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Critical Issues in Small and Microbusiness Finance

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This paper is a summary version of a study which was commissioned to IPC by three European development-cooperation organizations:

- Ministry of Foreign Affairs, The Netherlands;
- Swiss Development Cooperation, Switzerland; and
- Federal Ministry for Economic Cooperation and Development, Germany.

The present study is meant to be a discussion paper which will present new ideas and stimulate debate of key issues. The positions taken in it are a reflection, on the one hand, of many years of field consulting experience in small and microenterprise financing projects and, on the other, of the current "state of knowledge" in this area as embodied in the relevant works of academic and other experts in the field of development finance. Accordingly, the views expressed here are those of the authors and their views alone; they are not necessarily identical with the opinions of, and positions taken by, the three donor agencies which commissioned this report.

I. Summary

A: Introduction

1. The Conceptual Basis of the Study

Although the international donor community has, over the years, made several serious attempts to make financial services available to the poor segments of the economically active population of developing countries, it is fair to say that something like a consensus has only recently begun to emerge. This "new view", in turn, has its roots in a longer tradition of development-finance policy and thinking about the broad issues it addresses.

After the Second World War and into the 1970s, development finance was not particularly concerned about poor target groups. This began to change when it become obvious that the channelling of massive amounts of foreign funds to large projects in the developing countries did not lead to the "trickle down effect" which had been expected. The recognition of socially problematic consequences of the old policy led to a shift in donors' policy orientation. In the early 1970s, the concept of "target group orientation" started to emerge. In essence it entails the idea that development aid efforts should be designed and implemented in such a way that they will directly benefit the poorer segments of the population. As far as financing was concerned, donors started a wave of small and diverse projects which were meant to make credit available to the poor. Attempts to set up special target group-oriented, government-owned development banks failed almost everywhere.

This led to the evolution of a more radical version of the new policy of target group-oriented financing. It gained particular prominence in the 1980s and consisted in setting up credit programs largely outside of the banking sector as well as outside of the reach of governments. This was the heyday of non-governmental organizations (NGOs) and of all kinds of self-help groups (SHGs) as conduits for donor funds. Their ability to really reach the small and very small borrowers, which is unmatched by other types of institutions, was seen as their main strength. The main drawbacks of these efforts were that such financing schemes proved extremely costly for donors; that they inevitably failed to reach many members of their target group, and, most importantly in our view, that these foreign injections of funds did not lead to the creation of institutions which would have been able to play a lasting role in the lives of their "beneficiaries".

Around 1990, the "new view" emerged out of the criticism of these "blind spots" exhibited by a development strategy which was only target group-oriented. In addition to a clear gearing of efforts to poorer target groups in urban as well as rural environments, the new view consists in a fruitful combination of three main elements:

(1) **A focus on institution building:** Aid efforts should not be directly oriented to the provision of financial services to the target group, but rather to the creation of financial institutions which would be both able and motivated to cater to the relevant target group or groups. Setting up or strengthening such institutions should therefore be the primary objective of aid projects in the field of development finance.

(2) **A commercial approach:** A commercial approach to small and micro-lending is necessary because only an institution which, at least over the medium term, is able to cover its costs can hope to remain in existence and to really provide benefits to its clients on a continuing basis and at a predictable level. The essential elements of a commercial approach are that the institution tries to keep its costs as low as possible and is able - and also formally permitted - to charge interest rates and fees which are commensurate with its total costs.

(3) **A financial systems orientation:** All activities geared to improving the access of poor target groups to financial services have to look at things in the broad perspective of the entire financial system of the respective country, and this for two reasons. The first one is that the demand for financial services which poor target groups may have should be satisfied by some element of the financial system, but that it need not be the specific institution under consideration in a specific development aid project. The second reason, and indeed the more general one, is that an improvement of the overall financial system is likely to bring the largest benefit to the

target group over the long term.

This paper is firmly based on this new view of small and micro business finance. It tries to incorporate as much as possible of the financial systems perspective, the commercial perspective and the institution building perspective.

2. The Purpose, Orientation and Structure of the Study

We concur with the three main elements of the new view to such an extent that we do not consider it necessary to discuss them in this paper. However, we want to emphasize from the outset that we do not share all of the positions advocated by some of its proponents regarding the question of how the basic orientation should be put into practice. In fact, the starting point for this study is the proposition that putting the general principles into practice turns out to be a much more difficult task than some of its advocates seem to believe, and also more difficult than they have led donors to believe.

Instead of attempting to cover a broad range of issues which would merit consideration, the discussion in this paper is strictly focused on what we consider to be the most important questions in the field of small and micro business financing. The purpose of this concentration is to provide an orientation for donor institutions which, through their funding decisions, essentially determine the nature of the development projects in the field under discussion here.

The study contains three main sections, and each one of them focuses primarily on one main problem. In each of the chapters we make ample reference to what we consider to be examples of "best practice" in this field. But the purpose of including case material is not to provide an overview of what is really done in practice, nor to award medals to those who are responsible for designing and implementing successful and innovative projects. Rather, this material only serves to illustrate, and underscore the validity of, the points which are of particular practical relevance.

Section B covers institution building. It discusses downgrading and upgrading strategies. The main message which we want to convey is that institution building projects are useful and that they can be successful, but that they tend to take much more time and require much more effort and commitment on the part of the donors than they usually think or seem willing to acknowledge.

Section C discusses the credit business of a target group-oriented financial institution. Here we wish to demonstrate that the imperative of keeping costs low and achieving cost-coverage forces such institutions to adopt a special kind of credit technology. This technology is presented in some detail and its efficiency is compared with that of the "group lending approach".

The topic of Section D is the provision of deposit facilities to members of the target group. The question which is the focus of our discussion here is, What role should deposit business play in the process of building up a financial institution which is clearly target group-oriented, cost-conscious and innovative in its efforts to lend to small and micro entrepreneurs?

B: Institution Building

A strategy of development finance as institution building is based on three assumptions:

(1) The economic and social situation of the target group can be improved if more and better financial services are offered to them.

(2) Providing more and better financial services requires that there be institutions which can supply these services on a continuing basis and which are motivated to do so.

(3) An institution can provide adequate financial services to the poor only if it is financially viable, or can at least become financially viable over the medium term.

In an institution building perspective, financial institutions should meet two requirements. They should be target group-oriented and they should be financially sound. These two requirements are not in conflict in the long run, although there may well be conflicts in a short-run perspective.

In accordance with its general thrust, the section on institution building will concentrate on four issues which can be considered to be of particular importance and practical relevance from a donor perspective. The general message of the chapter is that institution building efforts are so worthwhile - and so difficult - that it seems to be advisable for donors to treat them as projects in their own right.

1. Selecting Partner Institutions

This section discusses whether particular types of institutions are, by their very nature, especially appealing, or especially likely to be unsuitable, as partners for institution-building projects. Various types of institutions differ above all in the following respects:

- their relationship to the target group, both in terms of social proximity and in terms of the nature of their business or other activities;

- the degree to which they can be regarded as professional financial institutions, irrespective of whether they are formally classified and registered as banks or not;

- their relationship to the local and/or national government in terms of both formal ownership structures and the degree to which they are subject to political pressure;

- their degree of profit-orientation. The ideal institution would be socially close to the target group; professional like a bank and therefore able to keep its costs relatively low; on good terms with, but not too close to, the respective government; and efficiency-oriented without being profit-oriented.

Traditionally, donors have treated the type of partner organization with which they would be willing to cooperate simply as a given. In an explicit institution-building approach, the selection of a partner institution is regarded as a problem of choosing among various alternatives mainly on the basis of the first two criteria mentioned above.

A crucial aspect of partner selection is the ownership and governance structure of a potential partner institution. Institution building typically entails the task of finding, and even of creating, an owner for the project at an early stage and of devising a governance structure for the institution. The task consists in assigning the function of being responsible for the project to some specific person or institution and in defining and, to some extent, also restricting the discretionary power which the "owner" has over the project and the institution in question. Of course, the government of the respective country can be an owner too. More important than legal ownership is economic or functional ownership. By this term we mean the general and ultimate responsibility for the success or failure of the project on the part of the developing country, and for the institution which is involved in carrying out the project. Ownership in this sense does not necessarily imply legal ownership, but legal ownership may, of course, be the basis of functional ownership.

How problematic the implications of private and public ownership will prove to be depends in large part on the specific regulations which define the responsibilities and powers of the owners; and these cannot, and should not, be treated as a given but designed carefully in the context of the project. This is why there ar no a priori grounds for considering only certain types of institutions - with certain ownership and governance structures - as eligible and suitable partners and "objects" of institution-building projects. Neither government-owned banks nor private commercial banks nor NGOs should be ruled out.

2. "Downgrading" - How to Make a Financial Institution More Target Group-Oriented

The idea of downgrading presupposes that there is a formal financial institution, a public- or private-sector bank, which could at least in principle provide financial services, especially credit, to the target group, but has so far not served this segment of the market, and whose owners and/or management would be willing to adopt this new approach and revise their overall business policy accordingly.

The financial sector reforms that have been initiated in many countries during the last decade, and in particular the deregulation of lending rates, have created an environment which makes the provision of financial services to the target group, if not an attractive proposition, then at least conceivable from the point of view of commercial banks. And they will make entrepreneurs from the small business community an important clientele for the banks in the years to come.

So there are now market forces which would in principle induce the existing banks to go "down market" in their efforts to expand their customer bases. As these forces are still weak, it may be worthwhile to strengthen them through complementary incentives and to induce formal sector institutions to serve the financing needs of the target group on an increasing scale. This can be attempted in the framework of a downgrading strategy.

There are certainly banks which will, over the medium to long term, adopt, or develop on their own, the credit technology and the organizational structures needed to serve this new type of client from the small business community. And it is precisely these banks which are most likely to be interested in becoming partners in a downgrading project. This raises the question of whether it is legitimate from a development-policy standpoint to speed up a modernization process which will take place anyway. Our answer to this question is clearly affirmative: if a development project speeded up the modernization and learning process in a bank with a large branch network by five years, many small entrepreneurs could get access to formal credit five years earlier.

On a practical level, the concerns which even innovation-minded banks may have with regard to the risks and costs of small business and informal sector lending are an obstacle to the successful implementation of a downgrading strategy. There is in the meantime a sizeable body of empirical evidence to the effect that loans to micro enterprises can indeed exhibit lower arrears and default rates than loans to large enterprises, provided that a suitable incentive structure is in place and that an appropriate credit technology is employed. Downgrading as an institution-building strategy requires, first of all, that this information be made available to the prospective partner institutions.

The core of the donor activities in a downgrading project relates to the costs of small-scale lending. It consists in introducing and implementing a credit technology which balances development policy considerations with the interests of the partner banks. Particularly during the start-up phase, when the new lending business is just getting under way, the costs incurred are considerably higher for a bank than they will be later on. It is precisely these "start-up costs" which may pose an almost insurmountable obstacle to the initiation of small and micro lending activities by institutions that are in principle willing to do so. Thus, international donor organizations should initially focus on this area and provide short-term support to enable participating institutions to

- recruit and train new loan officers who will specialize in small and microenterprise lending;
- implement computer-based credit extension and monitoring systems;
- establish new branches located in areas where there is a large concentration of small and micro enterprises.

The point of these measures, which amount to a short-term subsidization program, is to ensure that the start-up costs are not passed on in full to the institution's small and micro credit customers, even though in some cases this would be feasible.

The practical experience which the Inter-American Development Bank (IDB) and the European Bank for Reconstruction and Development (EBRD) are currently acquiring with what has in the meantime become an explicit downgrading strategy, illustrates the potential of, and the problems posed by, downgrading. The strategy appears to work well now. Nevertheless, it is interesting to note that, in the case of the IDB, a great many reservations had to be overcome at the level of the donor institution, the participating banks and the respective governments. The EBRD, which has been pursuing a similar strategy in Russia since early 1994, has avoided some of the problems which the IDB had encountered. Its concept is in fact simpler and more attractive for the participating banks, and the EBRD seems to be less concerned about the fact that in the context of the cooperation, it does indeed "interfere with" - modify - the internal structure of the Russian banks to a substantial degree.

3. Upgrading - How to Build an NGO and Turn it Into a Small Bank

3.1 The Focus of the Discussion in this Section

In this section of the study, we present a stylized case study of how an institution which tries to concentrate on providing credit to small and micro-scale businesses is born, grows up and becomes a formal financial institution with the potential to play a lasting role as an element of its country's financial system and as a provider of financial services to persons who have traditionally not had access to formal sector credit. The case study is based on the experience of GTZ, the German Agency for Technical Cooperation, gained in specific projects in Latin America with the strong support of the Microenterprise Division of the IDB. It is the purpose of the case study to convey three messages:

(1) Creating or supporting an NGO and converting it into a formal institution with a consistent target group orientation is a process which takes a long time to complete. During this time span the institution has to be able to rely on continuous support of the relevant kind from the donor or, as the case may be, donors.

(2) The most crucial aspects of the process are finding the appropriate combination of technical and financial assistance, and ensuring that the different forms of support, and especially the provision of funds for on-lending, are forthcoming at the right time and in the right quantities.

(3) The process of building up a financial institution should lead to a situation in which the institution's operating income is sufficient to cover its full costs. Before this stage is reached, there is a need for the donors to invest in - i.e. to subsidize - the institution. And even in this final stage, the operating costs, which by then will be passed on completely to the institution's customers, are still likely to be high when measured by conventional standards.

For ease of exposition - and because this proves to be advisable in practice, we assume that the partner organization is, or will be, an NGO. This is, after all, the typical case. In cases where this is not so the substance of our arguments still applies.

3.2 The Creation of a Financial NGO

In the first phase, an NGO is created or, as the case may be, modified. Four elements are needed in order for this to take place:

(1) <u>A legal form.</u> The institution which is to be created needs a legal and institutional set-up. It should be a non-profit organization (NPO), preferably constituted under private law. Its formal status should be such that the

institution to be created is to a certain degree independent of the people behind it, and is legally in a position to conduct serious lending business and also to receive donations from foreign institutions. These considerations make the legal form of a foundation more advisable than the alternative form, which would be an association.

(2) A governance structure and by-laws. At the heart of the governance structure is the definition of the institution's mission. In our case, it consists in providing appropriate financial services to a specific target group on a financially sound basis, i.e. target group orientation and sustainability. In the by-laws, the mission should be formulated explicitly, and expressed in operational terms to the greatest degree possible. The governance structure gives a board of trustees supreme authority to determine the institution's business policy and ultimate responsibility for internal control, yet provides for its business operations to be run by a management (preferably a team) which must perform its functions with a high degree of professional competence and whose members should not simultaneously sit on the board of trustees.

(3) Key individuals. A foundation's governing body is its board of trustees. It is composed of individuals who are ultimately the project partners. In its composition, the board should above all reflect the interests and objectives which will shape the character of the future financial institution. Ideally, it should include a number of individuals with a successful track record in business, some with experience in banking, and others whose experience lies more in the field of social services.

(4) Money and commitment. With this type of donor-induced NGO it is neither necessary nor desirable for the initial capital to be raised by the founders and/or board members themselves, and this for two reasons. Firstly, very few of the people who have the qualifications required for board membership would be capable of providing a sizable contribution to the sum of money which the NGO will need very soon after the start of its operations. And secondly, significant disparities in terms of the individual capital contributions would tend to rob the group of its all-important internal cohesiveness. This has an important implication: in order to guarantee from the outset that all members of the board of trustees enjoy equal status, it is essential that the start-up and original endowment capital be provided by a donor organization (albeit subject to conditions).

3.3 The Growth and Transformation Process

Assuming that a new NGO has been set up, or, as the case may be, that an existing NGO has been chosen as the basis for the project, the following scenario illustrates the possible economic and technical development of a largely donor-induced - financial NGO. The scenario, which is described in detail and backed up by specific figures in the main text of the study, shows the sequence of individual steps and the extent of the institution's need for funds required for lending, as well as the optimal timing for such injections. These funding needs should be covered by the donor or donors in addition to the pure technical cooperation component they provide.

The scenario covers a time span of ten years. The first four years are the time needed for the NGO to reach financial sustainability, and thus a situation in which transformation into a formal financial institution is advisable and possible. The remaining six years can be roughly divided into a phase of rapid efficiency growth and a subsequent phase of slower growth in efficiency. From the tenth year on, further growth is assumed to be possible only by a purely quantitative expansion of operations.

During the first year the institution's lending operations will be on a small scale, with a small portfolio and a small number of employees, each of whom manages only a small number of customers and a limited portfolio. The funds used for lending are essentially the endowment capital. The initial loans are very small, not only because of the particular target group involved, but also because the institution needs to exercise caution while learning to deal with the new borrowers. Despite high interest income of 40% p.a. on the average outstanding portfolio, the institution will not be able to cover its costs during this first year. The technical assistance component during the first year, as well as during the two following years, should include support by several international and local experts and the donation of computer hardware and fixed assets.

In the second year it will already be possible to treble the volume of lending, since both the absolute number of staff members and their efficiency will have increased. Now that the institution is more experienced in working with the target group, the average size of the loans will rise slightly. During this year, the institution must receive additional funds from the donor or donors in order to secure its growth. But this time the funding should take the form not of a grant but of an interest-free loan.

The third year will see another large increase in the number of borrowers, and they can be served more effectively due to the opening of new branch offices. Average loan sizes and maturities will rise slightly. A combination of the increased number of employees, the further improvement in their efficiency parameters and the rise in the average loan amount, together with a constant level of interest rates, leads to an earnings situation which, for the first time, enables the institution to cover all its operating and risk-induced costs. In order to ensure that the institution grows at as fast a rate as is technically possible, it needs to receive an additional injection of funds from outside in the form of a "soft" loan (6% p.a. in US$).

In its fourth year the NGO achieves a breakthrough in financial terms en route to becoming a cost-covering financial institution. In this phase, it is strongly recommended that the financial NGO initiate the transition to a formal-sector financial intermediary and change its legal structure to that of a corporation, as the legal form of a foundation will pose an obstacle to receiving the funds it needs in order to safeguard its future growth prospects. Its funding needs from year 5 on can, and should by all means, be met by loans provided by international development institutions at their normal "commercial" rates. From year 4 on and with a portfolio size of more than US$ 10 million, the combined administrative and risk costs of the institution will drop to below 20% and slowly approach 12% p.a.

As set forth in detail in the numerical example in the main text, the original endowment capital of the foundation, together with the donations of PCs and other fixed assets, will form the equity base required for the establishment of a formal financial institution - or part of it. The foundation becomes the (principal) owner of the bank in which the donor organization(s) can (and should) now also acquire a formal stake by converting a portion of the soft loan provided in year 2 into equity.

Once a bank has been founded, the focus of the technical assistance component can be gradually changed and shifted to other activities, e.g. the launching of a deposit-taking business.

4. Donor-Related Problems

In the concluding section of the chapter, the study points out four widespread deficiencies in the way that donor institutions consider and handle institution building projects. These observations are based on our consulting experience gained in cooperation with several major donor organizations. The general thrust of our critical remarks is that donors tend to exhibit a certain reluctance to consider institution building projects as a genuine and legitimate type of project and to take them as seriously as they need to be taken.

(1) Donors seem to feel that it is difficult to justify pure institution-building projects in the field of finance. As a consequence, they quite frequently incorporate elements of direct support for the target group into an institution-building project, even if these elements water down the project strategy and lessen its chances of success.

(2) In practice, donors tend to burden institution-building projects with multiple and inconsistent objectives. In part, this tendency seems to be grounded in the assumption that creating an institution and transforming it into a viable and professional financial intermediary is not a particularly difficult task, leaving the project management staff or the institution itself with plenty of capacity for doing other things at the same time.

(3) Many donors follow a general policy of very limited intervention. As a matter of principle, there can be no doubt that the optimum is as little intervention as possible. However, in the context of building financial

institutions, the real issue is how much non-intervention is feasible if the objective of the project is still to be achieved. In our experience, institution-building projects require a much higher degree of intervention and long term commitment on the part of the donors than other types of projects.

(4) A certain uneasiness about the responsibility they have in the context of an institution building project is probably the reason why donations and loans play a much bigger role in such projects than equity. Donors should understand that equity is in many cases the appropriate financial instrument for building up an institution.

C: Credit

1. The Object and the Purpose of this Section

It has long been doubted that it is feasible at all to extend credit to a target group which is poor and also rarely has adequate financial records or bankable securities. However, the costs and risks entailed in lending to this target group are not a "given"; instead, they are a function of the "credit technology" which is being employed. One objective of this chapter is to dispel the general doubts concerning lending to the target group. The second purpose of this section is to undertake a comparison of two "competing" credit technologies. Generally speaking, the term "credit technology" covers the entire range of activities carried out by a credit-granting institution which have to do with selecting borrowers, determining the type of loan to be granted, the loan amount and maturity and the way in which it is to be secured, as well as the monitoring and recovery of loans. More specifically, a particular credit technology is a particular configuration of these features.

In principle, one can distinguish two classes of credit technologies which can be characterized as either "individual-based" or "group-based".

There are two individual-based credit technologies. One of them is the conventional banking technology. Its applicability in the case of the target group that is considered relevant in the context of the present paper is naturally quite limited as the small and micro entrepreneurs typically do not have the required documents and titles.

The other individual-based credit technology is different from the first one insofar as it has been adapted to the special situation of borrowers from the small and micro business sector. It retains the advantages of dealing with each individual case separately and is tailored to the situation of the individual borrower, but makes a conscious attempt to acquire more information about the borrower by direct inspection rather than by studying documents. Because it is adapted to the economic and social situation of the potential borrowers, we call it the non-conventional technology.

The other class of credit technologies are those which involve groups of borrowers - in one form or another - in the process of granting and recovering loans. Two variants of group-based credit technologies are of special importance here. One variant involves the use of what may be characterized as groups as loan guarantors; in the other variant, the group plays more of a social role, and it may be characterized as the group as social network approach.

2. The Non-Conventional Credit Technology

In the following discussion we will draw upon the experience of certain formal financial intermediaries and NGOs in Latin America and Asia with a target group-oriented individual credit technology.

The basic advantage of the individual-based credit technology from the point of view of the borrower are the low transaction costs which he or she incurs. This is the case because the financial institution externalizes neither the risk-induced nor the administrative costs. However, from the point of view of the lender, an individual-based credit technology will only prove to be competitive if it succeeds in minimizing - or at least reducing to a level which does not jeopardize the financial viability of the lending institution - both the risk-induced costs and the administrative costs. In the following we will describe the key aspects of an individual-based credit technology which enable it to achieve these two objectives.

The default risk is reduced by using non-conventional methods of analyzing the borrowers` debt capacity, and by supplying a product that is tailored to the situation of the target group. The credit analysis is based on an assessment of the "family enterprise" in its totality, and in particular its ability to make repayment under the cautious assumption that the borrowed funds will have no impact on the earnings potential of the family business. This means that even if the loan were used solely to finance consumption, the borrower would still be able to pay it back, and the risk to the financial institution would be limited. Loan sizes as well as maturities and repayment patterns are also determined in such a way that the risk for lenders and borrower is limited.

The willingness of the borrowers to repay their loans is a factor which carries just as much weight in the individual-based credit technology as the analysis of their ability to repay. Although an attempt is made ex ante to ascertain the willingness of the borrower to repay the loan, the credit technology still has to include unambiguous penalty mechanisms which reduce the credit risk after the funds have been disbursed while still being appropriate to the economic situation of the borrowers. This entails, among other things, that borrowers are only asked to pledge assets as collateral which they can easily provide. However, care is taken to make sure that the items which are pledged are ones which would be relatively expensive - or difficult - for the borrowers to replace if they were seized. With this type of collateral policy, the primary goal of the credit-granting institution is to make the borrowers take seriously their payment obligations. It is not so important to ensure that all of the money owed the lender by a defaulting borrower could actually be recovered through the sale of pledged assets.

The non-conventional technology also provides for the utilization of rigorous credit monitoring and recovery procedures in the case of arrears, which complements the penalty mechanisms mentioned above. The components of the credit technology which are designed to minimize default and the "moral hazard" problem would fail to have their desired effect if they were not backed up by control and organizational structures which ensure incentive-compatible implementation. Accordingly, an institution utilizing the individual-based credit technology will make a single loan officer responsible for the entire loan-granting process as well as its relationship with the client after disbursement of the funds. Thus, the officer develops a quasi-personal relationship with "his" borrowers which gives him access to significantly more information about them and their businesses, which improves the quality of his loan portfolio. The effectiveness of this system can be enhanced by introducing an incentive-compatible, i.e. performance-based, pay scale for the lending staff.

A significant reduction in administrative costs is achieved by offering only a limited range of standard products, i.e. a smaller range of loan options than is generally offered by traditional commercial banks, and at the same time ensuring that the efficiency of all procedures utilized in the credit-extension process is maximized. Here, special computer software packages are employed which have been designed to meet the specific requirements of the non conventional credit technology.

3. Group-based Lending

While the utilization of the individual-based credit technology gives rise to specific risk-induced and administrative costs which the lender should strive to minimize, employment of the group-based credit technology seems to imply that the lending institution can avoid incurring precisely these kinds of costs by employing group pressure or, as the case may be, formal group liability, and by shifting a considerable portion of its administrative costs onto its borrowers. Therefore, it is not too surprising that group loans to members of economically disadvantaged target groups are fairly popular not only among certain new financial institutions and a great many credit-granting NGOs; they are also generally viewed favorably by most of the international donor community. Taking their cue from the successful group lending program of the Grameen Bank, a number of institutions, above all in Latin America, are using some features of this Asian model. Accordingly, the role of the Grameen Bank as a positive example makes it advisable to take a closer look at how this bank really goes about its lending activities.

Most surprisingly, closer inspection reveals that the Grameen Bank does not make use of any kind of formal group liability, nor does it rely very much on "peer pressure" - which is alleged to be the distinguishing characteristic of group lending systems of all types - to influence the borrowers' repayment behavior. In fact, it does not even impose any penalties whatsoever on a group if one of its members is either unable or unwilling to pay. The group merely has a moral obligation to try to induce a delinquent borrower to make his payments. Thus, the bank chooses not to exploit the potential of the group as a means of enforcing joint and several liability or other kinds of liability. Instead, it appears that the bank prefers a more individual form of liability, which is, for example, reflected in its requirement that, until a loan is paid back, the borrower must transfer to the bank ownership of any goods financed with that loan via a chattel mortgage. In other words, whenever it is technically feasible, the Grameen Bank insists that its individual customers secure their loans with tangible assets. (This "revelation" is certainly not intended to detract from the impressive achievements of this bank!)

Group-based lending approaches have been popular for a number of years in Latin America, and more and more credit-granting institutions have adopted them there. In particular, what we call "financial NGOs" have developed certain approaches which appear to be similar to the one used by the Grameen Bank without, however, being able to achieve a comparable degree of coverage of their target groups. Quite often, support for these efforts is solicited with an explicit reference to the Bangladeshi bank's system, which is cited as the model for the approach the institution wishes to use.

The main text of the study discusses in some detail how the Latin American NGOs form groups, what the main features of their credit contracts are, the kinds of problems they encounter with their groups in terms of instability, and what they do to mitigate these problems. We conclude that the overall costs of group lending in Latin American appear to be substantial, a conjecture which is in strict accordance with the findings of a study on lending costs of NGOs which we prepared for the IDB.

In our view, there are three major differences between the group-based credit technology used in Latin America and the one which has been developed by the Grameen Bank.

(1) Differences in the process of forming groups. This process can take up to six months in Bangladesh and can only be characterized as an intensive inculcation of values, principles and attitudes. In Latin America, on the other hand, it usually does not last much longer than a week. But the fact that the target group is defined in extremely narrow terms in Bangladesh, and that most of the members of that target group live in small villages with rigid, traditional social structures, tends to enhance the stability of the Grameen Bank's groups, increase the amount of information available to each group member on his or her fellow members and mitigate the moral-hazard problem involved in any type of group liability. By contrast, groups formed in Latin America are quite unstable and their composition is prone to change rather quickly.

(2) Differences in the concept of group liability. The Latin American version of the group-based credit technology requires that lending institutions adhere much more strictly to the principle of solidary liability - indeed, it requires the use of a formal joint and several liability arrangement - than the "model" that has been developed by the Grameen Bank. In fact, if one looks at the way in which the Bangladeshi institution deals in practice - if not in theory - with the loan-security problem, then one would have to say that, on balance, it is more accurate to describe its approach as an individual-based rather than a group credit technology.

(3) Differences in the cost of loans. The loans granted by Latin American financial NGOs using this group-based credit technology rarely carry an effective interest rate of less than 50% p.a. in real terms, and thus their interest charges are significantly higher than the Grameen Bank's rate, which is 10% p.a. Even if factors such as the difference in funding costs and the fundamentally different policies regarding the setting of interest rates are taken into account, the sheer size of this differential is itself an indication that there are probably also differences in terms of administrative costs and perhaps also of risk-induced costs.

A comparison of the technology developed by the Bangladeshi institution with what claims to be its replication in Latin America yields interesting results. In our view, the group-based credit technology as it is used in most cases in Latin America represents a kind of negative, "mirror-image" version of the system used by the Grameen Bank which in effect misses the point of what the intermediary in Bangladesh has done. Why, then, have so many institutions in Latin America chosen to use this approach? We can only surmise that in most cases institutions have adopted this strategy - which in fact only pretends to be the "Grameen Bank approach" - because they have reasons to believe that donors consider it to be a successful strategy and thus that it is easier to obtain funding from them if one can claim to be using the same "socially appealing" lending methodology as the Bangladeshi institution.

4. Comparing Group-Based Credit and Individual-Based Credit

4.1 Criteria and Data

This section contains elements of a comparison of the group-lending technology and the individual-based credit technology which we have characterized above as the "non-conventional technology". The criteria for such a comparison must relate to both the demand side, i.e. the borrowers, and the supply side, namely the financial institutions.

Considered from the point of view of institutions which may use it, a credit technology is attractive if it enables the institution to undertake lending activities in such a way that the revenue generated by these activities is, at least over the medium term, sufficient to cover their costs. A credit technology can be called "efficient" if it makes it possible to reach the target group better and to do so at a lower total cost to the lending institution than would be possible with other credit technologies. This definition focuses on the productivity and the cost efficiency of the technology.

For the purpose of comparing efficiency, we have compiled statistics from a number of formal and semi-formal financial intermediaries from Asia and Latin America, which cater mainly or exclusively to the needs of small borrowers; and use one of the two approaches. The institutions included in the comparison are generally considered to be very positive examples of institutions employing the respective technology. We use only data which we have been able to obtain directly from the institutions or from sources which we consider to be reliable. We have derived three hypotheses concerning the relationship between the productivity and cost-efficiency of the two credit technologies:

(1) Group lending has an advantage over individual-based lending in that at an early stage of the life of a credit program or a credit institution, group lending is more productive and cost-efficient.

The reason for this hypothesis is that, according to the claims made by advocates of the group-based lending approach, and based on what we know about the way in which groups are in fact being formed in Latin America, the process of setting up groups takes less time and is less costly than the corresponding learning and training process which is required in the case of an individual-based credit technology. Thus, we would expect a young institution granting group loans, especially if it is in Latin America, to be more efficient than one of comparable age which grants individual loans.

(2) In the course of time, however, the productivity and cost-efficiency of an institution using group lending increases only moderately, while a bank or NGO lending on a strictly individual basis can increase its efficiency rather quickly.

The reason for this hypothesis is that the group lending technology shifts a considerable part of the burden of selecting customers and monitoring their repayment behavior onto the target group and thus "externalizes" bank functions. In so doing, a bank using this technology deprives itself of the opportunity to learn and, by learning from its experience, reduce its administration costs. In contrast, the notion of learning, of getting to know customers better and developing routine procedures for extending, monitoring and collecting loans is at the core of the individual-based lending technology.

(3) The efficiency of a relatively old institution using groups is still higher than that of a bank or NGO of comparable age which employs the individual-based credit technology.

The reason for this hypothesis is that shifting important functions of the financial institution onto the borrower groups is assumed to lead to cost savings on the part of the institution, as this is, after all, a central part of the rationale of the group lending approach. Thus, even a bank which has had substantial experience in the utilization of the individual-based credit technology would presumably not be able to compensate for this cost advantage of the group approach.

Empirical verification or falsification of these hypotheses on the basis of scant information concerning only a handful of institutions is, of course, difficult, as productivity, cost efficiency and total administrative costs are a function not only of the age of the institution and, as we hypothesize, the credit technology used, but also of the situation in the respective country and the size of the average loan which the institution grants its borrowers. Taking this into account as much as we could, we came to the following conclusions concerning the three hypotheses:

- The first hypothesis may be correct, but it could not be verified.
- We were able to find strong evidence supporting the second hypothesis.
- The third hypothesis is likely to be wrong although the evidence is mixed.

If the first hypothesis were indeed correct and the third one indeed wrong, this would imply that due to increases in efficiency over time caused by institutional learning of the kind that can take place with the individual-based technology, an individual-oriented bank would in the course of time outperform a comparable group-oriented bank or NGO in terms of efficiency. Given a sufficiently long time perspective, which is called for in development finance projects anyway, the discounted value of the total administrative costs of an individual-based technology bank would then be lower than those of an otherwise comparable bank employing the group-based lending approach. We expect that this will be the case in practice as soon as institutions such as the "emerging NGO banks" in our sample and other similar intermediaries have had enough time to become mature financial institutions. Thus, we surmise that the non-conventional credit technology is more cost efficient in an overall sense than the group-based technology. Since risk-related costs doe not seem to differ very much, including them does not change this result.

In conclusion, it is possible to state that, based on the efficiency criteria of productivity and cost efficiency, individual credit extension has the medium-term advantage of allowing the institution to convert its experience in the screening process into cost savings, something which is fundamentally absent from group credit technologies. At first sight, the high degree to which banking functions, and thus also - or so the institutions hope - administrative costs are externalized appears to be an advantage of group credit extension. However, closer analysis reveals this to be an inherent disadvantage which calls into question the cost advantage of programs based on the group credit technology. The assessment from the perspective of the lending institution has to be supplemented by an assessment from the perspective of borrowers. Both groups of institutions which we have compared have the same target group and are equally good in terms of accessibility. However, in terms of the speed with which a loan can be obtained, flexibility regarding the terms of the loan, and most importantly, in terms of transaction costs, the non-conventional individual-based technology is definitely superior to all kinds of group-lending technologies for the small and micro entrepreneurs.

D: Savings

1. The Relevance of Savings

Savings is no longer "the forgotten half" of development finance. The promotion of saving through measures to foster the introduction of deposit facilities tailored to the needs of small savers has become an important topic in the ongoing international discussion of development-policy objectives. strategies and approaches. We wholeheartedly endorse this new awareness of the importance of saving and the problems involved in mobilizing deposits. Nevertheless, the main point which we want to make in this chapter is that not all target group-oriented financial institutions must at all times provide savings facilities and mobilize the bulk of the funds for their lending business from depositors and in particular from those depositors who belong to the target group on which the institution focuses its lending operations.

In order to avoid any misunderstanding of this proposition we will begin by reiterating why savings services and deposit mobilization are important. First of all, seen from a macroeconomic perspective, saving is necessary as it is the basis of capital accumulation. Secondly, seen from the perspective of the customers, the provision of deposit facilities is a service which is needed by all groups in society, and therefore it must be provided. Poor people and small and micro entrepreneurs also need and demand deposit facilities. Thirdly, deposit mobilization is necessary as it provides the funding required for the lending operations of the banking system.

It is in the spirit of the new view of small business financing to take a financial systems perspective. This perspective provides the straightforward insight that no single institution should be looked at - or treated - as though it were the entire system. The three arguments in support of the importance of savings apply without qualification to the financial sector as a whole. But it is an open question whether, and to what extent, they apply to an individual financial institution: if other institutions provide adequate deposit facilities, this may be sufficient from the standpoint of a given institution which specializes in lending.

Incidentally, there are institutions in developing countries such as Postal Savings Banks which only provide savings and payment transfer services and would never even be allowed to go into the lending business, even if they were willing and able to do so. From a financial systems perspective, it may be advisable to support such an institution. Neither macroeconomic nor demand-side considerations require that one and the same institution provide all services which are relevant for the economy and for all of its potential customers. Indeed, specialization may be better. Accordingly, we must look all the more closely at the supply side and ask why target group-oriented financial institutions should be, or should become. "full service banks". The question is worth asking for the simple reason that most donor agencies seem to have a strong and almost dogmatic preference for target group-oriented "full service banks".

There are. in fact, two different models of a "full service bank". One model can be named the "intra-sectoral full service bank". Such a bank would try to mobilize the bulk of its deposits from the same target group to which it directs most of its lending. Some observers would regard such a full service bank as the absolute ideal. The relevant question in relation to this model - which we shall call Question A - is simply: Is it at all a realistic one for an institution which considers poor people, and in particular small and micro entrepreneurs, as its target group?

The other model would be an "inter-sectoral full service bank" which tries to lend to "lower" social strata than those from which it collects the bulk of its deposits. The most interesting question to be asked in relation to this model is this: Is it good for the target group that "their" financial institution tries to mobilize deposits from other segments of the local society? (Question B) We believe that, just like the distinction between savings as a service to customers and savings as a source of funds, the distinction between the two models of a target group-oriented "full service bank" helps a lot to clarify the issues underlying the controversy regarding the advisability of offering deposit facilities. It should be borne in mind that a negative answer to these questions would not imply that a target group-oriented financial institution should not accept any deposits from its main target group. Thus, there is a third question (Question C), namely whether such an institution should provide savings facilities irrespective of the role which the funds it mobilizes in this way may play in terms of funding its lending operations.

In discussions of the subject of savings, this kind of question is rarely asked. Instead, four standard arguments are usually cited - and sometimes even explained - when the case is made for savings services as a complement to credit facilities in the product range offered by target group-oriented financial institutions.

The first argument is that there is clearly a demand for such services on the part of the target group. The second argument is that the provision of savings facilities in some way improves the quality of the institution and in particular makes it more responsible in its lending operations.The third argument is that there are positive synergies between the credit and the deposit business: by providing deposit services, a bank may be in a position to gain information which it can use in its credit business in order to reduce costs and risks. And the fourth argument is that the development finance institutions have a moral and political obligation to instill a spirit of thriftiness into their poor customers.

These four arguments have to be evaluated both in terms of their empirical validity and in terms of their relevance for answering Questions A, B, and C. The merits of the first two arguments will be considered after we have taken a look at some empirical material. However, the third and the fourth arguments can be discussed right away.

If we bear in mind how credit technologies used by target group-oriented financial institutions in developing countries actually work (see description in chapter C), we can see that the third argument is almost irrelevant. There is no room for synergies. The fourth argument is unacceptable simply because it is overly paternalistic. In addition, it is doubtful whether, for small and micro entrepreneurs in particular, financial saving, as opposed to real saving in the form of real investment, is the more suitable option, and the entrepreneurs of the informal sector can well be trusted to make this decision on their own.

2. Empirical Evidence

It is remarkable that there are only a few well-documented case studies of successful savings programs at target group-oriented financial institutions. In these studies, hard economic data such as the size distribution of savings deposits and the costs of providing deposit services are rarely found. Most of the relevant literature, fascinated as it is by the sheer ability of small savers to put aside money, usually focuses on indicators of success such as the growth in the number of savings accounts and the volume of savings mobilized and on investigations of the sociological and psychological motives which make people want to save.

We have looked at empirical material referring to institutions in Asia, as some Asian institutions, e.g. BKK and the Unit Desa Program in Indonesia, have the reputation of being very successful in their savings mobilization efforts. These and many other institutions in many countries are indeed quite successful in this field, and among other things, this success is evidence that there is a demand by very small savers for suitable deposit facilities. But considered in detail, the success of BKK is quite limited as far as voluntary savings are concerned. BKK's mobilization of small savings, for example, is insufficient to fund its lending operations to any appreciable extent. Unit Desa is more successful. But there appear to be several interesting reasons for its success. First of all, its deposits are guaranteed by the big government-owned bank BRI.

Secondly, it offers considerably higher interest rates than, say, BRI itself, thus raising the suspicion that many deposit customers of BRI may simply have shifted their deposits to another part of the same conglomerate, and that Unit Desa's success has come at the expense of BRI and other big banks. In macroeconomic terms as well as in terms of improving the supply of deposit facilities, the value of these savings services is therefore quite limited. In any case, the Asian experience seems to indicate that, although a relevant demand exists, it is difficult for target group-oriented institutions to mobilize a significant volume of "micro-deposits". Although we do not have data on the administrative costs of mobilizing savings, the high interest costs of mobilized funds alone would support the hypothesis that mobilizing small savings deposits is an expensive proposition in Asia.

The experience of certain target group-oriented financial institutions in Latin America points in the same direction: even when normal market interest rates, and rates which are positive in real terms, are offered, voluntary saving by the members of the target group contributes only a small volume of deposits. Thus, a rapidly expanding target group-oriented financial intermediary clearly needs alternative sources of funding. If it seeks to obtain these additional funds on the local market for deposits, it will find it difficult to quickly attract savings capital from members of the middle class even if it offers a substantial interest rate premium. This is so because it takes several years to gain the trust of potential savings customers and because competition among financial institutions for their business is intense in cities and for this group of clients.

The Peruvian municipal savings banks are an interesting case. Over the last few years, their savings deposit volume has been equivalent to more than 100% of their outstanding loans. The savings banks' growth in recent years has been primarily a function of their ability to attract savings deposits, and this, in fact, has proved to be a rigid constraint. The growth rate of 16% per year during the period 1986 - 1993 was by no means sufficient to meet the credit demand of the target group, nor did it permit the institutions to achieve the economies of scale in their lending operations which would have been possible with a stronger funding base.

The case of the Peruvian municipal savings banks provides the rare opportunity to say something about the administrative costs of mobilizing savings. Rochus Mommartz has just finished a study in the context of GTZ's support to the Peruvian savings banks. He finds that in 1993 the full costs of savings mobilization were in excess of 10% (per year) for the stock of total deposits. A large part of these deposits came from big savers and institutions. The full costs of mobilizing small savings, defined as savings deposits of less than US$ 500, amount to a surprising 40% per year - despite the fact that these banks have, with foreign assistance, gone a long way in introducing cost-saving administrative procedures and that they make ample use of electronic data processing techniques.

3. Implications

We want to come back to the two remaining arguments for the provision of deposit facilities in addition to credit, and to the three questions asked in section 1 above which refer to the two models of a "full service bank". The first argument was that there is a demand on the part of small savers for appropriate deposit facilities. The demand does exist. And this implies, as a kind of "moral imperative", that a target group-oriented institution - as well as the people who run it and the donors who support it - must be concerned that there be a supply to meet this demand. If other institutions which offer suitable deposit facilities are available and accessible to the target group, then the institution under consideration should think twice before it starts taking up an activity which may be as difficult as lending to the target group and which inevitably proves to be a very expensive source of funds. In rural areas this condition (the availability of alternatives) is often not met and, as a result, rural financial institutions must frequently provide deposit facilities at an early stage of their development. In doing this, they need to, and deserve to, receive support from donors. The essence of this support should consist in compensating the banks for the high costs of providing this socially valuable service. Above all, donors should appreciate the effort and make it clear to the banks that they do not expect the savings deposits to be an important source of funds, since relying too much on savings to fund lending can impede the growth of an institution granting credits to the target group.

However, in the urban environments in which most financial institutions providing credit to small and micro entrepreneurs operate, the condition is most often fulfilled: there is a supply of deposit facilities available "on the market". Therefore, these institutions should not be burdened and constrained by the expectation of donors that they themselves should also provide costly deposit services for borrowers from their main target group at an early stage of their lives as institutions. The "ideal" of an "intra-sectoral full service bank" for the target group is an illusion and should be abandoned. This answers Question A, and also sheds light on Question C: A target group-oriented financial institution with an innovative credit business should proceed with great care, and also move slowly, in taking up deposit business. We think that it should first have achieved cost-coverage on the lending side before it takes small deposits at all. So what remains to be discussed are the second argument, the model of the "inter-sectoral full service bank", and Question B: The "inter-sectoral full service bank" is in fact the only model which has been put into practice on any appreciable scale. If we wish to assess this model in concrete terms, we must first look at the kinds of people who are likely to become savings customers of a financial institution.

An "inter-sectoral" institution tries to mobilize most of its savings from middle- and upper-class depositors as well as from institutions, using its savings deposits to fund lending to lower-class borrowers. What are the merits of such a model, and what implications does it have as regards any potential benefits which the savings operations might entail for the quality of the lending operations? Middle-class savers typically contribute a substantial share of a target group-oriented financial institution's total savings deposits. However, persons from this social class are rarely part of the same institution's "natural" credit clientele.

Indeed, the most important consequence of efforts to attract savers from the middle class is that the institution incurs high funding costs. The reason for this is that, unlike small savers, many of whom will not have even had a savings account before, middle-class savers often must be induced to switch banks, and a target group-oriented intermediary has to pay a price to secure the business of this more affluent clientele. Not only must it pay a higher interest rate on deposits and incur considerable administrative costs; it also has to make changes in its credit business. As it must also have at least some of the attributes of a full service bank in order to be attractive to these customers, it must, among other things, introduce new credit and other products to meet the demand and wishes of its middle-class customers, whose credit demand differs from that of its small and micro entrepreneur clientele. Thus, attracting middle-class savings customers cannot be expected to lead to an increase in the quality of a target group-oriented intermediary's credit business with its primary clientele. With respect to the way in which a target group-oriented intermediary defines its basic mission as an institution, one possible consequence of this attempt to accommodate the banking needs of a different social class is a gradual shift away from the target group it was originally designed to serve.

A similar case can be made against efforts to attract big savers, including institutions. Their deposits are cheap in terms of administrative costs and expensive in terms of interest costs and, above all, quite unstable, forcing the institution to hold excessive liquidity reserves. This is likely to have a direct adverse impact on its lending operations and its general target group orientation. Thus, the "inter-sectoral full service bank" is also a concept which proves to be difficult to implement on an economically sound basis. This of course raises the question of where the bulk of the funding required for on-lending will come from. There is no getting around the fact that some kind of large deposits or other funds must be attracted. The precise extent to which large local deposits should also be sought will be a function of the institution's size. We feel that new and clearly target group-oriented institutions should be able to rely primarily on long-term borrowing in the framework of bilateral and/or multilateral Financial Cooperation programs, which makes their funding much more predictable and reliable. In view of the total costs of other sources of funds, it is evident that access to foreign aid funds is in itself a valuable form of assistance for the institutions which we are considering here. There is no need to provide these funds at concessionary rates.

II. Recommendations

In the following recommendations, the sequence in which the key issues are addressed is the reverse of the one used in the main body of the study. The reason for this is that the chapter on institution building, together with the recommendations which refer to this area, are clearly the centerpiece of the study, and in terms of their internal logic, a number of the individual recommendations relating to institution building are derived from those presented in the sections on "savings" and "credit".

Savings

General Recommendation

We welcome and support the new awareness of the importance of saving in the ongoing international discussion of development-policy objectives. However, many people are inclined to attribute an almost mystical power to this instrument and, above all, to overestimate its significance for an individual financial intermediary. When discussing the role of saving, one should distinguish clearly between the macro level - the level of the financial sector as a whole - and the micro level - that of a specific financial institution. And when presenting arguments for or against the provision of savings services at this latter level, positions should be backed up more by concrete statistics and cost calculations.

Specific Recommendations

As for other customers, it is important for small retail customers to have access to the financial service of "savings facilities", and intermediaries should be supported in their efforts to supply this service by means of TA measures. However, such services do not necessarily have to be provided by institutions which are target group oriented in their credit business. In the perception of their credit customers - and of their potential savings customers - target group-oriented financial institutions which grant loans are operating in a risky field. Borrowers cannot be absolutely certain that the lender will, as an institution, survive and prosper over the long term and be in a position to offer credit services on a permanent basis. On the savings side of an intermediary's business, however, criteria such as safety and long-term institutional stability play a key role in shaping clients' perceptions of it.

If one truly believes in the necessity of providing savings services to small retail customers as an essential element of the mission of the institution under consideration, and savings deposits are not seen merely as a source of capital to fund a target group-oriented institution's lending, then consideration can be given to promoting institutions which do not engage in lending per se (postal savings banks) or which do not necessarily target their lending operations to very small borrowers (state-owned development banks). In a macroeconomic perspective, i.e. seen from the standpoint of the financial sector as a whole, the decisive point here is to ensure that the national financial system encourages saving and facilitates access by many people - including small savers - to savings services. In this connection it is also crucial to ensure that foreign resources are substituted on an increasing scale by domestic savings. However, what an individual financial institution does - or chooses not to do - with respect to savings should not invariably be guided by these fundamental considerations. It is particularly important to distinguish between these two levels when one is dealing with institutions that operate in urban areas with a high degree of "coverage" by banks and in which a diversified range of financial services is available.

Be aware of the following: By mobilizing savings deposits from its own customers, a target group-oriented financial institution lessens its dependence on outside financing; at the same time, though, it becomes dependent in new ways - and perhaps to an even greater extent than before - on other "financiers", and these new forms of dependence can have adverse consequences for the institution and its borrowers.

Target group-oriented financial institutions are almost invariably young intermediaries which tend to be small and have high growth rates. On the liabilities side of their balance sheets, they need a stable, predictable source of financing which is by no means excessively expensive. Some of these institutions see (cumulative) forced saving by their borrowers as an appropriate means of acquiring such a funding source. In our view, it is highly inadvisable to promote forced savings programs as measures of this type not only make no sense economically but are also, from a psychological standpoint, authoritarian and paternalistic. They are directed at a target group of borrowers who are helpless and who, as a rule, have no choice but to take what the "educational" lenders are offering. Moreover, when borrowers must make savings deposits in order to be eligible to obtain loans, this pushes up the effective borrowing costs considerably and also makes the cost of credit difficult to assess for the borrowers. Thus, the only option - apart from that of obtaining funding from external sources, e.g. donor agencies

- is to mobilize savings capital on a voluntary basis.

From the point of view of a financial institution, three major groups of savers can be distinguished, and each group's deposits have different impacts on the institution. Big savings customers give rise to low administrative costs, but their deposits are highly volatile and thus they can have an adverse impact on the continuity of an intermediary's lending policy, especially if it is small.

Securing the business of middle-class savers, on the other hand, tends to increase the stability of any financial institution. But in most cases where an institution is not developing a new market in a rural area that has hitherto been insufficiently supplied with deposit facilities, these middle-class customers will have to be lured away from other banks. This is an expensive proposition. In addition, this type of deposit customer will demand other kinds of financial products which will not necessarily have been given a high priority by a target group-oriented financial institution, e.g. sight deposits, checks, credit cards and the like. Thus, this customer group exercises a kind of latent "pull" on the financial institution which induces it to expand its product range in ways that are not necessarily compatible with its mission as an instrument of development policy, and which are not necessarily viable for a small institution. In extreme cases, this can lead to an almost complete reorientation of an institution's business policy. Finally, small savers - and, in particular, micro-savers - give rise to very high administrative costs. This is even more likely to be the case if they use their savings accounts like current accounts. Generally speaking, the acceptance of savings deposits does indeed strengthen the sense of responsibility felt by the bank's employees, which, however, is also reflected in a considerably more cautious lending policy. In addition, if the savings deposits tend to be short-term in nature - and this is almost always the case - then this induces the institution to offer shorter-term loans than it otherwise would.

Bearing in mind all of the arguments presented in the preceding discussion, we can see that, for a small, target group-oriented financial intermediary, the wisdom of accepting deposits at an early stage of its development is questionable. Conversely, the points we have raised underscore the importance of providing such institutions with a continuous, and adequate supply of on-lending funds made available on stable terms. However, as a financial intermediary grows and expands its credit portfolio, the arguments presented here in favor of a cautious approach to the provision of savings services gradually become less relevant.

If donors wish to promote the micro-deposit business of a target group-oriented financial institution for educational or sociopolitical reasons, then they must create appropriate incentive structures.

The mobilization of small-scale savings is so expensive that one must ask why an intermediary which, in its lending operations, is already attempting to develop a market that is difficult and expensive to serve, should be expected to deliver this additional range of services, which are costly and extremely difficult to provide. New and small target group-oriented institutions should rely primarily on long-term borrowing, e.g. in the framework of international Financial Cooperation programs. If donors wish for these institutions to offer voluntary savings facilities as an additional service at an early stage, they should furnish incentives for the intermediaries to do so. By adopting such a policy, a donor can compensate the partner organization for the particularly high costs it will incur in this area of its savings business.

Credit

General Recommendation

Insist on target group orientation and cost-efficiency as the two indispensable requirements for the general orientation of lending activities.

Specific Recommendations

Pay very close attention to bank-specific efficiency parameters when you analyze a partner organization, and take into account the size of the loan portfolio. Target group orientation and (cost) efficiency are not, in a fundamental sense, mutually exclusive objectives. Indeed, an intermediary can be both target group-oriented and cost-efficient, especially if it achieves a sufficiently high rate of growth in its loan portfolio. A credit-granting institution which has fewer than 100 clients per staff member, administrative costs equivalent to more than 30% of its average portfolio, and arrears (> 30 days) of more than 7% is inefficient. If such ratios are calculated for an institution during its start-up or initial operating phase - i.e. during the first 2 - 3 years - then it still has a chance to become efficient; if such values are still being reported after the first three years, then it is probably too late to "turn it around". A target group-oriented financial institution with an average loan size of approx. US$ 600 and a portfolio of more than US$ 5 million is in a position to bring its administrative costs down to around 20% of the average portfolio. By contrast, an organization - say, an NGO - which only has a revolving fund of US$ 500,000 at its disposal, cannot ever be expected to get its administrative costs down to a level below 50%.

Pay equal attention to the transaction costs which the members of the target group will incur in their capacity as borrowers when evaluating an institution, and in particular the credit technology which it plans to employ. In the case of a credit technology which involves the use of borrower groups, be careful to assess the validity of the arguments presented to show that group lending is necessary, or beneficial, from the point of view of the borrowers.

Group lending approaches in particular give rise to a number of additional types of costs which a target group is forced to bear if there is no better alternative available to it. In many of the cases we analyzed in Latin America, our calculations showed the effective overall costs of micro credits to be in excess of 100% p.a. The fact that there was nonetheless a sizeable demand for these services does not necessarily tell us much about the quality of the credit technology. The danger that suppliers of credit will exploit a monopolistic market position is, theoretically, always given and, in the final analysis, this risk can only be limited through appropriate action on the part of donors to influence the relevant institutions' policies and procedures. Thus, a donor which takes its commitment to the target group seriously and wishes to act responsibly from the standpoint of social policy will always carry out a precise analysis of the "overall costs" to the target group of a given credit technology.

Under certain circumstances, it may be advisable to use a group-based approach to lending, and such an approach may also prove to be cost-effective. The relevant economic literature has clearly defined the set of circumstances that must be given in order for this to be the case. In the "real world" of micro-finance, however, one almost never encounters such a situation. And if the group-based approach nonetheless remains popular to a certain extent among decision-makers in the donor community, then this must be due in part to the fact that the pertinent issues have not been subjected to a sufficiently rigorous analysis.

Keep in mind that there are static and dynamic economies of scale in lending. Lending activities cannot be carried out in an economically efficient manner unless the lending institution has a sufficiently large portfolio under its management.

It is difficult or impossible to exploit the static economies of scale, i.e. decreasing costs with increasing size, that are a typical feature of lending unless one has a credit portfolio of at least US$ 1 million. Thus, the numerous small revolving credit funds that have been set up by donors are condemned to failure -even if they are being operated by competent partner organizations and even if they charge the final borrowers high interest rates. Either they will undergo decapitalization or they will have to charge such high interest rates in order to cover their costs that a donor agency will end up asking itself if there is in fact any real difference between the institution it is promoting and a money-lender.

In addition to static economies of scale, there are also dynamic economies of scale - or learning effects - particularly in credit operations, and these dynamic scale economies should be exploited to a high degree. Both kinds of economies of scale provide strong arguments in favor of concentrating donor support for small and micro-scale lending on a few partner institutions.

A Remark on Risks, Collateral and Credit Guarantees

The loan default rates of all of the target group-oriented institutions which, in our view, currently represent the "best practice" in small and microbusiness finance are very low. This demonstrates that the risks associated with lending to the target group - regardless of how loans are secured - can be controlled by an institution which is seriously interested in loan recovery. This unambiguous finding should help to eliminate another "bad habit" for which, in most cases, either donors or governments must assume responsibility, namely the propensity of small and micro-scale financing programs to establish credit guarantee funds for final borrowers. There is, to be sure, a loan-security problem, but if a well-run bank is doing the lending, it will be manageable. Providing the kind of insurance that is created by a credit guarantee fund does not act as a stimulus which spurs the banks to increase their lending to the target group. On the contrary, it acts as tranquilizer. If a donor wishes to provide venture capital, the bank's balance sheet provides a logical and appropriate place for such injections of outside funds: the institution's equity capital.

Institution Building

General Recommendation

Be aware - and accept that - when done properly, institution building takes a long time and, as a result, donors must be firmly committed to the projects they undertake in this area and be prepared to invest sizeable resources in their implementation. However, it makes no difference whether the target group itself has been integrated into the institution or is involved in the institution-building measures; the important thing is to ensure that the activities of the organization which is finally created have a sustainable positive impact on the target group over the long term.

Specific Recommendations

Find a financial institution whose impact on the target group is (potentially) sizeable, which would not face insurmountable obstacles in its efforts to achieve full cost coverage, and which is willing to utilize an efficient credit technology.

Institution-building projects tend to seem abstract and "technocratic" and to have less emotional appeal than other types of projects which provide direct benefits to the target group. Because it is "difficult to sell" institution building, the donors shy away from financing projects which consist exclusively of institution building and strengthening measures. Instead, they seek to demonstrate just how "targeted" their activities are - in the sense of being tailored to the needs of the intended beneficiaries - by making the credit-granting institutions meet particularly strict requirements as regards the utilization of the funds they receive. And even in cases where it is the declared objective of development projects to promote the institution-building process, preference is given to small projects which, at first sight, seem clearly oriented to the target group, e.g. because they involve the borrowers becoming shareholders in the institution or participating in its management. However, the point of institution-building activities should be to establish a financial institution which will be in a position to play a meaningful role in the respective national financial sector; which is able to deliver credit services efficiently - both from the standpoint of its own economic viability and from the standpoint of the target group - and which is able to sell these services on as large a scale as possible.

Especially when you are building up new financial institutions, be prepared to provide support over the long term and secure appropriate funding commitments for both technical and financial cooperation budgets. Concentrate on a few key objectives and plan to achieve them in clearly defined stages.

Donors should realize that financial institution building takes time and, especially in the case of upgrading projects, that it requires a considerable amount of money for the start-up capital of the counterpart organization, for the long term TA component and for the financial support of the newly created bank. Agencies that do not have this kind of patience, the requisite funds and an appropriate strategy would be well advised not to get involved in this area at all. The large number of donor-funded, mostly short-term mini and micro projects which engage in credit extension to the target group do not represent a viable, permanent solution; on the contrary, they run the risk of being counterproductive.

In practice, donors tend to burden institution-building projects with multiple and inconsistent objectives. Moreover, they expect that all of the goals they have set for the measures can be realized quite quickly. However, it can take years merely to achieve the balance between social vision and financial viability which any institution engaged in micro-lending must have. This is true not only at a philosophical level, but also at a more practical level where such things as the institution's business policy and its operating procedures are debated and defined. Not until an intermediary has built up a large loan portfolio and is able to exploit economies of scale, achieve learning effects and professionalize its operations will it be able to begin to resolve this initial dichotomy between social and financial considerations. Time and time again, we have seen what it does to a credit-granting institution when donors require it to pursue a "mixed bag" of objectives - e.g. lending, provision of general training, technical advice or enhancement of the ability of the members of the target group to form groups on their own and advance their interests through self-help. It condemns such projects to failure and also makes it impossible to measure the successes they may have or determine precisely how they came about and what they can be attributed to.

Underscore the seriousness of your commitment not only by donating technical cooperation funds and providing funds for on-lending, but also by acquiring - and holding for a limited time - a share of the equity capital of a partner institution.

Many donors follow a general policy of very limited intervention even in the affairs of those types of institutions - e.g. the majority of donor-induced NGOs - which would not even exist without the continuous, external support they provide. As far as the economic functions of ownership are concerned, donor agencies are already in the position of a co-owner of development finance institutions to a much greater extent than they are currently aware. They contribute a large share of the funds and bear a major part of the risk. Non-interventionism as a general attitude in institution-building projects is a contradiction in terms. Usually such projects are designed to serve the interests of a specific target group and they attempt to change a given situation. Thus, projects of this type are - by definition - "interventionist" and, in many cases, they involve trade-offs and lead to conflicts since changes in the policies of an institution can end up harming the interests of a certain number of people who benefited from the status quo ante.

Other Recommendations

In institution-building projects, we proceed from the assumption that it is necessary to provide comprehensive support, i.e. support which makes use of all relevant instruments. In view of the concentration of activities and resources which is entailed here, we call this approach the "adopt an institution" strategy.

We would advise the individual agencies to take up the "adopt an institution" strategy instead of trying to be involved everywhere by doing "a little here and a little there". Unfortunately, this latter approach is still the most prevalent one and, among other things, it leads to a situation in which the partner institutions maximize the benefits for the representatives of the institutions, and this seldom if ever means that the financing needs of the target group can be met in an optimal manner. The "adopt an institution" strategy would better reflect the special responsibility which an agency providing support must assume and, at the same time, it would enable the institution to concentrate its resources in a meaningful way.