repayment so they can qualify for additional credit. The nonprofit, by performing these functions, should also serve to reduce bank costs.

Alternative intermediaries could be money lenders. While their image is frequently negative they play a useful role in reaching borrowers. The high interest rates they charge may well reflect the high risk ventures to which they provide funds and perhaps their image is not totally deserved. Many banks already provide commercial credit to money lenders, who usually have collateral and repay on time. How much commercial credit is being extended to them is not known, but it is probably much larger than commonly thought. It may be a relatively easy next step for the banks to more actively involve money lenders as intermediaries in a small-scale lending program.

There have been more formalized steps in this direction in the Philippines. The banks themselves have set up small outlets with one or two people right in the markets. These outlets lend on a short-term basis at effective rates of near 40 percent. In contrast, larger money lenders have set up licensed finance companies, which borrow from banks on a large-scale and re-lend in markets and other locations at higher interest rates. These two approaches also are emerging in other countries which have somewhat developed financial markets.

Other approaches are also possible. Experimentation in this area should be encouraged.

D. The Role of Banks and the Issue of Subsidy.

This study was based on the hypothesis that the only way to reach large numbers of small borrowers efficiently worldwide is through commercial banks which provide unsubsidized credit. The large BKK program in Indonesia and several other experiments, such as that in the Dominican Republic, would seem to run counter to this argument since they are quite large and are not run by commercial banks. Even the Indian case, with heavy apparent subsidies, seems to disprove this argument.

However, it was also necessary to clarify whether the establishment of subsidized/non-commercial bank programs was the most efficient use of resources in each case. India provides a clear example. There seems to be little economic justification for a 4 percent interest rate, or for any other subsidy. Informal information indicates that by the time the loans actually reach the typical small Indian borrower, the effective interest rate has in most cases become the market rate. The subsidy has little real effect. Also, most information seems to indicate that higher costs have little effect on the benefit of the loans to the borrower. The main effect of the low interest may well be to restrain the supply of credit and thereby hurt the small-scale sector more than it helps it.

Despite the success of the BKK program in Indonesia, it is probable that a regular commercial bank could have been just as successful under these particular circumstances and at a much lower ongoing cost to the government.

Commercial banks know how to dispense credit. They have the networks established to do so efficiently. A bank that can profitably dispense credit to small borrowers goes a long way toward alleviating cost-benefit concerns, particularly among economists.

A key problem is getting the commercial banks to begin lending in this sector. This is when a subsidy makes the most sense. As in Bangladesh, banks may need various short-term subsides to start a small-scale loan program, but thereafter they should profitably operate it on their own.

Such subsidies will need to be carefully considered. It did little good in India to establish a loan guarantee scheme administered by the Central Bank. Lending institutions do not use the guarantee because they do not want the Central Bank to know about loan problems. Ways of weaning banks from initial subsidy will need to be considered. It would be useful to know what effect the removal of subsidies in Bangladesh in 1983 had on small-scale lending.

E. The Next Step.

The information on which this study was based, as has already been indicated, leaves a great deal to be desired. The most glaring limitation is that so little information is available on the impact of small-scale lending. Without such information, it is difficult to assess whether money spent in developing such programs is cost effective. More analyses are needed similar to the BKK evaluation (funded by AID's Science and Technology Bureau). The use of control groups and the better identification of impacts on profit and employment are essential for strong conclusions.

Another glaring deficiency is the lack of comparative data on costs of operation and profits of the banks. Banks are, and will continue to be reluctant to share such information. Even if willing, many banks have not broken out their financial information in a manner which will be meaningful for study purposes. Despite these problems, efforts should be made to develop such data.

More precise information is also needed on the thinking behind the efforts banks make to control costs. Why is one approach adopted over another? Why does a bank end up with a particular mix of policies? How do these compare with other banks?

In-depth studies of particular countries which have developed sophisticated and diverse small lending programs would be highly useful. Such country studies should include at least India, Philippines and perhaps the Dominican Republic. The studies should attempt to assess the policy environment, follow the emergence and development of small-scale credit, attempting to ascertain why certain approaches worked or did not work, and should help us understand what impacts we could anticipate from certain policy choices and economic situations.

The most useful next step would be replication of the Bangladesh experiment in another country. At the time of its development, the Bangladesh credit program was viewed as a potential prototype for other countries. Though flawed, the Bangladesh project is the best example we have of how a donor can work with the government and banking community to develop policies and programs aimed at small borrowers. Unfortunately, its valuable lessons have received little notice elsewhere.

Activities more immediate and less costly than replication are also useful. With the information available from this report, even though admittedly incomplete, it may be possible to begin the process of assisting governments and banks which are considering small-scale lending. The data developed in the report can be of considerable assistance to governments and banks in avoiding the major pitfalls encountered in other programs. Through such assistance, it would also be possible, at low cost, to continue the process of collecting data on small-scale lending.

Part B

CASE STUDY SUMMARIES

SMALL-SCALE BANK LENDING IN LESS DEVELOPED COUNTRIES

I. Small-Scale Bank Lending in Bangladesh
II. Small-Scale Bank Lending in India
III. Small-Scale Lending of Syndicate Bank, India
IV. Small-Scale Bank Lending in Indonesia: The Badan Kredit Kecamatan
V. Small-Scale Bank Lending in Thailand
VI. Small-Scale Bank Lending in the Cameroons
VII. Small-Scale Lending in Kenya
VIII. Small-Scale Lending of the Federation de Cajas de Credito, El Salvador
IX. Small-Scale Bank Lending in Ecuador

Part B. Case Study Summary I

SMALL-SCALE BANK LENDING IN BANGLADESH

Prepared from Studies
by
Clapp & Mayne, Inc.
Proggani Consultants
Public Administration Service
S.F. Ahmed & Co.

Developed and Edited
by
Jason Brown

I. INTRODUCTION

Beginning in 1978, nine Bangladesh credit institutions (seven banks and two cooperative societies) undertook an experimental program, under the aegis of the Bangladesh Bank. This program was to test whether it was possible to make extremely small loans, averaging less than $70,00, to large numbers of poor borrowers.

Actual loan funds were to come from the banks themselves. The Bangladesh Bank received $7 million from A.I.D. to cover the following: 1) all defaults; 2) one-third of the value of the loan on a grant basis for each loan made to a qualifying (e.g., poor) borrower; 3) one-third of the amount of the loan for each loan fully paid repaid to the lender.

II. DESCRIPTION

Through March 1982, 42,000 borrowers had received 72,000 loans with a total value of almost $8 million. These funds were provided by 98 bank outlets, each having an average of 730 loans. Most borrowers were rural agriculturists. Loan size in practice averaged $92 in March, 1979 and increased to $100 in March, 1982.

The banks were allowed to charge up to 36 percent interest. Crop loans carried interest rates of 12-18 percent and were repaid at the end of the crop cycle, with the crop serving as collateral. Non-crop agricultural loans carried interest rates of 18-24 percent, varying in length up to two years and were collateralized by building, equipment or other assets. Non-farm business loans carried interest rates of 30-36 percent, for periods up to two years and were secured by business assets. A surprisingly high proportion of loans (40 percent) have been used for business purposes.

III. LENDING POLICIES PROCEDURES

Lending policies and procedures vary considerably among the banks. Five of the banks lend only to individuals. Four lend only to groups. The banks were to provide loans to people previously having no access to credit. To do this, new outlets were to be opened. Some banks compiled with the requirement, others simply used existing facilities. On the average, banks tried to serve an area no greater than two to seven miles from the outlet.

Staffing levels varied from one to six persons. However, the larger number is represented by a bank which staffs its outlets with unpaid volunteers from the village. Staff tend to be well educated, with 50 percent having a BA and 27 percent having a M.A.

The banks operate between 4 and 19 outlets, with the average for the profitable banks being 12. The banks originally estimated that each outlet would need to handle an average 900 loans with an outstanding balance of $84,000 and each loan officer, 400 loans, to be profitable. By 1982, some of the banks exceeded these limits. Four banks averaged more than 900 loans per outlet and exceeded $85,000 in loan volume. Only one bank approached 400 loans per loan officer.

Savings mobilization received heavy emphasis. The average deposit to loan ratio for the profitable banks is 20 percent.

IV. COSTS

Delinquencies began very high, averaging 33 percent in 1979. This percentage fell to 11.7 percent 1981. For the profitable banks, delinquencies fell to 5.72 percent. However, for a variety of reasons, it began to climb after that and stood at 9.86 percent for the profitable banks in March, 1982.

Administrative expenses per outlet averaged $2,646 in 1981/82. Administrative expenses averaged approximately 8 percent of loan volume in 1982.

Given the high level of delinquencies and other costs, the banks estimate that they require on the average 21 percent effective interest rate to break even.

V. PROFITABILITY

By March, 1981, the experimental program was profitable overall and five of the nine banks involved were also showing a profit on the program. These profit figures discount the subsidy provided by AID. The level of profit ranged from 8.2 percent to 4.8 percent of average monthly outstanding loans. For those showing a loss, these ranged from 2.6 percent to 13.7 percent of average monthly outstanding loans. The financial situation for all but one institution was steadily improving.

Key factors contributing to profitability include interest rate spread (11.5 - 14.6 percent for profitable banks); amount overdue (16.2 - 18.6 percent for profitable banks), age of overdues (overdues 12 months or more average 1.9 percent to 10.9 percent for profitable banks), administrative cost per loan disbursed (range from 7.9 percent to 28.6 percent of total interest income for profitable banks), and volume of lending (all banks with a large volume of lending showed a profit, while only two of the smaller volume banks did). See Table II below, "Important Profitability Factors," for a more detailed comparison.

Table II.
Bangladesh: Bank Small Loan Programs
Important Profitability Factors[2]
(1982)

	Profit	Spread	Percent overdue	% Overdue Over 6 and 12 months	Reserve for Bad Debt/% Total Expense	Percent Admin. Expenses of Loans	Percent of Total Value of Program Lending	Average No. of Loans per Outlet	Percen Saving to Lendi
Krishi	8.2	14.6	10.5	(6)51.8 (12)10.9	20.6	4.1	37.0	1,550 # outlets: 96	14.2
Rupali	6.8	15.9	6.2	(6)17.9 (12) 1.9	9.2	8.2	6.2	678 # outlets: 7	28.6
Sonali	4.9	11.5	18.6	(6)21.2 (12) 4.6	27.3	2.3	17.2	1,038 # outlets: 10	10.7
IRDP	4.8	13.8	9.7	(6) 9.7 (12) 7.4	27.1	4.9	7.8	622 # outlets: 14	11.4
Agrani	(2.7)	11.3	4.3	(6)60.2 (12)20.7	17.5	7.1	10.6	1,011 # outlets: 11	35.1
Janata	(2.6)	9.0	14.5	(6)56.8 (12)41.4	20.1	8.7	6.5	370 # outlets: 12	21.8
Pubali	(8.4)	7.8	21.4	(6)31.9	31.1	7.5	5.5	1,105	4.1
BSBL	(9.3)	7.0	48.7	(6)30.6 (12) 9.2	39.4	3.9	7.7	370 # outlets: 19	2.9
Uttara	(13.7)	14.8	12.1	(6)25.8 (12)81.1	10.6	24.6	1.4	276 # outlets: 5	11.6
Average	3.3	10.8	15.4	(6)34.9 (12)11.5	25.2	7.92	100.00	737	15.6

[1]Loans per loan officer
[2]Bangladesh Credit Program, Major Evaluation Report. Public Administration Service, January 1982. p. 255

VI. IMPACT

An evaluation of the impact of the loans on borrowers found that over 28 percent of borrowers showed a greater than 10% increase in net worth, whereas just over 17 percent of non-borrowers showed a similar increase. If non-viable (delinquent) borrowers are removed from the sample (about 2 percent of borrowers), over 33 percent of the remaining borrowers had a greater than 10 percent increase in net worth.

As interest rates increase, the percentage of borrowers with viable loans drops from 76 percent at 12 percent interest rate (mostly crop loans) to 57 percent at 24 percent interest rate (non-crop farm loans), then increases substantially to 84 percent at 36 percent interest rate (non-farm business loans).

VII. CONCLUSIONS

This important experiment has, unfortunately, received much less attention than it deserves. This is partly because information on it, while voluminous, has been in a form which makes it difficult to assimilate.

The circumstances in which the experiment was carried out were extremely difficult. Bangladesh is characterized by extreme poverty, relatively weak institutional infrastructure (including banks) and considerable political and economic instability. That the banks were able to organize and carry out this program, much less make a profit, is remarkable.

The comparative success of efforts in these difficult circumstances should encourage other countries to carry out similar experiments. More complete analysis can be obtained in the 48 page case study available on request.

Case Study Summary II

SMALL-SCALE BANK LENDING IN INDIA

by
Dr. Varghese Keerikatte

edited by
Jason Brown

I. INTRODUCTION

India is unique in the degree to which government policy has been developed to encourage small-scale lending for business purposes via commercial banks. The fourteen largest Indian commercial banks were nationalized in 1969. The justification for this popular act was that the banks were not responding to the needs of the vast majority of India's extremely poor and most rural population. After nationalization, the banks launched an aggressive program of building rural branches and responding to small borrower needs. Banks were required to meet quotas established by the Reserve Bank of India (RBI) for lending in various "priority sectors."

II. DESCRIPTION

A. Outreach

In 1969, when the banks were nationalized, there were 8,321 branches of commercial banks in India. Of these, only 1,860 were outside major population centers. By 1982, through a massive building program, there were 39,659 branches, of which 20,774 or 52% were in rural and semi-urban areas. In addition, leading nationalized banks now sponsor Regional Rural Banks. There were 107 of these in 1983, with 4,795 branches. The number of branches is to be increased to 9,000 over the next few years. Regional Rural Banks receive preferential treatment in terms of licensing and financing by the RBI. They must be set up in areas not served by other banks. By 1981, commercial and regional rural branches had provided almost 15 million loans to small borrowers.

B. Types and Size of Loans

1. Agriculture. The Reserve Bank of India (RBI) has established goals which require that the public sector banks lend 15% of their loan capital to borrowers in the agriculture sector by 1985, with 40% of the being provided in amounts of $1,100 or less. Lending to the agriculture center and small-scale lending particularly, has been growing rapidly since 1969. By 1981, $5 billion was being lent to 10.5 million agricultural borrowers. Of this, approximately $1.2 billion was lent to less than 4 million borrowers, or 32 percent of the total, in amounts less than $1,100.

2. Small Scale Industries (SSI). The RBI has established goals requiring that 12.5 percent of all SSI lending be provided in amounts below $2,700 by 1985. SSI lending has grown rapidly since 1969, reaching $4 billion in 900,000 loans by 1981. However, only 3.5 percent, amounting to $97 million was provided in amounts below $1,100. In this sector, the banks may have trouble reaching the RBI goal, unless heavy pressure is applied.

3. Integrated Rural Development (IRDP). Approximately $3.3 billion has been set aside to provide loans to the poor in designated areas in the country under this program. The goal is to provide loans to 15 million families in five years. The banks fear that it may not be possible to productively absorb this amount of money in the time frame provided.

4. Differential Interest Rate Scheme (DIR). Public sector banks are required to allocate 1 percent of their loan portfolio to this program. Interest rates are 4 percent, as opposed to 15-18 percent for other loans. Loans are given to poor borrowers on the basis of personal surety or co-signature. In 1980, the most recent period for which information is available, $215 million was being utilized for this purpose or 1.1 percent of total commercial bank lending. Funds are provided to the banks at 2% for this program. There is also a guarantee scheme. However, despite the fact that default is apparently very high (banks estimate near 50 percent), very little use is made of the guarantee scheme due to the fact it is administered by the RBI, which also audits the banks. Banks do not want to admit high default rates to their auditors.

5. Other Programs. There are many other specialized lending programs, including industrial estates (3,000 loans in 1981), motor vehicles (345,000 loans), retail trade (201,000 loans), small business (794,000 loans), self-employment (934,000 loans), education (59,000 loans) and housing (200,000 loans). Most have priorities attached to smaller loans, below $1,100.

III. COST AND PROFITABILITY

Under the RBI guidelines, the public sector banks can offer "demand deposits" (savings) at 5 percent and term deposits (fixed deposits of three years or more) at 10 percent annually. Banks are allowed a 1/2-1 1/2 percent flexibility in offering higher interest. A five year deposit can receive 11 percent or so. On average, the interest cost on deposits is 8-9 percent.

Another source of bank funds is borrowing from the Reserve Bank. In 1983, the bank rate was 10 percent. The Reserve Bank offers a lower interest on cash-reserve deposits. Presently, the cash-reserve ratio is fixed at 43 percent of total and current liabilities. Altogether, the cost of deposits or borrowing for the banks was around 10 percent in 1983.

The administrative and overhead cost of headquarters and branches nation-wide is estimated to be about 3 percent. Since 90 percent of advances are guaranteed (insurance cost is 1/2 percent of the covered loan), the cost of bad debts for banks is minimal (1 percent at best).

On the whole, money will cost about 13-14 percent for the bank (9 percent interest + percent administrative establishment cost + 1 percent bad debts + miscellaneous cost of 1 percent).

Bank advances are charged at different rates. Preferred customers are given loans at 16-18 percent. RBI permits some latitude in this matter. Priority sector loans are charged at 12.5-15 percent. Most industrial loans are at 17.5-18 percent. Short-term commercial loans may cost 19.5 percent.

From all available information, it appears that the Indian public sector banks are operating with a healthy profit ratio. However, an individual bank's profit will depend upon many factors including deposit mix, the structure of branches, (compositon of urban-rural branches), investment portfolio, staffing pattern and so forth. The somewhat dated information in the table on the next page indicates levels of major bank profits.

VIII. CONCLUSIONS

The most impressive aspects of the small loan program in India are its size and spread. The program involves billions of dollars and millions of beneficiaries. It has reached even the remote corners of the country and is widely accepted, as indicated by its popular use. From the limited information available, it is difficult to measure objectively the effects of the program.

An important element is the elaborate and expansive infrastructure, which has been developed to undertake this massive program. This administrative machinery was built over decades of sustained effort. The government role since nationalization has only been to augment an administrative structure already in place.

Most importantly, massive amounts of small-scale lending has been possible without sacrificing bank profitability. How this has been accomplished while charging relatively low interest rates is, unfortunately, a well guarded secret of the banks.

It is not known whether the Indian economy can keep absorbing the continuous flow of low cost credit, or whether the poorer borrowers can use such credit productively. There has been a rise in corruption and the misuse of funds by politicians and bureaucrats. So far, such influences seem to be relatively moderate. However, the potential danger cannot be ignored.

Still another disturbing aspect of the program is the growing default rate, especially for D.I.R. loans. Unless the state governments take supportive and corrective measures, the problem may get worse.

It is clear that the banks would not have undertaken a massive credit program like the one in India without government intercession and support. From all that is known, the program works and the policy has proven politically and economically successful.

INDIA

PROFITABILITY RATIOS OF NATIONALIZED BANKS

1976

Name of the Bank	Dividend Ratio	Margin Ratio	Profitability Ratio
Indian Bank	8.863	3.761	0.3049
Canara Bank	7.027	2.840	0.2516
Bank of Baroda	6.805	3.137	0.2617
Union Bank of India	6.604	2.743	0.2322
Syndicate Bank	6.590	2.860	0.2446
Indian Overseas Bank	6.500	5.067	0.4445
Bank of India	6.132	2.992	0.2523
United Commercial Bank	6.081	3.364	0.2994
Punjab National Bank		5.704	0.3066
Allahabad Bank	2.500	2.721	0.2586
Central Bank of India	2.261	1.065	0.0992
United Bank of India	1.911	2.538	0.2131
Dena Bank	1.409	1.580	0.1513
Bank of Maharashtra	1.504	1.567	0.0571
NATIONALIZED BANKS (Average)	4.972	2.853	0.2390

Dividend Ratio -Ratio of Return to Government and the investment of the Government of India

Margin Ratio -Ratio of Net Profit to Total Income

Profitability Ratio -Ratio of Net Profit to Working Funds

<u>Case Study Summary III</u>

SMALL-SCALE LENDING BY SYNDICATE BANK, INDIA

Principally drawn from studies

by
N.K. Thingalaya and V.V. Bhatt

Compiled by
Dr. Thomas Timberg

Edited by
Jason Brown

I. INTRODUCTION

Syndicate Bank of India is noteworthy for the fact that it was founded and grew during its early years primarily on the basis of serving extremely small borrowers and depositors. Founded in 1925 and originally a regional bank established to assist members of one caste who were primarily rural farmers and small business people, it focused on ways to respond to the needs of small borrowers and depositors and still make a profit. Its success led to its rapid growth into one of the leading Indian banks.

II. DESCRIPTION

In 1975, of just under 1 million loans 95 percent were for less than $1,200 and 65 percent were for less than $120. In that same year, over 88 percent of almost 6 million deposits were less than $200. Small borrowers (under $1,200) actually account for only 18% of money lent. However, this percentage is higher than in most other Indian banks.

Interest rates are strictly controlled in India. During the 1970's, they were between 12-17 percent for small borrowers. Lenders find ways to increase their income through administrative fees and other charges, but these are not reported because they are not strictly legal and are therefore excluded from the discussion that follows. Syndicate reports a profit even when these fees are not considered.

The bank prefers fully collateralized loans for short periods. Higher interest rates are charged for longer loans with less than full collateral. Syndicate lends for agriculture, business and personal uses.

III. LENDING POLICIES AND PROCEDURES

Syndicate, since its foundation, has been aggessive in mobilizing small accounts and has been successful in doing so by providing a high density of bank branches in target areas, thus making services readily available. They have kept the cost of this saturation approach down by consistently paying the lowest interest to depositors (average 2.66 percent in 1973, as opposed to 4.0 percent average for the banking industry as a whole), charging the highest interest to borrowers, paying less to employees (typically only two-thirds the rate of other banks) and keeping worker productivity high (the average Syndicate officer handles 287 deposit accounts and 48 loan accounts versus 120 and 14 respectively for the banking industry).

To facilitate collection of savings accounts and loan recovery, Syndicate early developed a system for having collection agents go door to door on a daily basis. Compensation was a percentage of collection. Although the approach is no longer legal, Syndicate is still providing reular access to local bank personnel on a personal basis.

IV. COSTS

During the 1970's, the cost of all borrowing averaged 8.89 percent. The cost of all funds averaged 11 percent, including 2.24 percent administration and other charges. The spread for loans averaged 4 percent for industry loans and 2 percent for other business loans.

V. PROFITABILITY

Syndicate's profit levels have remained among the highest for many years. In the late 1970's its profit over working capital ratio was .2446 against .2390 for the nationalized banks as a whole. Syndicate's profitability has been a result of the following.

A. Connection between depositor and borrower base. Syndicate's large number of small depositors form a natural base for its lending.

B. Dense branch network and economies of scale. Their concentration of branches mean that they know an area well and are able to bring in many borrowers for each dollar of cost.

C. "Social" orientation which helps them to be perceived by small borrowers as having their interest at heart. This makes borrowers willing to pay higher interest rates to deal with them.

VI. IMPACT

There have been no published measures of impact.

VII. CONCLUSIONS

Syndicate is one of the banks which pioneered in a policy which was subsequently adopted as nation policy for all the major commercial banks when they were nationalized in 1969. The remarkable element in Syndicate's case is that they began their focus on small borrowers and depositors in 1925 and continued it profitably on a large scale. Examples from other countries did not appear for 50 years. As our knowledge of Syndicate's unique experience is limited, developing additional information about it could yield valuable empirical lessons.

Case Study Summary IV

SMALL-SCALE BANK LENDING IN INDONESIA

AN ASSESSMENT OF THE BADAN KREDIT KECAMATAN PROGRAM IN CENTRAL JAVA

BY
Susan Goldmark, Jay Rosengard and
Nancy Straughan, Development Alternatives, Inc.

Edited by
Jason Brown

I. INTRODUCTION

The Badan Kredit Kecamatan (BKK) is a program established in 1972 by the Provice of Central Java to provide small, short-term loans to poor, mostly rural borrowers for off-farm income generating activities. The program has been endorsed by the Indonesian Government and received financing from both Central and Provincial governments.

II. DESCRIPTION

Through late 1983, 2.7 million loans had been provided under the BKK program, totalling $55 million. The average loan size is approximately $50.

The program has a variety of loans available, with a repayment period ranging from a minimum of 22 days, to a maximum of 6 months, but averaging 3 months. Interest rates vary with the presence or absence of collateral and can range from a low of 12 percent to a high effective rate of almost 120 percent (annualized on 22 day notes). The average effective interest rate seems to be close to 70 percent.

III. LENDING POLICIES AND PROCEDURES

When government planners designed BKK, their objective was to provide "fast, cheap and productive credit" to the rural poor, who had no alternative source of inexpensive credit for productive off-farm purposes. The idea was to combine the convenience, care, and reliability of traditional moneylenders with the profitability and lower interest rates of large-scale commercial banks.

The BKK was charged with providing a local outlet in as many districts as possible to make credit easily available to rural borrowers. Loan eligibility was determined by character references provided by village officials. Initial loans were very small to keep risk low. Bureaucratic procedures were reduced by allowing most decisions to be made locally. Interest rates were high enough to allow the program to make a profit. Savings mobilization was a major element of the program and was required for all borrowers.

There were 486 BKK sub-district outlets in Mid-1983, out of 492 sub-districts in Central Java. Each of these BKK has a minimum of two staff people. These people rotate their location to various "village posts," located at the village level. There were 1,300 "village posts" in December, 1982. The goal is to have 4,200 village posts as quickly as possible. Initial loans over $7.50 to a borrower are approved by the chief government administrative officer of the sub-district. Smaller loans or repeat loans to the same individual are approved by the BKK staff.

Loan officers are usually from the subdistrict in which they work. Half have a secondary school education. The 1,200 BKK employees each handled an average of 200 loans in 1981.

IV. COSTS

Loan administrative costs averaged 13 percent of loan value in 1981. Over 14 percent of the loan portfolio is over 6 months overdue. However, the figure is deceptively high, since many of these loans are many years old. There is no policy for writing off loans. Only 6 percent of loans are less than 6 months overdue.

V. PROFITABILITY

In 1981, excluding all subsides, the BKK showed a healthy profit of 17 percent return on the average potfolio. Key factors contributing to profitability include:

A. High Loan Turnover. The average loan portfolio turned over 2.6 times in 1981. This jumps to 3.0 if overdue over 6 months are removed. High turnover reflects maximum use of loan capital, assuming added administrative costs can be minimized.

B. High interest rates. Few loans were made at below 5 percent monthly. Average effective interest is approximately 70 percent annually. This allows for coverage of all contingencies and a healthy profit.

C. Low administrative costs. Staff are hired locally and make approximately 2/3s of the salary of a comparatively qualified civil servant. Government facilities are used as offices. Each officer has a relatively high number of loans to handle.

D. Low delinquencies. The default rate has been dropping steadily and stood at 6 percent of current loans in 1981.

F. High volume. Large numbers allow costs to be spread widely. For instance, 270,000 loans totaling $12 million were made in 1981.

VI. IMPACT

A small sample of loan recipients were interviewed. There was no control group. No precise data were developed on growth of assets.

Almost all respondents felt their business had expanded as a direct result of the BKK loans, mainly by increasing their ability to purchase raw materials, number of customers, sales volume and net profit. The loans do appear to have had a positive effect on employment. Over 80 percent of respondents said they were able to devote more time to productive activity in the business because of the loan, and 17 percent of the borrowers hired additional full and/or part-time staff. Eighty percent felt that the credit increased their productivity.

VII. CONCLUSIONS

This is one of the largest and most successful programs in the world providing credit in such small amounts. It deserves close attention by both governments and commercial banks planning similar efforts.

Special attention should be given to the fact that this is one of the few programs in which the government has allowed interest to reflect true market rates. Despite comparatively high rates, the program appears very popular and a lesson worthy of notice by other governments.

Case Study Summary V

SMALL-SCALE BANK LENDING IN THAILAND

BY
Dick Sandler

Edited by
Jason Brown

I. INTRODUCTION

Banking institutions in Thailand provide only a very modest amount of small-scale lending. What is provided is a perfunctory response to Government requirements that the banks take a more aggressive role in this sector. Major banks have responded by making a handful of loans. The largest known program provided somewhat less than 2,600 loans between 1968 and 1982, totaling $4.37 million. Average loan size is $3,000.00. A tiny number of loans have been made for amounts between $4-500.00. The Government is, however, continuing to apply pressure and new programs are just now getting underway. There are no reports of results as yet.

II. DESCRIPTION

Thailand has a fairly sophisticated financial sector. Thus far, however, only commercial banks have engaged in small-scale business lending.

Bangkok Metropolitan Bank established the Thrift Credit for Small Investors program in 1980. Through mid-1983, 100 customers had received loans. Borrowers must first deposit at least $9 a month for two years. They may then borrow up to ten times the total savings, but not exceeding approximately $4,500.00. No collateral is required. Terms are 5 years repayable monthly with interest of 17 percent.

Bangkok Bank began making small loans for business purposes in 1966. Total loans provided through September, 1982 were 498, totaling $611,000 in value. The average size first loan under this program is $3,900. Repeat loans are common . Interest rates are 16-18 percent with a repayment periods of three to four years.

Krung Thai Bank provided approximately 2,600 small business loans between 1968 and 1982, totaling 44.37 million. The average loan size in 1981 was $3,275. Terms are 2 1/2-4 1/2 years with interest rates of 16-18 percent.

III. POLICIES, COSTS AND PROFITABILITY

Little is known about these Thai bank programs. Most have relatively conventional loan review procedures, which can be quite lengthy and complicated. Multiple reviews are standard. Careful loan supervision is customary. Little has been done to alter standard bank procedures, which may account for the small number of loans made to date. Costs are similar to those for supervision of larger loans. Programs are too small to justify separate accounting.

IV. CONCLUSIONS

Thai banks contacted indicated no particular interest in expanding programs beyond their present token level for the foreseeable future. Thailand is an example of a country with the institutional infrastructure and even the policy framework conducive to small-scale lending. Thailand might well benefit from examing other small loan programs and adapting them to their own economic environment.

Case Summary VI

SMALL-SCALE BANK LENDING IN THE CAMEROONS:
The Banque Cameroonaise de Development

by
Tamara J. Duggleby

Edited by
Jason Brown

I. INTRODUCTION

The Banque Cameroonaise de Developpement (BCD) is a multi-purpose bank owned by the Government of the Cameroons, West Africa. Like many similar institutions in West Africa, it does not engage in commercial lending and is not structured to make a profit. Its objective is to use its lending capacity to meet the development objectives of the government.

The BCD, with financing from the World Bank, in 1975 began providing loans to small to medium-scale business. By 1980, it had lent over $6.5 million in this category and was making a profit on such lending. The average loan size at this point was $170,000.

A second World Bank loan was made in 1980. Smaller "artisanal" loans were to be made, which Bank staff estimated would average just under $24,000. No data is available yet on the results of these loans. It is known that the smallest loan request considered to date was for just over $14,000.

II. DESCRIPTION

At the time this report was first prepared in late 1982, the first ten loan requests of the smaller size were under review. No further information was available on the results of these loans at the time this report was updated in late 1983. Only manufacturing activities are receiving lending. Trade is excluded. A minimum of just over $140,000 was to have been lent at an effective interest rate of 14.5 percent, on loans which are anticipated to average 3 to 5 years.

III. LENDING POLICIES AND PROCEDURES

Loan policies and procedures are expected to reflect traditional practices of the BCD. Loan application processes are lengthy and complicated, requiring completion of numerous forms and the development of an elaborate business plan. Careful checking on credit standing is required. There are strict collateral requirements. Co-signers can be used if sufficient collateral is not available.

The BCD has relatively little capacity to service borrowers after they receive a loan, especially if they are located any distance from the capital city. This makes collection of late payments difficult.

IV. COSTS AND PROFITS

Cost information is only available on older, larger loan activity. Transaction costs, including administrative costs and default costs, through the period of the first World Bank loan, were about 2.6 percent. The cost of money during that period was 5 percent and the interest rate payed by the borrower was 11 percent. BCD actually realized a spread of 2.75 percent. Other elements in the spread were a credit disbursement tax of 2 percent paid to the government and a foreign exchange risk guarantee of 1.25 percent. Default of larger BCD loans was running at 30 percent in 1980, which the World Bank considers average for similar banks world wide during start-up. The BCD lending has been arranged so that it will make a modest profit on its smaller loans (.15%).

V. IMPACT

No information is available on program impact.

VI. CONCLUSIONS

For the purposes of this study, the BCD program is more important in terms of its future than of its past. Small-scale lending is not practiced to any degree in Africa and certainly not in West Africa. The World Bank views this program as a potential model for other countries in Africa.

Small-scale lending of the type that we are discussing here is not comparable either in terms of loan size of number of loans with programs in most of Asia or Latin America. However, it is a step in what will probably be a very long and difficult path toward development of comparable programs.

Case Study Summary VII

SMALL-SCALE LENDING IN KENYA

by
Clay G. Wescott

Edited by
Jason Brown

I. INTRODUCTION

There is very little small-scale bank lending for business purposes in Kenya. Short-term credit in small amounts is usually in the form of overdrafts which are payable on demand. Overdrafts can be renewed and are often utilized as substitutes for unavailable longer-term financing. These overdrafts are usually provided in fairly large amounts for business purposes. Some non-profit voluntary organizations are providing quasi-commercial loans to small businesses in amounts of $500 or less, but this is on a very small scale.

II. DESCRIPTION

There are 19 operational banks in Kenya. All but four are foreign owned. There are 33 institutions which could best be termed companies. Most of these are locally owned. There are also several development finance companies which are government owned and focus on particular sectors of the economy. It appears that very few loans by any of these institutions are below $30-40,000.

The Kenya Commercial Bank, which is government owned, currently has a little over 9,000 small loans on its books which average in size $572. These loans are widely scattered throughout the country. They are primarily for personal rather than business purposes. However, it is likely that some of the loan proceeds filter into business uses. There are no formal programs of banks to lend small amounts for business purposes. There is very little information available on the operations, costs or profits of financial institutions.

Voluntary organizations have moved to fill some of the gap. Partnership for Productivity has made thirty or forty loans to businesses in amounts averaging $100-500 since 1976. The Daraja Trust made loans totaling $150,000 to 26 clients through April, 1982. Loans ranged in size from $700 to $15,000. The Small Business Scheme of the National Christian Council of Kenya has about $33,000 in capital, which it loans in very small amounts ($35 to $210 average) to urban slum dwellers. Approximately 150 loans were made under this program in 1981/82. These tiny programs generally are organized for social reasons rather than profit. In most cases, they have significant repayment problems. They have no intention at present of attempting to be profitable.

III. CONCLUSIONS

Kenya is an example of a country where the lack of clear policy directives has inhibited small-scale lending for business. Kenya has well developed financial institutions. These institutions are, however, extremely conservative in their lending policies. In the absence of government encouragement, they have not even made the marginal commitment that Thai banks have undertaken. There will be no significant small-scale lending in Kenya until the government sets out firm, supportive policy.

Voluntary organizations could potentially assist the banks in implementation as they have done in India. The lack of policy support and bank conservatism has kept them from doing so to date. Their own orientation is, however, also an inhibiting factor. Until these social agencies can understand the imperative of proving to the banks that small lending can be done at a low enough cost to justify the effort, they will not get bank cooperation.

Barclay's Bank, through the Barclay's Development Fund, has loaned small amounts to Partnership for Productivity and other groups for financing receivables of small stores and suppliers. Thus far, none of these loans have been managed in a way that has encouraged Barclay's to get more involved in such lending.

The voluntary organizations would need to be strengthened organizationally and their orientation changed significantly before they could possibly be of much help in small lending.

Case Study Summary VIII

SMALL-SCALE LENDING OF THE FEDERATION DE CAJAS DE CREDITO, EL SALVADOR

by
Robert G. Blayney

Edited by
Jason Brown

I. INTRODUCTION

The Federation de Cajas de Credito, El Salvador (FCC) is a cooperative society, set up in 1943 and almost totally owned by government agencies. It consists of 42 "cajas," with a total of 72,500 members, serving about 10 percent of the country's population.

Despite the country's current problems, it is noteworthy that through 1983, the FCC continued to operate at a small profit and to expand its coverage. As a government supported institution, it has a strong political role.

II. DESCRIPTION

In 1981 FCC provided $27 million to 61,177 beneficiaries. A substantial proportion of these loans were for business purposes and were for less than $500. Maximum loan size for most of its various loan programs is $1,200. Prior to FCC credit, most borrowers had received no commercial credit.

Nearly 80 percent of FCC credit is for 3 months or less. Interest rates vary, dependent on loan purpose, from 12 to 18 percent.

III. LENDING POLICIES AND PROCEDURES

The 42 "cajas" which are part of FCC are individually chartered. They must each have at least 30 members. FCC has several credit programs, including those aimed at farmers, small business and market women.

Th small business program, for instance, was established in 1977 with $3.5 million received from the World Bank. Its purpose was to respond to the needs of more urbanized, family-owned businesses, which previously had no access to credit. Technical assistance and training were to be part of the package.

By 1978, loans were being approved at the rate of approximately 200 per month, most with maturities of less than a year and primarily for working capital. The average loan size was $400.00. Between 70-80 percent of loans were to small store proprietors operating out of their homes. A high proportion of the loans were to women. Collateral for working capital loans was provided through co-signature or shared liability groups and by the borrower's savings. Borrowers are expected to save 5 percent of family income in interest bearing deposits with FCC. Simple feasibility studies are conducted for all loans over $375.

IV. COSTS

The cost of money was 6.5 percent of lent capital in 1981. Administrative costs have run at 2.5 percent of lent capital. Bad debt is 1.5 percent. Training costs for bank staff initially ran at 4 percent. Interest income is 15 percent with 1.5 percent application fee (first loan only).

V. PROFITABILITY

By March, 1979, profits were estimated at 10 percent of loan volume. Arrears, however, were rising. They reached 7.4 percent of portfolio volume by December, 1979. More recent information is not available.

VI. IMPACT

Fifty interviews with borrowers were conducted in 1979. For those interviewed, incomes increased an average of 35-40 percent since they received their first FCC loan. Most of the increase was attributed to the loan. However, since no control group was utilized, it is not possible to verify this contention. Employment effects were not measured.

VII. CONCLUSION

Unfortunately this is a case in which political events have temporarily overwhelmed what has been a strong program. Little current information is available on its status. It can only be assumed that it is facing the same kinds of problems of other institutions in the country. If politics allows, it will certainly be worth attempting to keep abreast of FCC activities. In any case, it is another useful model illustrating the potential profitability of such small loan programs.

Case Study Summary IX

**SMALL-SCALE BANK LENDING IN ECUADOR:
BANCO DEL PACIFICO
ARTISAN CREDIT PROGRAM**

Prepared from Studies
by
William R. Rucker
Steven H. Gross
Lawrence F. Salmen

Developed and Edited
by
Jason Brown

I. INTRODUCTION

The Banco del Pacifico, Ecuador, is a private, full-service bank founded in 1972. Its growth has been very rapid, due largely to its philosophy of seeking smaller clients in which other banks had little interest.

The Bank's aggressive stance is demonstrated by its response to a government requirement that 20 percent of available loan funds be earmarked for development purpose. Most banks have satisfied this requirement by buying government bonds. Banco del Pacifico chose instead to establish a number of programs designed to lend the funds to smaller borrowers.

II. DESCRIPTION

The Artisan Loan Program begun in 1977, is one of the programs the Bank established. It is specifically designed to meet the needs of the smallest businesses. It operates principally in the six larger cities of Ecuador, providing credit to small artisan/manufacturers who would not otherwise have access to credit. Just under 3,000 had been made through mid-1982, averaging in size from just over $1,000 in smaller cities, to $1,700 in Guayaquil. Total capital loaned has been $1.33 million or 3 percent of bank assets.

Loans are available for inventory (two year period), capital equipment (three year period) and construction (4-5 year period). The interest rate is currently 12 percent. The average borrower has received two or more loans.

III. LENDING POLICIES AND PROCEDURES

The Artisan Loan Program has remained relatively constant in size since its conception. The government continues to place a cap on the amount of interest a bank may earn at 16.25 percent. The Banco del Pacifico feels it needs at least 18 percent to make a profit on small loans. As long as this is not possible, it prefers to consider this a "social project" on which it will charge only 12 percent. The program has earned the bank a good reputation with the Government and the public. The Bank hopes that new borrowers in the program will become bigger customers in the future, justifying this initial subsidy.

Eight staff members are assigned to the Artisan Loan Program out of 400 total Bank staff. Each staff person handles between 180-200 loans. Since the program is small, relatively little promotional work is done by the bank.

To obtain a loan, an applicant must provide two personal references, two commercial references, a positive credit history, a co-signer, a business plan and an invoice against which the loan is drawn.

Despite strigent controls, late payments rose to 27 percent by 1980. As a result, several borrowers were prosecuted and policies were tightened yet further. As a result, since mid-1981, defaults on new loans have stood at 0.7 percent.

IV. COSTS AND PROFITABILITY

The Banco del Pacifico as a whole is very profitable. Since this program is so small, its operations are not accounted for separately. Very little is known about the costs of operation. A recent study found that 7 percent of current program income was expended on direct supervision costs. Indirect labor and overhead costs are not available.

The Bank was paying between 10 and 11 percent for money it lent in 1982. Average loan size for the Artisan Loan Program at that time was $1,300. Bank personnel felt, informally, they could make a profit with 18 percent interest, as indicated earlier.

V. IMPACT

A 1982 study of 100 borrowers found that on the average, monthly sales had increased 75 percent in four years, or 19 percent a year. Profits had increased 48 percent in four years or 12 percent a year. Only 20 percent of borrowers had received loans prior to their first loan from the program.

This study did not attempt to determine to what degree these increases were attributable to the credit. Also, it did not discount for inflation, which has been very high in Ecuador. When inflation is taken into account, real growth in sales and profits would have been negative for many borrowers. However, Ecuador has faced extremely adverse economic conditions in recent years. In this context, keeping nearly even is a real achievement.

VI. CONCLUSIONS

According to Bank personnel, the only factor hampering the growth of this program is the Government imposed interest rate ceiling. If the Government could be persuaded to lift the interest rate ceiling, or to be more flexible in its implementation, as has been done in Bangladesh, the Philippines, Indonesia and the Dominican Republic, we might see the emergence of a viable large-scale, small loan program.