Source Book on

Community-Based Shelter Finance

1995

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Foreword

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In February 1995, twenty-four representatives of fifteen NGO's met for two and one-half days in Hyderabad to consider expanding their existing savings-and-credit activities into shelter finance. The session was sponsored by RHUDO/USAID and the National Housing Bank, and organized by Abt Associates.

Discussion was stimulated by presentations about community-based shelter finance from the experts and practitioners whose papers are presented in this volume.

Participants raised a number of key points and issues for future exploration. These are listed in the opening section of this collection. Although they are concisely expressed, the lists contain many insights and important questions which will be useful to others in the field of community-based shelter finance.

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Summary of Key Issues Raised by Participants

February 14-15, 1995

Workshop on Community-Based Housing Finance

Summary of Key Issues Raised by Participants in Day Two Session

Which Services to Offer?

Market Study Needed

Independent Capacity Vs. Formal Linkage

Finding Long-Term Funds

Technical Know-How Needed (including Legal)

Ensure Community Control

Appropriate Organizational Forms (Registration)

Positioning the Organization: Linkage or Autonomy

Basic Institutional Pre-Requisites for Housing Finance

Identify Financial Options Considering the Market Realities

How to Price the Products

Engineering/Housing/Infrastructure Advice

Housing Costs and Standards in the Market

Structuring Linkages

Re-training the Formal Sector

Sites + Services Needed

Consider 90% Recovery as Reasonable

Linkage with Municipal Bodies

Maximum Community Participation

Simple, Fast Service for Community Housing

Training in Resource Mobilization

Share Information Among Groups

Emphasize Women's Role

Regulations and Programs Favoring the Poor are Threatened

Managing the Learning Curve (Long-Term)

CBFI's + NGO's Complement One Another

Forget "Housing Finance" When Innovating

Identify Specific Regulatory Changes + Lobby

Be Opportunistic - Forget Global Solutions

Do the Required Homework Before Moving On

Keep it Simple!

Some Key Points Raised During Workshop

Workshop on Community-Based Housing Finance

February 14-15, 1995

Some Key Points Raised During Workshop - Day One

1. Linkage with formal sector - a means or an end?
2. Time required to develop CBFI capacity.
3. Regulation of CBFI's taking public deposits (or even member deposit).
4. Need for a facilitative structure.
5. Legal questions, framework for collaboration.
6. "Spotlight" problem with pilot projects.
7. Risk: area concentration
8. Focus on women.
9. Relax "minimum" housing requirements (HUDCO-AVAS).
10. "Secret" donors.
11. AVAS pledged deposit to HDFC.
12. Controlling resale and retaining affordable stock.
13. HDFC holding deeds is a payment motivator.
14. DPG recommends max. 5-10 year term for loan.
15. Yearly or biannual payments.
16. No interest, low recoveries, 12% rates - big improvement.
17. Require 20% savings as "link" to housing finance access.
18. HDFC staff spending Saturdays delivering TA to BCC.
19. "Unregistered group can't enter into contracts, linkages."
20. "If land and services are made available, people can build their own homes cheaply."
21. Social pressure - peer lending brought recoveries from 40% to 90%.
22. Research on community finance is needed.

23. Credit federation interested in real estate development for a range of incomes.

24. CBFI's need a regulatory framework (Sharan).

25. Formal sector finance receives huge "subsidy" - Be clear about "market".

26. In some cities, housing "market" is broken down even for middle and upper-middle classes.

27. Don't try to transfer formal sector concepts of housing finance directly to informal sector.

28. Subsidies and assistance will be needed to get this "market" off the ground.

29. No patron/client relationship with formal sector is desired.

30. Not only financial techniques, but institution building is required.

31. Prepare for cultural shift as NGO's turn into banks - different kind of skills and personnel. Must be managed.

32. Who should control the CBFI?? One view: whatever structure delivers the desired low-income product most efficiently is best.

33. Critical constraint: long-term resources, generally not available to CBFI's.

34. Model: let thrift cooperative create a housing finance company. Take deposits from public, make housing loans only to members.

35. Basic "operational risk" in CBFI: Staff may be social workers at heart.

36. Diversifying operations essential to avoid concentration of risk, especially area concern.

37. CBFI's survival is as important as its mission.

38. Forget the term "housing finance," it limits thinking. What's needed is a sizeable, longer-term loan with reliable recovery/layers of security.

Mehta Meera, *Down Marketing Housing Finance Through Community-Based Financial Systems*

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Strategy: Down Marketing Housing Finance Through Community Based Financial Systems

Meera Mehta, Ph. D.

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Prepared for
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PREFACE AND ACKNOWLEDGEMENTS

In the quest for economic and financial reforms, issues of growth have become of prime importance. However, to make this growth sustainable and equitable, it is essential to address the questions of access to credit for all sections of the society. In the past, this has largely meant subsidized endeavours. But these have proved to be unsustainable and ineffective. During the last decade there has been a significant increase in community based finance systems. Unfortunately, and ironically, in housing finance the emphasis on loans with subsidized interest rates still continues. No effort has been made to use the more sustainable community based systems to enhance the reach of the low income groups to housing finance despite the increasing demand from these systems for housing finance.

This study explores the potential of using community based finance systems for downmarketing housing finance. This will help to enlarge the market for housing finance. It will also help to strengthen the community based finance systems, if appropriate partnerships between formal finance institutions and the Communit based Finance Systems are developed.

This study has been undertaken for the Abt Associates, Massechusettes, who are the Mnagement Support Systems contractors to the USAID, for the Indo-USAID Housing Finance Expansion Program. I have benefitted a greatly from the stimulating discussions on the study approach and its initial findings with Ms. Sally Merrill, Mr. Richard Genz, Mr. M. Prabhakaran and Mr. Harry Garnett of the Abt team at different stages of the work.

This part of the study is based on the initial review and analysis of the HFIs and CFSs through a study done at the National Institute of Urban Affairs, New Delhi, to which I was an advisor. I would like to acknowledge the excellent discussions and support in this study, especially from Dr. Dinesh Mehta and Ms. Saswati Ghosh of the NIUA. I also acknowledge the excellent support from the network of my past students, especially, Mr. V. Satyanarayana, Ms. Padma Desai, Mr. Adwait Khare, Ms. Swati Tanna, Mr. Abhijit Tanna, Ms. Esther Kumar and Mr. Rajesh Sharma, in a variety of tasks.

The officials of the housing finance institutions, NGOs, community finance institutions and cooperatives took time out from their busy schedules to discuss and provide all possible information. I am thankful to them for this. It is the 'dreams' and 'visions', especially of the people working at the grassroots with these community based finance systems, which have helped me to go beyond mere statistics, to visualize more systemic responses towards developing a system that reaches the poor .

The findings of this study and the proposed strategy are envisaged to be implemented through a number of carefully developed pilot projects. I hope that these will help to attain the twin objectives of downmarketing housing finance and strengthening the community based finance systems.

Meera Mehta
New Delhi.

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ABBREVIATIONS

ABHFL	-	Andhra Bank Home Finance Limited
APSRTC	-	Andhra Pradesh State Road Transport Corporation
AVAS	-	Association for Voluntary Action and Services
BCC	-	Baroda Citizens Council
BDA	-	Bangalore Development Authority
BMC	-	Bombay Municipal Corporation
BOB	-	Bank of Baroda
BDCB	-	Bhavnagar District Cooperative Bank
CBCU	-	Community Based Credit Union
CBHFL	-	Cent Bank Home Finance Limited
CBO	-	Community Based Organisation
CCS	-	Credit Cooperative Society
CFF	-	Central Financing Facility
CEDMA	-	Centre for Development, Madras
CFHL	-	Can Fin Homes Limited
CFI	-	Community Finance Institutions
CFS	-	Community Finance Systems
DCA	-	Delhi Catholic Archdiocese
DDA	-	Delhi Development Authority
DHFL	-	Dewan Housing Finance Company Limited
DPG	-	Development Promotion Group
DRAS	-	Death Relief Assistance Scheme
ECCS	-	Employees' Credit Cooperative Society
EIS	-	Environmental Improvement Scheme
EMI	-	Equated Monthly Instalment
ETC	-	Employees' Thrift Cooperative
EWS	-	Economically Weaker Sections
FGHFL	-	Fairgrowth Home Finance Limited
FTCA	-	Federation of Thrift and Credit Associations
GGVL	-	GIC Gruh Vitta Limited
GIC	-	General Insurance Company
GOI	-	Government of India
GRUH	-	Gujarat Rural Housing Finance Corporation Limited
HDFC	-	Housing Development Finance Corporation
HFI	-	Housing Finance Institution
HH	-	Household
HUDCO	-	Housing and Urban Development Corporation
ICU	-	Informal Credit Union
INDBHFL	-	Indian Bank Housing Finance Limited
KHB	-	Karnataka Housing Board
KKNSS	-	Karnataka Kolageri Nivasigala Samyuktha Sanghatane
LICHFL	-	Life Insurance Company Housing Finance Limited

LIG	-	Low Income Group
LWS	-	Lutheran World Services
MAS	-	Mutual Assistance Scheme
MM	-	Mahila Milan
NGO	-	Non-governmental Organization
NHB	-	National Housing Bank
NSDF	-	National Slum Dwellers' Federation
PARSHFL	-	Parshwanath Housing Finance Company Limited
PRTW	-	Participatory Research cum Training Workshop
PNBHFL	-	Punjab National Bank Housing Finance Limited
PTC	-	Primary Thrift and Credit Cooperative
RATC	-	Regional Association of Thrift Cooperatives
RBI	-	Reserve Bank of India
RTCS	-	Regular Thrift Contribution Scheme
SATC	-	State Association of Thrift Cooperatives
SAYAHFL	-	Saya Housing Finance Company Limited
SECS	-	Salary Earners' Credit Cooperative Societies
SBIHFL	-	State Bank of India Home Finance Limited
SCB	-	Slum Clearance Board
SPARC	-	Society for Promotion of Area Resource Centres
TC	-	Thrift Cooperative
UBSP	-	Urban Basic Services for the Poor
UTI	-	Unit Trust of India
VBHFL	-	Vysya Bank Housing Finance Limited
WTC	-	Women's Thrift Cooperative

EXECUTIVE SUMMARY

The last two decades have seen dramatic changes in housing policies the world over. Within less than a generation, public policies and outlooks in this sector have changed significantly. The last few years have seen the collapse of old orthodoxies. There is a continuing search for new paradigms which are both market friendly and ensure a better coverage and reach to all sections in society. Within the realm of housing policies there is a realization of the changing role of the government and the need to focus on enabling policies, especially related to land and housing finance.

The last decade in India has seen considerable developments in the housing finance system. While the role of private retail lending for housing finance has increased manifold, it still accounts for only 20 percent of the estimated total housing investments in the economy. There is thus ample scope for further expansion of the housing finance system in India.

The expansion of housing finance system poses two critical problems. First, in order to ensure adequate resource mobilization, it must be done in commercially viable terms. This becomes even more important in view of the financial sector reforms underway in the country, which will lead to decline in the directed credit systems. Secondly, however, such expansion must also ensure a better coverage and reach across different sections in society and not lead to increased conspicuous consumption of housing by a small section. It is within this two fold objective that this study explores the possibilities of a commercially viable downmarketing strategy for the housing finance industry.

Study Outline :

The role of newly emerging HFIs in financing the groups below median income is very limited at present, with its share of about 13.5 percent of total lending. This is despite the fact that there is an explicit demand from these groups as evidenced by thier borrowings from informal sources. Thus, the major issue in downmarketing of formal HFI lending appear to be that of an appropriate matching of the demand for housing finance among the low income households to that of the requirements of the HFIs. This study pertains to evolving a downmarketing strategy for housing finance through the variety of community based financial systems. It has looked at 18 NGOs working in cities all over the country as well as the urban cooperative credit systems in three states. We have also interviewed 8 HFIs for their willingness to participate in these linkages. This report presents a summary of these studies based on a detailed two part report which also has profiles and case studies of 8 HFIs, 18 NGOs and 6 cooperative societies (NIUA, 1994). The final section brings together these findings to identify the basic design principles and detailed guidelines for evolving a downmarketing strategy for housing finance in India.

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Community Based Finance Systems (CFS):

The review focusses on two different types of CFS, namely those developed through the efforts of the Non Governmental Organizations (NGOs) and the others which have come up through the network of cooperative finance institutions. There is a considerable overlap amongst these two systems, as many of the NGOs have used the cooperative systems for developing their finance systems. Occasionally, an NGO has specifically focussed on developing cooperative finance systems.

The NGO linked CFSs seem to be at different levels of development. Those NGOs which have focussed on strategising and creating external linkages have been able to expand their activities considerably, with an NGO linked Community Finance Institution (CFI) like the SEWA Bank having over 30000 members. The two forms of CFSs, the single and multi tiered ones present differing opportunities in terms of growth potential, controlling establishment costs and creating external linkages. It is necessary to evolve the linkages with these CFSs in relation to the organizational structures which have emerged. However, the linkages need to help strengthen the CFS by assistance on financial management and adequate spreads to cover the establishment costs. A review of the savings and credit operations suggest very systematic procedures with an emphasis on personal rapport, flexibility and group/social pressure for recovery rather than the conventional notions of high interest rates, long repayment periods and very safe collateral. It, therefore, seems essential to ensure that these characteristics are preserved in any linkage arrangement by allowing the NGO linked CFIs to originate and service the loans. The available subsidies, if any, need to be devoted to strengthening these CFSs, rather than being used for lower interest rates.

The urban cooperative finance systems are quite widespread in India with a network of over 32000 urban credit cooperative societies (UCCS), with a total working capital of Rs. 32 billion and a membership of over 15 million, as well as about 1400 cooperative banks, with a total working Rs. 134 billion by 1991. About 75 percent of the UCCS were based at the place of work and organized as employees' service credit cooperatives whereas the other were neighbourhood based. Their savings and credit operations are also based on personal rapport with emphasis on developing regular thrift habits. Their financial performance, however, varies considerably and any effort at linkages will need to assess each society carefully. The costs of management are lower than those of the NGO linked CFSs. As the ECCSs are able to do payroll deductions, the risks are considerably less. However, their reach is limited to the workers in the formal sector. The urban cooperative banks require specific policy changes like revising the ceiling limits on housing loans for inclusion as priority sector, permission for lending to primary housing societies, for extending lending operations for housing built on land exempted from the Urban Land Ceiling Act, revising the limits on housing finance and the possibility of receiving refinance from the NHB for housing loans for the non scheduled cooperative banks. Some of the smaller cooperative banks will also benefit from technical assistance for servicing longer term housing loans.

Compared to the experiences of cooperative finance system of operating a commercially viable housing finance activity, albeit on a small scale, the existing efforts by the HFIs to reach the households below the median income groups seem to focus on use of earmarked funds from donor agencies for specific projects. These emphasise lower interest rates and longer repayment periods designed as a project lending rather retail facilities for individual borrowers. Downmarketing of housing finance on commercial terms is perceived to be difficult by the HFIs, essentially due to three problems; i) lack of adequate affordability in relation to the prevailing housing prices, ii) likelihood of high credit risks and iii) very high transaction costs to reach the poorer households.

PROPOSED STRATEGY FOR DOWNMARKETING :

The strategy envisaged for downmarketing housing finance to moderate and low income groups, in urban areas, is based on using the existing CFSs. The important objectives of this strategy are to help enlarge the market for housing finance for the emerging housing finance institutions in the country on commercial terms, and to enable large segments of the urban population to improve their living conditions through a better access to credit for housing and community level infrastructure facilities.

The third objective of this strategy goes beyond the confines of housing finance. It is envisaged that it will also help to consolidate the different forms of community based finance systems by enabling them to expand their activities in a viable manner, enhancing their savings mobilization potential and help to integrate these systems with the general financial systems in the country. These structures would be far more replicable than the public housing projects with their limited reach.

Key Design Principles:

The development of a downmarketing strategy for housing finance requires a careful identification of the perceived constraints for a commercially viable system and the key design principles which attempt to overcome these constraints. Our review of the existing housing finance institutions suggest three main areas of constraints for a commercially viable downmarketing strategy. These are illustrated in Table 1 along with the main design principles to deal with these. We would highlight the approach which moves away from the conventional notions of reaching the low income groups through subsidies with an overemphasis on mortgage security. The strategy aims towards more innovative efforts at evolving more appropriate loan products and enabling larger spreads to meet the higher establishment costs. The underlying premise of this approach is that wider access to housing finance is more critical for the low income groups than access to a limited few at lower costs. This strategy will also be far more sustainable in the long run.

Table 1 : Constraints and Key Design Principles

Constraint		Design Principles
1. High Credit Risk		
	i.	Measures to cover credit risk including insurance cover
	ii.	Delinquency Risk Fund
	iii.	Appropriate Underwriting
2. Affordability for Housing		
	i.	Design of appropriate new loan instruments
	ii.	Selection of appropriate markets
	iii.	Technical support
3. High Transaction and Servicing Costs		
	i.	Developing CFI capabilities
	ii.	Adequate scale of operations
	iii.	Spreads to cover establishment costs

Types of Linkages:

In view of the basic design principles, two types of linkages between the HFIs and community based finance Systems are envisaged in this strategy. The first is based on Financial Intermediation by a CFI through a Bulk loan from the HFI/FI. Basically the arrangement involves a bulk loan from the HFI to the Community Financial Institution (CFI) with specified terms and conditions for on lending to the households. The CFI will have the responsibilities for loan origination and servicing and, would, therefore, also bear the credit risk. Many of the NGOs surveyed for this study, expressed a desire for such independence and freedom. In this arrangement, the limit on total bulk loan maybe specified in relation to the capital base of the CFI or the thrift and credit groups under a NGO federation/association. The basic aim of this linkage would be to use the grass roots strength of the CFI for downmarketing and use the housing finance to consolidate the CFI itself. Within this, two forms of intermediation are visualised.

i. Multi-tier Intermediation
ii. Single-tier Intermediation

The multi-tier intermediation uses the structure of federation or the apex agencies, which in turn lends to the primary CFI. The CFI in this case may either be linked to NGO or to the

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Table 2

HFI-CFI LINKAGES FOR HOUSING FINANCE

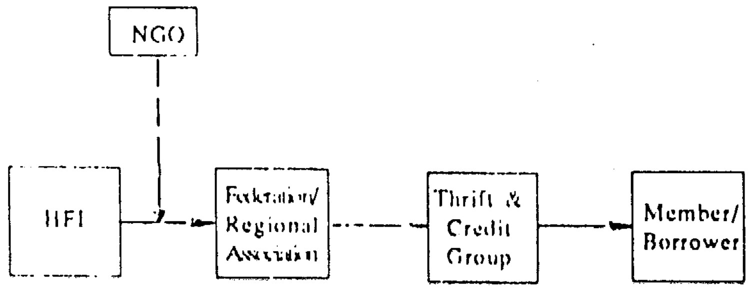
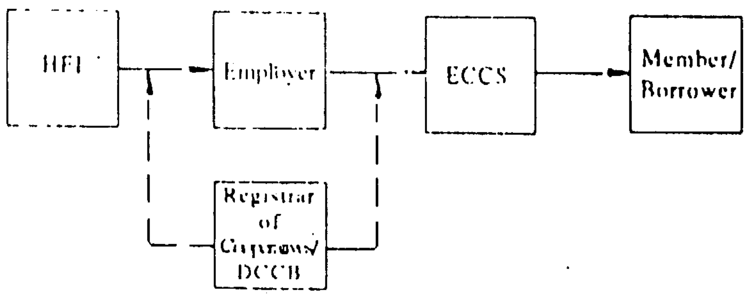
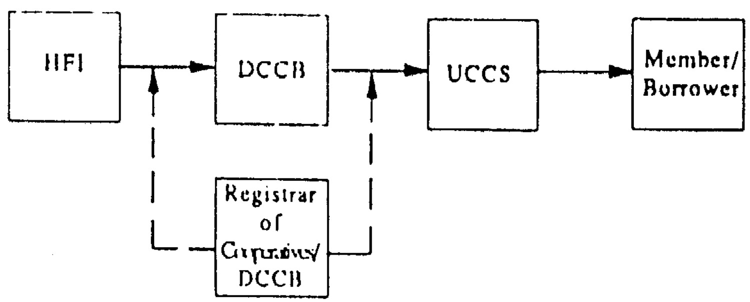
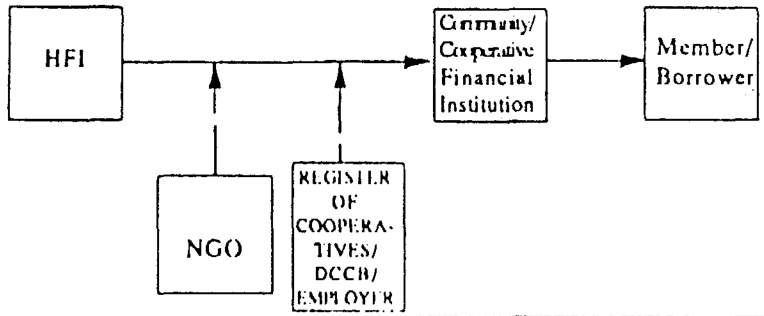
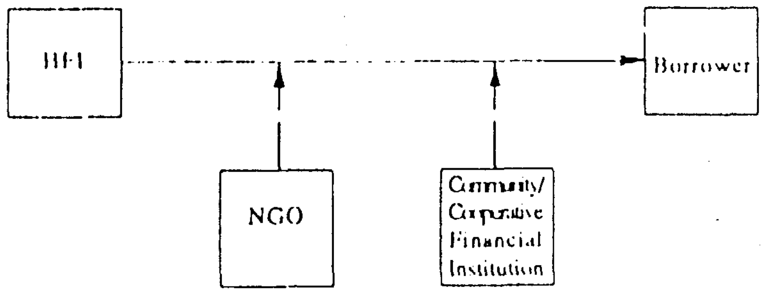
TYPE OF LINKAGE	ORGANIZATIONAL LINKAGES	INSTITUTIONAL RESPONSIBILITIES
A. BULK LOANS/ LINE OF CREDIT Loan purposes include home construction/purchase, purchase of land, plot, home upgradation/extention individual and/or community infrastructure. **a. Multi-tiered Intermediation** i. NGO-Federation- Thrift and Credit Group Mode		HFI — Providing bulk credit — Defining credit and underwriting terms — Providing financial management assistance Federation — Appraise and monitor TCGs for bulk credit — Mobilize DRF — Technical support — Market information Thrift and Credit Group — Loan origination and servicing
ii. Employer-ECCS Model		HFI — Providing bulk credit — Defining credit and underwriting terms Employer — Ensuring payroll deductions ECCS — Loan origination and servicing Registrar/ DCCB — Assist in identifying ECCS
iii DCCB-UCCS Model		HFI — Providing bulk credit — Defining credit and underwriting terms. DCCB — Appraise and monitor TCGs for bulk credit — Mobilize DRF — Technical support and market information. UCCS — Loan origination and servicing

Table 2 (cont'd)

HFI-CFI LINKAGES FOR HOUSING FINANCE

<table>
<tr><th>TYPE OF LINKAGE</th><th>ORGANIZATIONAL LINKAGES</th><th>INSTITUTIONAL RESPONSIBILITIES</th></tr>
<tr><td>b. Single-tiered Intermediation

iv. NGO linked CFI Model</td><td>
</td><td>HFI — Providing bulk credit
— Defining credit and underwriting terms
NGO / REGISTRAR/ DCCB/ EMPLOYER — Facilitate appraisal of CFI, generation of DRF and loan servicing
— Technical assistance and market information
CFI — Loan origination and servicing</td></tr>
<tr><td>B. NGO FACILITATION
Loan purposes include home construction/purchase, Major house upgradation/ extension

v. NGO Facilitated housing loans</td><td>
</td><td>HFI — Loan origination and servicing
NGO/CFI — Facilitate loan origination
— Loan servicing</td></tr>
</table>

HFI — Housing Finance Institution
DRF — Delinquency Risk Fund
NGO — Non-governmental Organization
ECCS — Employees' credit cooperative society
UCCS — Urban credit corporative society
TCG — Thrift and credit group
CFI — Community/cooperative financial institution

x

cooperative institutions. In the single-tier intermediation, the HFI will deal directly with a primary CFI, which again maybe either linked to an NGO or be a primary cooperative society. The NGO or the cooperative registrar would facilitate the identification and assessment of the CFI. The detailed institutional responsibilities are shown in Table 2.

The second form of the linkage is the NGO/CFI facilitated direct lending by HFIs. This arrangement is similar to the one that some of the HFIs like HDFC, LICHFL, Griha Vitta and GRUH have been currently experimenting. In this linkage, the loan agreement is directly between the HFI and the individual borrower, though the process is facilitated by the NGO or the credit cooperative society. The latter may help in loan origination and also actually service the loan on behalf of the HFI, at a fee. The credit terms and underwriting criteria suggested in Table 4 will also be applicable here. The basic aim of this linkage would be to encourage the HFI to develop a working knowledge of lending to these groups more directly, though its costs may be kept under a check by using the NGO-cooperative structures for loan servicing.

Financial guidelines:

The emphasis in the HFI-CFI linkages for bulk loans for housing finance is on developing the basic financial principles for giving bulk credit to the community based financial institutions so that the risks are minimized and more appropriately shared. This will make it possible to replicate this arrangement on a larger scale in the future. The important elements of these are highlighted in Table 3. Major changes from the existing practices relate to the loan products in terms of purpose and security requirements, creation of a delinquency risk fund which is linked to the recovery performance of the CFI, allowing adequate spreads to cover the higher transaction costs of the CFI at least in the long run, legal registration of the CFI and not only the NGO and the limits on bulk credit linked to the net worth of the CFI. Such financial guidelines need to be worked out jointly by the HFI/FI and CFI. These will get refined through the implementation of the pilot projects. However, initially negotiation with an open mind are essential to evolve mutually beneficial set of guidelines.

Table 3 : Financial Guidelines For HFI-CFI Linkages

1. Mutually agreed upon and flexible purpose of loan, credit terms and underwriting
2. Delinquency risk fund.
   Group insurance to cover housing loans in the event of death
3. Necessary spreads to cover establishment costs.
4. Legal form for the community finance institutions - to permit borrowing of bulk credit.
5. Plan of operations for the bulk credit to be submitted by the community finance institutions (CFI).
6. Limits on bulk credit (overall debt equity ratio of around 10 for CFI).

Support Systems:

The linkages between the HFIs\FIs and CFIs can succeed only through a supportive mechanism. There are three main components of a Support Package. The first one is Technical support for evolving viable projects for housing and/or community level infrastructure. The CFIs often donot have the necessary expertise to guide their borrowers and do proper assessment of the proposed housing action.

Another totally neglected area is market information for these groups regarding available housing options and the related prices. A property information service would help to overcome this to a great extent. It would also enable the NGO or the cooperative to develop a better understanding of the housing costs. The third part of the support relates to the building up the financial management capacities of the CFIs through a better reporting system and through better auditing services. Appropriate training in this regard is essential.

Such a support system will need to be evolved by national level agencies like the National Housing Bank in the initial period. Subsequently the HFIs or regional associations should take up these tasks. Such a system maybe supported initially through a grant carefully planned for phasing out. Over time, however, it must operate through a fee structure which will make it self supporting over time.

Towards Pilot Projects:

While the downmarketing strategy envisages expansion of the housing finance system to lower income groups on a widespread basis, the process may be initiated through selected pilot projects. The pilot projects need to be selected carefully to represent different models discussed above and aim for replicability. They will also need specific support systems as discussed above.

While the design of the pilot projects will imply benefits both for the HFIs and CFIs, it is likely that the process needs to be facilitated, both by creating opportunities for interaction amongst the potential partners and by providing the necessary inducements by a careful use of subsidies for insurance cover, risk fund and support systems related to technical assistance, developing market information and training in financial management for the community based financial institutions. This support, through the necessary subsidies will need to come from the National Housing Bank or the USAID.

The different NGOs will, however, require considerable efforts to meet certain pre-requisites like legal registration, developing a plan of operations, mobilizing funds for Delinquency Risk Fund and compilation of essential financial reports. Such assistance would also be helpful in enabling the other smaller NGOs with nascent arrangements to become a part of the downmarketing strategy. Similarly, the HFIs will also need to make considerable adaptations in their lending procedures. Specifically, they will have to extend the concept of bulk lending to CFIs. Most HFIs at present use this concept for lending to the corporate sector in any case. Secondly, they will also have to design new lending instruments (especially for non-mortgage lending) and evolve suitable financial guidelines for these linkages.

Conclusion:

The growth of housing finance system in India in recent years has not been accompanied by significant downmarketing. The downmarketing strategy as outlined above is cast in a pareto optimal mould, as the benefits accrue to both the sides; the HFIs developing a commercially viable expansion of their markets and the low and moderate income households gaining access to housing finance which has largely eluded them so far. An additional benefit in this process will also be a further strengthening of the different forms of Community Finance Systems in the country and their integration with the general financial systems in the country in the coming years. These efforts, however, require careful design, the will to innovate and improve from 'learning by doing' and above all the readiness to respond to the constraints of the partners in a positive manner in these partnership experiments.

SECTION ONE

INTRODUCTION

The last two decades have seen tremendous changes in housing policies the world over. Within less than a generation, public policies and outlooks in this sector have changed dramatically. The last few years have seen the collapse of old orthodoxies and a continuing search for new paradigms which are both market friendly and ensure a better coverage and reach to all sections in society. Within the realm of housing policies there is a realization of the changing role of the government and the need to focus on enabling policies, especially related to land and housing finance.

The last decade in India has seen considerable developments in the housing finance system. The role of private retail lending for housing finance has increased manifold. For example, in the period from 1987 to 1991 , the total institutional finance for housing is estimated to have increased from 900 to 2600 million rupees. Even then this constituted just 20 percent of the estimated total housing investments in the economy. There is thus ample scope for further expansion of the housing finance system in India.

The expansion of housing finance system poses two critical problems. First, in order to ensure adequate resource mobilization, it must be done in commercially viable terms. This becomes even more important in view of the financial sector reforms underway in the country, which will lead to decline in the directed credit systems. Secondly, however, such expansion must also ensure a better coverage and reach across different sections in society and not lead to increased conspicuous consumption of housing by a small section in society only. It is within this two fold objective that this study explores the possibilities of a commercially viable downmarketing strategy for the housing finance industry.

The limited information available on the share of below median income groups in the retail lending indicates some down marketing efforts by the housing finance companies being made already. However, the available evidence suggests that only 13.5 percent of the institutional lending is for families below the median income (JPS, 1993). This is unfortunate as the demand for housing by the households below the median income has been well documented. Mehta and Mehta (1989) report housing expenditure of nearly 17 per cent of monthly income among low income households as against just 5 per cent, for higher income groups. NIUA (1991) reports that access of formal housing finance is quite limited for the low income groups. In this survey of 2000 households, 41 per cent households were found to be using finances from informal sources. Nearly 31 percent of households borrowed for short term period at interest rates exceeding 24 per cent per annum. Flexible collateral, easy accessibility and quick processing were the three main factors that seem to have forced the low income households to borrow from informal sources. Mehta and Mehta (1992) based on a study of two cities in Gujarat also highlights the greater financial leverage achieved by lower income households when they had access to institutional finance as compared to the middle and upper income households.

Thus, the major issue in downmarketing of formal HFI lending appear to be that of an appropriate matching of the demand for housing finance among the low income households to that of the requirements of the HFIs. Downmarketing of housing finance on commercial terms is perceived to be difficult by the HFIs, essentially due to three problems; i). lack of adequate affordability in relation to the prevailing housing prices, ii). likelihood of high credit risks and iii).very high transaction costs to overcome the other problems.

The need for such alternatives has been increasingly recognised in the general financial framework of the country. For example, the Chief of the Central Bank (RBI) was quoted in a recent public address to have pointed to the need for "People's participation credit delivery and recovery and the linking of formal credit institutions with (low-income) beneficiaries through intermediaries such as non-governmental organisations could be thought of as alternative mechanisms for meeting the credit needs of the poor" (Economic Times, 1994).

Innovative financing arrangements and linkages which enable the use of alternative mechanisms for assessing creditworthiness, group security, door to door collection of savings and loan instalments, and alternate collateral are needed to increase the reach of HFIs.

Study Outline :

This study pertains to evolving a downmarketing strategy for housing finance. The initial terms of reference for the study focussed exclusively on the identification of NGOs as potential intermediaries to reach the low income households. The study began with a list of eight potential NGOs which have done significant work in the housing sector and/or setting up of community - based finance institutions for mobilizing savings and providing credit to the low income groups. As we began the work, the list of eight NGOs was expanded to 18 NGOs. This was necessitated to understand the diversity of housing related activities and the range of experiences associated with the community based finance systems.

While examining the formal organisational structure of these community based financial institutions, it was found that most were established under the cooperative financial institution statutes. It was thus deemed appropriate to dwell deeper into the cooperative finance institutions and their potential role in down marketing housing finance. India has a wide network of over 30,000 registered primary non-agricultural credit cooperative societies. In the states of Andhra Pradesh, Gujarat and Maharastra, where a large number of urban credit cooperatives are located, detailed case studies were undertaken to assess their capacity for participation in housing finance.

This report presents a summary of our analysis of the major Housing Finance Institutions, the NGOs and the Cooperative Finance Institutions. The next section presents the major findings of these existing systems. This summary is based on a detailed two part report on this analysis along with profiles and case studies of 8 HFIs, 18 NGOs and several cooperative societies (NIUA, 1994). The final section brings together these findings to identify the basic design principles and detailed guidelines for evolving a downmarketing strategy for housing finance in India.

SECTION TWO

COMMUNITY BASED FINANCE SYSTEMS

A Summary of Study Findings

During the last decade, there has been a growing awareness of the importance of community based approaches in developmental action and processes. Whether it is in the national policy outlooks or the agenda of the international agencies, there is a consensus on the potential offered by the community based systems. This study has focussed on two different types of community based finance systems (CFS), namely, those developed through the efforts of the Non Governmental Organizations (NGOs) and the others which have come up through the network of cooperative finance institutions. There is a considerable overlap amongst these two systems, as many of the NGOs have used the cooperative systems for developing their finance systems. We present the main findings of the detailed studies of these two finance systems in several Indian cities.

2.1 NGO LINKED COMMUNITY FINANCE SYSTEMS

Our review covers 18 different NGOs spread throughout the country and who have been involved with housing and/or finance related activities. Out of these, 12 have been involved with community based finance systems. Table 2.1 highlights the profiles of these 18 NGOs.

Coverage and Organizational Roles :

While limited coverage and reach has often been cited as limitations of the NGO sector, our analysis suggests that some of the NGOs have a large and expanding coverage. This increase in scale and coverage is critically linked to evolution of appropriate organisational roles and linkages. The three critical roles in this regard are,

Grass roots base with a single activity	-	through community groups or own organisation delivery of a single service in one or a few communities.
Developmental activities	-	many related activities like provision of education and health services, savings and credit groups, training for income generating activities, etc, in one or more communities.
External linkages and strategy	-	to mobilise resources, receive technical assistance, enhance interactions and expand the coverage.

All the three roles are critical for an effective coverage and expansion of NGO operations. Thus, those NGOs which have combined these roles, like SEWA, BCC, SPARC, FTCA, etc have enhanced their coverage significantly and effectively.

Table 2.1
NGO Profiles

NGO (Year of Inception)	Areas of Operation	Coverage	Housing/Infrastructure Related Projects (No.of Projects)	Finance Related Activities		
				Form S - Single tiered M - Multi tiered	Members/ Size	Purpose of Credit
SEWA (1972)	Ahmedabad, Gujarat, MP, UP	50000 members of SEWA Union	1 Project - New housing (150)	Co-operative Bank (S)	25000 Members	IGA Housing
BCC (1966)	Baroda	30 Slums, 1300 HHs	1 Project - New housing (200)	Unregistered Thrift and Credit Association (S)	4000 Members	IGA Housing Infrastructure Health
SPARC (1984)	Bombay, Kanpur, Banglore	5 Federations covering many slums	2 Projects - New housing (350)	Unregistered Thrift and Credit Groups with Federations (M)	5 Federations (Members not known)	IGA Consumption Crisis
FTCA (1989)	Hyderabad, AP, TN, Karnataka, Kerala, Goa, Pondichery	14 Regional Associations and 380 T&C Associations 282000 members		Regd/Unregd Thrift and Credit Groups with 14 Regional Associations with National Federation (M)	380 TC Groups with 282000 Members	IGA Consumption Housing
AVAS (1980)	Bangalore	12 Slums	4 Projects - New housing (435) Upgradation	-	-	-
VIKAS (1978)	Ahmedabad, Jambusar Taluka, Gujarat	Not Applicable	4 Projects - New housing (325) Emergency Shelter (50) Infrastructure Maintenance	-	-	-
LWS (1974)	Calcutta, Orissa, WB, AP, TN	21 Slums in Calcutta, 2 Slums in Cuttak 40000 Persons		-	-	-

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Table 2.1 continued ....

NGO (Year of Inception)	Areas of Operation	Coverage	Housing/Infrastructure Related Projects (No.of Projects)	Finance Related Activities		
				Form S - Single tiered M - Multi tiered	Members/ Size	Purpose of Credit
Sharan (1979)	Delhi	6 Slums 75 T&C Groups 1675 Members		Unregistered Thrift and Credit Groups with 3 Federations (M)	75 Groups with 1700 Members	IGA Consumption Health
Deepalaya (1978)	Delhi	21 Slums 15000 Children 214 CBOs with 31 Lakh members		Regd/Unregd Thrift and Credit Groups (M)	188 Groups with 20000 Members	IGA
CEDMA (1977)	Madras, Vellore, Ennore	27 Slums	3 Projects - Self help housing (925)	-	-	-
Shramik Bharati (1986)	Kanpur, Kanpur District	10 Slums		Unregistered Thrift and Credit Groups (M)	67 Groups with 1500 Members	IGA
Adhikar (1989)	Bhubaneshwar, Rural Areas of Orissa	1-2 Slums 27 T&C Groups with 875 members		Regd/Unregd Thrift and Credit Groups with 1-2 Federations (M)	25 Groups with 875 Members	IGA
CASP-PLAN (1979)	Bombay, Delhi, Pune	3 Areas in Delhi		Credit Cooperatives (S)	3 with 200 Members	IGA
Punervas (N.A)	Delhi	6 Slums 4000 HHs	4 Projects - New housing Cooperative Housing (4000)	-	-	-
DPG (NA)	Madras, TN, AP, Karnataka, Pondichery	Not Applicable	2 Projects - New Housing (129) Drinking water (bore wells in 40 villages)	-	-	-

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Housing Related Experience :

About half of the 18 NGOs have been involved with housing related activities. General discussions, however, suggest that housing related experience is limited, as dealing with housing projects puts considerable and intensive demands on them. As a result their housing activities have been quite limited. Involvement with housing projects require access to land or a secured tenure. In most cases, the NGOs have been working with slum dwellers, where the tenure related problems inhibit new housing construction. Housing projects by NGOs have been taken up, only with a supportive land policy by the government with intensive involvement in the housing process. Some NGOs have been involved in providing support for legal issues related to tenure and evictions.

While most NGOs expressed a keen interest in housing and infrastructure of the communities, there is often a lack of technical expertise which is essential to develop specific projects. Support to develop such projects with community participation is a very important need. Secondly, financial innovations to cater to different preferences for scheduling of payments of different borrowers need to be evolved even in a project approach.

In comparison to specific housing projects, however, more NGOs are inolved in housing finance through community organisations. These provide finance, especially for house repairs and upgradation. An additional area where NGOs can prove effective is the information on opportunities in the housing market. At present, the information about low income housing market is very weak. However, given their access to low income communities, a market information system catering to their needs would be very useful and assistance should be provided for this.

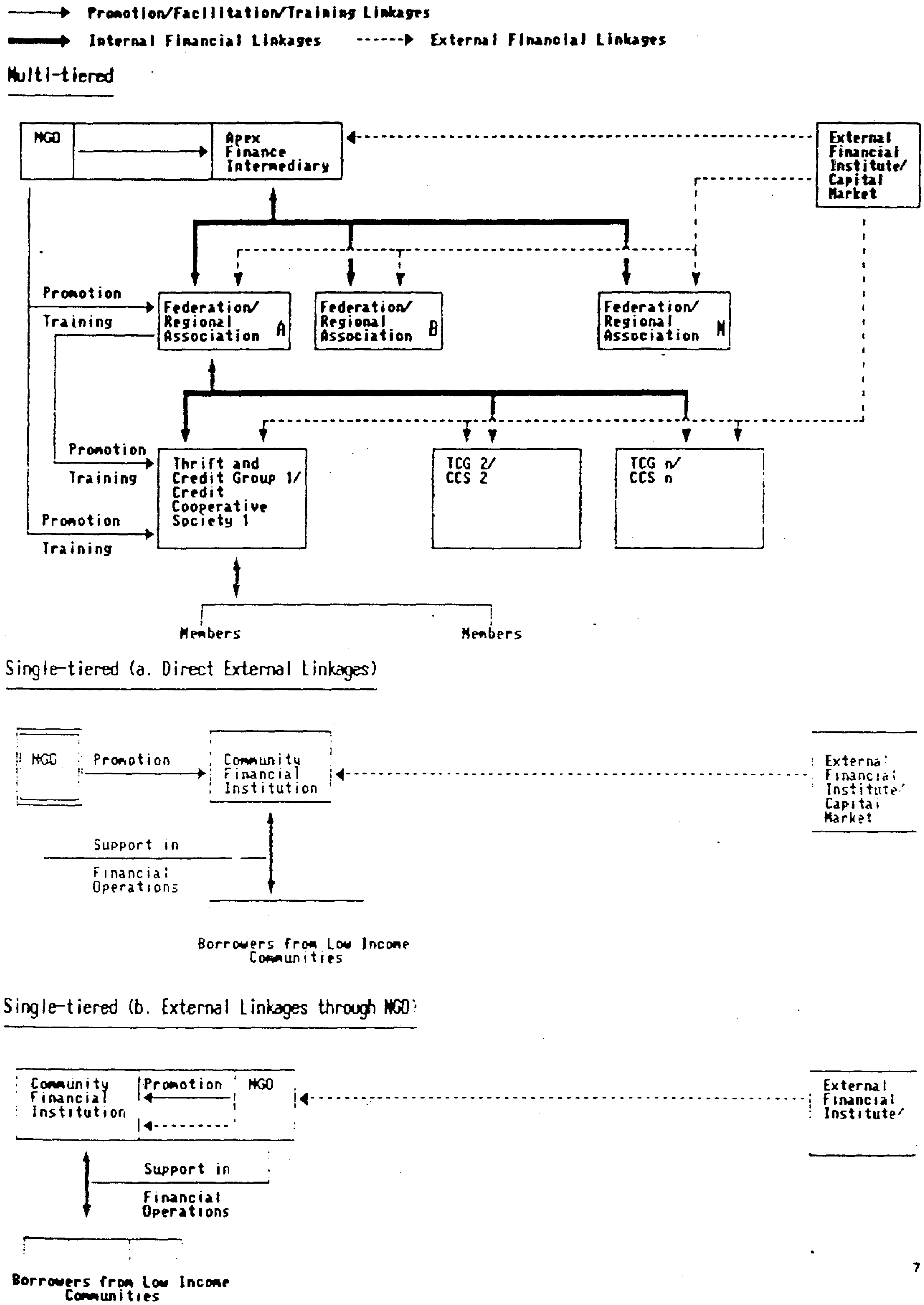
Forms of Community Finance Systems :

Out of the 18 NGOs surveyed, 12 have been involved with thrift and credit related operations. This is in response to needs emerging from the communities, especially for crisis and income generation related activities (e.g. SEWA, SPARC, Sharan) or indirectly through repayments for housing related loans. (e.g. AVAS, CASP-PLAN). Only in one case, the FTCA, the NGO has specifically focussed on activities related to development of finance systems. In a few cases, these operations have led to a separate financial institution, as for SEWA, FTCA or BCC. This is also being visualized by some of the other NGOs like Sharan and SPARC, and will probably emerge as a strong organizational form for all NGOs.

Multi-tiered System : Figure 2.1 highlights the two generic forms of community based finance systems. The first is a **multi-tiered system** which is a financial arrangement of a thrift and credit groups, linked to an NGO supported hierarchy of financial institutions.

In this model, the initial efforts are linked to the development of small savings groups, which begin with 12 to 25 households. The decisions regarding terms and conditions and procedures for compulsory savings and credit, as well as actual sanction of credit to members are done by the groups themselves. Over time, as more groups develop, there is generally an attempt to form federations or associations of several groups, both in order to share the financial resources as well as exchange ideas regarding improvements in systems and provide management training and support. In most cases, except for FTCA, there is no separate apex

Figure 2.1
Forms of NGO Linked Community Finance Systems



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financial intermediary of all the federations/associations.

NGOs which have been using this model include FTCA, SPARC, Sharan, Deepalaya, CASP-PLAN, Adhikar and Shramik Bharati. Their organizational and financial structures are illustrated in Table 2.1. These NGOs make considerable efforts to develop the groups and continue to provide organizational and management support. Even a small NGO like Adhikar, seems to have made attempts to inculcate seeds of financial discipline amongst the groups by laying down the accounting procedures to be followed. Others like SPARC and Sharan have also realized the importance of sustainability. However, their efforts at introducing systems have been at the centralized level with complete automation through computer based packages.

In this perspective, it is necessary to review the FTCA experience which represents an advanced version of this model, even though it is a relatively new NGO. FTCA's experience stands apart in several ways. First, its focus is explicitly on the development of thrift and credit societies only. Secondly, it has introduced a clear and logical organizational structure, where the local decision-making is retained by the thrift and credit groups which may or may not be registered. (75 percent are registered as non-agricultural cooperative societies under the relevant State Cooperative Acts). The extent of operational sophistication is thus dependent upon the group characteristics. However, at the level of the Federation and the apex financial intermediary, greater sophistication in financial management is possible to introduce and is being developed with external donor agency support. Attempts are also being made to move towards supporting the establishment costs at these levels through financial operations.

SPARC also envisages a similar structure in their vision for 'Jansampati', which is visualized as an apex financial intermediary serving the federations in different cities. Under the federations are the different thrift and credit groups which aren't always legal registered entities and largely operate on an informal group basis. Vikas Centre for Development, in Ahmedabad has also suggested a similar model in their proposal for a Habitat Development Fund (HDF). However, its focus is more on the 800 existing informal and unregistered thrift and credit groups which Vikas has surveyed through a research study for HDFC.

Single-tiered System : The second generic form of **single-tiered system** is based on a larger community based institution with low income groups being its direct members rather than through the smaller savings groups as in the case of the earlier model. The decision-making is thus more centralized, though it is through their representatives on the Board of this Financial Institution. For example, in SEWA Bank, the members elect the managing committee of the Cooperative Bank. This model, though not widespread, represents two examples of NGO linked financial arrangements, namely SEWA Bank in Ahmedabad and the Community Savings and Loan Association (CSLA) by BCC in Baroda.

Comparison of the Mutli-tiered and Single-tiered Models : The two forms, in actual operations present different opportunities and constraints. The first is in terms of the growth potential of the CFS. The first model presents far greater possibilities in this regard, as it is possible to expand the system even in areas where the NGO may not have any significant presence through thrift and credit groups. In fact, even SEWA Bank has been using the group approach to expand in the rural areas. It is also possible to incorporate the existing thrift and credit groups as is being done by the regional associations under the FTCA, and proposed by Vikas centre for Development. This means that the expansion can be delinked from intense NGO inputs which tend to be very expensive and time intensive.

The second comparison should be with regard to internalizing the establishment costs. On one hand, in the multitiered model there is a possibility of linking the services and pooling of resources at appropriate levels. As proposed in case of the FTCA, these costs can then be covered at each level by surpluses generated by appropriate financial services. However, if the nature of services at each level are not carefully identified, this may only end up in adding unnecessary costs at each level. This will ultimately increase the costs for the borrower. In relation to the development of role and functions of the NGO structures, the lowest level of the thrift and credit group in the three tier structure in the multitiered model focuses on the grass roots base. The middle tier of federation or regional association as in the FTCA structure, focuses more on the developmental activities including those related to finance. The top/apex tier concentrates on the external linkages and strategy development.

In this aspect, the second model of NGO linked financial intermediary is likely to be more dependent on the NGO for meeting its establishment costs, albeit indirectly. This is mainly due to the fact that the grass roots base comes from the NGO operations and not directly as in the case of the group based model. In this model, the scale of operation of the NGO and its grass roots strength become crucial for the success of the financial intermediary also.

The third aspect relates to the potential for external resource mobilization and access to credit for an individual member. In the group model, there is far more flexibility with regard to external resource mobilization as illustrated in Figure 2.1. An institution in any tier has the opportunity to mobilize external resources, depending on its abilities and preferences. On the other hand, individual credit-worthy members of a poorly performing society, maybe unnecessarily constrained for funds. In the second model, while there is less flexibility for mobilizing external resources, an individual member has more direct access to a larger institution and its greater resources. For an external finance institution, the multitiered model makes it easier to reach a large number of small groups through a single institution.

Savings and Credit Operations:

The main difference in these NGO linked community based financial arrangements are the procedures and mechanisms used for savings and credit. These are highlighted in table 2.2. The main observations which emerge from these are as follows:

Savings Mobilization: Unlike the conventional notions that these groups do not have any capacity to save, the CFSs very clearly demonstrate the possibility of mobilizing savings from these groups. The average savings amounts are, however, not very high and range from Rs. 15 to Rs. 50 per month. However, introduction of special savings schemes for housing and infrastructure provision have generally evoked a very positive response. Unfortunately, detailed and systematic data on savings patterns is not maintained to draw more meaningful results.

Table 2.2
Savings and Credit Operations - NGO Linked Community Finance Institutions

NGO	Savings			Credit			
	Collection method	Frequency of collection	Rate of Interest (%)	Rate of Interest (%)	Repayment period	Maximum loan	Minimum savings
SEWA	Door to door collection by bank's field staff. Savings boxes provided	Weekly/monthly	As per RBI guidelines. Higher rate than comm. banks	10.5 to 16.5% as per RBI guidelines, based on loan amounts	1 to 3 years (can give long term loans for 10 years also)	Maximum unsecured loan Rs 15000	Repayment/savings round checked
BCC	Savings collected from members & deposited with accountant	Weekly (Friday/Sat.)	6%	12 % p.a	20 months	Rs 2000	Minimum balance at 20% of loan amount for a period of 6 months
SPARC	Door to door collection by community volunteers	Daily	Not known	12 % for Consumption 24 % for Productive	Fixed by borrower not exceeding 2 years	Generally not exceeding 2500	Minimum savings period is verified but not specified
Sharan	Deposited by members in group meetings	Monthly	Varying rates for each group decided by them	Interest rates decided by each group. May vary from bank rate	12 months maximum	Rs 2000	Decided by each group
FTCA	Done by each group separately	Monthly	Varying rates for different groups (9 to 16%)	Varying for different groups (14 to 24%)	-	Varying for different groups (Rs 1000 to Rs 40000)	33.3 % of loan amount
AVAS	Saving boxes provided	Monthly	Bank rate for Savings Accounts				

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Table 2.2 continued ....

NGO	Savings			Credit			
	Collection method	Frequency of collection	Rate of interest (%)	Rate of interest (%)	Repayment period	Maximum loan	Minimum savings
Deepalaya	Deposited by members to group leaders	Monthly	Bank rate for savings accounts	No interest charged	NA	NA	Min. balance of 10 % of loan amount for 6 months
Adhikar	Deposited with any official of co-operative.	Monthly	Bank Rate	24 to 60%	Max 18 months	Rs 2000 to 6000	Amount not specified but min of 1 year
CASP-PLAN	Deposited by members with any official of credit co-op.	Monthly	Bank rate	14 %	12 months	6 times contribution/ savings	For 18 months

i. Method and frequency of collection: There are essentially two methods of collection being used. The first is door to door collection by paid staff (whose costs are generally covered by other programmes of the NGO which are financed by grants) or by community volunteers. The collection frequency varies from daily (reported only by SPARC) to weekly or monthly. The second method, which is used by most in the group based arrangement, is either monthly collection during the group meetings or members directly depositing with the group/society leaders. Many NGOs have also introduced the system of special collection boxes which are kept by the women/members to collect savings as and when possible. These are then opened in the presence of the member and NGO or CFI staff/community volunteer.

ii. Returns on savings and other incentives: It is interesting that the returns offered on savings are generally not high, despite the fact that in many cases, the interest on loans are kept high. In most cases, it is linked to the prevailing bank interest rates for savings accounts. In some cases, however, no interest is paid at all. The main attraction for the low income groups to save in these CFSs is thus not the returns but the possibility of access to loans at rates far lower than the informal 'moneylenders'.

In many cases, the NGOs have also attempted to introduce other incentives related to insurance, special savings scheme related to housing or community infrastructure, as done by SPARC in Bombay and BCC in Baroda slums. The FTCA in Hyderabad has, through its regional associations, introduced a death relief scheme.

iii. Minimum savings requirements: Most NGO linked CFSs, like the credit cooperatives reviewed in the next section, have minimum savings requirements which carry some, at times very severe, penalties for delayed payments. While this is very important for inculcating a habit of regular thrift, it does not link the savings to the household economy directly. Most NGOs do not have innovative savings instruments related to time deposits or monthly incomes, as done by the more mature cooperative societies.

Credit Operations: The credit operations in the CFSs are in direct contrast to the prevailing notions of financing the low income groups.

i. Small, short term loans: In most CFSs, the credit policies focus on creating access to the maximum possible number of borrowers by keeping a ceiling on the maximum loan amounts and lending for short to medium term only, which permits the maximum roll- over of funds. The shorter terms are also felt to be essential for reducing the credit risk. In most cases, there is some attempt to assess the credit-worthiness by previous savings and repayment records. Some of the agencies require a minimum savings period of 6 to 12 months. Some of the CFSs also require a minimum savings balance, ranging from 10 to 33.3 percent of the loan amount. This assesses the past savings behaviour and provides a hedge against default.

ii. Loans for different purposes: Another important aspect of lending to the low income groups relates to their need for credit for a variety of purposes, ranging from crisis, consumption, income generating activities as well as for housing and infrastructure services. Of the different CFSs, only SEWA (50%) and BCC (66%) show a significant proportion of the lending for housing, largely for repairs and upgradation purposes. In the case of AVAS and CEDMA, housing loans from other financial institutions have been routed through them. Some of the thrift and credit groups/societies under FTCA have been providing housing loans upto Rs. 40,000 for housing construction.

iii. Cost of credit: Probably, the most important finding relates to the rather high interest rates at which credit is given. This is especially true when the group/community decide the rates on their own. The interest rates range from about 12 to 36 percent. These are generally fixed in relation to the prevailing 'market rates' in the locality. This finding is in direct contrast to the usual misconceptions about subsidised interest rates on the grounds of affordability.

iv. Security for loans: A large proportion of the loans are unsecured and based on the direct knowledge of the borrower. In some cases, the personal guarantees of one to two other members is required, especially for larger amounts. In cases of registered financial institutions, like the cooperative societies or cooperative banks, the value of unsecured loans cannot exceed Rs. 20,000. For secured loans, the security is largely in the form of gold or other movable property.

Mortgage loans are not found in any case, except when an external financing institution has used the NGO as a facilitator while lending to the households directly or to their housing cooperative. The two specific cases in this regard have been AVAS, for its Sudhamnagar project and SPARC for two of their housing projects in Bombay. In both the cases, the loans have been provided by HDFC. The experience in these suggest the need to introduce more innovations at the project level to deal with the delays in project implementation as well as repayments.

v. Default and delinquency: It is very common to hear claims of very high 'cost recovery' by most NGO linked CFSs. However, systematic evidence based on an analysis of the available records is often not readily available to ascertain these observations. Only for three of the CFSs such analysis was available. Amongst these the delayed payments range from 8 to 16 percent of outstanding loan balance for SEWA. The FTCA reports recovery rates for the primary thrift and credit cooperatives in the range of 75 to 100 percent.

The only other NGO, BCC, which was able to give a detailed estimate for delinquency, reported 31 percent of total loan accounts to be in default. While this rate may seem very high, it must be remembered that the loans are made for a maximum of 20 months and that the detailed reports as prepared by the BCC-CSLA are the first step to pursuing better loan recovery by any financial institution. Further despite the delays in payments, there are often some regular payments being made by these defaulters. This suggests that a better assessment of the credit-worthiness of the borrower initially, or more sensitive loan instruments with periodic adjustments of the repayment period are necessary. More importantly, linkages using the CFSs need to build up reserves to compensate for the likely delinquency.

Discussions with the staff of many NGOs and their financial intermediaries suggest that bad debt is almost absent. For example, for BCC only 1 percent of the loan accounts were actually bad debt. The main reasons for these were linked to death and riots. Even in these few cases, their savings and shares with the CSLA were to the tune of 38 percent of the outstanding loan balance.

Financial Performance and Management of Community Finance Systems:

The reporting systems in most of the CFSs are rather weak even though the basic record keeping is being done at the group level in all of them. This makes it difficult to assess the financial performance. However, for at least three of these, namely, SEWA Bank, Community Savings and Loan Association (CSLA) of BCC and the FTCA and its regional associations, better financial reporting permits this to some extent.[1]

Capital Structure: The details of capital structure presented in Table 2.3 show the importance of thrift and deposits, which range from 50 to 90 percent in the total capital employed. For SEWA Bank, the debt equity ratio is already high, though its plans to enhance its equity base may provide the possibility of further deposit mobilization and borrowing. In fact, it has shown considerable growth in deposit mobilization in recent years.

For FTCA, the capital, for itself and the RATCs, has essentially come from capital and other grants from donor agencies as well as the deposits from the PTCGs under different schemes like the Death Relief Assistance Scheme (DRAS), fixed deposits and the Regular Thrift Contribution Scheme (RTCS). The volumes under these schemes are so far not really adequate to cover the costs. The debt equity ratios of 2.7 for the Primary Thrift and Credit Societies (PTCG) under the RATC Hyderabad are lower than for SEWA Bank and BCC-CSLA, suggesting the possibilities of further credit absorption, especially as the utilization of available funds is very high at almost 90 percent.

Lending and profitability: The analysis presented in Table 2.3 shows rather contrasting performance for SEWA Bank and BCC-CSLA. Both have reasonable profit levels, comparable to some of the HFIs, though lower than the leading ones like HDFC and LIC Housing. However, in both these cases, the profitability has declined over the last three years. The reasons for this appear to be different. In the case of SEWA Bank, the reasons maybe attributed to the decline in credit to deposit ratio. As it does not report the interest income from lending and investments separately, this may only be speculated. It may also be linked to the rising cost of funds which may have resulted from the changing structure of deposits. On the other hand, in the case of CSLA - BCC, the declines seem to be related more to considerable expansion in lending with problems of the delayed payments. The data available from them suggest that about 31 percent of the loan accounts are in default. For SEWA, the delayed payments as a proportion of recoverables are to the tune of 16 percent.

SEWA Bank's low credit to deposit ratio suggests the possibility of increased lending from their own funds. Further, SEWA has recently increased its authorized share capital from Rs. 3 million to Rs. 5 million. It may thus be able to more than double its share capital over the next few years. This will also allow it to mobilize far greater funds, either through deposits or external borrowings. On the lending side, SEWA has so far avoided long term loans, concentrating only on short and medium term loans. It is however, now set to consider these both to improve its credit-deposit ratios, and therefore, profitability, as well as satisfy the emerging demand for housing finance from its members.

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[1] We would, however, point out that this assessment is based on the reported and published figures as the scope of this assignment did not permit more detailed inquiries into the accuracy of the reported information.

Table 2.3
Financial Performance of SEWA Cooperative Bank, CSLA-BCC, FTCA and RATC, 1992-93.

		SEWA Bank Ahmedabad	CSLA-BCC Baroda	FTCA Hyderabad	RATC Hyd
a.	CAPITAL STRUCTURE				
1.	Deposits/Owned Funds	8.9	3.3	_	_
2.	Debt Equity Ratio (Deposits+Borrowings)/Owned Funds	9.4	4.0	_	_
3.	Liability Structure				
	Total Liabilities and Owned Funds (Rs Lakhs)	671.2	11.6	15.7	26.1
	(Percentage to total)	100	100	100	100
	Share Capital	3.4	15.7	_	_
	Reserves	6.2	4.4	50.2*	7.8*
	Deposits+Compulsory Savings	86.0	65.9	49.8	92.2
	Borrowings	4.3	14.0	0.0	0.0
b.	OPERATIONS				
4.	Debt-Coverage Ratio (Income-op. exp)/Int.exp.	1.2	_	-7.4	0.7
5.	Cost coverage ratio (Income-int. exp.)/op. exp.	1.4	2.4	0.1	0.7
6.	Cost of Funds (%)	8.1	0.0	5.0	9.4
	Returns on Lending (%)	11.4	2.4	9.6	16.4
	Spread (%)	3.3	2.4	4.6	7.0
7.	Loans Outstanding/Deposits (%)	38.4	136.7	51.8	76.5
8.	Loans Outstanding/Working Capital (%)	30.6	87.9	25.8	70.5
9.	Rate of recovery (%) (Ontime payments as a % of total recoveries)	84.0	_	_	_
10.	Est. Cost/Outstanding Loans (%)	10.7	2.0	88.0	9.1
c.	PROFITABILITY ANALYSIS				
11.	Profits as a % of total assets	1.2	2.4	_	0.08
12.	Profits as a % of Shareholders' Funds	13.8	12.2	_	_

Sources: Based on the Annual Reports of SEWA Bank, CSLA-BCC, FTCA and RATC.
Note : * Resources includes capital grants received from donor agencies

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Despite the high fund utilization and a spread ranging from 2 to 12 percent across the different PTCGs under the RATC Hyderabad, their aggregate performance shows rather low profits at 2.4 per cent return on assets and 9.7 percent returns on total equity. This may hint either at high transaction costs or significant delays and defaults in loan repayments.

Costs of Operation: It is often not recognized that the costs of reaching the low income groups are likely to be very high. This is evidenced by the available data from these three institutions. The reported establishment costs for SEWA Bank at about 10 to 11 percent of the outstanding loans are almost double those reported for the urban credit cooperative societies for Gujarat. The reported costs for BCC-CSLA are very low at 2.0 percent in 1992-93. However, in both these cases, the actual costs as absorbed by the parent NGO are very high. While we do not have the information for SEWA, BCC's estimates are that the value of time spent by BCC staff on CSLA activity is as high as 22 percent of all loan assets.

This is also true for FTCA and the various RATCs under it. At present, the establishment costs are being met by grants from external donor agencies. However, there is a consciousness regarding this and attempts are being made to introduce financial services whose spreads will in the future be able to cover these costs. The different deposit mobilization schemes and lending permit the RATC to cover 66 percent of its costs at present. Its spreads are as high as 7 percent. The picture for the FTCA itself is different, with the financing services having been started only recently, and the considerable reliance on subsidies for meeting the establishment costs. However, the funding agencies have shown awareness regarding these and there is discussion on the possibility of capital expansion to cover the costs. It is in this regard that the possibility of routing bulk housing finance through this arrangement also needs to be explored.

2.2 URBAN COOPERATIVE FINANCE SYSTEMS

The cooperative movement in India has been quite widespread with a very large network of primary cooperative institutions which is supported by a governmental structure of financial, regulatory and training institutions.

Types of Urban Cooperative Financial Institutions:

Within the cooperative structure in the country, there are two primary cooperative financial institutions which operate in the urban areas, the primary cooperative banks and the primary non-agricultural cooperative credit societies (PNASs). As a large proportion of these institutions are in the urban areas, they are also referred to as 'urban cooperative banks' (UCBs) and Urban Credit Cooperative Societies (UCCSs). There are basically two types of credit societies, namely the Employees' (or Salary Earners') Credit Cooperative Societies (ECCSs) and the other Urban Credit Cooperative societies (UCCSs). In 1990-91, of the total PNASs, almost 75 percent were of the former type, that is the SECSs. The overall organizational structure of the urban cooperative finance institutions is illustrated in figure 2.2.

Cooperative Credit Societies: As it is common to relate the cooperative movement with the rural sector, it is not often recognized that there are over 32000 credit cooperative societies in urban centres in India with over 15 million members. Their total outstanding lending in 1990-91 was around Rs. 20 billion, with deposits of Rs. 12 billion and a total working capital

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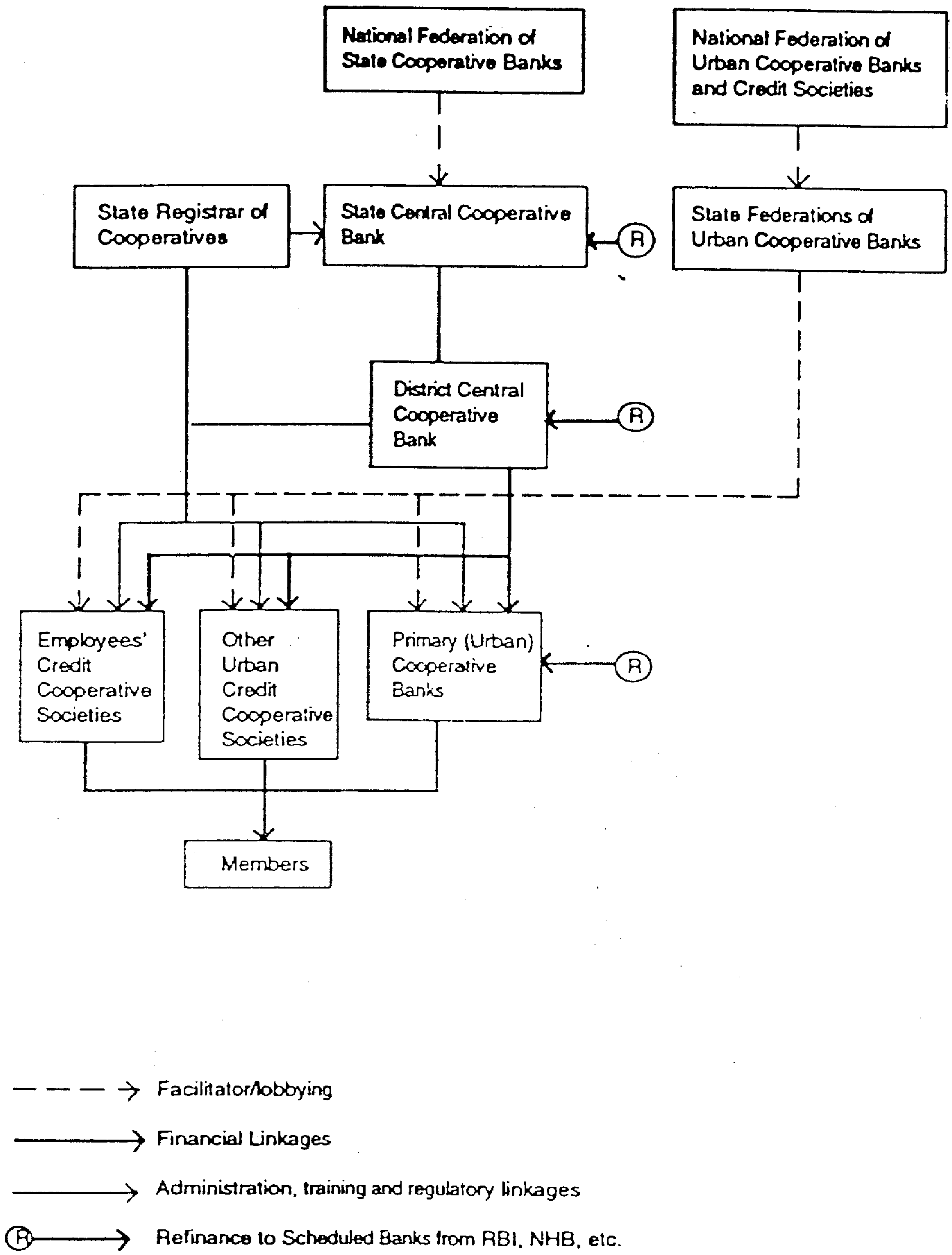
FIGURE 2.2

COOPERATIVE FINANCE INSTITUTIONS IN URBAN CENTRES



of Rs. 32 billion (NAFCUB, 1992). Inquiries and discussions with the concerned cooperative officials suggest that these societies cater largely to the lower middle classes and low income groups, though specific studies of the income profiles of their members are not available. Their main source of funds are the deposits of their members and their owned fund, with a relatively low debt equity ratio of 2.1. As their credit deposit ratio is very high, there is a possibility of enhancing their operations through external borrowing. However, this needs to be done carefully, as the experience of different societies for overdues on loans and overall financial viability is quite varied. Thus, external borrowing needs to be closely linked to incentives for improved financial management.

Cooperative Banks: In addition to these societies, the other important cooperative financial institutions are the 1400 primary urban cooperative banks with over 3400 branches throughout urban India. The available evidence regarding the spread across size class of cities in Gujarat highlights their importance in small and medium sized urban centres.

The cooperative banks mobilize deposits from the household sector and lend to both the small trade and manufacturing enterprises as well as the households. They can thus essentially be classified as Savings Banks. Their close rapport with the households for savings mobilization make them ideal vehicles for financing the household sector. The total membership of these UCBs was about 14 million in 1990-91 with outstanding loans of over Rs. 80 billion and deposits worth Rs. 101 billion.

The UCBs have a higher aggregate debt equity ratio at 6.9, though they are dependent only on deposit mobilization. Credit deposit ratios are lower than those of the UCCSs and ECCSs, though comparable to the commercial banks in general. Their larger scale enables more profitability and possibility of absorbing the overdues. Thus, in Gujarat, none of the cooperative banks made losses in 1990-91 and the percent share in Maharashtra was also only 3.4.

While recent studies on the relative shares of these cooperative institutions in savings mobilization and lending to the household sector are not available, an older study covering the period from 1951 to 1975 highlights the very important role of these societies and cooperative banks. During the period from 1971-72 to 1975-76, the cooperative institutions' share of total borrowings by the households was as high as 31 percent as against only 5.6 percent of the savings (Swami, 1981). The available data for 1989-90 and 1990-91 suggests that the share of cooperative banks in net deposits by the household sector had increased to 14.9 and 18.1 percent.[2] In 1990-91, the aggregate deposits of the urban cooperative institutions were Rs. 11,337 crore (NAFCUB, 1992a), or 5.24 percent of the aggregate deposits of the scheduled commercial banks.[3]

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[2] The total net deposits for cooperative banks for these two years were Rs 1428 and Rs 1497 crore (NAFCUB, 1992a) and for the household sector were Rs 9572 and Rs 8248 crore (CSO, 1993) respectively.

[3] The aggregate deposits of the scheduled commercial banks were Rs 216279 crore (RBI Bulletin, November 1993)

Table 2.4
Financial Status of Urban Cooperative Societies and Urban Cooperative Banks, India
(All monetary values are in Rs Lakhs)

		Cooperative Societies		Cooperative Banks	
		All India	Average Per Society	All India	Average Per Bank
	Total Number	32080		1397	
	Members ('000s)	14957	466		
I.	CAPITAL STRUCTURE (June 1991)				
1.	Share Capital	65419	2.04	44807	32.07
2.	Own Funds	19703	0.61	103276	73.93
3.	Deposits	118009	3.68	1015689	727.05
4.	Borrowing	58579	1.83	0	0.00
5.	Working Capital	319692	9.97	1338953	958.45
6.	Outstanding Loans	197586	6.16	800313	572.86
II.	ANNUAL PERFORMANCE (1989-90)				
1.	Net Deposits	10871	0.34	142816	102.23
2.	Loan Advances	195221	6.30	98296	n.a.
	(1990-91)				
1.	Net Deposits	14956	0.47	149680	107.14
2.	Loan Advances	200185	6.23		n.a.
III.	FINANCIAL RATIOS				
1.	Deposits/Owned Funds	1.39		6.86	
2.	Debt Equity Ratio (Deposits + Borrowings)/Owned Funds	[illegible]		6.86	
3.	Loans Oustanding/Deposits	[illegible]		0.79	
4.	Loans Oustanding/Working Capital	[illegible]		0.60	

Source : NIUA (1994)
Notes : The Financial ratios are based on aggregate statistics only, as detailed information on individual societies/banks is not available

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Table 2.5
Comparative Financial Status and Performance

		Employees' Credit Cooperative Societies			Other Urban Credit Coop. Societies *		Urban Cooperative Banks		
		Andhra Prdesh 1986-97	Gujarat 1991-92	Maha-rashtra 1990-91	Gujarat 1991-92	Maha-rashtra 1990-91	Andhra Prdesh 1986-97	Gujarat June 1991	Maha-rashtra 1990-91
1.	No.of Societies/Banks	2541	2724	6117	620	4790	61	288	381
2.	Average Membership per Society/Bank	298	450	441	392	447	7327	7228	11717
3.	Average Working Capital per Society/Bank (Rs Lakhs)	1.00	6.94	17.34	5.25	5.65	4.60	119.70	100.97
4.	Financial Ratios								
a.	Deposits/Owned Funds	0.82	0.91	0.30	1.33	1.16	6.43	5.19	6.28
b.	Debt Equity Ratio (Deposits+Borrowings)/Owned Funds	1.37	1.30	0.61	1.62	1.43	6.43	5.19	6.73
c.	Loans Outstanding/Deposits	2.60	2.30	3.57	1.68	1.24	0.73	0.81	0.78
d.	Loans Outstanding/Working C	1.08	0.75	0.75	0.67	0.62	0.70	0.58	0.59
5.	Liabillity Structure (Percentage to total)								
a.	Share Capital	16.80	31.69	27.94	21.96	17.67	3.93	3.28	3.26
b.	Reserves	25.44	11.69	34.32	16.28	23.50	9.53	12.88	9.58
c.	Deposits	34.72	39.68	18.48	50.71	47.84	86.53	83.84	81.31
d.	Borrowings	23.04	16.93	19.26	11.05	10.98	0.00	0.00	5.75
6.	Operational Performance								
a.	Percentage of Societies/ banks making loss	30.54	15.01	6.16	12.42	23.07	19.67	0.00	3.41
b.	Loans Overdue as a % of Loans Outstanding	23.66	3.82	3.82	14.66	14.79	8.54	11.42	12.61
c.	Structure of Overdue Loans as % of Loans Outstanding	-							
	Upto 1 Year	-	1.29	-	3.92	-	-	3.16	3.85
	1 to 2 Years	n	0.84	n	4.73	-	-	1.79	1.49
	2 to 3 Years	a	0.79	a	3.15	n	n	1.84	1.24
	Over 3 Years	-	0.90	-	2.86	a	a	4.63	6.02
	Total	23.66	3.82	3.82	14.66	14.79	8.54	11.42	12.61

Source: Relevant State Level Registrar of Cooperative Societies
Note :
1. * Details of UCCS are not available for Andhra Pradesh
2. The Financial ratios are based on aggregate statistics only, as detailed information on individual societies/banks is not available

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Financial Operations of Credit Cooperative Societies:

The main functions of the SECS, UCCS and UCBs are to mobilize thrift and enable their members to have access to credit. The regularity of thrift is an important consideration in deciding on the credit-worthiness of the member. The UCBs with a far greater volume also offer regular banking services.

Capital Structure: Most of the credit cooperative societies, as we observed earlier, have a far greater reliance on their own funds, with the debt equity ratios generally not exceeding 2.0. However, there is some tendency to rely more on deposits, once a certain volume of owned funds is achieved. The basis and extent of different sources are explained below in greater detail.

Share Capital: Besides an entrance fee, a new entrant to a society has to buy shares of the society, which are generally Rs. 10 each. The share capital is also enhanced by conversion of the compulsory savings to share capital at the end of a given year. This helps in enhancing the owned funds of the society. The member is generally willing for such conversion as the interest on deposits is lower than the 12 percent dividend paid by most of the societies. Secondly, any member who does not have adequate deposits (25 percent of the loan amount) is required to retain some percent of the loan as share capital. Some societies make it compulsory for the members to have a specified percentage of the loan amount as shares. For example, SECS of the Bhavnagar District Cooperative Bank requires the members to buy 10 percent of the loan amount as shares for the first loan and 2 percent of the loan amount for the second loan, till the member has at least 25 percent of the maximum permissible loan amount in the society's shares.

The society bye-laws generally also put a maximum limit on the total shares which can be held by an individual member. Given the cooperative nature of the society, the voting rights are not linked to the share capital. Each member has only one vote.

External Borrowings: According to the State Cooperative Acts in some of the states or by convention, the PNASs are permitted to borrow from the respective District Central Cooperative Banks.

In Gujarat, the DCCBs have been lending to the PNASs under the 'incidental finance' facility or through the over draft facility. The loan has to be repaid in 1 year, though in most cases, if the repayment is found satisfactory, the loan is renewed. The interest is 16.5 percent, with a penal interest rate of an additional 1.5 percent for delays. The data for Gujarat indicates that on an average 58 percent of the ECCSs and 50 percent of the UCCSs had borrowed in this manner during 1990-91. The borrowings were, however, of very low values and generally did not exceed 2 to 3 times the net owned funds.

The PNAS is not constrained by any RBI regulations regarding the interest rate to be charged on lending. Thus the decision regarding spread for the borrowings from DCCB is essentially a decision of the executive committee. In most cases, the rates are in the range of 18 to 19 percent. Our studies of a few societies suggest that the UCCSs tend to charge a slightly higher rate of interest, probably due to greater problems with delayed payments. In some cases, the societies borrow from the DCCB for a specific purpose like purchase of

Table 2.6
Financial Performance of Selected Urban Credit Cooperative Societies

	Name	Members	Liabilities and Owned Funds (Rs Lakhs)	Reference Date	OPERATIONS: Debt Coverage Ratio	Cost Coverage Ratio	Average Cost of Funds (%)	Average Return on Loans (%)	Average Spread (%)	Loans/ Working Capital (%)	Establishment Cost/ Outstanding loans (%)	PROFITABILITY: Return on Assets (%)	Return on Equity (%)
A.	**EMPLOYEES CREDIT COOPERATIVE SOCIETIES (ECCS)**												
1.	Maharashtra Housing Board ECS	3302	123.8	30.3.93	2.1	3.9	8.2	8.9	0.7	77.2	1.7	3.8	8.0
2.	Mahaned Dairy Emploees Cooperative	425	6.0	30.3.93	1.9	1.9	13.5	11.0	-2.5	96.8	3.8	3.5	6.3
3.	Bhavnagar Dist Co-op Bank ECS	373	56.7	30.6.93	0.0	5.2	0.0	3.5	3.5	95.0	0.7	2.7	11.0
4.	ST ECS	1912	165.2	30.6.93	2.4	2.7	13.3	17.1	3.8	94.4	4.4	5.4	13.3
5.	Excel Industries	931	66.0	30.6.93	18.7	3.7	1.4	13.1	11.7	77.9	4.2	8.9	16.3
6.	Blind Men's Association Staff Cooperative	157	21.1	30.6.93	2.1	22.2	16.5	10.8	-5.7	97.2	0.3	5.5	8.8
7.	Ahmedabad Cotton Mills ECS	724	28.6	30.6.93	2.2	6.5	11.0	7.2	-3.8	86.3	1.3	6.3	13.8
B.	**URBAN CREDIT COOPERATIVE SOCIETIES (ECCS)**												
8.	Shramik Credit and Supply Cooperative Society	450	3.1	30.6.93	0.0	5.4	0.0	9.2	9.2	99.5	1.8	7.8	8.5
9.	Rajpur Bhagyodaya Credit and Supply CS	538	6.3	30.6.92	0.0	4.2	0.0	10.9	10.9	94.7	2.6	8.0	10.2
10.	Samaj Sahayak	1962	49.5	30.6.91	2.0	6.9	8.6	13.7	13.7	88.5	1.1	5.6	18.7
11.	Sahayak Credit and Supply Cooperative Society	2068	54.4	30.6.92	2.5	4.0	9.0	10.0	10.0	99.3	1.7	4.0	7.1
12.	Platinum Credit and Consumer Cooperative Society	1684	159.0	30.6.92	1.8	6.9	12.2	19.2	19.2	65.0	1.6	5.8	27.4
13.	Yerala Cooperative Society	9122	263.4	31.3.92	1.9	1.4	3.6	10.3	10.3	77.7	7.1	1.6	7.0
14.	Salgaan Sanmitra Cooperative Society Ltd	5855	317.5	31.3.92	1.5	1.8	10.2	14.4	14.4	71.1	4.6	2.2	8.0

televisions by the members, as was_done by the Ahmedabad Cotton Mills' Employees' Cooperative Credit Society. In such cases, the members had to produce a bill as proof of purchase for this loan.

It must be pointed out that for the DCCBs, lending to the PNAS, especially the SECS is a preferred option, due to the higher rate of interest, good repayment records and relatively lower transaction costs. In fact, in most cases, these societies have a good rapport with the DCCBs and it is easy for the DCCBs to assess their track record as there is regular accounting done by the society and annual audit by the Cooperative Registrar's office. Of the societies reported in Table 2.3, only 2 of the 7 UCCSs had external borrowings, while 4 of the 7 ECCSs had external borrowing. In both cases the borrowings have not exceeded the share capital.

The details of the DCCBs from Bombay and Ahmedabad suggest that they have adequate additional resources with credit to deposit ratios being low at 0.5, as against a permissible 1.0. If it is possible to work out some arrangement for them to extend housing finance to the PNASs, it will be possible to use it as an incentive to augment their own resources. Thus, HFCs can in fact consider lending to DCCBs on a part refinance basis for onlending to the SECSs and UCCSs for housing purposes, based on their assessment of these societies depending on their past repayment record.

Savings Mobilization: Most societies have a compulsory thrift system. Under this, an amount decided at the formation of the cooperative society, is to be saved by each member every month. The amounts may range from as little as Rs. 10 to Rs. 100 and more. The amounts are decided on the basis of ability and willingness of a large proportion of the members. Over time, the society may also increase this amount. The interest to be paid on savings is also decided by the society. Of the societies reported in Table 2.3, this has ranged from as low as 6 percent to a higher return of 14 percent. The deposits with the PNASs are not covered by the deposit insurance, as are the deposits with the banks.

The procedures for savings mobilization vary for different societies. In most cases, the members are expected to make the deposits in the office of the cooperative before a fixed date every month. Most societies also have penal charges in case of delayed payments. For SECS, however, the compulsory savings are deducted directly from the monthly salary of the employee through an arrangement with the employer.

Some of the larger and/or older societies have also introduced different savings instruments like fixed deposit schemes where the amount is doubled in five years, or other time deposits.

Credit - Assessment, Disbursal and Recoveries: Credit is available to all members. There is generally a minimum period of regular compulsory savings required by all societies before a member becomes eligible for a loan. This varies from 6 months to about 2 years. The procedures for sanctioning the loans are simple as the executive committee generally has a fairly good knowledge of the member. Essentially, the procedure involves applications by all the interested members by a specified date each month. The loans are sanctioned on the basis of date of application. Rejections are not many (about 5 percent for the selected societies). Depending on the cash flow situation there maybe waiting lists, in which case the application is carried over to the next month. For the older societies, the borrowing limits from the DCCB provide adequate funds. This is largely due to the limits on maximum loan size and the dominance of short term loans. For example, the available details for Gujarat suggest that 92 percent of the loans advanced during 1991-92 were for a short term.

Purpose of Loans: The loans are available for any purpose. However, they are largely used to meet social obligations, health related expenses and also for housing upgradation or construction. The details for Gujarat suggest that the ECCSs had given 14 percent of the short term and 33 percent of the medium and long term loans for housing during 1991-92 with a total value of Rs. 227.6 million.

Loan sizes: The size of the loan is generally linked to the savings and is four to five times this amount. Alternatively, as noted above, a certain proportion of the loan amount is required as shares. There are clear limits in all the PNASs regarding the maximum loan amounts available to any member. Clearly, this amount is linked to the total resources of the society and are determined by both owned funds (share capital and reserves) as well as deposit mobilization. The former of these also determine the total borrowings possible from the DCCB. At the initial formative stages of a cooperative, the maximum loan amounts are low, in the range of Rs. 500 to Rs. 2,000. Over time, as the funds position improves, the maximum loan amounts are also increased. For example, for the Shramik Credit Cooperative Society in Ahmedabad which is only 6 years old, the maximum loan amount is only Rs. 2,500. However, for the Platinum Credit and Consumer Cooperative Society in Bhavnagar, which is 34 years old, the maximum loan amount is Rs. 50,000 and the maximum repayment period is 50 months.

The detailed analysis of loan sizes for Gujarat, highlights the fact that credit cooperative societies focus on giving a large number of smaller loans. Thus, generally over 50 to 70 percent of the loans are for less than Rs. 1,000. In terms of the value, however, the largest share is of loans between Rs. 1,000 and Rs. 5,000. Even for ECCSs, the loans above Rs. 10,000 are about 20 percent of the total loan amounts advanced.

Security for Loans and Defaults: The loans advanced by the credit cooperative societies are unsecured and largely based on personal surety/guarantee of other members. The UCCSs also gave 16.4 percent of the total loans using immovable property as security. (Refer table 4.13).

The real effective security in cooperative society lending thus is group and peer pressure. The rapport of the executive committee with the members and a quick follow-up are critical in this approach. Further, the high priority given to the past repayment records and regularity in thrift for credit sanctions also act as an incentive for regular payments. This is evident from the detailed information on delayed payments presented in Table 4.14 for Gujarat. During 1991-92, only about 3.5 percent of the borrowers had defaulted. The total default amounts ranged from 3.8 to 14.6 percent of the total outstanding loans for the ECCS and UCCS respectively. Unfortunately, as the available data does not report the total recoverables, it is not possible to ascertain the recovery rates.

Profitability: At an aggregate level, as we reviewed earlier, the cooperative societies in Gujarat show a better performance with only 12 to 15 percent of them making losses. The ECCSs in Maharashtra perform even better. However, amongst the UCCSs in this state, almost a fourth are in the red. The profitability analysis shown for the selected societies in Table 2.6, range from 7 to 27 percent on shareholders' funds and 1.6 to 9 percent on the total working capital. We explore the possible explanations for this performance below.

Spread on Operations: For a financial institution, one of the main aspects of profitability relates to the spread achieved. Interestingly, for the selected credit cooperative societies, the spread was negative for three ECCSs and ranged from 0.7 to 11.7 for the others. For UCCSs, the spreads were generally higher with only one society having a low spread of 1.1 percent. For all others, these ranged from 4.2 to 10.9 percent.

Costs of Management: Compared to the very high management costs reported for the NGO linked financial systems in the previous chapter, the credit cooperative societies show a much lower level of costs. For the 14 selected cooperative societies, the establishment costs ranged from as low as 0.27 percent of the total outstanding loan balance to the highest at 7 percent. For most, however, the costs were largely in the range of 1 to 2.5 percent. Further, in most cases, the financial operations adequately covered these costs with the cost coverage ratios being generally in the range of 3 to 5 with no significant difference between the ECCS and UCCS.

The detailed analysis for Gujarat for 1991-92 suggest somewhat higher costs of management, including depreciation and other expenses at about 6 percent of the outstanding loans.

Role of Urban Cooperative Banks (UCBs):

The UCBs play a significant role both in mobilizing household deposits and, especially, in lending to the household sector. They have a fairly good rapport with their members which can be extremely useful for housing finance also. In fact, the available data for Gujarat suggests that the urban cooperative banks played an important role in housing with the outstanding loans of over Rs. 16460 million for this purpose in 1990 at about 11 percent of the total lending. Detailed studies of the Anyonya Cooperative bank in Baroda, Gujarat showed that the housing loans as a proportion of total outstanding loans has come down from 51 percent in 1984-85 to 33.4 percent in 1989-90 (Karvekar, 1991 and Mehta and Mehta, 1992).

The possible reasons for this based on the discussions with some of the leading banks in Ahmedabad, Baroda and Bombay are as follows.

Housing as a Priority Sector: The UCBs are required to lend 60 percent of their funds for the priority sector. For housing, the loans of less than Rs. 25,000 are considered as a part of the priority sector. Given the price levels for housing, this limit makes the price to loan ratios unattractive for potential borrowers. On the other hand, for many of the banks, the credit to deposit ratios are rather low, ranging between 0.5 to 0.6, suggesting the potential for increased lending. It would thus be advisable to increase the loan ceiling for housing to be included as a priority sector, at least in line with the NHB pattern for refinance. The recent revision in the ceiling on housing loans to Rs. 200000 for inclusion as priority sector for the commercial banks needs to be extended to the cooperative banks also.

Limits on Extent of Housing Finance: The RBI, through its circular in 1989, has fixed the maximum limit on lending for housing and other block capital loans at 10 percent of total deposits. While this limit may not affect the very large UCBs, some of the smaller UCBs, which had an extensive portfolio for housing, have been constrained by this limit. It is of course possible to overcome this constraint by creating linkages for long term funds through loans or refinance as these are not included in the limit.

Possibility of lending to Primary Housing Cooperative Society: At present, due to the State Cooperative Acts, the UCBs which are also considered as primary ones, are not permitted to induct the primary housing societies as members. If this is permitted, it would enable the UCBs to improve their lending for housing purposes considerably. This requires a change in the state level Cooperative Acts.

Permission to lend for schemes under Section 21 of ULCRA: At present, the UCBS are not permitted to lend for housing schemes taken up under Urban Land Ceiling exemptions. As these schemes are cheaper and compatible with the affordability of the borrower groups, such a permission will enhance their role in reaching the lower middle classes for housing finance. It maybe pointed out that HDFC has been permitted to lend for schemes under Section 21 of ULCRA.

Technical Assistance/ Refinance/ Risk Fund: Some of the smaller UCBs like SEWA do not have the experience of long term mortgage financing. They would benefit from technical assistance and some support in the form of a risk fund in the initial years to get them started. This may also be true for other Women's UCBs. This approach will help larger cooperative societies that do not require additional funds. These finance institutions will be able to improve their credit/deposit and credit/working capital ratios and, therefore, improve profitability. However, initially it may be helpful to provide refinance (line of credit) for this purpose which will help to build up their expertise and confidence for long term lending. Subsequently, they will be able to carry out these activities with their own funds.

Refinance by NHB to Urban Cooperative Banks: NHB's refinance facilities for housing loans upto Rs. 50000 are currently available only to the scheduled cooperative banks. Many of the smaller cooperative banks have been lending for housing or have a tremendous potential, especially for reaching the households in smaller urban centres and those below the median income. It will, therefore, be useful to consider the possibilities of refinancing even the-non-scheduled cooperative banks, if the UCB generates adequate volume of housing loans.

2.3 DOWNMARKETING BY HOUSING FINANCE INSTITUTIONS

As we reviewed in the first section, the role of the emerging housing finance institutions in reaching the households below median income has been rather limited so far. The available estimates suggest that the finance to these groups probably does not exceed 15 percent. The only company which had a specific mandate to serve these groups was HUDCO, a company fully owned by the Government of India. It earmarks 55 percent of its lending for these groups. Besides HUDCO, the only other company which has made specific attempts in this regard is the HDFC through its project financing for the KFW line of credit which is meant for households with a monthly income of less than Rs. 1000. The only other attempts have been through projects financed by LICHFL and GIC Grihvitta for low income workers in Bombay through payroll deductions.

HUDCO's emphasis for the low income finance has been by offering subsidized interest rates and more favourable credit terms, especially longer repayment periods and higher loan to cost/price ratios. It has largely operated through the public housing agencies for providing bulk finance for what has been termed as 'social housing'. Over the years, however, public agencies have found it difficult to provide housing within the cost ceilings imposed by HUDCO. HUDCO has recently also introduced a scheme to provide loan assistance to NGOs for housing projects on a pilot basis. However, even in this the emphasis is on a specific project and inadequate attention is paid to developing viable finance systems.

The emphasis on subsidized interest rates is also evident in the HDFC projects through KFW line of credit. KFW, a German development bank has sanctioned a total of DM 55 million (about Rs. 770 million) in two lines of credit. The first one was of DM 25 million. Under this, HDFC has so far sanctioned 43 low income projects for Rs. 400 million and disbursed almost Rs. 160 million. loans to low income households have been either given directly to households with NGO facilitation or routed through the NGOs. The loans to low income households are at 7 percent interest to be repaid in 22 years with a 1.25 percent spread for HDFC but none for the NGOs.

The only notable case of using the Community based Finance systems for housing finance is by the GRUH in Gujarat. It has attempted to use the cooperative societies for identifying potential borrowers and assessing their creditworthiness. However, their attempts to use these structures for intermediation have not materialized. However, GRUH emphasizes that this would a far better arrangement.

On the whole the HFIs have been extremely wary of reaching out to the households below the median income. while most of them visualize the possibilities of expanding market opportunities through such reach, they feel that specific constraints, especially related to a perceived high credit risk, lack of affordability for housing and high transaction costs, inhibit such expansion. However, our discussions with eight of the leading HFIs suggest that all but one was interested in experimenting with innovative measures. In the next section we present a strategy for enhancing the reach of low income groups through a downmarketing approach using the community based finance systems discussed earlier in this section.

SECTION THREE

STRATEGY FOR DOWNMARKETING

The strategy envisaged for downmarketing housing finance to moderate and low income groups, in urban areas, is based on using the existing finance systems. It is hoped that this will in turn consolidate and develop these systems further. The strategy may be initiated as a series of pilot projects, which can be replicated widely. This necessitates a gradual approach which builds on the strengths of these pilot projects while also recognizing their inherent limitations.

Many of the problems related to housing for low income groups, especially regarding legal access to land at affordable prices and those related to foreclosure laws, have long been pursued in housing policy. It must be recognized that solutions to these will emerge only gradually. This strategy, therefore, takes the current conditions as system limitations and suggests indirect measures to overcome these. In a longer term perspective, demand pressures created through the improved access to credit for housing will itself help find solutions to these constraints.

3.1 OBJECTIVES OF DOWNMARKETING STRATEGY :

This strategy, if successfully implemented, will fulfill three important objectives. First, it will help to enlarge the market for housing finance for the emerging housing finance institutions in the country on commercial terms, and secondly, it will enable large segments of the urban population to improve their living conditions through a better access to credit for housing and community level infrastructure facilities.

The third objective of this strategy goes beyond the confines of housing finance. It is envisaged that it will also help to consolidate the different forms of community based finance systems by enabling them to expand their activities in a viable manner. These structures would be far more replicable than the public housing projects with their limited reach. More importantly, they will help to integrate these systems with the general financial systems in the country.

Consolidating and Integrating the Community Based Financial Systems: The recent literature on housing finance has repeatedly emphasized the possibility of enhancing household savings rates and general finance system development with better housing finance systems. In a similar vein, the downmarketing strategy as envisaged in this paper will also help in the consolidation of the different forms of community based finance systems in the country and lead to their better integration with the general financial systems. The emphasis on such arrangements for housing finance will also mean a change from the subsidised interest rate financing, that has been the mainstay of public policy for low income housing finance in India so far. The emphasis now shifts to supporting development of commercially viable community based finance systems. Any available subsidies must be consciously utilised for the initial building up of such systems. These efforts however, need to be designed to become financially self-sustaining in the medium to long term.

Enhancing Savings Mobilisation: It must be realised that the access to housing finance can also be critical to sustaining and increasing the desire for regular thrift by the low income groups. The experience of SPARC (housing savings) and BCC (group infrastructure savings) suggest that it would be possible to enhance savings, if access to housing finance is possible. In fact, discussions with SPARC personnel suggest that in later years, it was difficult to sustain the flow in their housing savings scheme as the housing loans did not materialize. Similar observations were also made by another NGO, Sharan in Delhi. They indicated that in their savings groups, there is now a demand emerging for larger loans and for purposes related to housing. However, such loans would require funds beyond those available with the community based systems themselves. There is thus a need to ensure that the system does not collapse only on account of lack of funds.

3.2 CONSTRAINTS IN DOWNMARKETING AND KEY DESIGN PRINCIPLES:

The development of a downmarketing strategy for housing finance requires a careful identification of the perceived constraints for a commercially viable system and the key design principles which attempt to overcome these constraints. Our review of the existing housing finance institutions suggest three main areas of constraints for a commercially viable downmarketing strategy.

1. High Credit Risk:

The first and the most emphasized constraint stated by many HFIs relate to the high credit risk perceived in lending to these groups. Our review of the community based financial systems, either those linked to the NGOs or the cooperative institutions, suggest that while delinquency is likely to be prevalent, bad debt is not very common. This has also been the experience of HDFC which has largely used the NGO mode for routing its KfW line of credit, meant for the low income groups.

These experiences suggest that appropriate financial arrangements and strong grass roots base is essential for controlling the bad debt. A better tracking of actual extent of bad debt is essential. However, the discussions with NGOs suggest that this may occur due to either death or other calamities like fire or loss of income/assets due to riots. In fact some of the NGOs linked CFIs have either their own insurance schemes (like the Death Relief Assistance of FTCA) or started to avail the group insurance facilities of LIS (as done by SEWA as well as SPARC for their members).

Greater check on delinquency on the other hand probably requires better underwriting criteria, more sensitive lending instrument design and a financial mechanism to cover the delinquency risk. In the case of the Community based Financial Institutions (CFIs) which have grown beyond a small community controlled group, better record keeping for tracking the defaulters' - is also important.

Table 3.1
Downmarketing Housing Finance
Constraints and Key Design Principles

	Constraint		Design Principles
1.	High Credit Risk		
		i.	Measures to cover credit risk including insurance cover
		ii.	Delinquency Risk Fund
		iii.	Appropriate Underwriting
2.	Affordability for Housing		
		i.	Design of appropriate new loan instruments
		ii.	Selection of appropriate markets
		iii.	Technical support
3.	High Transaction and Servicing Costs		
		i.	Developing CFI capabilities
		ii.	Adequate scale of operations
		iii.	Spreads to cover establishment costs

Specifically, the following design principles emerge as important to overcome the perceived constraint of high credit risk.

i. Measures to cover the credit risk: In the initial period of downmarketing strategy, the risk of bad debt will need to be borne by the community based (NGO linked or the cooperative) intermediary financial institutions or through subsidies for insurance cover. This is important to first create a willingness by the HFIs to initiate the downmarketing. Over time, as the experience builds up and a better assessment of actual levels of credit risk become known, this arrangement may change.

The linkage arrangement needs to also support the CFI to introduce better systems of record keeping and loan recovery which are prerequisites to good financial management. In addition and more importantly, the CFI must also be encouraged to introduce some type of insurance cover for bereavement and loss/damage to property. The experiences of FTCA for death relief assistance scheme or of SEWA and SPARC's insurance cover through group insurance need to be emulated. The linkage must include these insurance arrangements as a part of the cover for the larger housing loans. In the initial period, the insurance cover may be provided through subsidies as essential.

In addition to these measures, the CFIs have largely focussed on group and peer pressure to minimize the credit risk and this must be continued. In case of the Employees Credit Cooperative Societies (ECCS), payroll deductions with the employers' consent will also help to reduce the credit risk to a minimum.

ii. Delinquency Risk Fund: Delayed payment or delinquency is likely to be quite common, as suggested by the limited data available about the CFIs and the discussions with them. In order to cater to cover this risk, the HFIs must be ensured of payments in time. This may be achieved by keeping a delinquency risk fund as a block balance or deposit with the HFI. It may be drawn upon by the HFI in case of delayed payments by the CFI. The size of this fund must be linked to the past recovery performance of the CFI, so that it acts as an incentive to improve the cost recovery performance. At the end of the loan period, the unutilized deposit with the accumulated interest will be returned to the CFI.

iii. Appropriate Underwriting: The bulk loan arrangement must also require and encourage the CFI to move towards appropriate underwriting criteria for housing finance for these groups. Besides the instalment to income ratio (IIR) used by most of the HFIs, a minimum period of regular savings and regularity in the repayment of past credit need to be emphasised. It is the latter criteria which have been used by the CFIs in the past. For larger loans, participation in special savings scheme for housing can be made mandatory.

The HFI also use a cap on loan to cost/price ratio for determining the loan amount. However, as we discuss below, the control of credit risk is linked more to the other arrangements rather than the security of mortgage, it would be preferable not to use this consideration at all. In fact, unduly low ratios would necessitate the use of other more expensive sources of finance like the moneylenders, increasing the possibility of credit risk on CFI finance.

2. **Affordability for Housing:**

The second constraint relates to a perceived lack of affordability for the low and moderate income households in relation to the prices of available options in the housing market. Many of the HFIs have posed this as a major constraint.

The question of affordability is, unfortunately, not spelt out clearly. Housing affordability is generally viewed only in the context of household income. It should, in fact, be examined in the context of the terms at which finances are available, the ability of the household to make the downpayments and the proportion of the monthly income (the instalment to income ratio), that would be made available by the household to service the loan. Table 3.2 highlights the affordable housing costs under a range of these parameters. Our inquiries in some of the cities that were visited, suggest that the range of affordable costs presented in Table 3.2 are adequate to meet the

Table 3.2
Maximum Affordable Housing Costs (Rupees)

HH Income Rs per month	Instalment to income ratio (%)	Repayment period (Years)	Interest Rate (% per annum)			
			12.0		18.0	
			Loan to cost ratio		Loan to cost ratio	
			0.9	0.7	0.9	0.7
1500	0.1	2	3541	4463	3338	4292
		5	7493	9209	6563	8439
		8	10255	12335	8450	10865
		15	13887	16091	10349	13306
	0.25	2	8851	11158	8346	10731
		5	18731	23023	16408	21097
		8	25637	30839	21126	27162
		15	34717	40227	25873	33265
2800	0.1	2	6609	8331	6232	8012
		5	13986	17191	12252	15752
		8	19142	23026	15774	20281
		15	25922	30036	19319	24838
	0.25	2	16523	20828	15579	20030
		5	34965	42977	30629	39380
		8	47855	57566	39435	50702
		15	64806	75090	48297	62096

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costs related to housing upgradation, housing construction costs (without the land component) and community infrastructure provision. Even for purchase of new housing, some options, which match the affordability of the households in the 40th-50th percentile, are available in the formal housing market. For example, in Ahmedabad, private sector housing in the eastern periphery is available at Rs. 75,000. This matches the affordability levels of the households in the income range of Rs. 2500 to Rs. 3000. The prices in the informal markets are even lower and well within the reach of households even in lower income brackets.

These observations suggest the urgent need of information about local housing markets, especially for those options which fall within the affordable range of below median income groups. Secondly, technical systems which help lower the costs of construction for new house as well as for upgradation should be made available to these groups. This will help improve the effectiveness of credit targeted at them. More importantly, it becomes necessary to provide housing finance for a variety of purposes which are more in tandem with the affordable levels to facilitate incremental improvements.

Specifically, the following design principles emerge as important to overcome the perceived affordability constraint.

i. Design of Appropriate Loan Instruments: It is necessary to design appropriate loan instruments which are more in tune with the affordability and housing market conditions. This requires two major changes. First, the purposes for housing loans must include besides new housing, home upgradation, purchase of land and community infrastructure projects. Secondly, the loan amounts need to match the affordability, permitting much smaller amounts.

Thirdly, and most importantly, the new instruments must permit non-mortgage based loans, especially in order to cover the options in the informal housing. This requires a clear change in the conventional HFI lending and may be promoted through bulk lending to the CFIs. Initially, such lending may be promoted as far as the loan amounts are small enough to be covered by other forms of non mortgage security or guarantees.

ii. Selection of Appropriate Markets: The question of affordability for new housing is linked to selection of appropriate markets. This necessitates a proper information system about the affordable housing options in the given housing markets. The pilot projects must support the building up of a market information system for the low and moderate income groups. It would be also necessary to select appropriate markets where such affordable options are likely to be available.

iii. Technical support: To maximize the effectiveness of available credit and to help formulate community level projects, technical support for the CFI should also be a part of the pilot project. Such support, however, must be properly costed and accounted for, in order to move towards meeting these costs from the surpluses of financial operations.

High Transaction and Servicing Costs:

The third constraint pertains to the high transaction or loan servicing costs associated with downmarketing. The HFIs are often reluctant to make small loans to the below median

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income families as this would add to their administrative costs of loan servicing. However, reaching this group through NGOs or Cooperative institutions is probably more expensive route. Our analysis for the community based finance systems highlights the high establishment costs of NGOs as compared to the HFIs. Unfortunately, adequate data is not readily available to ascertain the possible effect of economies scale on these costs.

Analysis of the available data suggests that as compared to the NGO linked CFIs, the loan servicing costs are lower amongst the cooperative societies, both because of the decentralised loan administration and availability of voluntary staff. Some of the services required for training and regulatory functions are also being met through government supported machinery in the cooperative sector at the state and district levels. Some NGOs like the FTCA in Andhra Pradesh, have also been providing these services to their members. This is possible given the large scale of its operation. The NGO operations are generally supported by grants from national and international donor agencies. Over time, it is necessary to make a realistic estimate of the total costs of NGOs' operations, pertaining to housing finance, to make the system replicable in a commercially viable manner. The system, then, needs to be designed to meet these costs from the surpluses generated through financial operations.

It is with this commercial viability in mind that the following **design principles**, for alleviating the constraint of high establishment costs, are suggested.

i. Scale of Operations: The arrangements must aim at an adequate scale of operation for a given CFI. This requires a careful assessment of the demand for housing finance and requisite time for external support until the CFI moves towards sustainable level. This means that in the initial period the CFI maybe supported through grants to meet the establishment costs which are phased out over a carefully designed time period. If the linkage is established without such a plan of operations, there may be serious difficulties for the CFI to sustain its activities.

Any linkage arrangement developed in the pilot project should ideally be related to a community based financial arrangement providing all types of credit, so that there is a scope for generating surplus from the financial operations to cover the establishment costs. It should not be confined only to a specific housing project as has been done in the past by both HDFC and HUDCO, unless they are designed with a purpose to develop or strengthen a CFI.

ii. Spreads to Cover Establishment Costs: The interest rates to be charged on housing loans must be decided by the CFI, depending on their rate structure for other loans. However, adequate spread must be available to meet the establishment costs over a defined period. Initially, grants may be provided to set up a system, with an explicit plan for phasing out the grant.

Table 3.3
Comparative Assessment of Establishment Costs

Institution	Establishment costs as percent of outstanding loans
NGO Linked Institutions, 1992-93	
- SEWA Bank, Ahmedabad	10.7*
- BCC - CSLA, Baroda	2.0 (20.0)**
- RATC - Hyderabad	9.1
HFI - 1992-93	
- GRUH	2.5
- LICHFL	0.8
- CHFL	1.2
- CBHFL	1.0
- SBIHFL	1.6
- GGVL	2.2
- HDFC	0.9
- HUDCO	0.3***
Cooperative Societies	
- ECCS, Gujarat, 1991-92	6.4
- UCCS, Gujarat, 1991-92	6.1
- Selected UCCS in Gujarat and Maharashtra, 1992-93	0.25 to 4.35
- Selected ECCS in Gujarat and Maharashtra, 1992-93	1.08 to 7.07

Source : From the relevant annual reports of different financial institutions.
For Gujarat, State Registrar of Cooperatives.

Note :
* Does not include the probable costs of SEWA Union Employees.
** Including the CSLA estimate of the value of BCC staff time spent for CSLA activities.
*** HUDCO provides only bulk loans.

Even in cases where the HFI plans to use the CFI or NGO only as a facilitator with direct loans to the households, the establishment costs for the NGO or CFI need to be costed, recognized explicitly and covered by a service charge paid to the CFI by the HFI.

iii. Capacity for Financial Management: In order to recover the establishment costs entirely through its financial operations, the CFIs have build up their capacity for financial management, without sacrificing their special measures for savings and credit operations. The linkage arrangement must encourage this capacity building through necessary training and interaction with the HFIs.

3.3 TYPE OF LINKAGES:

In view of the basic design principles, two forms of linkages between the HFIs and community finance insitution (CFI - NGO linked or cooperative) are envisaged.

i. HFI-CFI Linkages for Bulk Loans for Housing:

Our review of Cooperatives and NGOs has illustrated a wide variety of arrangements as well as different stages of development of community based financial institutions. They range from the nascent financial arrangements like those with SPARC, Sharan, Adhikar, to the more developed ones like SEWA, FTCA and the Community Savings and Loan Association of the BCC. Similarly, amongst the cooperatives also, there are many which are very small with low credit absorption capacity, while others have grown fairly large with a greater absorption potential. There are substantial regional variations in the availability of such arrangements. In all cases, however, the strength of these community based systems is their close rapport and linkages with the community and their members. It is this rapport that has to be used to further develop and strengthen the systems.

In response to these, the Downmarketing strategy envisages a linkage arrangement between the HFI and the community finance institution (CFI) which is flexible enough to accommodate institutions at different levels of development and promotes their further consolidation and strengthening. Basically the arrangement involves a bulk loan from the HFI to the Community Financial Institution (CFI) with specified terms and conditions for on lending to the households. The CFI will have the responsibilities for loan origination and servicing and, would, therefore, also bear the credit risk.

Many of the NGOs surveyed for this study, expressed a desire for such independence and freedom. In this arrangement, the credit risk would be borne by the CFI and the limit on total bulk loan maybe specified in relation to the capital base of the CFI or the thrift and credit groups under a NGO federation/association. The basic aim of this linkage would be to use the grass roots strength of the CFI for downmarketing and use the housing finance to consolidate the CFI itself.

Institutional Arrangements:

In order to evolve a successful and viable linkage arrangement, it is important to define the role of different institutions. Based on our review of the community finance systems, different potential models are identified as illustrated in Table 3.

Basically, two forms of intermediation are visualised.

i. Multi-tier Intermediation
ii. Single-tier Intermediation

The multi-tier intermediation uses the structure of federation or the apex agencies, which in turn lends to the primary CFI. In the single-tier intermediation, the HFI deals directly with a primary CFI. The description of each is provided in subsequent sections.

Multi-tiered Intermediation

Under this framework, there are many possible options to link the existing networks of primary CFIs, Cooperative Societies and the HFIs. Three of the potential approaches arising from the study are described below.

i. NGO-Apex Federation-Thrift and credit group model: In this model, the bulk loans for housing are envisaged to be routed through an apex federation or regional association of thrift and credit groups. The review, assessment and monitoring of the TCGs can be handled better by this federation or association, which will also take on the responsibility of mobilizing the Delinquency Risk Fund (DRF). However, the loan origination and servicing will be done by the primary CFI or Thrift Group which may or may not be a registered entity. This arrangement will mean spreads at two to three levels (federation, regional association and TCGs), However, the different activities, as they take place at appropriate scale are likely to be more cost effective. The institutional responsibilities for different activities are also highlighted in Table 3.

ii. Employer - ECCS model: The second model envisages use of the widespread structure of Employees' credit cooperative societies (ECCS) in the country. The HFI can, with the help of the state/district registrar of cooperatives and the district central cooperative bank, identify potential ECCS. This selection may be based on their past financial performance. The bulk loan would be routed either through the District Coop. Bank/Employer to be given to the ECCS. The employer will also play a facilitating role to permit payroll deductions. This model thus, has very low or no delinquency risk.

iii. DCCB - UCCS model: Compared to the NGO linked arrangements, bulk loans to be routed through the Urban Credit Cooperative Society (UCCS) require a greater scrutiny and appraisal. However, our earlier review suggests that there are many large and viable UCCSs in operation. The bulk loan may be routed either through the DCCB, to be onlent to the UCCS. The role of DCCB needs to be considered only in case where no NGO linked federation structure is already available. The activities related to technical assistance, market information, etc. are crucial for the UCCS to service large volume of loans.

Single-tiered Intermediation:

iv. NGO linked CFI model: In this model, the NGO linked CFI assumes far greater responsibility. The CFI in this case may be a primary Credit Co-operative Society, cooperative bank or registered under any other relevant Act. The legal basis is, however, essential, as described below. The HFI bulk loan will be given directly to this CFI, with the NGO only facilitating the liaison. NGO will, however, be involved in the loan recovery process indirectly by the deployment of its staff, as has been happening for the SEWA bank and BCC linked CSLA. In order for the CFI to shoulder all the envisaged activities, it must operate at an adequate scale. It is likely that access to funds for housing finance can itself aid in this process.

The different institutional responsibilities for different activities in the four models are highlighted in Figure 3.1.

ii. **NGO Facilitation:**

The second form of the linkage is the facilitation of direct lending by HFIs. This arrangement is similar to the one that some of the HFIs like HDFC, LICHFL, Griha Vitta and GRUH have been using to some extent. In this linkage, the loan agreement is directly between the HFI and the individual borrower, though the process is facilitated by the NGO or the credit cooperative society. The latter may help in loan origination and also actually service the loan on behalf of the HFI, at a fee. The credit terms and underwriting criteria suggested in Table 3.5 will also be applicable here. The basic aim of this linkage would be to encourage the HFI to develop a working knowledge of lending to these groups more directly, though its costs may be kept under a check by using the NGO-cooperative structures for loan servicing. Direct payroll deductions for employment based Credit Cooperative Societies are also possible. In other cases, a risk fund to cover the delinquency risk may also be required.

3.4 FINANCIAL GUIDELINES:

The emphasis in the HFI-CFI linkages for bulk loans for housing finance is on developing the basic financial principles for giving bulk credit to the community based financial institutions. So that the risks are minimized and more appropriately shared. This will make it possible to replicate this arrangement on a larger scale in the future.

i. Purpose of loan, Credit terms and Underwriting: A major change in the general outlook in the housing finance industry will have to be made in terms of the different purposes for which loans may be given. These should include, besides the house construction or purchase, purchase of land plot, house repairs, house upgradation/ additions, addition of sanitation facilities and community infrastructure. While most HFIs are not likely to have the experience of community infrastructure projects, this is an important demand from the low income groups in urban areas. Further, many studies have shown that provision or improvements in community

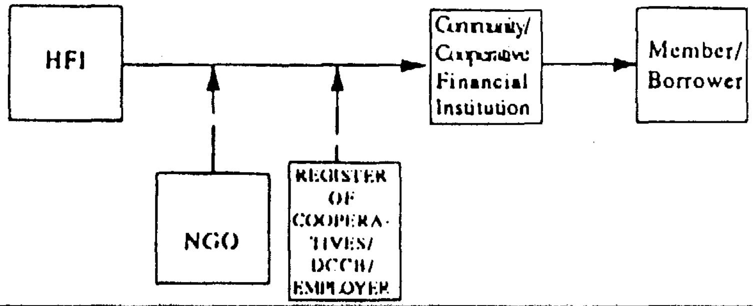
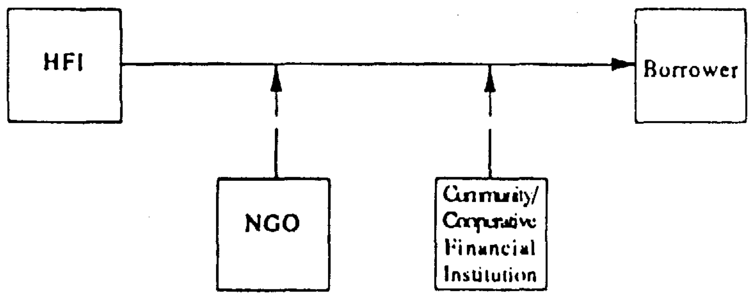
Figure 3.1

HFI-CFI LINKAGES FOR HOUSING FINANCE

TYPE OF LINKAGE	ORGANIZATIONAL LINKAGES	INSTITUTIONAL RESPONSIBILITIES
A. BULK LOANS/ LINE OF CREDIT Loan purposes include home construction/purchase, purchase of land, plot, home upgradation/extention individual and/or community infrastructure. **a. Multi-tiered Intermediation** i. NGO-Federation- Thrift and Credit Group Model	NGO HFI → Federation/ Regional Association → Thrift & Credit Group → Member/ Borrower	HFI — Providing bulk credit — Defining credit and underwriting terms — Providing financial management assistance Federation — Appraise and monitor TCGs for bulk credit — Mobilize DRF — Technical support — Market information Thrift and Credit Group — Loan origination and servicing
ii. Employer-ECCS Model	HFI → Employer → ECCS → Member/ Borrower Registrar of Cooperatives/ DCCB	HFI — Providing bulk credit — Defining credit and underwriting terms Employer — Ensuring payroll deductions ECCS — Loan origination and servicing Registrar/ DCCB — Assist in identifying ECCS
iii DCCB-UCCS Model	HFI → DCCB → UCCS → Member/ Borrower Registrar of Cooperatives/ DCCB	HFI — Providing bulk credit — Defining credit and underwriting terms. DCCB — Appraise and monitor TCGs for bulk credit — Mobilize DRF — Technical support and market information. UCCS — Loan origination and servicing

Figure 3.1 (cont'd)

HFI-CFI LINKAGES FOR HOUSING FINANCE

TYPE OF LINKAGE	ORGANIZATIONAL LINKAGES	INSTITUTIONAL RESPONSIBILITIES
b. Single-tiered Intermediation iv. NGO linked CFI Model		HFI — Providing bulk credit — Defining credit and underwriting terms NGO / REGISTRAR/ DCCB/ EMPLOYER — Facilitate appraisal of CFI, generation of DRF and loan servicing — Technical assistance and market information CFI — Loan origination and servicing
B. NGO FACILITATION Loan purposes include home construction/purchase, Major house upgradation/ extension v. NGO Facilitated housing loans		HFI — Loan origination and servicing NGO/CFI — Facilitate loan origination — Loan servicing

HFI — Housing Finance Institution
DRF — Delinquency Risk Fund
NGO — Non-governmental Organization
ECCS — Employees' credit cooperative society
UCCS — Urban credit corporative society
TCG — Thrift and credit group
CFI — Community/cooperative financial institution

infrastructure will help augment demand for housing finance considerably. Annex 1 gives the details of the community infrastructure loans.

Table 3.4
Financial Guidelines For HFI-CFI Linkages

1. Purpose of loan, credit terms and underwriting as per Table 3.5.

2. Delinquency risk fund as per Tables 3.6 and A.1.
   Group insurance to cover housing loans in the event of death - Rs 7-9 per annum per Rs 1000 of outstanding loan.

3. Necessary spreads to cover costs.

4. Legal form for the community finance institutions - to permit borrowing of bulk credit.

5. Plan of operations for the bulk credit to be submitted by the community finance institutions (CFI).

6. Limits on bulk credit (overall debt equity ratio of around 10 for CFI).

SUPPORT SYSTEMS

1. Technical support.

2. Market information.

3. Accounting, auditing and monitoring for the use of loans.

Table 3.5 illustrates the suggested credit terms and underwriting criteria which maybe linked to the loans for different purposes. For large loans beyond, the amounts generally handled by these CFIs, mortgage security may be essential. However, for smaller loans, group guarantee or peer pressures may be sufficient. In specific cases, where mortgage is not possible, flexibility in accepting lease papers or other documents suggesting defect security of tenure, should be accepted.

ii. Delinquency Risk Fund : To cover the risk of delinquency, a Delinquency Risk Fund (DRF) should be required in proportion of the bulk loan from the lending agency (HFI). The DRF is essentially a deposit kept with the lending agency to cover the delinquency risk. It earns interest at the standard deposit rate and would be owned by the CFI. The balance, if any, would be paid back to the borrowing CFI at the end of the repayment of the loan under the bulk credit.

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Table 3.5
Suggestive Credit and Underwriting Terms of Different Loan Purposes For Outlending by CFIs

Loan purpose	Loan amounts (Rupees)	Repayment period (Years)	Security	Maximum Instalment to Income Ratio (%)	Minimum Period of Regular Savings	
					Loan amount (Rs)	Years
House construction purchase	Maximum to 60,000	5 to 15 years	- For loans above 20,000, mortgage - For loans less than 20,000, two known guarantors or gold or LIC policy	25.0	Uptill 20,000 Above 20,000	1 2
Purchase of land plot	Maximum 30,000	5 to 8 years	- Mortgage - Lease papers from public authorities	15.0	Uptill 20,000 Above 20,000	1 2
House upgradation/ repair (including toilets, and other water-sanitation facilities)	25,00 to 20,000	Upto 5 years	- Two known guarantors or gold	10.0 (Total housing expenditure to not exceed 35% of income)	-	1

Table 3.5 contd. : Suggestive Credit and Underwriting Terms of Different Loan Purposes For Outlending by CFIs

Loan purpose	Loan amounts (Rupees)	Repayment period (Years)	Security	Maximum Instalment to Income Ratio (%)	Minimum Period of Regular Savings	
					Loan Amount	Years
House extensions	2,500 to 60,000	2 to 15 years	- For loans above 20,000, mortgage - For loans less than 20,000, two known guarantors or gold or LIC policy	25.0 (Total housing expenditure to not exceed 35% of income)	Uptill 20,000 Above 20,000	1 2
Community infrastructure	Uptill 5,000 for household covered	2 to 8 years	- Mortgage of land or - Compensating block balance - size (5 to 30%) linked to availability of approval of public agency	10.0 (Total housing expenditure to not exceed 35% of income)	-	1

While the CFI will not be able to have access to this account till the loan is fully repaid, the HFI may draw against the DRF, if the CFI fails to make a regularly scheduled loan payment or makes only a partial payment.

The size of the DRF should be linked to the assessed recovery performance of the CFI, and may range from 1 to 15 percent, as illustrated in Table 3.6. The details of the method used for determining the size of DRF, as a percent of the bulk credit, are given in Table A.1. This linking of DRF with the repayment record of the CFI can act as an incentive to improve the cost recovery performance of the CFI.

Savings for Housing: In order to meet the DRF requirements, the CFIs maybe encouraged to start a Savings scheme for housing. Some of the NGOs, notably, SPARC has operated such a savings scheme with considerable success. Similarly, BCC has, very recently, introduced a savings scheme for receiving group finance for community infrastructure. Studies of low income housing suggest that there are considerable unanticipated delays linked to external factors like permissions, linkages for services, etc. The savings pool can help provide bridge loans to meet such contingencies.

Table 3.6
Delinquency Risk Fund Requirements (as a % of total loan)

Rate of Interest on Bulk Credit to be Repaid in 12 Years	Recovery Rate (Recovery as a % of Total Recoverable/Demand at any given Month)			
	95%	85%	75%	60%
12%	0.8	2.7	5.1	9.8
15%	0.9	3.1	5.8	11.2
18%	1.1	3.5	6.6	12.7
20%	1.2	3.8	7.1	13.7

Note: See Table A.1 for details of the methods used.

iii. **Necessary Spreads:** The spreads necessary on such bulk credit arrangement should ideally cover both establishment costs and the credit risk. While the actual data on bad debt has not been available for most CFIs, the estimate from BCC-CSLA and discussions with several CFIs suggest that it is not very high. The risk of delayed payments will be covered by DRF as discussed above.

The question of establishment costs may be linked to the scale of operations. While detailed estimates for the scale effects are not available, the FTCA provides an example for sharing services at different level. As contemplated for the FTCA, it is essential to plan for the establishment costs at each level to be met with the surplus from the financial services/operations at that level. In fact, the FTCA and RATCs under it, suggest that the routing of housing finance through these CFIs can itself contribute to the improvements in their cost coverage ratios.

For example, for the Hyderabad RATC, to meet the shortfalls in current cost coverage, as well as the additional establishment costs attributable for housing loans, would probably require total loan volume of 5 million rupees a year with a 1.0 percent spread. It is likely that the RATC may require at least 2 to 3 years to reach such a target. However, in the interim period, the establishment costs can be supported by a grant with a clear mandate to cover the costs from financial operations beyond this period. Thus, as a principle, while in the long run, the spreads should cover these costs, in the initial period, it is necessary to support the system development through grants. The costs will reduce in the future with increased scale of operations and can be absorbed by the financing arrangement without any subsidies.

A different aspect of the permissible spreads relates to the general lending rates adopted by the CFI. Some of these have been lending at high interest rates of 18 to 24 percent. Ideally, they should be permitted to charge these rates with an explicit proviso that a part of the profits will be kept as a special reserve which can be used for DRF requirements for the future loans or be used for the necessary technical support services. (and its records) in the future. Over time, the DRF requirement can be linked directly to the repayment performance for the bulk credit itself.

iv. Legal Form of the Community Financial Institution: An appropriate legal status for the community financial institution (CFI) to be able to receive the bulk credit is essential. Our review of NGOs suggest a variety of legal forms ranging from simple registration under the Societies Act, or as a primary credit cooperative society or even as a primary urban cooperative bank. The legal form should permit receipt of bulk credit for housing related activities.

It must be emphasized that while almost all the NGOs reviewed are registered under some appropriate Act, many of the CFIs linked to the NGOs have not been registered so far. For example, the savings and credit groups with SPARC, Sharan, Deepalaya, etc. Despite this HDFC, for its KfW funds, has lent to the NGO in such cases. HUDCO under its new scheme of financing NGOs also plans to do this. However, it is useful to insist on registration of a CFI or a membership of some federation. This would facilitate rating of CFI through annual audits of cooperative departments. Such ratings would help route the Bulk loans to the CFIs from the intermediaries.

v. Plan of Operations for the Bulk Credit: The CFI wishing to receive bulk credit in this arrangement need to develop a Plan of Operations for one to three years. Such a plan needs to cover the different loan purposes for which the bulk credit for housing finance is sought, the general socio-economic and housing profiles of the borrower groups and the prevailing housing costs. The selection of actual borrowers and loan amounts within the permissible underwriting

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criteria should, however, be left to CFI.

vi. Limits on Bulk Credit: The total volume of bulk credit can be controlled by keeping a limit on the bulk credit to equity ratio. In instances when the CFI can pass on mortgage assets to the HFI, the outstanding loans on this need not be included in this ratio. The overall debt equity ratio for the CFI should be around 10.0.

3.5 SUPPORT SYSTEMS:

The linkage of HFIs and NGO can succeed only through a supportive mechanism. The support system described below need to be evolved by national level agencies like the National Housing Bank in the initial period. Subsequently the HFIs or regional associations should take up these tasks.

i. Technical Support: In the housing sector a variety of support activities related to technical inputs for construction have received attention. Our review of NGO experience also suggests the need to have such supports for them to venture into housing related activities. In fact, most of the NGOs, who have been engaged in housing related activities have had such support, through either in house technical expertise or linkages with other agencies. A lack of such support has often limited their scope in such activities, (e.g. Sharan). Such support would help the borrowers to evolve better and more cost effective solutions. It will also help the agency to better assess the repairs, upgradation and construction costs.

The need for technical support is very essential for developing projects for community infrastructure provision and upgradation also.

ii. Market Information: Besides the technical inputs, another totally neglected area is market information for these groups regarding available housing options and the related prices. A property information service would help to overcome this to a great extent. It would also enable the NGO or the cooperative to develop a better understanding of the housing costs. Such a system maybe supported initially through a grant, but must operate through a fee structure which will make it self supporting over time.

Such support systems covering both the technical inputs and the market information should be developed to assist the borrowers to use the loans more effectively.

iii. Accounting, Auditing and Monitoring for the Use of Loans: The review of the NGO linked financial arrangements suggest the need for introducing better accounting procedures for the CFIs. In the cooperatives such practices are quite common, with a regular annual auditing. The FTCA and RATCs also provide such services and training for these to the member thrift and credit societies. The costs of these services also need to be accounted for properly and support services for these need to developed. In specific pilot projects, the emphasis on development of these systems must receive priority. Proper reporting systems are essential to improve financial management. The system, however, need to be simple and easily understandable by the staff of the community based financial institutions.

The CFIs are often weak in offering different innovative lending instruments to their members. However, they have attempted to keep flexibility in lending arrangements. Many of the CFIs do not use the concept of EMI in their lending operations. It would be particularly useful to develop the necessary illustrations of EMI and or repayment schedules for different financing terms, in simple tabular formats. This should be used as ready references by the CFIs.

The main responsibility to monitor the use of loan for housing related purposes will need to rest with the borrowing CFI. However, it is likely that lending for housing is new for the CFI, or has not been monitored in the past. It would be necessary to assist the CFIs to evolve cost effective monitoring mechanisms. Ideally, the monitoring should be integrated with the support services discussed above.

3.6 TOWARD PILOT PROJECTS

While the downmarketing strategy envisages expansion of the housing finance system to lower income groups on a widespread basis, the process may be initiated through selected pilot projects. The pilot projects need to be selected carefully to represent different models discussed above and aim for replicability. They will also need specific support systems as discussed above.

Institutional Roles:

While the design of the pilot projects will imply benefits both for the HFIs and CFIs, it is likely that the process needs to be facilitated, both by creating opportunities for interaction amongst the potential partners and by providing the necessary inducements by a careful use of subsidies for insurance cover, risk fund and support systems related to technical assistance, developing market information and training in financial management for the community based financial institutions. This support, through the necessary subsidies will need to come from the National Housing Bank or the USAID.

Potential Agencies to Participate in Pilot Projects:

For the models identified earlier, it is possible to suggest some of the potential agencies. For the bulk loan arrangement, two NGO linked models have been suggested. For the first, multi-tiered intermediation, FTCA or source of its regional associations already have the appropriate structure in place. Other NGOs like SPARC and Sharan also have nascent arrangements aimed at similar models. On the other hand Vikas, in Ahmedabad has also developed a similar proposal but lacks the grass roots base as yet. An NGO like AVAS has considerable strengths on the housing front and needs to be supported to develop financial systems. For the second model with single-tiered intermediation, there are two NGO linked financial institutions, namely the SEWA BANK and the Community Savings and Loan Association of the BCC.

The different NGOs will, however, require considerable efforts to meet certain pre-requisites like legal registration, developing a plan of operations, mobilizing funds for DRF and most importantly compilation of essential financial reports. Such assistance would also be helpful in enabling the other smaller NGOs with nascent arrangements to become a part of the downmarketing strategy.

Similarly, the HFIs will also need to make considerable adoptions in their lending procedures. Specifically, they will have to extend the concept of bulk lending to CFIs. Most HFIs at present use this concept for lending to the corporate sector in any case. Secondly, they will also have to design new lending instruments (especially for non-mortgage lending) and evolve suitable financial guidelines for these linkages.

For identifying the specific cooperative institutions without the NGO linkages, it will be necessary to work in liaison with the Federations of Cooperative institutions as well as the state and district level Registrar of Cooperatives and State and District Central Cooperative Banks.

CONCLUSION:

The growth of housing finance system in India in recent years has not been accompanied by significant downmarketing. The downmarketing strategy as outlined above is cast in a pareto optimal mould, as the benefits accrue to both the sides; the HFIs developing a commercially viable expansion of their markets and the low and moderate income households gaining access to housing finance which has largely illuded them so far. An additional benefit in this process will also be a further strengthening of the different forms of Community Finance Systems in the country and their integration with the general financial systems in the country in the coming years. These efforts, however, require careful design, the will to innovate and improve from 'learning by doing' and above all the readiness to respond to the constraints of the partners in a positive manner in these partnership experiments.

ANNEXE 1

PROJECT LOANS FOR COMMUNITY INFRASTRUCTURE

Many of the settlements inhabited by the low and moderate income households suffer from severe infrastructural deficiencies. However, financing improvements in the community level infrastructure poses at least three problems. First, in many cases, the land titles are not clear. Thus, though there maybe implicit security of tenure, formal legal tenure may not be possible. Often, the public authorities allow the settlement to exist, but authorization can take a long time as it is linked to political influences and would imply financial commitments to provide basic amenities through subsidies. Secondly, as a concomitant of this process, the households/communities from these settlements expect to receive subsidies at some stage and therefore, would prefer to wait for these. Even when there is an ability to pay for these services through loan finance, this is not availed of or it is difficult to access this finance due to the land tenure problems. Thirdly, the finance for this purpose would require to be made on a community/group basis as the investments have to be made on a joint basis also. The second envisaged financial linkage of a Project loan for community infrastructure attempts to overcome some of these problems.

Essentially two forms of organizational linkages are envisaged. In the first case, the involvement of the public agency is included in case the freehold tenure is not available. The advantage in this would also be that the community can pool the resources from the subsidies of the public agency with the loan resources and it becomes possible to finance without freehold tenure. In the second model, the arrangement maybe directly with a CFI. In this arrangement, the loans maybe given for the settlements without the tenure also. However, in this case, the size of the DRF will be higher to cover at least a part of the bad debt risk also.

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Table A.1
Delinquency Risk Fund - Approach to Measures

Total loan Amount (Rs) (L)	100,000
Rate of Interest (%) (I)	20
Repayment Period (R)	12
Recovery Rate (% to demand) (RR)	60

Year (t)	Required annual debt servicing (ADS)	Total Demand (D)	Actual Collection (C)	Shortfall to be met from DRF (SH)
1	22039	22039	13224	8816
2	22039	30855	18513	3526
3	22039	34381	20629	1411
4	22039	35792	21475	564
5	22039	36356	21814	226
6	22039	36582	21949	90
7	22039	36672	22003	36
8	22039	36708	22025	14
9	22039	36723	22034	6
10	22039	36728	22037	2
11	22039	36731	22038	1
12	22039	36732	22039	0
		Present value of shortfall to be met from DRF at discount rate (12 %)		13713
		DRF as % of loan		13.7

1. Required Annual Debt Servicing (ADS) = L
2. Total Demand (D_t) = $ADS_t + SH_{t-1}$
3. Annual Collections (C_t) = $D_t * RR / 100$
4. Shortfall in Collections (SH_t) = $D_t - C_t$

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ANNEXE 2

EXPLANATIONS FOR TERMS IN THE REPORT

Non Governmental organization (NGO) :

A generally registered legal entity which is set up on the principle of non profit and/or cooperation amongst its members to carry out developmental activities in either low income communities or for promoting and supporting the other such agencies or CFIs. Most NGOs are registered under an appropriate Act like the Cooperatives Act, Societies registration Act, Public Charitable Trusts Act or Section 25 under the Companies Act. Most NGOs also receive grants from national or international agencies or the government for carrying out their activities.

Community Finance Institution (CFI) :

A registered or unregistered agency primarily dealing with savings and credit activities with direct participation and control by a 'community' which maybe based in a neighbourhood or a collection of individuals at the place of work or based on a certain characteristic like occupation or common geographic origin. The CFI may be developed by the community itself or be promoted through the efforts of an NGO or governmental agency.

The CFI may be either a primary institution with members coming directly from the community or an apex institution which offers financial services to the member primary CFIs. The CFI can also mobilize external resources as permitted by its legal form.

Some of the CFIs arenot registered and continue to operate on an informal understanding amongst the members, though even these generally have a fairly systematic though flexible set of procedures. The others which are registered are generally under an appropriate Act like the Societies Registration Act, Cooperative Act (as a primary non agriculture society or a primary cooperative bank) or as a non profit development corporation under section 25 of the Companies Act.

Primary Non-Agricultural Society (PNAS) :

Within the cooperative structure in the country, there are two primary cooperative financial institutions which operate in the urban areas, the primary cooperative banks and the primary non-agricultural cooperative credit societies (PNASs). As a large proportion of these institutions are in the urban areas, they are also referred to as Urban Credit Cooperative Societies (UCCSs). There are basically two types of credit societies, namely the Employees' (or Salary Earners') Credit Cooperative Societies (ECCSs) and the other Urban Credit Cooperative societies (UCCSs). The ECCSs are organized at the place of work and enable payroll deductions. The UCCSs are organized by a group of individuals coming together on the basis of place of residence, geographic origin or caste. Both of these are controlled/regulated under the respective State Cooperative Acts. They are regularly audited by the Registrar of Cooperatives.

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Urban Cooperative Banks :

Urban Cooperative Banks are also organized under the State Cooperative Acts. They are, however, also controlled/regulated by the Reserve Bank of India. Many of the PNASs graduate to become a UCB. They essentially operate as a Savings bank. They play a significant role in financing the household and the small enterprises sector. They also offer many banking services. They are regularly audited by the Registrar of Cooperatives.

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COMMUNITY DEVELOPMENT BANKING

Techniques and Practices of Community Development Financial Institutions

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TABLE OF CONTENTS

Over time, the common thread discovered among these emerging organizations was the critical role of credit in the health of a local economy. When credit is not available for everyday investment and reinvestment, the local economy begins to deteriorate. Housing and commercial buildings deteriorate and new structures are not built to replace old ones. Small businesses are not able to start up or expand to meet local demands and employ the local labor force. The opportunity for local ownership of land, housing and small businesses becomes harder to come by, creating a lack of cycle of disinvestment, discouragement and disinterest in the community.

However when credit is available, it serves as a catalyst for renewal in the community. The extension of credit by a financial institution is a statement of confidence in the stability of the economy. The visible signs of the availability of credit, in the construction and renovation of the built environment, become symbols of the health of the community. Credit also creates a multiplier of economic impacts leading to the creation of more jobs, more income and more investment. For these reasons, many NGOs have turned to the provision of credit as a major tool for community development.

COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS

Today there are a wide variety of CDFIs whose primary mission to provide credit to promote community and economic development. They offer credit for housing for low-income families, job creation, the development of small businesses and for general revitalization of economic distressed communities. In addition, many offer other ancillary services that enhance their ability to address a broad range of community development needs. This paper will describe the work of CDFIs in the United States in general, and specifically reference one of the leading U.S. models - the Center for Community Self-Help.

Definition of Community Development Financial Institutions

CDFIs have been able to find gaps in the credit markets, lending to niches in which a specialized knowledge of local conditions and cultural differences make it possible to have an advantage over larger conventional financial institutions. Some CDFIs have a very defined focus on one type of loan program, while others have a broad economic development mission with a variety of products and services. However, these diverse institutions share several common characteristics which serve to define the CDFI sector:

- Their **primary mission** is to create new economic opportunity for communities, businesses and individuals who do not have access to the mainstream economy and are experiencing some degree of economic distress.

- Their **primary means to achieve this mission** is the provision of credit for housing and business needs. They lend to communities, businesses and individuals that are not served by conventional financial institutions.

- They are **private institutions**, often not-for-profit NGOs, but are not public agencies. They derive their financial support chiefly from the provision of financial services but supplement this income from a diverse base of community, foundation and governmental sources.

- They often **provide more than credit** in order to make their lending activities successful. Ancillary services include training, technical assistance, housing development and construction, real estate development, and credit and home ownership counseling.

- They are **successful lenders**, managing to lend to borrowers whom conventional lenders shun, and they achieve a high degree of repayment. Loan losses remain at, or slightly above, rates in conventional banks, despite the difficult circumstances in which they lend. Unsuccessful CDFIs generally do not remain in operation for long.

- Either through demonstration or involvement in policy making, they **advocate for change** in the behavior of the conventional financial industry and government to better serve the credit needs of their markets.

Types of Community Development Financial Institutions

CDFIs take many forms because they have grown organically out of a variety of anti-poverty and economic development programs. In the United States the various forms can be classified as follows:

Micro-enterprise Funds: These organizations provide small amounts of credit to self-employed individuals to start or expand very small (hence the name micro) businesses. These Funds are most often components of micro-enterprise development programs that integrate both economic and human development strategies. They are designed to fight poverty, increase income, raise self-esteem, develop personal and technical skills, create role models and increase personal savings. The enterprises served by these loans are often in the informal sector, and sometimes provide supplemental income for families. More formal businesses may employ as many as 5-10 employees, but these firms usually outgrow the programs because their credit needs exceed the amount available from the programs. Loan funds are generally obtained from government or private charitable sources. Micro-enterprise funds were pioneered by groups such as the Grameen Bank in Bangladesh and Accion in Latin America, and have spread to virtually every continent.

Community Development Loan Funds: These are non-regulated financial intermediaries that aggregate funds from individuals and institutions that are willing to support the loan funds with below-market rates of return. The Funds re-lend these monies primarily to non-profit housing and business developers in low-income rural and urban communities. These Funds are often created by other NGOs. They may be spun-off into separate entities or integrated into the NGO organization. They have been leaders in financing land trusts, cooperative housing projects and other innovative forms of low-income housing.

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Community Development Credit Unions: Cooperative and mutual savings and loan organizations are one of the oldest models of development finance systems. Community Development Credit Unions (CDCUs) are owned by and operated for low-income persons and typically provide consumer banking services not available within their communities. Until recently most CDCUs limited their activity to consumer banking services. Now a growing number of CDCUs are targeting their lending to community development projects. These credit unions are making home mortgages, home repair loans, micro-enterprise loans and general business loans. Unlike Community Development Loan Funds or Micro-enterprise Funds, these credit unions rely primarily on member savings as a source of funds for lending.

Community Development Banks: These are regulated banking institutions organized specifically for community development purposes. They are composed of a regulated banking institution (such as a bank, credit union or thrift) linked through a parent company to one or more affiliates (usually organized as NGOs) that undertake related development services. These affiliates include real estate development companies, venture capital funds, development loan funds, and technical assistance agencies. By combining a variety of development organizations and programs within one banking institution, they are able to provide a wide range of services and be considerably more pro-active in their development activities. These comprehensive banks use funds from savings deposits as well as bulk loans from the private and public sectors.

Information about the industry is scare because there has been no effort to study CDFIs as a worldwide industry. In the United States, it is estimated that there are more than 300 CDFIs managing more than $1 billion in investments and savings deposits for community development lending.

ORGANIZATIONAL STRUCTURE

CDFIs have a variety of organizational structures due to their different historic roots, yet management and staff requirements are remarkably similar for the different forms of

CDFIs. Since Community Development Banks are the most complex of the CDFIs structurally and offer the greatest breadth of service for a community, the discussion of corporate structure will be limited to these institutions.

Corporate Structure

Community Development Banks (CDBs) are constructed of several affiliated corporations, including a parent corporation, a regulated financial institution, and one or more affiliated corporations with special development functions. There are two models of this structure in the U.S. :

- A for-profit model based on a bank holding company and affiliated bank, exemplified by Shorebank Corporation and its South Shore Bank in Chicago; and

- A non-profit model featuring a non-profit parent corporation affiliated with a credit union exemplified by the Center for Community Self-Help and its Self-Help Credit Union serving the state of North Carolina.

These CDBs share the features of a CDFI, as described earlier. The only major distinction in these models is the use of a bank or credit union as the lead financial institution, which has some ramifications for raising capital and governance as described below.

In each of these models the parent corporation is the overall manager of the group of affiliated corporations. It controls the direction and programs of each affiliate through ownership, designation of board of directors, and appointment of management. Day-to-day management is generally carried out autonomously within each affiliate, and parental control is exercised though establishment of overall mission, purpose, and objectives. Ownership of a bank holding company is held by private stockholders, most of whom invest stock recognizing that their returns will be lower than comparable returns at other banks. Capital is raised from foundations, wealthy individuals, local banks and corporations that invest in these bank holding companies. The holding company controls all, or a majority of, stock in its affiliates, thereby controlling appointment of directors.

Non-profit parent corporations have no stockholders. They are public trusts with boards of directors selected because of their interest in supporting the mission of the CDB. These non-profit parent corporations will have some implicit and explicit control over their affiliate credit union, through identification of the credit union's membership base and by appointment of a large block of directors. The same sources are tapped to build the capital base of the non-profit parent, but instead of investing in stock they make grants and long-term loans.

In a *community development bank (CDB)*, the regulated financial institution is the largest entity and carries out the majority of activity in a CDB. It is also the public face of a CDB, since it is the main contact most customers will have with a CDB. The elegance of the CDB model is its ability to use ordinary depository capital and convert it into development credit. Regulated banks and credit unions are viewed as relatively safe places to save money because of the close oversight of their operations by the government and deposit insurance. Regulatory agencies have just begin to understand the unique mission of these CDBs and the financial support offered by their affiliates. CDBs do not get special treatment from regulators on safety and soundness issues, and often receive a more thorough review of loan documents, financial statements and management practices. However, US regulatory agencies have increasingly learned that community development lending is not necessarily more risky if done carefully.

Subsidiaries of the parent corporation carry out other development services such as employment training, real estate development, technical assistance and specialized development lending. These are either for-profit or non-profit corporations, entirely owned or controlled by the parent. It is often the case that these affiliates carry out the programs

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most effective in addressing community development needs, because they are more able to attract low-cost, subsidized funds and are not subject to regulatory limitations. On the other hand the scale of the subsidiaries' impact is much less than the bank's or credit union's because the subsidiaries are smaller in size than depository institutions.

Management and Staffing

Senior CDFI management are in general exceptionally strong in leadership, technical competency and overall management skills. They come from a variety of professional backgrounds, but most of them have extensive management experience in a related community development activity. The CDBs, particularly the banks, also generally require management with experience in a regulated financial institution because of the complexity of the regulatory environment.

Senior management in CDFIs are highly motivated by the mission of their organizations. Common to the most successful CDFIs is the degree of innovation, independent thinking and pugnacity embodied in senior management. This is a field in which these qualities are absolutely necessary. Nearly every major CDFI has been told by banking and finance experts that their products, programs and institutions are not feasible. Conventional wisdom indicates that if there were a market for loans to low-income communities, banks would be making them. Government agencies and foundations are often skeptical of the abilities and proposed programs of CDFIs. Management must be assertive, learn from industry practices and their experience, and react quickly to opportunities. Consequently, it is no surprise that CDFIs do not follow five-year business plans very closely, but rather react to opportunities for funding and lending that can arise without notice or planning. Senior management are paid less than their counterparts in conventional banking because CDFIs are under more pressure to reduce operating costs. Lower salaries are also a reflection of the organization's dedication to a mission of economic justice.

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Middle level management and support staff are also attracted to these institutions because of their mission, though they are paid salaries more comparable to those of similar positions in other banks and credit unions. Technical skills are often learned through internal training, although the large CDBs also take advantage of traditional banking training in areas such as loan servicing, loan origination, accounting and deposit management.

Scale of Operations

A major factor contributing to CDBs' viability and success is the size of their operations. Banking is an industry that has significant economies of scale, particularly in the "back room" operations: loan servicing, deposit administration and loan origination. CDBs that have large loan portfolios are able to reduce the cost of administration considerably. Automation of these functions is more possible in larger institutions, which also reduces administration. In addition, they can afford to pay more for senior management because the cost of management can be spread over a larger revenue base.

Scale also contributes to the CDB's ability to address community needs and be an effective advocate for changes in government policy. The CDBs' variety of services, from lending, to real estate development, to technical assistance and training, give them more developmental tools than other community development financial institutions with which to solve local problems. They are able to combine, for example, home ownership counseling, mortgages, housing construction and small business finance to redevelop a specific community. Large-scale CDBs are more able than other CDFIs to help other NGOs develop their capacity to carry out development programs, and have a more credible voice in policy deliberations at the state and national levels.

THE GREAT BALANCING ACT: MISSION VS. MONEY

By their very nature, CDFIs operate in an arena that requires a careful balance between developmental goals (e.g. the creation of jobs and affordable housing) and financial goals (e.g. profitability and preservation of assets). Failure to achieve either goal is usually cause for the collapse of the organization.

A CDFI must be successful in achieving its overall mission: to create housing or jobs. If the CDFI is not able to show tangible results it will lose credibility with its customers, its depositors, and its funders. Ultimately, it may become irrelevant and ineffective. On the other hand, a CDFI may be extremely productive in achieving its mission, but if its loan portfolio performs too poorly to provide the income necessary to sustain operations, the organization will collapse.

The CDFI must carefully balance these two goals with each loan it makes and each new program it undertakes. Often, but not always, there is a direct trade-off between these goals: a project to house the homeless may present an unmanageable risk for a lender, while a home mortgage program for close-to-median-income families will provide a stable source of income for the CDFI. No one gains when a CDFI goes bankrupt, so it is crucial for these institutions to learn to accurately assess and manage the risk inherently associated with community development projects.

The remainder of this paper will discuss the management techniques which many of the more successful CDFIs have employed to achieve this delicate balance between mission and money. None of these techniques are foolproof; there has not been enough experience in the industry to document unqualified success. Nor is there agreement about each of the methods described below. However they have been tested, modified and re-tested in the field by CDFIs which have successfully maintained the delicate balance of developmental and financial objectives.

FINANCIAL MANAGEMENT

There is no doubt that the provision of development credit is a costly undertaking. No matter how efficient and productive a CDFI is, there will always be extra costs that a conventional financial institution will not have to bear. Compared to a bank, CDFIs take on additional risk, make smaller loans, lend in remote or difficult-to-serve areas, provide technical assistance, have higher delinquencies or default rates, are constantly developing and adding new programs and products, and are not able to achieve the economies of scale of banks. Each of these factors adds cost to the operation of a CDFI. Consequently, CDFIs must be even smarter than conventional financial institutions in their financial management in order to ~~operate~~ succeed.

Unlike other NGOs, **CDFIs make money from their development activities.** If CDFIs are managed wisely, interest derived from loans can support much of their operating costs. A common practice is to cover loan-related expense with interest revenue and allocate any available subsidies to technical assistance, development of new programs, and advocacy work. The fact that CDFIs earn their income from their loans makes them unusual among NGOs, and gives them a built-in incentive to be effective: their lending must be successful for the organization to survive. Some commonly used financial management "rules of thumb" are described in this section.

Improve Access to Credit, Don't Subsidize the Cost of Credit

Historically, governmental and private development programs have subsidized the interest rates of loans made to community development projects. Policy makers and elected officials quite naturally believe that if a program is targeting low-income people it should make interest rates more affordable. Yet many of the most effective community development financial institutions charge interest rates that are at or above the rate charged in the market. The major reason CDFIs are able to charge a "market" rate and still serve a low-income

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target population is because disadvantaged people need **access** to credit more than they need low-cost credit.

Indeed, in most economically distressed communities, conventional sources of credit are simply not available. In some cases, there are no banks or other traditional financial institutions nearby. Or, certain populations (such as minority groups or women) may be underserved by these institutions. In these cases, the **availability** of credit is the issue, not the interest rate. In some areas there may be money lenders offering loans at extremely high rates. In either situation, if a CDFI is providing loans at or slightly above banking rates, it is providing a real service to the community.

Looking at the interest rate issue from another angle, often an interest rate that is 5-10% lower does not make a great deal of difference to a borrower. For example, most small self-employed individuals borrowing short-term for their business can just as easily pay back a 15% loan as a 5% loan. In a one-year period, the difference between a 5% and a 15% rate for a $500 loan is only $2.30 per month. Clearly this amount of money will not determine the financial success of the business. What will make the difference to these borrowers is the fact that they have a reliable source of credit when they need it. In short, access to credit is the key requirement for a successful program. Also, by not offering a lower-than market interest rate, CDFIs discourage applicants who can qualify for a bank loan and are simply shopping for a better rate.

There are two other reasons that interest rates should not be subsidized. These affect the very survival of a development credit program. First, interest should be the major source of revenue for a CDFI. If a CDFI is to remain financially solvent, it must maximize their interest revenue. A 5% difference in interest rate on a portfolio of 5,000 loans can make the difference between a successful or a bankrupt CDFI.

Second, credit programs offered by CDFIs will remain small and marginal unless they can be done in a cost-effective manner. A low-interest loan program will simply require too much subsidy from some government or private source to ever be more than a small demonstration. In order for development credit programs to reach a scale necessary to address a nation's community development needs, they must use the limited amount of external subsidies judiciously.

Keep the Cost of Funds Low

The corollary of charging market interest rates is keeping the cost of funds to the CDFI as low as possible. Development credit is dependent on good sources of low-cost funds, whether they be bulk loans or savings deposits. Low-cost funds provide a broader interest spread between the interest earned on loans to borrowers and the interest paid to investors and depositors. This larger spread provides the CDFI an internal source of subsidy, since it generates more income on loans than banks can earn. CDFIs are usually able to earn 1%-5% more than banks on their loan portfolios.

Build Significant Net Worth in the Organization

Even better than low-cost funds, net worth (equity, permanent capital) offers CDFIs a permanent source of no-cost funds. Like an endowment, net worth provides a steady source of income protected from the frequent changes in interest rates paid on savings deposits or bulk loans. Internationally, banks maintain a ratio of net worth to assets of 8%. CDFIs, through a long-term strategy of seeking permanent capital, seek a ratio of 10%-20%. These funds are generally provided from foundation capital grants, government appropriations targeted for capital uses, other charitable sources, and retained earnings. Using government or foundation funds for capital purposes is somewhat uncommon among NGOs. This is an area in which a CDFI can effectively use external subsidies to support a development program (i.e., to make loans) and at the same time enhance the institution's long-term financial stability.

Match Assets and Liabilities

Like any financial institution, CDFIs must pay attention to maintaining a base of savings deposits, bulk loans and net worth to fund their loans. This is a common principle of banking, but one that is new to many NGOs that enter into the community development finance field. There are two features of liabilities and assets that must be matched. The most obvious is interest rate, as discussed earlier. CDFIs must insure that spread between asset yield (interest on loans) and cost of funds (interest paid on savings and bulk loans) remains constant. Thus if deposit rates adjust over time, the CDFI must take steps to insure that it can vary the interest on a loan to match deposit rate changes.

Adjustable interest rates are generally used by CDFIs that hold long-term loans, like mortgages. Rates are pegged to a fixed margin above a well-known index of cost of funds. For example, Self-Help Credit Union offers mortgages that adjust every year, every 3 years, or every 5 years, and use an index of US Treasury Bills with maturities of 1, 3 or 5 years respectively.. The rates are pegged at anywhere from 4% - 6% over the appropriate Treasury Bill rate depending on risk. Annual changes in interest rates are limited to a maximum of 2% to protect borrowers against severe changes. This method of pricing has allowed Self-Help Credit Union to almost entirely eliminate interest rate risk in its mortgage portfolio. Many borrowers, particularly self-employed borrowers, prefer these adjustable rate mortgages (ARMs) because they tend to have lower initial interest rates than fixed-rate mortgages. Self-Help Credit Union also offers a fixed-rate mortgage that is immediately sold to the secondary market upon origination. Due to standardized secondary market requirements, this product is not nearly as flexible in its underwriting and therefore is not as useful for serving the low-income market.

Perhaps more difficult is matching terms of assets and liabilities. Put simply, short term loans should be funded with liabilities with short terms, and loans with long term maturities should be matched with liabilities that don't have a short term payout. Of course, an institution's net worth has no maturity, thus is ultimately flexible when it comes to lending long- or short-term.

Maturity matching is especially difficult because the real maturity of a loan is often shorter than what is stated in the loan documents. On the other hand, there is often some degree of long-term stability in short-term liabilities. A good example is in home mortgage lending. Banks often fund 15-30 year mortgages with savings deposits, which by definition have a very short maturity (they can be withdrawn on demand or within a year or two). This apparent mismatch is able to continue for two reasons. A 20 year mortgage is almost never held to its full maturity. In the US, it is usually paid off in less than 10 years, because houses sell, people move, and other factors make mortgages pre-pay. In addition, banks have historically been able to maintain some deposit base for years on end. Thus even though specific deposits will be paid out frequently, new deposits are made to take their place. Because of the stability of a deposit base, banks are able to lend long-term against some percentage of their short-term deposits. Banks often will have between 10% to 40% of their deposits loaned in long-term mortgages.

In short, CDFIs should simply learn the tools banks use in their asset and liability management in order to maximize the use of their funds for their constituency. With careful asset/liability management, CDFIs can provide loans with terms much more favorable to the borrower, enabling them to reach lower-income families with their loan products.

IDENTIFICATION OF TARGET MARKETS

CDFIs have some ability to select the constituencies, geographic areas, and types of community development needs they choose to serve. Deliberate attention to these factors can permit the organization to increase or decrease its operating costs. It is important to recognize that **need** for development services does not always translate into a **market** for CDFI lending. Loan programs are limited in their ability to serve community development needs, because they do require repayment. There are many individuals and projects that are in desperate need of assistance, but could never repay a loan. Nonetheless, there are many market niches in which downmarketing can be an effective way of bringing credit to work for community development goals.

Focus On One Development Goal At A Time

Resisting the temptation to require each community development project to include a wide range of development impacts (hire low-income people, locate in distressed area, provide employment training, etc.) is difficult for many CDFIs. In general, the more developmental impact a project has, the more risk is associated with the loan. At some point the CDFI that attempts to "save the world" with each one of its loans will find an unacceptable amount of risk in its loan portfolio, and end up in financial ruin due to non-payment.

The CDFI which I help operate - the Center for Community Self-Help - learned this lesson the hard way. We first began lending to very small businesses, in an effort to provide jobs for poor people. We were intent on ensuring that each loan had a maximum development impact: the businesses we loaned to had to employ poor, unemployed people with low education levels, *and* be located in distressed rural areas. On top of that, these firms were owned and managed by these workers. These small businesses were the ideal embodiment of our organization's mission: to provide jobs and ownership opportunities for economically distressed individuals and communities. Unfortunately, each of these development goals made companies less able to compete with other firms in their market.

Needless to say, each of these firms went out of business within a year or two and defaulted on their loans. At that point, we realized that we would have to de-link our objectives, i.e., to be satisfied that only 1 or 2 objectives would be met with each loan. For example, we began making loans to low-income self-employed persons, but placed no other requirements on the business. We started a rural business loan program that focused on distressed rural areas. Loan programs for ethnic minorities and women were developed. In short, we addressed our targeted constituencies one at a time, rather than simultaneously. If we had not made this strategic change, our organization would not have survived another year.

Market Gaps and Developmental Needs

CDFIs give considerable attention to assessing and reassessing development needs and underserved credit markets. It is clear that a community **need** does not necessarily create a **market** for development loans, and that credit market gaps are not always located in low-income communities. (Corporate financial markets may be as frequently underserved as low-income housing markets.) Development lending only works where development needs and credit gaps exist simultaneously.

CDFIs use different means to identify potential markets for their credit. Most CDFIs start with some macro-economic analysis of regional credit markets. Much of this analysis is available from various university, corporate and government sources. To identify local demand, some groups use detailed studies of specific needs, drawn from secondary data sources and sometimes direct data collection through surveys. These can be very helpful in assessing the volume and nature of aggregate demand in specific markets, but fall short of precise market identification.

Once this material is digested, more targeted studies are sometimes commissioned. More often, the CDFI will use its own knowledge of its low-income borrowers to fashion a program that modifies conventional practices. Then, using trial and error, it modifies the practice, making it safe to offer it as a standard loan product. **Experience is the best informer of effective market demand.** Fortunately CDFIs can learn relatively quickly from their lending experience because payment histories are very good indicators of success. Through continuous monitoring, CDFIs can gauge whether they have found that place where need and market demand meet.

Develop Specialized Knowledge of Borrowers and Community

Conventional lenders often do not have the ability to learn the peculiarities of specific communities and therefore, treat all borrowers and communities as essentially the same. CDFIs, as community-based institutions, develop a much better knowledge of their low-income borrowers and the communities in which live. Better information about local real estate markets, economic conditions, employment patterns, and borrower behavior help ameliorate the perceived risk of community development lending. In addition, specialized knowledge of innovative development schemes (like low-cost house-building techniques, self-help housing efforts and land trusts) adds value to loan transactions, permitting CDFIs to participate in projects that banks shun.

Cross-Subsidizing Through Diversification of Lending Niches

Diversifying the loan portfolio is a standard banking practice that insures that management errors or other factors that negatively affect loan performance do not threaten the viability of the entire operation. Diversification can take many forms. Geographic diversification protects against local economic and political instability. Offering different types of loan products (e.g. home repair loans and mortgages) allows the institution to continue lending if families shift from buying homes to fixing up their existing houses. Sectoral diversification (i.e. lending to various industries) prevents an economic decline in a key lending sector from having a disastrous effect on the CDFI's portfolio performance.

Diversification can also be used to enhance the income of a CDFI, thereby providing additional income to support its more costly community development agenda. Many CDFIs have looked to a strategy of identification of profitable lending markets that are overlooked by conventional lenders. In the US, cooperative businesses are such a niche market. Banks often overlook cooperatives because they don't understand their unusual corporate structure, not because of their inability to repay. A lender that develops expertise in the structure and business of cooperatives can sometimes find a profitable lending niche. There may be other new and growing enterprises with which banks are not familiar that can temporarily be a viable lending niche. Although literature frequently advocates this approach, in practice these niches are very difficult to discover. In fact, apparent market gaps often reflect real difficulties in lending: a lack of local market and management experience in rural businesses; small and rural loans require higher transaction costs for lenders; or shifting economic trends that create temporary credit needs that fill again once economic trends settle down.

Market displacement is another diversification strategy aimed at enhancing income. Here the CDFI is explicitly competing with conventional financial institutions in certain commercial or mortgage markets in order to create a low-risk profitable portfolio that can offset the cost of its development lending. There are two approaches to market displacement lending. One is to originate conventional, non-development loans, thereby maximizing return and minimizing risk without consideration of development targets. Another approach is to participate fully in loans where typically a development lender would make only a higher-risk subordinate loan. In development banking, commercial and larger housing projects are usually financed with combinations of loans involving a fully secured senior bank loan and an unsecured subordinate loan taken by a development lender. If the development lender chooses to originate the entire financial package instead of just the higher-risk subordinate piece, it is able to gain some stable income from the lower-risk senior loan to support the higher cost of the high-risk piece. This strategy has worked well for CDFIs that are willing and able to make larger loans.

TECHNIQUES OF LENDING

Many would think that by now there would be consensus on the common lending practices used by CDFIs, but this is not the case. Since the community development financial industry is so new and diverse there has been little time to test, evaluate and compare the most effective lending techniques commonly employed by the individual institutions. Nevertheless some practices used by Community Development Banks have been consistently successful.

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Loan Underwriting Policies

Seasoned CDFIs use the general underwriting techniques that banks have used for years, but usually with a slight deviation. Consistently CDFIs have found the "four Cs of credit" (character, capacity, capital and collateral) to be valuable criteria for making loan decisions, if used with flexibility. Many CDFIs combine these loan criteria with the use of "compensating factors". That is, a loan that is weak in one of the criteria can still be approved if a compensating strength can make up for the weakness. For example, technical assistance can help to compensate for inexperienced management skills. A co-signer or guarantor can compensate for weakness in the capacity of the borrower to make monthly payments. A group savings plan can take the place of conventional collateral in solidarity lending schemes. Determining the earnings history for a self-employed borrower can be used instead of the typical practice of verifying wage income. If foreclosure is not an option (which is sometimes the case in the US), a mortgage insurance pool can be used as a secondary source of repayment.

While it would be convenient to be able to state the one or two magic rules to turn "unbankable" loans into "bankable" loans, there is only one way to learn how to apply flexibility in underwriting standards: through experience. Each CDFI has found its own formula for success after trying several deviations from common practice and having lost several loans in doing so. Of course a knowledge of credit underwriting theory helps, but in reality through experience one must find the right combination of factors for each borrowing segment to judge when to allow flexibility and how far one can stretch loan criteria before loan performance is compromised.

Specialized Knowledge of the Market

One advantage CDFIs have over conventional lenders is their intimate knowledge of the market niches in which they lend. Increasingly banks are becoming more standardized in

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their practices, particularly as they rely more on secondary market institutions to fund their loans. The more standardization, the less loan officers are able to apply local knowledge and common sense to loan decisions. CDFIs can develop a unique knowledge about their borrowers, both because they are closer to the borrower as a community-based institution and because they have learned often through trial and error where additional flexibility can be used in loan underwriting without adding risk. The Center for Community Self-Help has been making home mortgages to low-income families for ten years using underwriting criteria that banks have not approached even in their most adventurous programs, yet we have yet to lose any money on these loans. Obviously banks and the secondary market institutions are applying more caution than necessary in the application of their standardized rules.

Incremental Lending

One clear way to limit risk is to limit the amount of funds loaned to a borrower. It is often the case that a home buyer seeks to buy a home that is larger or more expensive than necessary, or a businessman wants extra cash from a loan so he doesn't have to come back to the bank again for more funds later. Loan requests can often be reduced without jeopardizing the project, whether it be buying a home or starting a businesses. Smaller loans obviously have small payments, thus increasing the likelihood that the loan will be repaid. In addition, if the loan defaults, losses are less to the lender. Surprisingly, most banks either approve or reject loan requests without trying to size a loan to the borrower's ability to repay. Once again, specialized knowledge of the field in which the CDFI is working helps loan staff add value to the transaction in this manner.

Technical Assistance

All CDFIs provide some degree of technical advice to support their lending operations. The degree to which technical assistance is provided varies considerably, usually

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depending on whether the organization began as a technical assistance provider or a lender. In all cases, technical assistance services add cost to a lending operation. These costs cannot usually be covered by the spread income, so they must be subsidized from some other source. Most large-scale CDFIs focus their technical assistance on businesses, organizations and individuals that have a high potential for qualifying for a loan, and on existing borrowers. This strategy ensures that their technical assistance will probably lead to some income from an eventual loan. Thus the types of technical services provided are usually those that specifically enhance the ability to qualify for and repay a loan. Housing lenders, for example, will focus on home ownership counseling to help a borrower manage debts and living expenses to make repayment more likely.

CDFIs with many loan products find it impossible to be technically competent in all areas demanded by their clients. For example, a lender that provides a wide range of housing loan products will not be able to manage to provide home ownership counseling, construction management assistance, tenant management services and the host of other services that are necessary to make a housing lending strategy successful. In response to this problem, lenders try to find other providers who specialize in these areas, or they simply limit those to whom they provide their assistance. In the housing field, lenders are not able to master all the technical aspects of the housing process: land acquisition, financial packaging, construction, maintenance and family services. Instead, they will seek NGOs, private companies and other groups who can provide these services, while focusing their technical assistance on loan qualification issues (such as stabilizing income, securing credit enhancements, managing debt payments).

Effective Loan Collections

Most NGOs that begin lending are rudely awakened to the realities of the situation when their borrowers do not pay them back. They find the new task of collecting payments from delinquent borrowers to be unrewarding and offensive. However, a lending organization must carry out its legal right to collections if it wants to have any credibility with future borrowers. Once the practice of non-collection begins, the CDFI gains a reputation as the bank that doesn't have to be repaid.

The most important collection practice is closely monitoring loans when their first payment is late. At this point any problems the borrower is experiencing are probably not too severe to correct. Specialized technical assistance may be helpful to solve a financial problem, or maybe the borrower is inexperienced in the practice of making regular payment and simply needs more frequent reminders and assistance in budgeting. Once the loan becomes three to four payments late it is much more difficult to address these problems. A schedule of visits, phone calls or correspondence must be planned for borrowers who have not paid by certain predetermined dates. For this reason it is imperative that delinquency reporting be immediate and frequent, and be made available to the staff responsible for managing the loan portfolios.

Good delinquency information is also necessary to complete the feedback loop for development program evaluation purposes. It provides the information necessary to determine the success of specific loan products and the impact of changes in underwriting rules or external factors such as economic cycles. The lender must have an accurate and timely system for reporting on loan performance or the institution will not be able to make informed decisions to determine its success in carrying out its basic mission: making loans successfully to the "unbankable".

The actual performance of CDFI loan portfolios is difficult to characterize due to the lack of industry-wide data. Some observations can be made, however, from the segments of the industry in the United States that track these figures. Delinquency levels are slightly higher than conventional banks, as one would expect. Measured by the percentage of the loan portfolio delinquent by more than 30 days, delinquencies are usually in the 2%-8% range, which is close to conventional banks and credit unions. Loan losses (net charge offs) can vary significantly. CDFI charge-offs range from 5% of annual loan balances per year +0.5%. Micro-enterprise funds often have higher delinquency and charge-off rates, while

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community development banks may have rates at or below bank rates. Self-Help Credit Union, the affiliate of the Center for Community Self-Help, has never had a charge-off on its home mortgage portfolio, having made over $30 million in mortgages in the last 7 years.

DOWNMARKETING HOUSING LENDING

Most CDFIs provide loans for low-income housing. This section describes the aggregate experience of the industry in the United States as it now stands.

Types of Loans

In an effort to improve and increase the housing stock in low-income communities, many different types of loans are offered. The table below summarizes the four main types of housing loans offered by community development banks. Specific terms and conditions differ depending on local market conditions and the practices of a specific CDB.

	Terms	Interest Rates	Downpayment/ Equity Required	Loan/Value Ratio
Land Acquisition & Construction Loans	1-2 years	variable 9% over COF*	20%-30%	50%-60%
Home Improvement Loans	5-15 years	fixed 9% over COF variable 7% over COF	0%-20%	80%-100%
Long-Term Owner-Occupied Mortgages	15-30 years	fixed 4% over COF variable 6% over COF	1%-20%	80%-98%
Long-Term Rental Property Mortgages	15-20 years	variable 8% over COF	5%-30%	70%-90%

*COF = Cost of Funds

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Housing-Related Technical Assistance

CDFI's in the United States generally provide home ownership counseling for first-time home buyers. They also package various sources of loans financing for rental housing projects. Development assistance is often provided as well, for example, estimating construction or rehabilitation costs, compliance with building regulations, assessment of innovative building techniques, and supervision of construction. In addition, many CDFIs help renter groups manage their properties. A few CDFIs operate their own subsidiaries whose function is to build housing or manage rental properties. Many of these services are paid through fees are that built into the cost of the project and paid out from the loan proceeds. As much as possible, CDFIs utilize organizations (very often NGOs) established to provide these related housing services, in order to reduce costs and build the capacity of local organizations.

Credit Enhancements

A few CDFIs have become quite nimble at using existing housing credit enhancemen programs or creating new ones to support their housing finance efforts. Many use government and private mortgage insurance companies to protect themselves against mortgage losses. Mortgage insurance only provides limited protection however, so lenders are not shielded entirely from losses. In circumstances where there are several mortgage insurance companies and agencies, CDFIs have attempted to negotiate greater amounts of insurance coverage at lower cost, generally using their own specialized experience as evidence that insurance rates are too conservative. By striking more flexible insurance terms, low-income borrowers are more able to obtain affordable mortgages.

Several CDFIs have established their own internal mortgage insurance pools funded with foundation or government contributions. These are small programs and usually only insure one housing loan product offered by the CDFI. However small, they serve as examples to the larger mortgage insurers of how these schemes can be better tailored to the needs of low-income families.

Secondary Mortgage Markets

Secondary mortgage market institutions purchase large quantities of mortgages from banks and housing finance institutions, bundle them into some form of security, and resell them to investors. They have fairly rigid underwriting standards for the mortgages they purchase which are enforced uniformly across all sub-segments of the housing market. As a result secondary markets seldom serve low-income housing markets effectively. Several CDFIs have attempted, on a demonstration basis, to create a viable secondary market for downmarket mortgages. These experiments fashion mortgage underwriting terms that work for low-income families. The are then sold to either secondary market institutions or directly to interested investors, by-passing the mainstream secondary market institutions. It is too early to tell whether these efforts will make a substantial difference in the behavior of the secondary market and create a permanent conduit for downmarket mortgages. If successful, efforts like these can potentially provide a new source of low-income mortgages for millions of families in countries with developed secondary markets.

CONCLUSION

Poor communities have layers upon layers of social and economic difficulties that beset them. Among these problems is the lack of financial capital to improve the lives of their residents and revitalize the economy. Capital, a scare commodity in these communities, can be effectively imported into these communities through Community Development Financial Institutions. CDFIs have proven to be practical and productive agents for the provision of credit and other development services. Created from NGOs, and specializing in the special credit needs of low-income communities, these financial institutions have demonstrated that the poor can indeed repay loans and that poor communities can support viable businesses.

One must keep in mind that CDFIs are not a panacea for the problem of poverty. They are limited by the incomes of their clients simply because they provide credit, and loans must be repaid. CDFIs are generally not effective in addressing the needs of the desperately poor who have no economic means at their disposal. Yet CDFIs have been surprisingly agile in devising financing schemes that meet the needs of a variety of community development projects, from housing development and ownership to large-scale business development. Combining the market discipline of the private sector with the goals of a public agency, these private financial institutions support a broad range of housing and economic development at minimum cost to the public sector.

Community Development Financial Institutions are still evolving. Their products, strategies and management continue to change rapidly as they mature. Whether CDFIs come to be common institutions worldwide, or continue to be isolated experiments, remains to be seen. Regardless, this much is clear: CDFIs have demonstrated that credit can be extended to the "unbankable" in a financially sound manner, which has an extraordinary impact on the revitalization of poor communities.

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Tharmarantnam Vyjanti and Garnett Harry,
Lessons Learned from Microenterprise Financial Institutions

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Lessons Learned
from
Microenterprise Financial
Institutions

Vyjanti Tharmarantnam
and
Harry Garnett

Abt Associates
New Delhi
India

February 14, 1995

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Target Clientele

— Duality of purpose

- Social commitment: serve disadvantaged group

- Economic commitment: maintain profitability for sustainability

Develop an Institutional Framework

- Vision: organization's commitment to its mission
  - leadership
  - strategic planning

- Capacity: structure
  information system
  personnel policies
  staff development

- Resources: fund raising policies
  budgeting
  financial projections
  accounting
  portfolio management

- Linkages: government relations
  peer networks
  donor partners
  banking partners

Adopt Group Lending

- Lower administrative costs
- Provides guarantees
- Reduces risks
- Induces timely payments

Mobilize Savings

- Transforms organization to a full-service financial institution

- Savings -- timely repayment link

Reach Financial Sustainability

Self sustainability

Return on equity $\geq$ opportunity cost of equity

Less dependence on grants, subsidies

More dependence on clients' deposits

Commercial interest rates

- lending
- borrowing

Access to capital markets

Stages of Financial Self-sufficiency

1. NGO or bank receives grants and soft loans to cover operating costs and establish a revolving fund. Many programs operate at this level. Precarious self-sufficiency; difficult to expand.

2. Programs raise funds by borrowing at near market rates. Interest income covers cost of funds and portion of operating costs. Grants for operations still required.

3. Able to cover operating costs from income and most of subsidy eliminated by less dependence on subsidized finance. But still some subsidies. Examples include Grameen, BKK (Indonesia) and the ACCION promoted programs in Latin America.

4. Full self-sufficiency. Fully financed from savings from clients and funds raised at commercial rates from formal financial institutions. Fees and interest income cover real cost of funds, loan loss reserves, operations and inflation. BRI (Indonesia).

Attract Leadership

- Motivational charismatic leadership

- Expertise of board members

Develop Dependable Bank Staff

- Recruit well-educated staff
- Encourage female applicants
- Special training reflecting dual social/economic mission
- Incentives to perform efficiently

Adopt Non-Traditional Banking Operational Procedures

- Loan disbursement: quick process, small, short-term loans

- Mobile banking: lender goes to client

- Incentives and discipline for timely repayment: additional loans, careful, close administration

Welcome Flexibility and Experimentation

- Adjust to changing conditions
- Monitor performance
- If subsidies, use in experimental period

Provide Complimentary Services

- Better housing, sanitation, education will lead to higher productivity hence better repayment

- Grameen's "Sixteen Decisions"

- Accion: business courses, savings plans, life insurance, medical insurance, fire insurance.

BRI: Bank Rakyat Indonesia

Unit Desa System

The Context

Set up 1984

Indonesian financial sector highly regulated

BRI providing financial services for rural development, especially the rice intensification program: a credit channel

Program declined: production problems

more convenient ways to acquire inputs

rising defaults due to economic and climatic conditions

Unit Desa covered only fraction of operating costs from revenues: cheap capital and administrative subsidies

Liberalization of bank regulations began

Market lending rates permitted

BRI: Bank Rakyat Indonesia

The System

Unit Desa system integral part of BRI, but separate profit center

BRI has 312 branches and covers all of Indonesia

Almost 3,000 Unit Desa, 735 "posts," and 15,000 employees

Unit has 4 person staff: manager, bookkeeper, loan officer and cashier

Village posts have bookkeeper and cashier

BRI: Kupedes Interest Rate

Interest charges cover:

funding and operating costs

loan loss provision

profit

Not a market rate, in the market where it operates

Kupedes from 22 to 32 per cent annually

moneylenders 10 per cent per month

other commercial banks 20 to 25 per cent

BRI: Savings

Four times as many savers as borrowers

Three schemes

Favorite is "SIMPEDES": interest varies by size of balance

positive real rates of return

unlimited withdrawals permitted

lottery

BRI: Loan Program (Kupedes)

Loans: for any productive enterprise, but includes "consumption" purposes

Banking law requires collateral-- any property including assignment of wages accepted

Working capital loans of 3 to 24 months

Investment loans of up to 36 months

Minimum $13, maximum $13,000 (for repeat customers)

Average balance outstanding about $250

PRODEM and BancoSol

An NGO that became a bank

PRODEM: established in Bolivia in 1986

microenterprise finance

three quarters clients women, most market vendors

average loan $270

training of borrowers

USAID grant funding plus other subsidized loans

ACCION International technical support

116 employees in 11 offices

loans to value $27 million

default close to zero

PRODEM and BancoSol

PRODEM's Problem

Overwhelming demand for credit not being met

PRODEM wanted to expand

Limited by subsidized funds of uncertain sustainability

Interest income and fees from lending covered only operating costs and minimal expansion

PRODEM could not take savings, commercial debt, shareholder investment and loans from Central Bank

PRODEM needed increased flow of funds to finance expansion

and offer clients full range of financial services: an intermediary not just a lending operation

PRODEM and BancoSol

Setting up BancoSol

Task force set up to manage the transition

Transition cost $500,000

Set up 1992

Six PRODEM offices converted into banks

Savings schemes introduced including mandatory 5 per cent savings component of each loan, with market rates

Loans $80 to $5,000

Interest rate double commercial banks

Solidarity groups substitute for collateral

BancoSol arrears one tenth that of other commercial banks

High equity: PRODEM assets transferred

Issued bonds and CDs

By second year small net profit

Scoggins Anthony, *Credit Unions and Housing Finance: Strategies for Self-Financing*

CREDIT UNIONS AND HOUSING FINANCE:

STRATEGIES FOR SELF-FINANCING

A Discussion Paper

by

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For Presentation

to

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Hyderabad, India

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Appendices:

1. INTRODUCTION[1]:

As member-owned, co-operative organizations, credit unions are committed to meeting the financial service needs of their members.[2] Traditionally, this has first meant mobilizing member savings, and then using these savings to provide a mix of provident and productive loans back to members.

Shelter is a basic human need. As the majority of credit union members in most countries are drawn from the lower and middle economic strata of the population, sooner or later, member demand for housing loans must be addressed by the credit union system. While small home improvement loans can generally be addressed within the framework of existing resources and policies, most credit union systems have experienced some difficulty in responding to member needs for financing of housing construction and purchase.

A summary review of the credit union experience world-wide indicates that the response of credit union systems to member demand for housing finance fall into three general approaches:

a) primary-level credit unions develop the capacity to respond directly to member needs for housing finance;

b) credit union federations provide these services, either directly through their own central finance facility or through special housing finance subsidiaries established by the federation; and

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1. I wish to acknowledge the helpful comments of Wayne Paterson, Manager of League Savings and Mortgage Co. and Dan Hodgins, Manager of Bergengren Credit Union, in reviewing an early draft of this paper.

2. Terminology varies between countries. The term "credit union" is used in this paper to denote a primary-level savings and credit co-operative.

c) rather than provide housing finance itself, the credit union system serves as an intermediary or "hand-holding" agency between members and other (often government-sponsored) financial institutions.

As the purpose of this paper is to address the capacity of the credit union system to respond to the housing needs of members directly from its own resources, I will proceed to elaborate the key elements of the first two models noted above.

2. PRIMARY CREDIT UNIONS AND HOUSING FINANCE:

2.1 The Starting Point:

Primary-level credit unions in most areas of the world slowly build their financial base through the long-term accumulation of member savings.

A small portion of these savings are actually members' investment in the form of share capital. This is conventionally a fixed amount, rarely represents more than 5% of total assets, and is legally speaking risk capital with a return paid only in terms of year-end dividends. In keeping with co-operative principles, this share capital is non-speculative and receives only a limited return. In keeping with general financial management practice, these funds tend to be invested in the purchase of the long-term assets required for the operation and development of the enterprise (i.e. building, equipment, etc.).

The bulk of members savings, at least in the early years of credit union operations, are generally held in ordinary savings accounts with a set interest rate and varying terms and conditions for withdrawal. Given that credit union members often have limited access to other financial institutions, credit unions frequently offer rates on savings that are lower than the prevailing market rate. These savings are considered core or relatively "captive" savings, given that the primary incentive for members is usually access to credit, rather than return on savings.

It is these savings that provide the pool of funds available for on-lending to members and it is not unusual to find credit unions with 85% of these savings out in loans. Indeed, in many employee-based credit unions this ratio can frequently exceed 95%. Generally, these loans tend to be short-term (i.e 2-3 years), relatively small (a reflection of both members' limited financial capacities as well as a philosophical commitment to meeting the needs of as many members as possible), and granted for a mix of consumer purchases, provident purposes, and production-related activities.

It is difficult to generalise about the cost to members of credit union borrowing, as there is great variation on interest rate strategies. A significant but diminishing number of primary credit unions have held interest rates on loans at artificially low levels. The current trend is for credit unions to be more or less in keeping with prevailing market rates, with a minority charging rates significantly above formal market rates.

I will therefore make a rather qualified generalization and summarize that most credit unions pass through an initial phase of operation in which their financial operations are characterised by small, low-cost and generally short-term savings being rolled over into relatively small, high-yielding and short-term loans.

2.2 Moving into Housing Finance:

By definition, housing finance involves longer term and larger size loans. Furthermore, the competitive market in housing finance, combined with its relatively low administrative costs and risk factor[3], means that the yield on housing finance also tends to be somewhat lower than that of consumer or production loans.

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[3]. Although housing finance loans tend to be much larger than other loans, professional appraisals and prudent lending policies can ensure that the risk of lending loss associated with housing loans is much lower than that of a similar-sized portfolio of personal or business loans. The major risk in housing loans (as experienced in the billion dollar collapse of the American Savings and Loan industry in the 1980s) relates to asset/liability management. See section 4, below.

Some direct financial implications for credit unions moving into housing finance are therefore:

- developing longer-term savings instruments by which to match longer-term loans;
- mobilizing a larger pool of savings from which to make these larger loans;
- narrowing of the financial margin, due to both higher cost term deposits and lower-yield mortgage loans;
- reduced administrative costs per loan volume; and
- enhanced reliability of cash flow.

The issue of savings mobilization is particularly critical for credit unions intending to offer housing finance. Unless the credit union begins the program with a pre-existing liquidity surplus, in the short to medium term loan demand will almost always exceed the pool of loanable funds. Credit unions planning to build their savings pool primarily by motivating potential home-buyers to increase their savings in the society should note the following conclusions from an international study of this very issue.

> "While it can be argued that the desire (and opportunity) to own a house is a powerful incentive for individual savings, it is difficult to determine what effect, if any, an expansion in the availability of housing...has on private savings behavior. While it may be hypothesized that individual savings are encouraged by the existence of a mortgage market that enables individuals to finance the purchase of residential property, there is no formal evidence to support or disprove this hypothesis, whether in developed or developing countries."[4]

A further set of operational implications for credit unions moving into housing finance include:

- diminished exposure to loan loss risk due to the relative security of housing loans;
- increased exposure to matching risk in terms of both

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4. P. Nathan Associates, An Overview of Financial and Economic Analysis of Housing Projects, U.S.A.I.D., Washington, 1986, pp.34-35.

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liquidity and profitability;
- the development of policies, procedures and systems appropriate to management of housing finance; and
- technical upgrading of staff, in terms of both the specific competencies required for delivery of housing finance, as well as the handling of related financial management issues of asset/liability matching, liquidity, profitability, etc.

2.3 Conclusions:

While the specific context of any primary credit union moving into the housing finance market will largely determine the operational mechanisms and marketing and financial strategy to be pursued, some general guidelines can be put forward.

First of all, a systematic market assessment must be conducted. In particular, the credit union must undertake a realistic appraisal of the financial resources and needs of its members. These must be assessed in terms of the competing demands for their financial services.[5]

Secondly, moving into housing finance should be perceived as an expansion of services to be offered to members, rather than as a substitute for another (perhaps problematic) service. Credit unions experiencing problems with other programs or services (for example, commercial or enterprise loans) need to address those

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[5]. In some markets (both urban and rural) credit unions have found that introducing housing finance to members who previously had no access to such services has been both a positive financial initiative and a powerful instrument for consolidating member loyalty and commitment. But in other circumstances, entering into the housing finance sector has prompted an aggressive response from competing financial institutions that had previously ignored the credit union clientele. In some cases, this competition has undermined member patronage of even conventional savings and loan services and caused considerable difficulty for the credit unions in question.

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problems first, before even considering entering the housing finance sector.

Furthermore, it is neither feasible nor desirable for credit unions to move funds out of one loan portfolio and into the housing sector. Unless the society has a large pool of excess liquidity, experience indicates that the most appropriate strategy is for a credit union to use a new housing finance program to expand its existing financial base (i.e. to generate additional savings through new deposit instruments and new loan demand through its mortgage program). Otherwise, the impact on the bottom-line of the credit union can be disastrous.

Finally, the success of a housing finance initiative will largely be dependent upon the technical capacity of the society's staff to manage it effectively. In-house training needs of staff must be clearly assessed and effective staff development programs designed, delivered and evaluated.

3. HOUSING FINANCE THROUGH THE CREDIT UNION SYSTEM:

3.1 Introduction:

In a number of credit union systems globally, it has been concluded that housing finance is best delivered through the apex structure of the movement, rather than through the primary level credit union. This decision usually reflects a mix of concerns, including the limited financial resources of primary societies and their limited managerial and technical capacities. In some jurisdictions, there are also legal obstacles to primary credit unions offering the mix of savings and credit services required for housing finance.

There are two general models of credit union federations offering housing finance services: one is for the required financing to be offered through the federation's central finance facility, and the other is for a legally separate (but usually wholly-owned) subsidiary company to provide the housing finance services.

3.2 The Central Finance Model:

Most credit union systems around the world follow a relatively conventional federative model of organizational hierarchy in which primary-level societies own and control district-level unions, which in turn own and control state or national-level federations. These unions or federations offer to their member societies a mix of services including education and training, representation, purchasing and supplies, inspection and audit, and banking services.

In many systems, this banking service is simply constituted as the Deposit and Loan Department within the federation. In other cases it is a separately incorporated company. For the purposes of this paper, I will simply refer to it as the Central Finance Facility (CFF).

The CFF generally constitutes the primary depositary of credit union funds, in the form of statutory (required) liquidity and reserve deposits, as well as discretionary deposits of surplus funds. This pool of funds is in turn used to provide loans back to credit unions with liquidity shortfalls or occasional excesses in loan demand. The large volume and relative stability of CFF deposits (compared to the rapid turnover of funds at primary society level) make it possible for the CFF either to undertake housing loans directly itself, or to support local credit unions wishing to introduce this service.

There are two ways in which Central Finance Facilities of credit union federations are able to facilitate the introduction of housing loans by the credit union system. The most common is for the primary-level credit union itself to negotiate a term loan from the CFF. These funds are then on-lent by the credit union to the individual members. The loan from the CFF is based primarily upon the credit-worthiness of the credit union as a whole, rather than upon the respective merits of the individual loan applications at hand. However, some of the loan notes may be assigned to the CFF as security.

A second option is for the credit union to refer the loan applicants to the CFF, which then lends the funds directly to the individual members. This latter practice is not widely followed, as most credit union systems prefer to keep direct service linkages between the individual member and his/her local society.

3.3 The Housing Finance Subsidiary:

A further variation on this theme is for the credit union federation to establish a legally distinct company for the purpose of housing finance. Such companies are usually wholly-owned subsidiaries of the credit union system,- either of the federation itself, the primary societies, or a combination of both.

There are three likely advantages to incorporating such a company:

- to gain the right to mobilize deposits from beyond the confines of the credit union system;
- to gain access to various government-sponsored housing programs; and
- various tax benefits.

Given the constraints in savings mobilization experienced by many credit union systems, which are legally prohibited from accepting savings from non-members, the first of these three factors tends to be the most significant. The model simply elaborated is for the credit union system to incorporate a housing finance company under the appropriate legislation and then proceed to raise funds in the open market by offering a mix of savings instruments such as deposits and debentures.

These funds are then used to on-lend to credit union members for housing loans. Members' loan applications are solicited, assessed and processed by their local credit union, which then hands over the completed file to the housing finance company. For this service, the credit union receives a referral fee, usually quoted as a percentage of the loan amount. A second alternative is for the primary credit union to bundle up these loans as a package and effectively sell them to the subsidiary company. In both cases, the credit union members interact primarily with their local society, but the loan in fact is held by the subsidiary company.

4. THE ISSUE OF RISK IN HOUSING FINANCE:

4.1 Defining Risk:

"Risk" simply means uncertainty of outcome, or more pointedly, uncertainty of loss. All lending involves some degree of risk, and the managerial challenge for financial institutions is to ensure that the risk exposure (i.e. exposure to loss) is within acceptable limits. For this discussion of housing finance, two major types of risk can be identified: lending risk and financial risk.

4.2 Lending Risk:

The most obvious risk in lending is the risk of non-repayment. But despite the large size of most housing loans, this is not usually considered the greatest risk associated with housing finance. This is due to the relatively secure nature of the collateral taken on most housing loans; i.e. a mortgage on the property itself.

Most credit unions active in housing finance generally lend no more that 75% of the assessed market value of the house, and will take a legally registered mortgage (with appropriate insurance) on that property.[6] Unless the assessed value of the house is widely over-stated or there is a subsequent collapse in real estate values, the credit union is well protected as the value of the collateral exceeds that of the outstanding loan balance.[7] The relative security of well-administered housing loans is

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6. In order to better serve low-income households that are hard-pressed to generate the required 25% down-payment, credit unions frequently take advantage of government mortgage guarantee schemes which will guarantee loans up to 90% of market value.

7. This discussion assumes that the credit union is prepared to foreclose on delinquent borrowers. Experience suggests that this is not always an appropriate assumption.

reflected in the fact that in many banking and credit union systems, the statutory requirements for loan-loss reserves on housing loans are significantly lower than those required for other, less secure loans.[8]

4.3 Financial Risk:

The second type of risk is financial risk, - the risk to the credit union's general financial performance created by the delivery of housing finance. Financial risk relates to the matching (or mis-matching) of the term and cost of credit union liabilities with the term and yield of its assets.

The key concern regarding the matching of terms of assets and liabilities is of course, liquidity. Simply stated, the risk is that a credit union undertaking housing finance will lend long-term with short-term money. A sudden withdrawal of savings or increase in loan demand will mean that the credit union will experience a shortfall in liquidity. The implication for credit unions engaging in long-term lending such as housing finance is therefore that they must develop a set of matching, long-term savings instruments.

The financial risk related to the mis-matching between cost of assets and yield on liabilities is known as interest rate risk (IRR). In deregulated financial markets this is generally considered the greatest risk associated with housing finance.

IRR is the risk that a credit union's financial margins will change over time due to fluctuations in interest rates. Since changes in rates on the two sides of the ledger (savings and

8. The exception to this general rule is the case of quasi-commercial housing loans. These are loans for the purchase or construction of multiple unit buildings, from which the owner must earn rent in order to meet the loan repayments. Many credit unions limit their housing loans to owner-occupied single units.

loans) rarely co-incide exactly, the credit union is exposed to the risk of increased costs of savings not being matched by increased yields from loans.

Clearly, this is not so great a risk when the credit union deals mainly in core savings and short-term loans. But longer term savings instruments are generally considered "hot" money, in as much as these funds can be very transient in response to market competition. When the savings mobilised through such instruments are rolled over into longer term housing loans, the risk of an interest mis-match having a negative impact on the bottom-line of the society is greatly increased.

4.4 Conclusions:

There are many advantages for credit unions introducing a housing finance service. Firstly, housing finance responds to a felt need amongst members and in meeting that need, the credit union can consolidate member loyalty and patronage as no other service can. Secondly, housing finance can provide a reliable, secure and low-cost source of income that serves to solidify a loan portfolio previously dominated by short-term, high-cost and risky loans.

However, these benefits cannot be realized without risk to the credit union, most particularly in terms of management's capacity to manage the society's asset/liability match. There are a range of management tools available to assist in the matching process, notably gap analysis and various income simulations.[9]

For credit unions just entering this field, a set of simple "rules of thumb" is probably as useful a tool as any. For example, in the Canadian context the rule of thumb for asset mix is 50% in mortgage loans, 35% in personal loans and 15% in

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9. A brief overview of these techniques is provided in Bill Merrick's article "Control mortgage risk with ALM", Credit Union Magazine, November, 1994. pp. 26-30.

liquidity deposits. The 50% in mortgage loans is then divided equally between open market mortgages and government guaranteed (low-income) mortgages. The liability mix of the credit union is then worked out based on the term and rate matches required to achieve and maintain this asset mix.

Clearly, systematic research and testing would be required to identify those rules of thumb appropriate to significantly different contexts.

5. HOUSING FINANCE FOR LOW INCOME HOUSEHOLDS:

This paper has spoken generally of housing finance by credit union systems, with no explicit reference to low-income households beyond the general assumption that most credit union members belong to households of moderate means. In this section, I will briefly explore both some of the constraints and initiatives observed within the credit union system in this regard.

First of all, the financial constraints facing credit unions in the granting of housing loans to low-income households are identical to those facing other financial institutions in the same situation. Indeed, the limited financial base of many credit unions, and the non-professional nature of much of its management often exacerbates the nature of these constraints. These constraints would seem to be threefold:

- the difficulty experienced by low-income households in accumulating the capital required as a down payment for a housing loan;
- the risk associated with uncertain sources of household income, over the long term of a housing loan; and
- in many developing country situations, the uncertain tenurial arrangements in areas in which low-income housing is built.

Those credit union systems that have most successfully addressed the issue of housing finance have recognized that the comparative advantage of the credit union system is not so much its financial structure but its membership base. Such systems have taken an integrated and long-term perspective in relating to their members. Local credit unions work with individual members to identify household needs, assess resources and develop financial plans.

This commitment is explicitly stated in two of the Operating Principles of the International Credit Union Movement:

> MEMBER SERVICES: Credit union services are directed to improve the economic and social well-being of all members.
>
> SOCIAL RESPONSIBILITY: Continuing the ideals and beliefs of cooperative pioneers, credit unions seek to bring about human and social development. Their vision of social justice extends both to the individual members and to the larger community in which they work and reside. The credit union ideal is to extend service to all who need and can use it.

As such, this explicit recognition of a social mission has prompted a variety of program initiatives at credit union level in an effort to find creative ways in which to meet the housing needs of low-income members. In my work, I have observed amongst other examples, - special savings programs that assist members to build up the capital required for down-payments; schemes by which members' in-kind contribution of labour in housing construction (i.e. "sweat equity") is considered part of the down-payment; credit union facilitated low cost building projects, including joint purchase of land and supplies; and also the sponsoring of housing co-operative projects.

At this moment, in my home province of Nova Scotia, the credit union system's housing subsidiary is collaborating with local credit unions to purchase in bulk a number of houses on a soon-to-be abandoned military base. The plan is for these houses to be re-located to nearby communities as homes for credit union members. It is this sort of imaginative thinking that puts the credit union motto into practice: "not for profit, not for charity, but for service."

6. CONCLUSION:

The specific circumstances of each credit union system, never mind that of each primary credit union, make it very difficult to extract a single set of conclusions to this discussion. Let me try instead to enumerate what I see as being the key questions to be addressed by any credit union (or system) considering entering the housing finance market for the first time.

I would suggest that the answers to these questions can provide first the framework for deciding whether such an initiative is appropriate. Secondly, the questions also outline the key elements to be built into the ensuing business plan.

1. To what extent does housing finance fit with your organization's mission statement and strategic priorities?
2. What are the current housing finance needs of your members?
3. To what extent, and how are these needs being met at the moment?
4. Are the savings capacities of your members adequate to meet the financial demands of the housing finance sector?
5. Given the current financial structure and performance of the credit union, what are the implications of entering into the housing finance sector,- for savings mobilization, loan portfolio management, matching of assets and liabilities, and profitability?
6. What legal, policy, and administrative changes are required to incorporate housing finance within the credit union's existing operations?
7. What new knowledge, skills and attitudes must be developed amongst staff to successfully manage this new program and service?
8. Given the technical nature of many of these issues, how can they be presented to credit union members, (collectively or through their elected representatives), in a manner that will best ensure informed and responsible decision-making?

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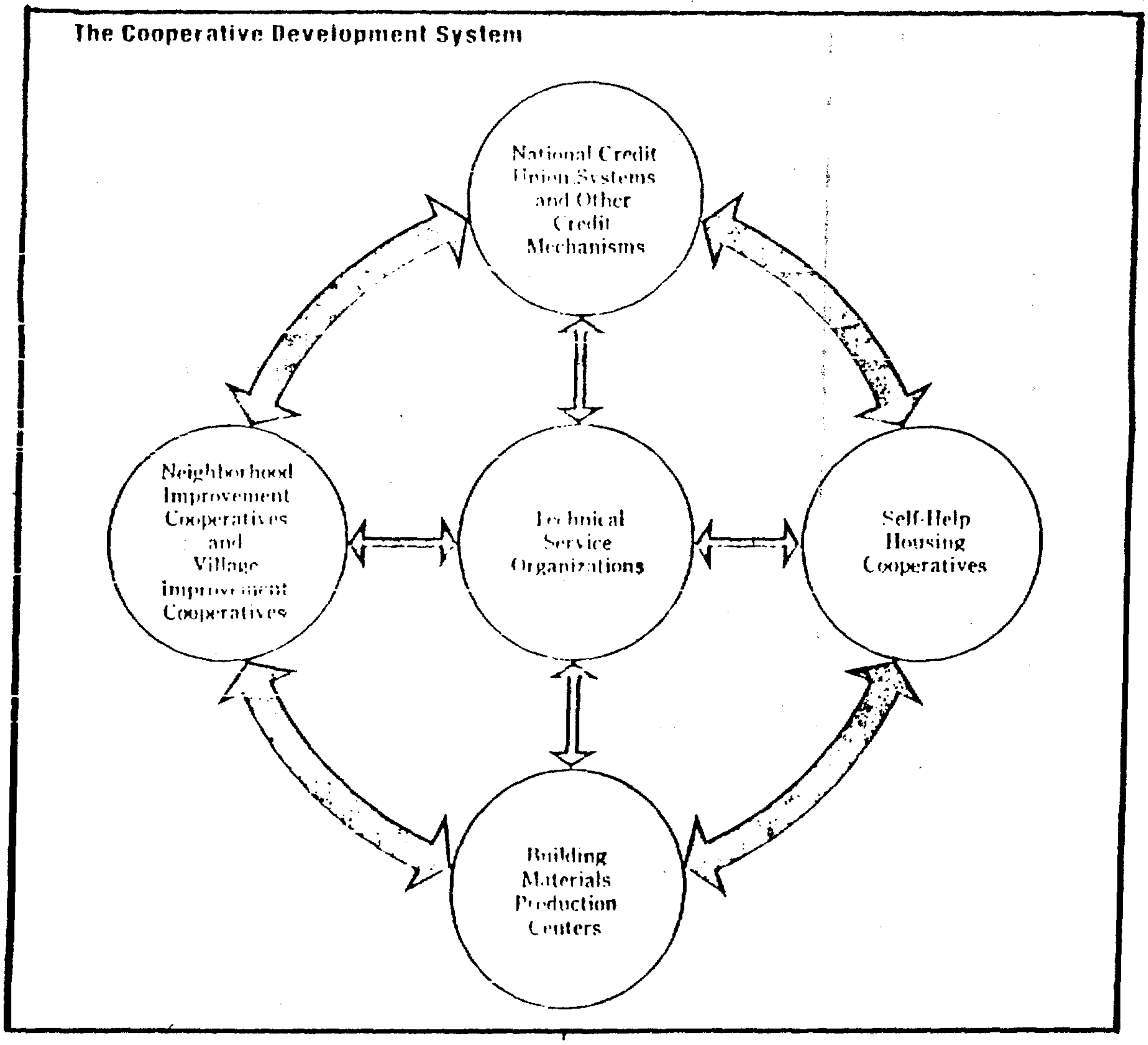
Appendix 1[10]

AN INTEGRATED APPROACH TO HOUSING FINANCE THROUGH CREDIT UNIONS

Through the 1980s, the Co-operative Housing Foundation (USA) undertook a series of housing development projects in Central America. The projects involved a mix of credit, technical assistance and training and were delivered through both credit union federations and local savings and credit co-operatives.

From their various experiments, the CHF developed a model of an integrated approach to housing finance which involved a broad mix of partner organizations.



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[10]. The three cases presented as appendices are all extracted and adapted from "Home Financing", <u>World Reporter</u>, World Council of Credit Unions, Madison, WI., 1987.

Appendix 2

THE CASE OF THE ECUADORIAN CREDIT UNION SYSTEM

In 1986, the World Council of Credit Unions undertook a study of five Ecuadorian credit unions that had undertaken housing finance loans.

The study noted the following conclusions:

1. Pre-existing financial management systems in the five credit unions were exceptionally strong, and all five were large, well organized and well managed societies.

2. Membership growth in these, and other societies, had levelled off, indicating that the credit unions were approaching the limits to their "natural market".

3. By 1986, housing loans made up to 35-40% of the loan portfolio of the credit unions.

4. Terms and conditions for the loans varied between the different credit unions:
   - loan to value ratio: from 70%-90%
   - debt to income ratio: from 30% to 50%
   - loan interest rates: from 17% to 25%
   - loan terms: from 4 years to 15 years.

5. A key element for the success of the program was the elaboration and enforcement of a tightly monitored mortgage process, which included the following elements:
   - certificate of clear title from registrar of deeds;
   - certified property value appraisal;
   - original deed of title;
   - certificate from registrar of deeds that the borrower does not own an additional home;
   - legal description of property;
   - notarized sale of contract for home or land purchase; and
   - abstract or chain of title covering the last 15 years, from the registrar of deeds.

6. The decision on loan granting remained with the regular credit committee, but the application required prior review and approval by a technically qualified loan officer.

7. In terms of general financial performance all credit unions performed reasonably well, although they were being hard-pressed to cope with the steadily increasing rate of inflation in the national economy.

Appendix 3

THE CASE OF THE JAMAICAN CREDIT UNION SYSTEM

In 1977, the member credit unions of the Jamaica Co-operative Credit Union League directed JCCUL to establish a special housing finance program for low-income households.

The mortgage fund was capitalised by the primary societies themselves, which pledged to deposit 5% of their net growth in share capital in the fund. (About half of the societies actually met this commitment.) These funds are relatively long-term, low-yielding deposits in the federation and are effectively a subsidy provided by the local credit unions.

Members interested in borrowing from the fund apply through their local credit union which does a preliminary assessment of the application before passing it on to the federation. The program has been enormously popular, with demand for loans far outstripping the funds available. In response to the emerging technicalities experienced in processing the housing loans, JCCUL established a special housing department and staffed it with a qualified manager.

Following this first entry into the housing finance market, JCCUL was subsequently able to negotiate soft-loans through both the Jamaica Mortgage Bank and the National Housing Trust. These funds are loaned to member credit unions for on-lending to individual members.

Rather than provide large loans for housing purchase or construction, local credit unions have focused on smaller, shorter term home improvement loans. This is also considered an appropriate strategy for ensuring that low-income households are the primary beneficiaries of the programs.

Nagarajan V., *Organizational Characteristics for Groups Considering Community-Based Housing Finance*

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ORGANIZATIONAL CHARACTERISTICS FOR GROUPS CONSIDERING COMMUNITY-BASED HOUSING FINANCE

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February 9, 1995

Prepared for:

Abt Associates Inc.
Indo-US Housing Finance Expansion Program
New Delhi

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Organizational Characteristics for Groups Considering Community-Based Housing Finance

Organizational Characteristics for Groups Considering Community-Based Housing Finance

Overview

The purpose of this report is to initiate and support discussion of the various legal forms under which community based groups interested in providing housing finance are presently organized or under which they conceivably might organize in future in India. In addition to the statutory issues relating to the formation, governance and control of these organizations, certain selected Income tax and other regulatory legislative matters relevant to housing finance are also briefly outlined.

This compilation of legal issues under various forms of organization points out gaps in the existing regulatory and legal framework which policy-makers may wish to address. Their attention through appropriate legislative amendments can ensure that the development of community-based financial institutions follows a course which guarantees the safety of public deposits and the solvency of organizations in which shareholders, members and contributors have placed their confidence.

They key points in this report have been selected with the intention to avoid complexities. Each of these summaries, could of course, be expanded into a treatise if all the laws and regulations were fully discussed. Nevertheless, it is hoped that the summaries will be useful as a starting point for discussion and further exploration.

Finally, a word of caution: Though every care has been taken to compile this legal information, these may not be valid sometimes if seen in isolation and entirely a different scenario may arise, if applied to specific facts and circumstances and other legal frame work. This may be treated as a point of indication for further exploration, than as a legal opinion.

V. Nagarajan

I. NIDHI--MUTUAL BENEFIT ORGANIZATION (MBO)

Under which legislation & section	Companies Act 1956 Sections 12; Sec. 25 optional; Sec. 620A Evaluation period min. 3 years is required to ensure bona fide mutual benefit activities.
Definition of "member"	Anyone admitted by the members. A member's control is proportionate to his shareholdings.
Regulating Authority	Registrar of Companies Regional Director of Company Law Board
Registration Document	Memorandum of Association & Articles of Association
Geographical Area?	India; but only one office may be operated.
Any restriction on dividend payment?	No restriction.
Any limit on activity?	Can deal only with members to retain "mutuality of interest."
Capital required	For financial companies, capital must be 8% of risk for entry weighted assets plus off-balance sheet items
Limit on mobilizing deposits?	Borrowings ok. Shares are tradeable between members, but no public quotes. Expedites grassroots ownership. Small man can own shares.
Is housing finance permitted?	Yes
Income tax	Exempt as Mutual Benefit Organization under Section 2(15) or under section 11,12, & 13 Income Tax Act.

Nidhi--Mutual Benefit Organization (MBO)

Any limit on accepting savings deposits?	10 times net owned funds for housing finance companies
Types of deposit accounts permitted?	Time deposits of 1 year to 7 years, per NHB Directions.
Total loans permitted?	Limited by capital requirement (see above)
Total housing loans?	Minimum 75 percent of HFC loans must be for housing acquisition or construction per NHB Directions.
Who can borrow?	Anyone.
Can loan guarantees be given?	Yes, up to the value of unencumbered assets

/cfi3

2. PUBLIC CHARITABLE TRUST

Under which legislation & section	Indian Trust Act
Definition of "member"	As defined by by-laws.
Regulating	Public Charitable Trusts are not governed by any law. In the event of mismanagement, only members have standing to take action, and that must be by way of civil suit. Except in Gujarat and Maharashtra, recourse for rejected members is limited.
Registration	By-laws.
Limit on Geographical Area?	India
Any restriction on dividend payment?	Not permitted.
Any limit on activity?	As per Trust Deed, otherwise, no restriction. Finance activity OK.
Capital required for entry	No minimum required for entry or operation.
Limit on mobilizing funds other than deposits?	Only charitable donations.
Is housing finance permitted?	Yes.
Income tax	Exemption under Section 11, 12, 13 or 10(23)(c) read with Section 2(15).
Any limit on accepting savings deposits?	None.

Public Charitable Trust

Types of deposit accounts permitted?	Any type.
Total loans permitted?	No limits.
Total housing loans?	No limits.
Who can borrow?	Anyone meeting trust's criteria as a beneficiary.

/cfi7

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3. PUBLIC LIMITED COMPANY

Under which legislation & section	Companies Act, 1956 Sec. 12
Definition of "member"	Anyone holding a share
Regulating Authority	Registrar of Companies
Registration Document	Memorandum of Association & Articles of Association
Limit on Geographical Area?	None
Any restriction on dividend payment?	No restriction
Any limit on activity?	As per Memorandum of Association. Finance activity OK.
Capital required for entry	Nominal, but for operation of financial companies, capital must be 8% of risk-weighted assets plus off-balance sheet items
Limit on mobilizing funds other than deposits?	SEBI requires that promoter must have at least 25% of equity and should offer atleast 25% to the public. Debentures, equity, deposits permitted.
Is housing finance permitted?	Yes
Income tax	Taxable. Housing finance company (HFC) can exempt 40% of income tax liability income under Sec. 36(i)(viii); refer to Appendix.
Any limit on accepting savings deposits?	10 times net owned funds for housing finance companies, per NHB Directions. Deposits from Public Charitable Trusts available only if approved under Sec. 36(i)(viii)
Types of deposit accounts permitted?	Only time deposits of 1 year to 7 years for housing finance companies

Public Limited Company

Total loans permitted?	Limited by capital requirement (see above)
Total housing loans?	Minimum 75 percent of HFC loans must be for housing acquisition or construction, if 36(i)(viii) exemption is sought.
Who can borrow?	Anyone
Can loan guarantees be given?	Yes, up to the value of unencumbered assets

4. SECTION 25 COMPANIES:

Under which legislation & section	Companies Act 1956 Sections 12 & 25
Definition of "member"	Anyone holding a share
Regulating Authority	Registrar of Companies Regional Director of Company Law Board.
Registration Document	Memorandum of Association & Articles of Association
Geographical Area?	India
Any restriction on dividend payment?	No dividend payment permitted. Profits are retained, not distributed. No benefit to promoters/shareholders, even in the event of winding up the company.
Any limit on activity?	Restricted to charitable activities. Finance activity OK.
Capital required for entry	For financial companies, capital must be 8% of risk-weighted assets plus off-balance sheet items
Limit on mobilizing funds other than deposits?	No limit on borrowings. Equity shares are not publicly tradeable.
Is housing finance permitted?	Yes
Income tax	Could be exempt as Mutual Benefit Organization or Charitable under Section 2(15)" and under section 11,12, & 13 of the Income Tax Act". Sec. 36 (i)(viii) exemption is available. Public Charitable Trust deposits <u>and</u> equity are available if Sec. 36 (i)(viii) approval is secured, please refer to Appendix.
Any limit on accepting savings deposits?	10 times net owned funds for housing finance companies

Section 25 Companies:

Types of deposit accounts permitted?	Time deposits of 1 year to 7 years per NHB Directions.
Total loans permitted?	Limited by capital requirement (see above)
Total housing loans?	Minimum 75 percent of HFC loans must be for housing acquisition or construction.
Who can borrow?	Anyone.
Can loan guarantees be given?	Yes, up to the value of unencumbered assets

/cfi1

5. SOCIETY

Under which legislation & section	Society Registration Act 1860 as amended or as administered by the respective states.
Definition of "member"	As defined in by-laws
Regulating	Societies are subject to no effective regulating authority except in Tamil Nadu, Maharashtra and Gujrat. In the event of mismanagement, only members have standing to take action, and that must be by way of civil suit.
Registration	By-laws. Incorporation certificate.
Limit on Geographical Area?	Can operate throughout India, regardless of place of registration.
Any restriction on dividend payment?	Not permitted.
Any limit on activity?	As per by-laws. Finance activity is permitted RBI non-banking finance company guidelines do not apply. Housing activities could be organized as for-profit division to meet the main charitable purpose of the society.
Capital required for entry	None.
Limit on mobilizing funds other than deposits?	Cannot raise capital from members. Borrowing permitted.
Is housing finance permitted?	Yes.
Income tax	Exemption under Section 11, 12, 13 or 10(23)(c).

Society

Any limit on accepting savings deposits?	None.
Types of deposit accounts permitted?	Any type of deposit, from any person
Total loans permitted?	No limit.
Total housing-loans?	No limit.
Who can borrow?	Anyone meeting the main charitable purpose of the organization.

/cfi6

6. STATE COOPERATIVE SOCIETY

(Ongoing financial society such as Thrift & Credit Cooperative; NOT a single-project "housing cooperative")

Under which legislation & section	Cooperative Society Act as applicable to each state
Definition of "member"	Any individual admitted as per the institution's by-laws
Regulating Authorities	State Registrar of Cooperative Societies
Registration Document	By-Laws
Geographical Area?	Within the state.
Any restriction on dividend payment?	Maximum dividend 12 %.
Any limit on activity?	Should be organized for a single or narrowly defined common purpose. Otherwise, By-laws govern activity.
Capital required	No effective minimum capital.
Limit on mobilizing funds other than deposits?	Share capital must be raised entirely from members. Borrowing is permitted. Shares are tradeable between members, but no public quotes.
Is housing permitted?	Yes.
Income tax	Restricted exemption under Sec. 80P; lower tax rates than on companies.
Any limit on accepting savings deposits?	None.

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State Cooperative Society

Types of deposit accounts permitted?	Passbook savings and time deposits.
Total loans permitted?	No limit.
Total housing loans?	No minimum limit; Recognition U/S 36(i)(viii)of Income Tax Act not relevant as tax rates are low. However, Charitable Institution deposits not permitted.
Who can borrow?	Members only.
Can loan guarantees be given?	Yes, up to the value of unencumbered assets

/cfi4

7. UNREGISTERED SELF-HELP GROUP

Under which legislation & section	Unregistered.
Definition of "member"	No limitation, but maximum membership is 20 persons.
Regulating Authority	None.
Registration	None. However group by-laws and the governing board mechanism provide status for entering into commercial transactions.
Limit on Geographical Area?	Local, by definition.
Any restriction on dividend payment?	Distribution is possible.
Any limit on activity?	None, as long as membership is limited to 20 persons.
Capital required for entry	None.
Limit on mobilizing funds other than deposits?	Restricted to members.
Is housing finance permitted?	Yes.
Income tax	Applicable, unless Income Tax act provisions regarding mutuality of benefit are met.
Any limit on accepting savings deposits?	Only from members, by definition.

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Unregistered Self-Help Group

Types of deposit accounts permitted?	Any deposit from members ok.
Total loans permitted?	No limit.
Total housing loans?	No limit
Who can borrow?	Members of the group only. Members are jointly liable for external liabilities.
Can loan guarantees be given?	Not applicable.

/cfi8

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8. URBAN COOPERATIVE BANK

Under which legislation & section	State Cooperative Society Act 1972 Multi State Coop Society Act 1984, secs 2 or 7 Banking Regulation Act, Section 45
Definition of "member"	As defined by the institution's by-laws; number of members is unlimited.
Regulating Authorities	1. Central or State Registrar of Cooperative Societies (for incorporation & management issues) 2. Reserve Bank of India (re: inspection, maintenance of cash & liquid assets, regulation of loans and advances) 3. Deposit Insurance & Credit Guarantee Corp.
Registration Document	By-Laws
Geographical Area?	State or India depending on registration.
Any restriction on dividend payment?	Maximum dividend 12%
Any limit on activity?	60% of loans must go to Priority Sector. Otherwise, By-Laws govern activity.
Capital required	In Metro areas, minimum Rs. 30 lakhs. Some flexibility from RBI in non-metro areas. Capital must be 8% of risk-weighted assets plus off-balance sheet items.
Limit on mobilizing funds other than deposits?	Share capital must be raised entirely from members. Borrowing is permitted.
Is housing finance permitted?	Yes, Max to 15% of the bank's total deposits for loans held in portfolio. No limit on NHB refinanced loans. Maximum repair loan Rs. 75,000. Special RBI Circular governs housing finance.
Income Tax	Exempt under Section 80P.
Any limit on accepting savings deposits?	Governed by capital requirements (see above). Deposits may be accepted from anyone.

Urban Cooperative Bank

Types of deposit accounts permitted?	- Savings accounts with checking - Time deposits - All individual deposits are insured up to 1 lakh
Total loans permitted?	Limited by capital requirement (see above)
Who can borrow?	Any member.
Can loan guarantees be given?	Yes, up to the value of unemcumbered assets
NHB Refinance	Presently available to scheduled urban cooperative banks. Available to non-scheduled banks via State and District Cooperative Banks, but each tier adds costs.

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Salient Features of Section 36 (i) (viii) of IT Act 1961

In respect of each housing finance company, which is approved by the Central Government for the purpose, the following tax concession benefits are available:

1. A public company formed and registered in India with the main object of carrying on the business of providing long-term finance for construction or purchase of houses in India for residential purposes, can create a special reserve with an amount not exceeding 40 per cent of the total income and, such a reserve is admissible as a deduction in computing income chargeable to income tax under the head Profits & Gains of Business or Profession vide Section 36-(i)(viii) of the Income Tax Act. This reserve so created shall not exceed twice the amount of equity capital.

2. For a HFC to be approved under Section 36-(i)(viii), at least 75% of loan portfolio should be as prescribed above. (Executive discretion and no CBDT guidelines are available prescribing the above percentage).

3. For deposits placed with housing finance companies:

   a. Deposits with or investments in any bonds issued by such companies by trusts/societies established wholly for charitable or religious purposes, qualify as an eligible mode of investment under Section 11(5) of the I. T. Act. Deposits of capital gain funds derived from property can also be made till invested in property as permitted under the Income Tax Act.

   b. For loans taken from housing finance companies:

      Repayment towards the principal amount of loan taken from any housing finance company for housing purposes is eligible for a tax rebate under Section 88 of the I. T. Act upto a limit of Rs. 10,000. Subject to the aforesaid ceiling, the rebate- from the tax payable- will be equivalent to 20 per cent of the amount repaid. The interest payable on the housing loan is a deductible expense under income from house property under Section 24 of I. T. Act.

   c. Interest on deposits by an individual or person with such companies will qualify for deduction of upto Rs. 7,000 per annum under Section 80-L of the I. T. Act(along with other eligible deductions).

Scoggins Anthony, *Introducing a Housing Finance Program: A Framework for Planning and Decision-making by Community-Based Financial Institutions*

INTRODUCING A HOUSING FINANCE PROGRAM:

A Framework for Planning and Decision-making

by

Community-Based Financial Institutions

A Participant Workbook

Designed By

Anthony P. Scoggins
Coady International Institute
Antigonish, N.S., CANADA

For A Workshop on

Community-Based Housing Finance

Sponsored by

The Indo-US Housing Finance Expansion Program

Hyderabad, India

February, 1995

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TABLE OF CONTENTS

INTRODUCTION

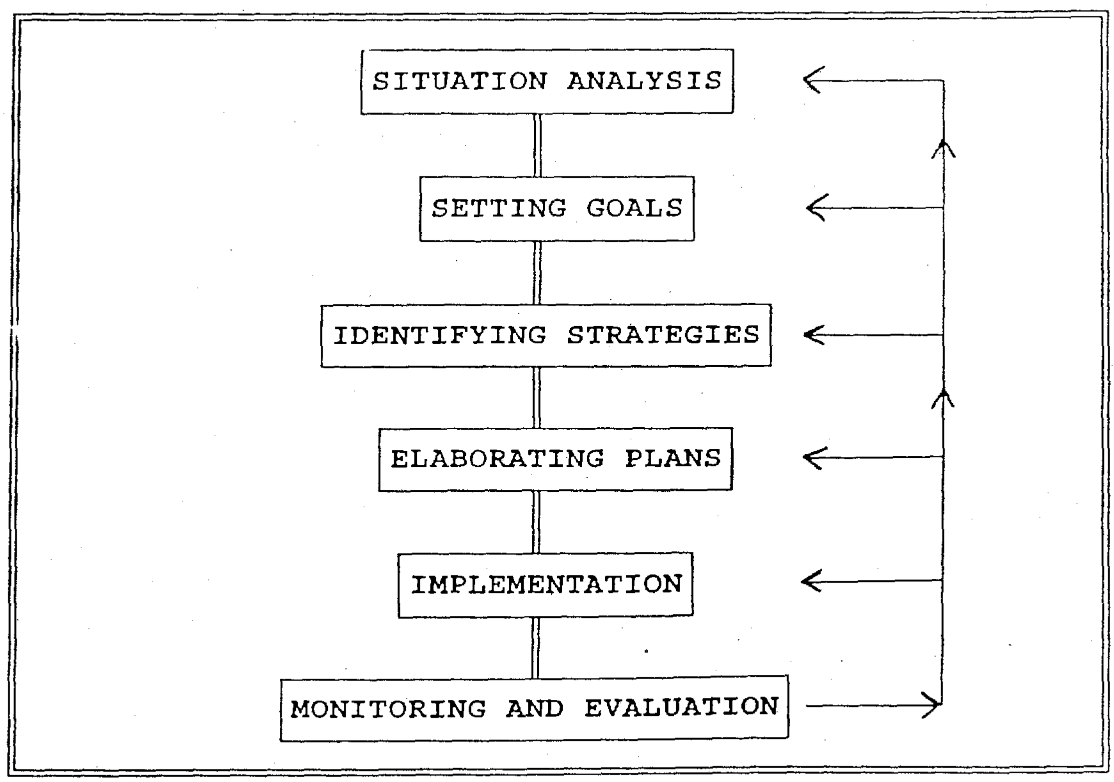
This document is designed as a workbook for participants attending a workshop on community-based housing finance. The participants will be staff of community-based savings and credit organizations (both non-governmental organizations and co-operatives).

The purpose of the workbook is to provide a simple framework with which participants can examine the key issues involved in deciding whether or not their organization should engage in housing finance.

The first part of the workbook comprises an exercise known as situation analysis in which the current status of the participating organization is examined, and its capacity to introduce housing finance assessed.

The second section provides a simple framework for decision-making, while the third and final section of the workbook applies a conventional planning framework to the specifics of developing a housing finance service within a savings and credit organization.

Figure 1: The Planning Framework



Given the limited duration of the workshop, the framework provided in this manual is relatively short and simple. However, all the key issues are presented and those organizations wishing to pursue the housing finance option following the workshop can use this workbook as the basis for developing a more comprehensive action and business plan.

Before Getting Started ....

IN YOUR OPINION, WHAT WERE THE KEY POINTS ABOUT HOUSING FINANCE THAT EMERGED FROM TODAY'S PRESENTATIONS AND DISCUSSIONS?

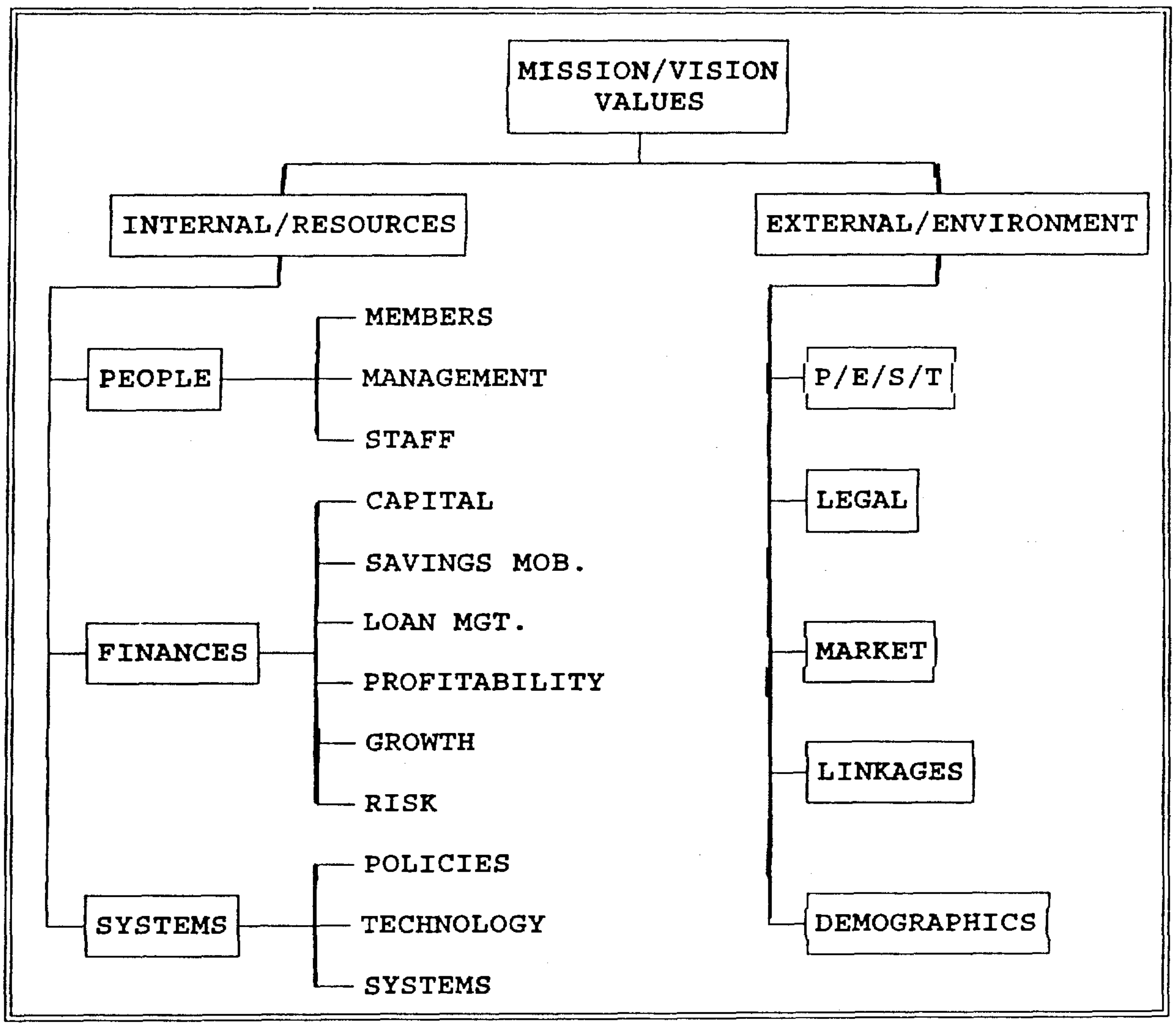
PART I. SITUATION ANALYSIS:

1. Elements of a Situation Analysis:

A situation analysis attempts to give the managers of an organization a clear picture of the current status of that organization, both in terms of its internal strengths and weaknesses and its position and capacity to respond effectively to external threats and opportunities.

In the case of a community-based savings and credit organization, the major components of a situation analysis are presented in Figure 2.

Figure 2: Elements of a Situation Analysis



2. Review of Vision, Mission and Strategic Priorities

2.1 Does your organization have a clear statement of its long-term vision and mission? If yes, what are they elements of these statements?

2.2 To what extent is the provision of housing finance services congruent, in contradiction, or ambiguous with regard to these statements?

2.3 Does your organization have a clear statement of its medium term priorities (i.e. strategies) for moving towards its desired vision?

2.4 To what extent is the provision of housing finance services congruent, in contradiction, or ambiguous with regard to these strategic priorities?

3. Assessment of Strengths and Weaknesses:

Looking first at the "internal" dimensions of your organization, what do you think are its major strengths and weaknesses? Do this assessment in two parts:

i) identify strengths and weaknesses in terms of the organizations general performance (related to the achievement of its mission); and
ii) review that list and highlight those strengths and weaknesses that will be important in relation to introducing a housing finance program.

PEOPLE

	STRENGTHS	WEAKNESSES
MEMBERS		
MANAGEMENT		
STAFF		

SYSTEMS

	STRENGTHS	WEAKNESSES
POLICIES		
TECHNOLOGY		
SYSTEMS		

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FINANCES

	STRENGTHS	WEAKNESSES
CAPITAL		
SAVINGS MOB.		
CREDIT MGT.		
PROFITABIL-ITY		
GROWTH		
RISK		

4. Assessment of Threats and Opportunities

EXTERNAL ENVIRONMENT

	OPPORTUNITIES	THREATS
P/E/S/T		
LEGAL		
MARKET		
LINKAGES		
DEMOGRAPHICS		

Part II: Decision-Making

5. Enumerating the Costs and Benefits

5.1 Keeping the above assessment of your organization in mind, make a list of the major advantages (i.e. benefits) and major disadvantages (costs) you think are associated with the introduction of housing finance?

ADVANTAGES/ BENEFITS	DISADVANTAGES/ COSTS

5.2 What are the major risks (uncertainties) associated with your analysis of costs and benefits?

6. Making the Decision

Do you currently have enough information with which to make an informed decision about housing finance?

YES

NO

What additional information do you require?

How do you plan to obtain this information?

In your opinion, should the introduction of housing finance be a strategic priority for your organization over the next 3 - 5 years?

YES

NOT SURE

NO

LEANING TO YES

LEANING TO NO

WHY?

WHY NOT?

7. Reality Check:

7.1 Assumptions:

WHAT ARE THE MAJOR ASSUMPTIONS THAT UNDERLY THIS DECISION?

7.2 Risk:

WHAT ARE THE MAJOR RISKS OR UNCERTAINTIES (EITHER EXPLICIT OR IMPLICIT) IN THIS DECISION?

7.3 Opportunity Costs:

WHAT, IF ANY, OPPORTUNITY COSTS DO YOU SEE FOR YOUR ORGANIZATION AS A RESULT OF THIS DECISION?

8. Elaborating the Strategy

8.1 Defining the Strategy:

Describe in general terms the approach you propose for providing housing finance through your organization:

Make reference to types and sources of funds to be mobilized, types of housing finance to be offered, the priority market segment to be developed, etc.

8.2 Thinking Strategically About Applying the Strategy:

Looking realistically at your organization at the moment, enumerate what you think to be the major helping forces and hindering forces in applying the above strategy.

HELPING FORCES	HINDERING FORCES

Part III: DEVELOPING A PLAN

9. Settings Goals and Objectives:

9.1 Goal Setting:

DEFINE YOUR ORGANIZATIONAL GOAL RELATING TO HOUSING FINANCE. SET A THREE YEAR TIME HORIZON.

9.2 Objective Setting:

IDENTIFY REALISTIC ONE-YEAR OBJECTIVES FOR YOUR ORGANIZATION IN THE VARIOUS KEY PERFORMANCE AREAS RELATED TO HOUSING FINANCE:

KEY PERFORMANCE AREA: ______________________
OBJECTIVE:

KEY PERFORMANCE AREA: ______________________
OBJECTIVE:

KEY PERFORMANCE AREA: ______________________
OBJECTIVE:

KEY PERFORMANCE AREA: ______________________
OBJECTIVE:

10. Elaborating Action Plans

For each of the objectives listed above, elaborate the basic elements of an action plan, using the following format.

OBJECTIVE: ____________________

____

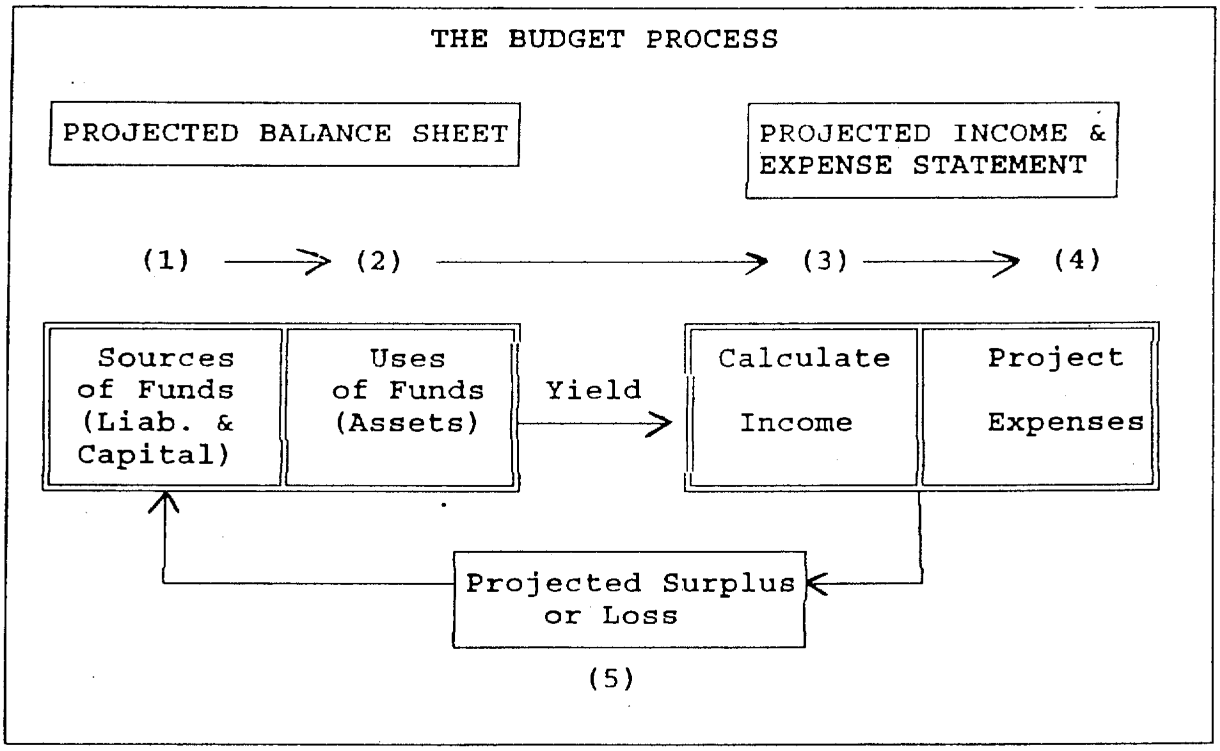
ACTION STEP	PERSON RESP.	RESOURCES REQUIRED	DEADLINE DATE	VERIFIC-ATION

11. Elaborating Financial Plans

11.1 The Budgeting Process:

A budget is the financial plan of an organization and is developed to assist the organization to achieve its stated objectives.

The budget of a financial institution is prepared in a sequence that follows the flow of funds within that organization, i.e. beginning with the balance sheet and then moving to the income and expenditure statement.



Worksheets for a budgeting exercise follow. But prior to beginning to work on the budget it is important to specify:

1. Key Assumptions:

2. Key Financial Results/Objectives

11.2 BUDGET WORKSHEETS

11.2.1 PROJECTED BALANCE SHEET:

11.2.1.1 LIABILITIES AND CAPITAL

	BEGINNING OF YEAR	END OF YEAR	AVERAGE
MEMBERS SHARES			
MEMBERS SAVINGS			
MEMBERS DEPOSITS			
BORROWED FUNDS			
STATUTORY RESERVE			
OTHER RESERVES			
RETAINED SURPLUS			
CURRENT SURPLUS			
TOTAL LIAB & CAP			

11.2.1.2 ASSETS

	BEGINNING OF YEAR	END OF YEAR	AVERAGE
CASH IN HAND			
SAVINGS ACCOUNT			
PERSONAL LOANS			
HOUSING LOANS			
INVESTMENTS			
FIXED ASSETS			
TOTAL ASSETS			

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11.2.2 PROJECTED INCOME AND EXPENDITURE STATEMENT:

11.2.2.1 PROJECTED INCOME

	PROJECTED YIELD AS %	AVERAGE BALANCE	INCOME
CASH IN HAND			
SAVINGS ACCOUNT			
PERSONAL LOANS			
HOUSING LOANS			
INVESTMENTS			
FIXED ASSETS			
TOTAL INCOME			

11.2.2.2 PROJECTED EXPENSES

a) FINANCIAL COSTS:

	AVERAGE BALANCE	INTEREST RATE	COST
DEPOSITS			
SAVINGS			
SHARES			
BORROWINGS			
TOTAL FINANCIAL COSTS			

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b) OTHER COSTS:

	LAST YEAR	COMMENTS	PROJECTED COST
PERSONNEL			
FACILITIES			
OPERATIONS			
SECURITY			
DEMOCRACY			
TOTAL COSTS			

11.2.3 SUMMARY OF INCOME AND EXPENDITURE:

TOTAL PROJECTED INCOME: ____________________

FINANCIAL COSTS: ____________________

OTHER EXPENSES: ____________________

TOTAL EXPENSES: ____________________

PROJECTED SURPLUS/LOSS: ____________________

PROJECTED SURPLUS/LOSS ON BALANCE SHEET ____________________

DIFFERENCE ____________________

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11.2.4 QUARTERLY CASH FLOW PROJECTION

a) CASH RECEIPTS	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
SHARES SAVINGS DEPOSITS LOAN PAYMENTS INTEREST INCOME INVESTMENT INCOME OTHER INCOME												
TOTAL RECEIPTS												

b) CASH DISBURSEMENTS	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
SHARE WITHDRAWAL SAVINGS WITHDRAWAL DEPOSITS WITHDRAWAL LOANS DISBURSED INVESTMENTS MADE EXPENSES PAID PURCHASES OF ASSETS												
TOTAL DISBURSEMENTS												

c) CASH BALANCE												
OPENING BALANCE PLUS RECEIPTS CASH AVAILABLE LESS DISBURSEMENTS CLOSING BALANCE												

Glover Christine, *The Group Credit Company, Cape Town South Africa: History from 1987 to the Present*

Glover Christine, *The Group Credit Company, Cape Town South Africa: History from 1987 to the Present*

The Group Credit Company, Cape Town South Africa: History from 1987 to the Present

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February 1995

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1. INTRODUCTION

The GCC has gone through six distinct phases in the last eight years. Each of these phases has been accompanied by differing principles, strategic thinking, preconditions for success and therefore also different results. The six phases are:

1. research and feasibility study
2. pilot
3. first expansion (one region)
4. second expansion (multiple regions) and finally
5. re-direction and finally
6. transformation to Mutual Bank.

These phases will be discussed below in terms of the particular objectives and achievements of the phase.

2. PHASE 1 - RESEARCH & FEASIBILITY

2.1 BACKGROUND

The original research was undertaken in the Urban Foundation's Housing Policy Unit in 1987/88 as part of the strategic thrust to develop access to housing finance for all but the indigent in S.A.[1]

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[1] The Urban Foundation (UF) was in 1987 the largest NGO in South Africa (S.A.). It was set up by big business after the 1976 riots in South Africa. The mission was primarily to facilitate and indeed engender change in S.A. The organisation concentrated on housing, education and small business issues. Housing, however, constituted 80% of the focus of the UF. The UF operated with various policy divisions which were based in a central head-office in Johannesburg. They had a branch in each of the five major centres of S.A. The branch network concentrated essentially on project activity. The principle was essentially that the branches were to pilot and test the policy work undertaken by the UF's policy units. Part of its focus in recent years has been that of institutional development. The following institutions are examples of what were developed.

Institution	Function
NEWHCO	The largest non-profit housing construction company in S.A. delivering sites and houses to the low-income market
Home Loan Guarantee Company	Offers 30% guarantees for mortgage loans below a certain size.
Land Investment Trust	A land-banking and bridging finance company in support of low-income housing development.
The Group Credit Company/CASH Bank	Initially a small loans company
Primary Science Project	Supports the upgrading of the skills of science teachers
Funda Centre	A large community centre that focuses on educational activities.

The focus was exclusively housing. Housing was the end, finance the means. This narrowed the focus in the research to exclude e.g. finance or banking services for low-income people as the desired result of which housing finance would be one product. This critical emphasis structured the parameters of the research.

The objectives were therefore to *"obtain an understanding of the key characteristics of the housing finance industry, to identify options for a small loans company, to identify how the options could be structured and refined and to identify the options which would make the selected option viable"*[2].

The primary sources for the information gathering were banks, building societies, consumer credit companies, local authorities, specialised housing institutions and briefly the informal sector in terms of its lending or its facilitation of the housing process.

The scale of the housing demand justified the belief that the appropriate solution would or should be closely aligned to the formal banks, by for example offering back to back guarantees for any lending done in this market by banks.

It was only due to the repeatedly expressed lack of interest *"at this stage"* by the formal banks that the research turned to informal options. The key parameter of the research i.e. housing, narrowed the options for exploration and the researchers found a *"paucity of publicly available research in this area"*. The limited research material available showed that an informal option might be feasible but that the circumstances and structure which could result in success *"would need to be created by managerial action during implementation"* due to the *"lack"* of research information.

The consequent conclusion was clear - to offer housing finance through existing informal infrastructure (stokvels)[3]. Distortions would be required of the stokvels, namely:

- to persuade savings associations to manage external finance. However, the existing infrastructure only had mechanisms to handle member savings and rotational draws on the pool of member savings.
- to persuade stokvels that housing needed to be a distinct focus of activity.
- to extend the period which the stokvels normally used as a cycle i.e. 10 months to one which could encompass 5 year cycles.
- to change the allocation method of stokvels from the rotational basis to once-off allocations.
- to persuade stokvels to take security from members.
- members would be required to participate in a managed housing scheme
- members would be obliged to run bank accounts.

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[2] Deloitte's Management Consultants co-ordinated and undertook most of the background work. All quotes in this section are from their summary document.

[3] Stokvels are the common S.A. name for a form of rotational savings and credit association (ROSCA). The most common form found for instance in a lower income community would be one where a group of eight to ten people (normally women) would decide to use peer pressure to facilitate saving towards a specific objective. The objective could be a specific form of consumption or simply of ensuring sufficient money for the Christmas season. The women will agree to a specific monthly sum that must be saved by each and every person. The pooled money is either paid out to a different individual each month to make the desired purchase or kept for Christmas and then shared out.

There are as many variants of this example as there are stokvels

2.2 EVALUATION

The research identified some key issues which with hindsight were worthy of a lot more exploration:

- the decision to look at informal lending institutions was correct as international experience shows that formal banks that have traditionally lent more upmarket do not succeed in lending on scale into this market unless they establish an entirely separate division.

- the mechanisms that stokvels use to manage their own finance offered the key to already proven international successes.

However, the primary focus - housing - precluded discovering the pre-existing international industry which operates not under a housing label but under either finance (micro-credit) or micro-enterprise label.

Hindsight too taught the GCC an important lesson on the establishment of the principles of the operation i.e. it is easier to change a system than an existing industry or market. In other words, never attempt to change a market to suit a product. It is easier to change the product to suit the market unless you are a mega-industry.

Many of the later problems which occurred in the GCC were as a direct result of having attempted to change the time tested methods of stokvel operations to something which suited the financial product we wished to sell.

2.3 TRANSITION TO PILOT

The conclusion of the research was that it remained desirable for the formal banks to eventually be the key actors but that both product and method needed to be well tested before they would consider introducing such methods into the formal banking system.

3. PHASE II - PILOT

3.1 OBJECTIVES

The pilot started in mid 1989 while an agreement was being finalised with the Development Bank of South Africa (DBSA) to provide loan finance at the then prime interest rate to fund the GCC's debtors book[4]. The agreement was for R1.5m, which was the amount identified in the feasibility study as the minimum amount required to test both product and procedures. The Urban Foundation agreed to provide a loan of R600 000 worth of interest free working capital to support the pilot.

The pilot was to run for three years and then be evaluated. The mission, long and short-term objectives for the pilot phase were as follows:

- to stimulate the supply and upgrading of low income housing stock on scale, through the extending of small, short-term loans to savings associations at market related interest rates.

Long term objectives:

- to offer appropriate housing finance to low-income households

[4] The DBSA is a state bank set up to fund at normally slightly softened rates projects in key areas such as infra-structural development like water supply, sewage works etc. particularly in areas where local authorities were not in a position to fund such development. Support for initiatives that stimulated necessary housing supply was therefore also a key focus.

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- to establish an apex organisation to interface with informal savings associations
- to offer a finance facility to the informal savings associations who in turn would on-lend to their members.
- to raise money from the capital market either directly or indirectly for the purpose of on-lending

Short-term objectives:

- to test under operating conditions the principles of on-lending to associations via an apex organisation.
- to test whether savings associations can maintain pressure on group members.
- to test the financial viability of these principles
- to test and develop the systems and structures required for such a financial institution
- to test the acceptability of this form of finance to informal savings associations.
- to test under operating conditions the critical variables which influence the viability of the company
- to evaluate under operating conditions legal constraints which hamper the operations of the GCC.
- to evaluate the acceptability and viability of the proposed staff structure to interface with savings associations and maintain group pressure.

3.2 PROGRESS

The GCC started advancing loans in November 1989. By October of 1990 it had 57 groups (919 individuals) who were performing well. R1.78 million had been advanced.

The loan product offered was a facility to a group of up to 20 people who were jointly responsible for the repayment of the loan. The money was advanced in three stages at five monthly intervals. The group instructed the GCC to pay over an approved amount to particular members. The term of each advance was 60 months with a maximum amount per individual of $2,000.

The amount and term were chosen because of the need to be able to support fairly significant housing inputs.

Demand for loans continued and it was considered appropriate to raise an additional sum of money to continue lending so as not to create a negative affect in the community through a sudden stop to the system as it was becoming established. Pressures from a range of housing actors and general community demand provoked an alteration to the initial concept of the pilot.

The performance of the debtors was most encouraging at this early stage. consequently a bolder approach to the experiment was considered desirable.

3.3 EVALUATION

Several positive lessons were learnt during this phase in relation to:

- methods of marketing at grassroots level
- procedures for advancing money
- games played in order to access resources
- basic administrative procedures

- the difficulty of operating in an environment which states *"we are entitled to what we demand"* which is compounded by the resonance that such a statement finds with staff
- the difficulty of teaching potential credit officers the difference between real affordability of a client and expressed affordability by a client.

3.4 POTENTIAL PROBLEMS FOR EXPANSION

The GCC faced a catch 22 situation in considering expansion as:

- the product though performing well was not a year old in the field and had not entered its risky period. There were three such periods perceived in the cycle of this loan. The first was when the full money was advanced to the group i.e. after the third advance in month ten of the cycle and the incentive to keep paying in order to access more money was no longer available. The second was potentially when a sum of money equivalent to the capital had been repaid and the issue of paying interest had to be faced. The third was when the possible benefits derived from the application of the loan were no longer perceivable and therefore no longer worth paying for.

- the formal banks represented on our Board of Directors indicated that the scale of the pilot was too small to be able to derive definite results. The pilot might thus still run its full course and end up with inconclusive results as a different scale might fundamentally alter the findings of the pilot.

- the sudden halt of any resource in a resource scarce environment normally creates a negative response which makes it more difficult to reintroduce the product in the same community. Furthermore, loan recipients themselves stop paying as the only reason for repaying i.e. further loans, is withdrawn. A pilot programme therefore needed to be an ongoing programme at a certain scale to firstly create the perception of continuity and secondly to be at a scale where it is not possible to *"over-manage"* the portfolio i.e. manage it in a sustainable manner.

4. PHASE 3 - FIRST EXPANSION : ONE REGION

4.1 BACKGROUND

The decision was to expand the pilot to the level of one viable regional operation capable of financial viability. Two problems had to be resolved before implementation.

- from whom to raise the money and under what conditions it could be raised.

- from whom to raise some *"reserves"* in order to off-set the wider risks involved.

The position was compounded by the inability to estimate the level of risk involved as the following excerpt from a motivation document produce in October 1990 illustrates.

"The inability to estimate risk on the basis of an adequate track record forces the Company to allow for a high level of default (25%). This level of risk provision on the one hand combined with the total lack of reserves within the Company on the other means that the Company can neither make financial provision for this level of risk as earnings do not allow for it nor raise the loan capital to allow for this expansion."

"The acquisition of a reserve fund for The Group Credit Company would allow the Company to sustain growth over the next six years. This could be achieved while simultaneously generating a track record which hopefully will no longer require excessive provisions for bad debt. It would also allow the Company to establish a real risk profile for this form of operation and no longer operate from the basis of assumed and perceived risk.

A reserve fund would allow the Company to make a 15% provision for bad debt. A further 10% provision already exists in the form of a 10% deposit that groups are required to pledge to the Company.

This fund will be able to sustain this provision for the next six years whereafter the Company can make a reasonable provision from its own earnings. Earnings on the fund at this later stage would be put back into the fund".

The GCC was therefore in the market looking for both money for reserves for risk. These were in the order of R6 million ($2m) while also looking for collateral.

The four financial institutions represented on the Board of Directors were approached to ascertain if they would be prepared to jointly lend the required cash to the GCC. A positive response from all four had as a pre-condition for lending an eighty percent collateral requirement in the form of either cash deposits or acceptable guarantees.

The establishment of the Independent Development Trust (mid 1990) opened up a possible source for collateral and reserves. A proposal was put to the Independent Development Trust requesting support[5].

4.2 PROGRESS

- In late November 1990 the Independent Development Trust gave GCC a grant to facilitate the expansion while DBSA and the GCC embarked on negotiations concerning guarantees.
- A R20 million (± $7 m) facility was raised from the four represented financial institutions.
- An additional four loan officers were employed in January 1991 for the expansion and underwent a three month training programme which was funded by ODA[6]. The total staff at that stage was 8 people. The total number of anticipated and budgeted staff was 18 people for this programme.
- The new loan officers started negotiating with clients in April and advancing loans a couple of months later by which stage the strategy for the GCC had changed again.
- The performance of the loans remained adequate - though arrears existed, the youthfulness of the loans (maximum age of debtors 18 months with most debtors well under 12 months) combined with the continual advancing kept the profile satisfactory. Arrears were also primarily in current or 30 days.
- GCC received the funds from Independent Development Trust in two tranches between February and June. As the GCC had not yet successfully negotiated donations tax exemption it was agreed that the grant be initially structured as a long-term subordinated loan until the GCC received its exemption.

4.3 CHANGES IN THE ENVIRONMENT

While the GCC tentatively embarked on its first expansion plan the overall housing credit environment was changing in particular due to the introduction of the Independent Development Trust. Two particular events sparked the change:

- the Independent Development Trust in wishing to introduce its capital subsidy scheme for housing was concerned with the adequacy of resources and resource institutions to facilitate consolidation once

[5] The Independent Development Trust (IDT) was established with funds from government that had bee released through its privatisation drive. The mission of the IDT was the redistribution of resources in terms of housing, education and health activities to the disadvantaged sectors of the population.

[6] ODA - The Overseas Development Administration which is the external development arm of the Briti government.

site and service schemes had been introduced at scale[7]. Credit remains an important component of consolidation[8].

- similarly, the proposal from the GCC evoked concern that such an approach was not sustainable at scale because of the level of collateral required from the financial institutions

The GCC was then requested by Independent Development Trust to develop a plan for an ambitious expansion of the GCC into a national operation highlighting what was required to facilitate such an action

5. PHASE 4 - MULTIPLE REGIONS

5.1 BACKGROUND

A national expansion plan was developed with three pre-conditions before implementation was possible.

- firstly, an outside institution had to carry the full risk of the debtors book
- secondly, access to funding was required with limited collateral requirements
- thirdly, the GCC required a *"growth fund"* namely a revolving fund which would pay for all the expansion costs in terms of working capital. As one unit of expansion repaid its working capital the next would be started. The money would therefore revolve between an additional five branch operation in the period of six years.

The Usury Act was identified as a major barrier because the margin allowed the GCC was inadequate to support the cost structure even once the company had stabilised after the major growth as the following two historic graphs illustrate[9].

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[7] The capital subsidy scheme introduced allowed for a once-off subsidy of + $2,500 to low income earners who had never received a subsidy in other forms. This amount of money would normally allow for the purchase of a serviced site. In some areas of S.A. there would be some money left over to support the start of building a house as well. In the major urban areas however, it was between 70 - 100% of the cost of a fully serviced site with potable water and a reticulated sewage system.

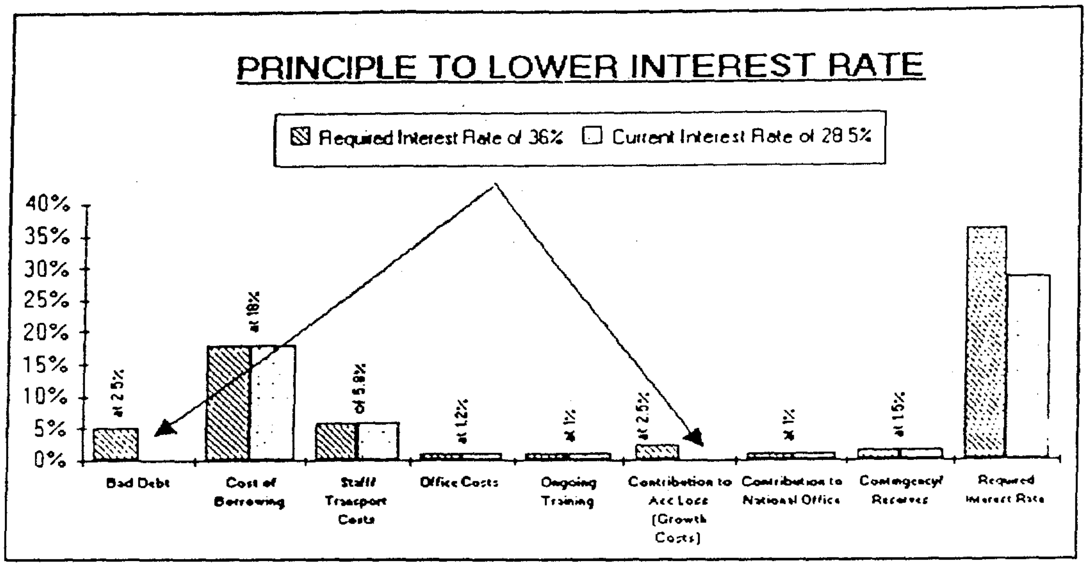
[8] Consolidation refers to the process of gradually developing and formalising the superstructure (house).

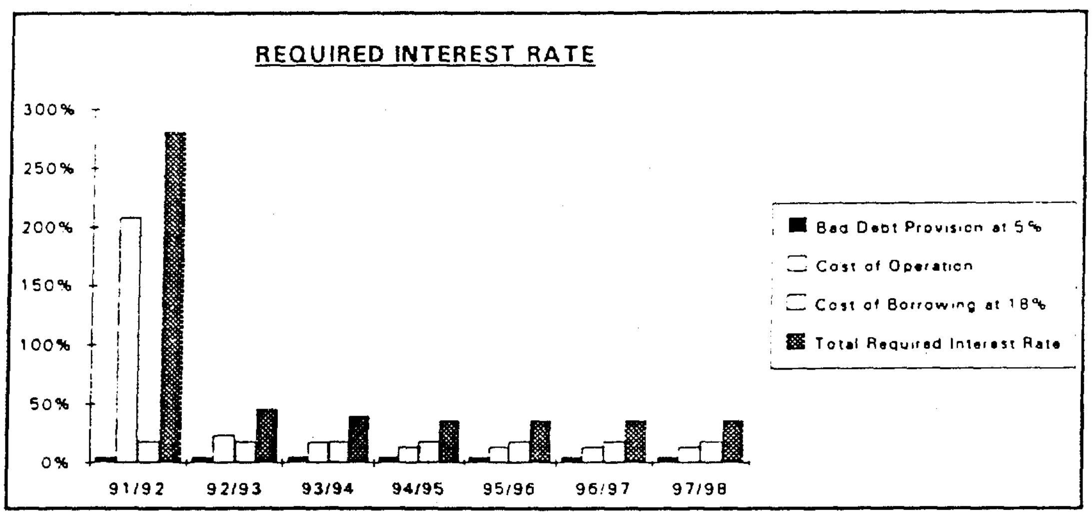
[9] The Usury Act in S.A. has three categories of loans:

1. loans that are less than R6 000 ($2,000) and for less than 36 months.
2. loans that are greater than R6 000 but less than R250 000.
3. loans that are greater than R250 000.

In 1991 the interest rate restriction on category (1) was 28.5%; on category (2) 26.5% while category (3) had no such restriction.

In 1993 the restriction on category (1) was released in order to facilitate micro-lending programmes. They are currently, however reviewing this due to perceived exploitation by certain operators.





5.2 PROGRESS

- By June 1991 an additional 6 loan officers were employed in Cape Town to expand the existing operation.
- By end of August 1991, fourteen staff members had been employed to start the PE office.
- By October 1991 the GCC had advanced R8.2 million to 183 groups of 2848 individuals in the Western Cape.
- The GCC located 80% of the required *"Growth Fund"* by August 1992 from US Aid, Hanns Seidel Foundation and the Independent Development Trust[10].
- By June 1992 PE started advancing to clients

[10] The Hanns Seidel Foundation is the overseas development arm of Bavaria, a region of Germany

- By June 1992 the expansion plan was halted due to the developing arrear problems and the strategy of the company again changed.

5.3 EVALUATION

- By October 1991, as the oldest debtor reached the 24 month mark, there was a sufficiently large pool of older debtors to show a definite trend of a strong increase in arrears at 16 months i.e. 6 months after the last advance.

- Due to the level of advances undertaken during 1992, the trend was obscured in the overall figures and it was several months before the Directors agreed that a trend was clear and that it would be prudent to shorten the term to 36 months i.e. a maximum effective term of 46 months.

Hindsight shows that this was not prudent enough but the initial analysis was on the group of debtors that had had a much higher level of interaction as the earlier scale of the operation had allowed for a more intensive level of management.

- By October 1992 the GCC had four particular problems occurring simultaneously:

  - ◆ product failure.

  - ◆ the change of scale in the organisation and the failure of some principles to operate at a different scale.

  - ◆ the rapid expansion of staff none of whom had experience in this form of credit elsewhere and too few staff who had any depth of experience in the GCC. This was compounded by the fact that many staff had a limited educational background with limited numeracy and writing skills and consequent productivity problems.

  - ◆ the scale induced a lower level of supervision and the difficulty of acquiring good supervision skills or promoting from within to supervisor level became (and remains) a key problem.

5.3.1 Product Failure

The experience within the GCC over the last few years allowed us to assess the sensitivity of key factors and the advisability of having manipulated international experience in relation to these parameters.

In order of sensitivity the following factors resulted in the development of arrears:

5.3.1.1 Term

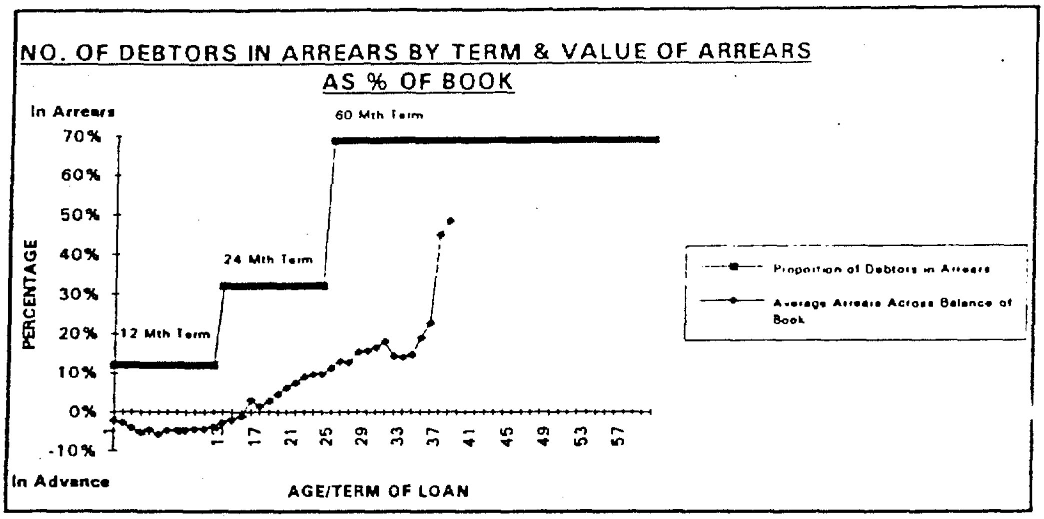
The major sensitivity was the term of the loans:

* The GCC had already proved that group loans with a 12 month or less term have a very good recovery rate. On a pilot group of loans (65 groups) that were restricted to a 12 month term the GCC achieved a recovery rate of 93% of all instalments raised.

The GCC's risk exposure on short-term group loans is limited to 12% of the number of loans in that defined section of the book (the arrears rate runs at 12%)

* The position changes markedly with any increase in the term. For group loans with a term of 24 months the arrears treble (32%). The important element is, however, that the real risk exposure increased from 12% to 32% by the addition of a further 12 months to the term.

* By the time the term increases to 60 months the arrears increase to 69% of the number of 5 year loans with only 1% fully covered.



5.3.1.2 Size of Loan

Trust as a basis of assessing potential repayment for sums of money which fall within daily personal cash flows works exceedingly well (the normal basis of group assessment). However, the difference of working with instalments which might require a full month's salary of one member of a family was not recognised by groups.

The group method of assessing members' ability to borrow small sums of money was directly applied to the large sums i.e. *"I trust you will repay R200 because you have borrowed it in the past from a neighbour/friend/relative and I know you repaid it"* became *"I trust you to borrow R5 000 because I know you have borrowed and repaid R200".*

The consequence of utilising the informal method of assessing members was the invariable over extension of a person's affordability.

5.3.1.3 Affordability

The group mechanism of assessing an individual member's ability to pay is only effective for short-term loans involving relatively small sums of money. As the sums of money moved beyond commonly used limits, the basis of assessing affordability became need and not ability to pay. Affordability over the medium term in our experience is also not easy to assess for even an experienced credit officer as one is dealing with a sector of the population that is characterised by irregular income, cyclical employment and differing monthly priorities for use of disposable income.

Offering large loans with a large instalment cancelled out the benefits of utilising group principles to facilitate affordability namely:

* the ability to assess each other for creditworthiness;
* the ability for the collective membership to bridge a member who is having to face other priorities in any given month.

5.3.1.4 Peer Pressure

People only exert pressure if they are not disadvantaged personally by such action.

Continued pressure over a 60 month term operates to the disadvantage of the good payers as they:

* directly bear the transport costs of contacting the other members.

* are subjected to personal abuse and threats by the people who are unwilling to pay,

* soon perceive that they will lose any money that they personally put into the kitty to bridge short payments.

* recognise that the performance of some members will permanently prejudice their own record and that they personally do not have the means or methods to rectify the situation.

Such pressure is possible and feasible in the short term but is not sustainable as a principle to ensure repayment over the medium term. The perception of groups once they have experienced significant long-term problems is that the system of joint and several responsibility is intrinsically unfair and inequitable and consequently it is more to their advantage to join the ranks of the non-payers.

5.3.1.5 Interest Implications

The GCC in charging interest on daily balance compounded the disincentives once a group or individual went into arrears. For example, if an individual was retrenched but found a two day job and continued paying R50 of a R125 instalment, the person's balance continued to rise each month. The person perceived himself to be powerless to repay the debt. The interest bill kept rising and the person could not measure the total interest bill given his personal circumstances.

The perception is that the goodwill that the person is indicating through paying at least something is not being met by a corresponding gesture on the part of the GCC but by a statement like *"We will take more and more and more from you until infinity"*.

The positive effect of a payment no matter how small is a very important part of ensuring ongoing payments.

5.3.1.6 Simplicity

The GCC's experience is that complexity and sophistication increases costs as it results in firstly the need for numerous higher skilled people to field the multitude of queries on product, procedures and statements and secondly increases the costs of managing clients as loan officers need to do a multitude of trips to a client to solve queries.

The simplicity required is one that allows for all product information and management details to be on the back of a couple of matchboxes. If loan officers don't feel that they can confidently handle all clients queries they cease to be an interface and client officer but became an interpreter to some other person who then becomes the client officer. The real client officer then avoids contact with the clients or concentrates on those with maximum queries to the detriment of the remainder of the portfolio.

5.3.1.7 Housing

Experience has shown that the essential issue for low-income communities is that credit per se should be available. The recipient should have the prerogative of selecting the use for which the credit is applied according to immediate priorities, if he/she does not, the use of the loan will always be manipulated.

CONCLUSIONS REGARDING GROUP LOANS

5.3.1.8 If GCC had restricted its product to a maximum term of one year the group product applied to housing would have been successful. It has proved the success of a group loan of 12 months and it has also clearly demonstrated the failure of group loans where the loan exceeds 12 months.

5.3.1.9 In the Target Market, collectibility depends on:

* ensuring affordability (which is heavily influenced by short-term environmental problems whether due to family problems or economic downturns).

* contactibility - one collects more through a personal collection system than through an impersonal hands off mechanism.

* rigorous regular contact with clients who do not have a stop order payment system.

* relatively small repayments - large instalments are only maintainable in the short-term

In terms of product design simply:

* Term (as short as possible)

and

* Size (as small as possible)

IMPACT OF RESULTS OF PILOT ON PRE-EXISTING BOOK

The GCC recognising that it had delivered a poor product to its longer term clients attempted to select the potential good customers from the remainder. As good clients needed the opportunity to maintain and enhance their credit record the decision was taken to allow clients to convert their loans from group loans to individual loans if they so wished. In converting groups we could consolidate the portfolio of good clients. It is interesting to note that:

* of the 65 groups whose term did not exceed 12 months only 5 groups (0.7%) chose to convert

* of the 32 groups with a term of 24 months 22 (69%) decided to convert.

* of the 184 groups with a five year term, 111 (60%) groups converted, but increasingly smaller proportions of the group actually converted.

As at 1 June 1993, the GCC had moved 2018 individuals from groups to having an individual account. This is 42% of all clients who were acquired as group clients.

The average loan profile of these *"converted clients"* is:

Size	R2908
Term	31 months
Instalment	R159 per month
Deposit	R587
Deposit as % of loan	20%

The repayment performance of these 2018 individual clients was analysed in order to streamline the management of these debtors and were classified as follows at the point of conversion

Always pays	528	26%
Usually pays	288	14%
Pays only when collected	477	24%
Seldom pays (never pays a full instalment 2 months running)	209	10%
Never pays (bad - pays less than 1 instalment in 6 months)	488	24%
Unclassified	28	2%
	2018	100%

People were not weeded out in the conversion process on the basis of performance as the GCC hoped that it could potentially still get garnishee orders against poor payers.

Unfortunately, only 18.4% of clients signed a new Acknowledgement of Debt (AOD) for a term of 12 months or less. However, the value of these loans only constituted 9.11% of the converted book while 57.7% of the value of the book were in loans where the new AOD's were for terms in excess of 30 months. It was recognised that the conversion process will not have overcome problems but will merely have provided opportunities for good clients[11].

5.3.2 SCALE RELATED PROBLEMS

The development of new staff from a small core of experienced staff with good products and procedures is possible with the marrying of one new person to one good person for the *'apprenticeship period'*. In our experience this is the best way of inducting new staff. The rate of growth is then always determined by the number of good staff with sufficient experience that an organisation has. Growth therefore becomes exponential over time, but never at the initial stage.

The GCC when it started training the second round of Cape Town loan officers had neither secure product, therefore no time tested procedures and no sufficiently experienced staff who could transfer skills on an apprenticeship basis. Staff were still busy trying to discover the dimensions of their own job when they acquired a trainee.

Trainees outnumbered staff and frequently intimidated them on critical *'unpopular'* issues involved in the lending of money. Staff who *'should know better'* wisely held their tongues in areas that were critical to the GCC but unpopular outside of the GCC.

There is unfortunately no adequate short-cut in institutional development where only limited compatible experience exists in a country. Staff have to be given the time to develop experience.

If the GCC were to have 100 experienced staff members with one tried and tested product, it can easily train another 100 but with 3 experienced and 4 newly trained it tried to process an additional 18 people.

This took its toll on people's confidence at a stage when creative energies had to be applied to growing arrears in an untested product, in other words, in developing new procedures to manage a new area of required expertise in the company. Furthermore, the original client to staff ratios of 60 groups (900 people) was not a feasible ratio and had to be drastically adjusted downwards. The attempt to have loan officer manage such large portfolios resulted in inadequate aftercare and therefore aggravated arrears at a stage the GCC could least afford it.

[11] Now, two years after the attempt to convert these clients, it is now recognised that no special benefit was derived from undertaking this exercise. The GCC could as easily and without the expense of the conversion have simply done its best at managing through the failed product.

6. PHASE 5 - RE-DIRECTION EARLY 1993

6.1 NEW PRODUCTS

The failure of the long-term group product combined with:

a) a need for products with a lower risk profile;
b) non-housing products to satisfy demand;
c) individual products in response to demand; and
d) short-term products for unsecured lending

the GCC changed its products during 1993 to:

- a largely unsecured community based short-term product for either individuals or groups which does not have a defined use.

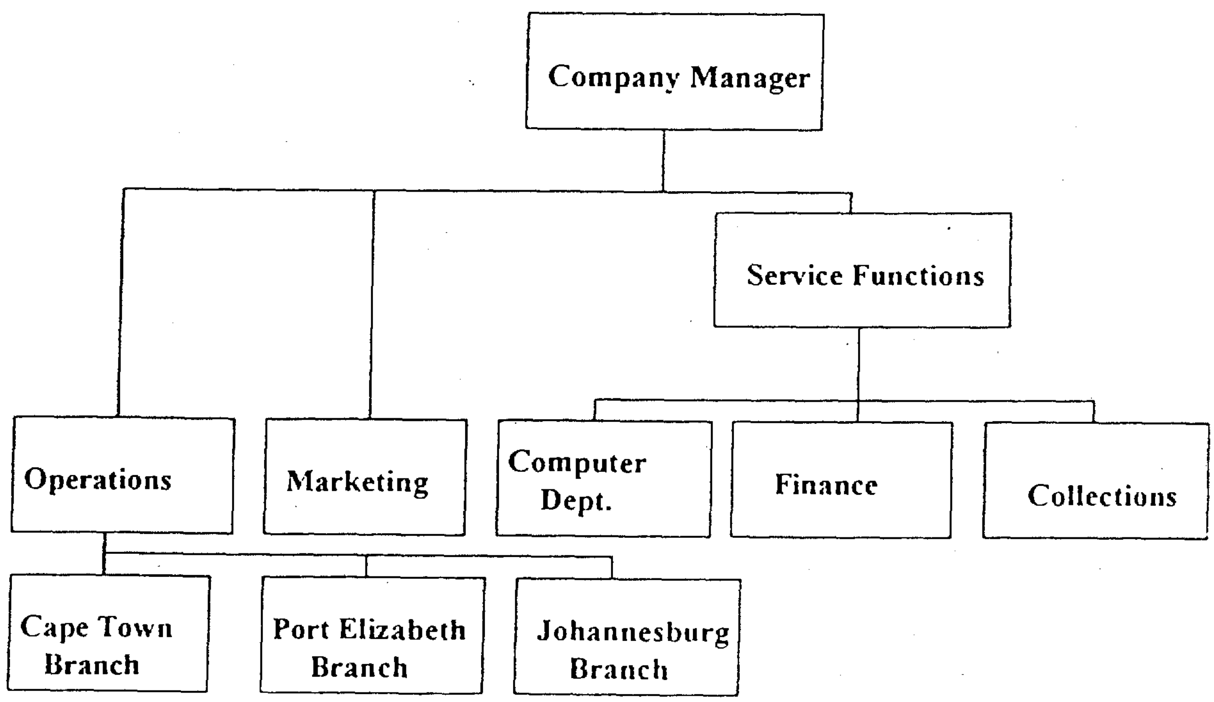
- an employer based product either for housing or non-housing which is essentially payroll driven with the larger housing loans fully covered by Provident Fund guarantees.

  The GCC therefore again entered another experimental phase with one proven product and two experimental products. These products have a very different earning profile and procedural requirements which in turn necessitated a restructure of the company.

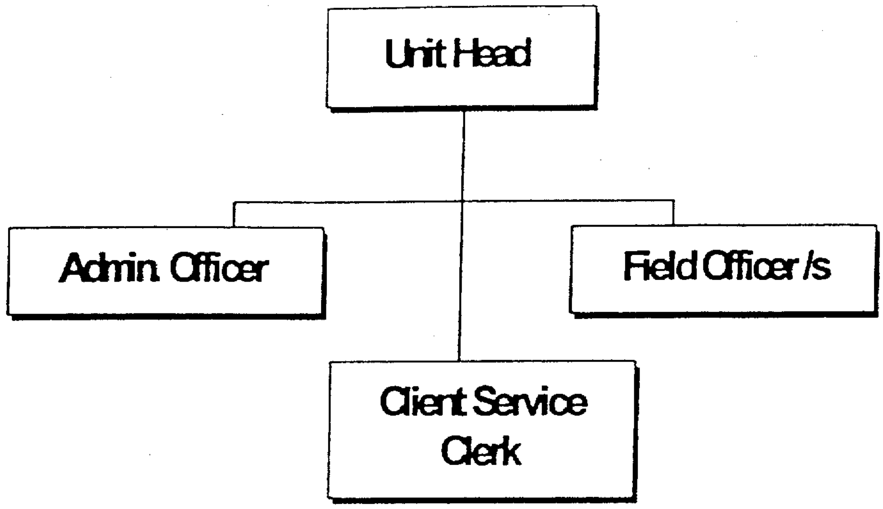
6.2 CHANGE IN ORGANISATIONAL STRUCTURE

The company changed from a decentralised two region approach with most functions duplicated in the regions to a centralised servicing structure coupled with decentralised operational units and a marketing department.

The structure was:



The operations section will be made up of small operational units (a minimum of 4 and a maximum of 10 people) who will manage all functions directly required at the interface with the client The unit structure will be based on the following key positions.



The principles behind the unit structure were:

* to develop a modular system which allows for easier replication and on-site training.
* to have clear career and training paths which provide both motivation as well as a structure which did not require that all staff perform uniform functions at a relatively super-performer level. It should allow people to learn at their own pace before being confronted by additional performance requirements.
* to have operational units which never exceed the size where all in the unit can be aware of the full unit's performance and be in a position to personally contribute and impact on that performance.
* to therefore be able to structure an incentive package for staff which was geared to both individual performance as well as the unit's performance. Hopefully, this would encourage both better team performance as well as individual performance.
* to have a minimum size where all admin as well as operational requirements for effective client servicing can be met without delay. Delays are a concomitant of a separate operations and administration structure.
* to reduce risk through limiting the exposure in any particular area by setting the maximum size of a unit before a further unit is established[12].

6.3 <u>CHANGE IN REMUNERATION STRUCTURE</u>

A major problem for the GCC had been the range in productivity between staff. For example, if the GCC priced for a productivity value of 10, it has only achieved a range of 1 to 5.

The reason for this problem is that the GCC expected to pressure-cook staff in terms of training and developing work experience at a much faster rate than has turned out to be either practical or feasible. The necessity of swinging the company onto a performance based system became an imperative to allow for the range of performance achieved and to avoid a system whereby the average performer is not a liability to the company but can continue to be employed at a lower level of performance. Investment in each staff member has been enormous and is not easily discarded. Furthermore, experience has shown that some of the medium term *"strugglers"* can become your good performers given more experience and supportive/educational management.

[12] This structure for servicing high risk micro-loans in particular was loosely based on the unit system used by the Bank Rakyat Indonesia, Unit Desa Division.

6.4 STRUCTURE TO FACILITATE ONGOING TESTING AND EXPERIMENTATION

The GCC must, in order to ensure long-term success, develop an active Research and Development section that on an ongoing basis develops and tests new ideas. Before the failure of the long-term group product, the GCC followed the *"all eggs in one basket"* approach to its detriment. Any modification to the company's structure or product has therefore required major negotiations which are exceedingly time consuming and not always constructive.

The ongoing testing with limited risk must be part and parcel of the company's operations so that it can constantly be involved in finding products with a better chance of success without requiring the company to hit the major lows and equally negatively carry major external expectations of any or every new idea.

Risk diversification in terms of product, geographic exposure and funding is an imperative for survival.

Testing needs to be a low-profiled occupation which does not have the ability to sink the company with every new idea and or need to be the debating point of the micro-credit industry before it can be tested.

6.5 IMPACT OF REDIRECTION

The diversification of products with a range of risk profiles included products with a relatively low risk profile but which were in high demand. These required easier administration than the high risk micro-loans and this allowed the GCC to expand much more rapidly.

However, the spread of products also implied a range of operating margins which were significantly different from the large margin small loan historic situation.

At the secured end the loans only offered a margin of 4.6% and were therefore volume sensitive. A significant size book is needed to reach break-even point.

These loans are also on average eight to ten times the size of the average loan at the bottom end of the book.

This structure of loan book has its major advantages as it offers the credit organisation a secure cash-flow low maintenance base of which the high risk loans become attractive as they are kept at a level which cannot threaten the entire institution. The larger margin provides the cream (the profit) on top of the bread and butter portfolio which covers costs.

The problem with this type of portfolio is however, that it is exceedingly cash hungry. The funding of such a portfolio in a non-bank structure is very difficult. Instititutions that are not registered as banks in S.A. may not take deposits from the general public. The concept of deposit includes loans from any corporate body other than a bank as well as savings from the man in the street.

GCC with R20m raised in grants and R20m facilities with banks against which it had to provide 80% collateral needed an ongoing commercial source of funds to sustain such an operation...

This had to be through accessing the capital market, in particular the large insurance companies and industry wide pension funds.

An institution the size of GCC (small) had never approached the capital market looking for commercial investments previously.. The barrier to access was real. The life offices are traditionally conservative investors who are extremely risk adverse. They are also primarily interested in large scale investments dealing in tranches of R50m - R100m as opposed to the R5m - R10m tranches that the GCC was wanting.

A mechanism was established whereby GCC ceded debtors and accompanying securities to a "Securities Trust" administered by a large and reputable company with a division of debenture trust managers. The mechanism looked attractive and two of the more progressive life offices indicated a preparedness to invest

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The mechanism, however, hinged on a particular interpretation of the Banks Act regarding the issuing of commercial paper/promissory notes.

The GCC approached the Registrar of Banks to gain approval of the mechanism. A few months later the Registrar instructed the GCC to restructure the operation as a Mutual Bank[13].

At this stage the GCC was primarily managing the following products.

COMMUNITY LOANS
• 1 to 2 Year Term
• Average 11 Months
• R200 to R6 000
• Average R948
• Unsecured
• Manual Collections
• Required Margin 50%
• 1668 Debtors

EMPLOYER LOAN PROFILES	
• LOW RISK HOUSING	• MEDIUM RISK - GENERAL PURPOSE
⇒ 3 to 15 year term	⇒ 1 to 2 year term
⇒ Average 59 months	⇒ Average 21 months
⇒ R1 000 to R25 000	⇒ R1 000 to R6 000
⇒ Average R6 380	⇒ Average R2 160
⇒ Secured by Provident Fund	⇒ Unsecured
⇒ Payroll deduction	⇒ Payroll deduction
⇒ 85 companies	⇒ 85 companies
⇒ 4000 debtors	⇒ 2000 debtors

The volumes involved in these products at that stage are outlined below.

COMMUNITY LOANS	
HIGH RISK UNSECURED LOANS	
⇒ Total advances	= R4.4 million
⇒ Tot.' recovered	= R3.4 million
⇒ Total written-off	= R0.07 million
⇒ Value managed	= R1.3 million
⇒ Monthly cash-flow	= R0.2 million

[13] A Mutual Bank in S.A. differs from a commercial bank merely by virtue of the scale of the required capitalisation and the nature of the share instruments. The share instruments in a mutual bank are designed to be able to include ordinary savings instruments so that the man in the street can in a real sense own a piece of the bank.

LOANS	
MEDIUM RISK UNSECURED LOANS	
⇒ Total advances	= R7.0 million
⇒ Total recovered	= R3.1 million
⇒ Total written-off	= Nil
⇒ Value managed	= R4.7 million
⇒ Monthly cash-flow	= R0.4 million
⇒ Average margin	= 10.5%

EMPLOYER LOANS	
LOW RISK SECURED LOANS	
⇒ Total advances	= R25.9 million
⇒ Total recovered	= R3.8 million
⇒ Total written-off	= Nil
⇒ Value managed	= R25.1 million
⇒ Monthly cash-flow	= R0.4 million
⇒ Average margin	= 4.6%

7. PHASE 6 - TRANSFORMATION TO MUTUAL BANK

7.1 BACKGROUND

The instruction from the Registrar was a major turning point for the GCC. It offered on the one hand:

- a very real way of establishing a bank with a full range of banking services and products that would focus on the traditionally disadvantaged sectors of the S.A. population.
- an ability to start taking deposits both from the man in the street as well as actively canvassing for corporate deposits (provided the bank had a strong balance sheet).
- investors the security of knowing that the GCC was now a regulated body overviewed by the Registrar of Banks.

On the other hand, the GCC would have to:

- conform with all the standard banking requirements concerning liquid assets.
- submit monthly returns to the Registrar in a standardised format which calls for a fairly sophisticated analysis of the activities in any month. This requires a computer system which an NGO that concentrates on variants of micro and small loans does not require.
- conform to the risk management policies considered desirable by the Registrar.
- have quarterly meetings with the Registrar to account for any major deviations from the industry average in any key areas.
- have all senior executives approved by the Registrar before appointment
- have all directors approved by the Registrar before appointed to the Board of Directors.

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The GCC is the first pre-existing credit organisation from an NGO background that is transforming into a bank in S.A. It is therefore both a learning curve for the GCC in terms of what is needed to conform to banking standards but still remain consistent in terms of reaching the original target market. It is also a learning curve for the Registrar who is having to draw into his ambit of regulation an organisation who has very few features of a normal commercial bank.

7.2 APPROACH

In order to qualify for registration as a Mutual Bank the GCC had to indicate that it could satisfactorily answer the following questions. Questions which one needs to answer through developing a business plan.

- what are the mission and objectives of the organisation?
- does the institution envisage a long-term existence and therefore need to ensure that it was focussed on planning for total cost-recovery?
- what is the target market?
- what are the demand gaps in the market?
- can the organisation offer products that can meet these demands?
- what are the organisation's strengths, weaknesses, opportunities and threats (SWOT) in trying to fill these perceived market gaps?
- what organisational structure would best suit the management of the products?
- what skills are required at the various positions in the structure and how much will these skills cost the organisation?
- what support do these skills need in order to be effective and what will that cost?
- what systems and technology will be essential to manage the potential products outlined?
- what risks is this organisation going to face? How are they going to be managed and what are the cost implications of managing these risks?
- can the risks be contained within the structure proposed for the organisation?
- how long is it going to take before the organisation hits break-even? What are the stages along that road?
- what are the assumptions made in order to arrive at an answer to the question on the break-even point?
- what is the capital structure of the organisation and which investors are going to be approached to invest in the organisation?
- what price will have to be paid for the capital? (What is the penalty component considering the higher risk nature of the organisation?)
- How must the product be priced to ensure a sustainable company that recovers costs, makes reserves and rewards stakeholders?
- how sensitive is this business to any changes to the key assumptions?
- can one forecast the impact of these sensitivity analyses?

7.3 DEVELOPING THE ANSWERS

In working through these questions, one needs to bear in mind that survivial in the market place requires constant revisiting of these questions and making adjustments quickly to the original concept.

A business plan remains fairly detailed and accurate for about a year, thereafter it becomes more and more conjecture and wishful thinking. Responsiveness to the environment remains the key to success. It is frequently the smaller companies that are the market leaders as they have the ability to face a challenge, perceive an answer, refocus the organisation and respond. The larger an organisation grows, the more bureaucratic it becomes, the less easy it is for that organisation to adjust to specific threats or opportunities quickly.

NGO's often suffer from the same plight as the large bureaucratic organisations for two reasons. Firstly, they are frequently linked to a particular donor organisation. Grants are always conditional with the terms incorporating detail on how the organisation should work and detailing products and procedures. Adjustments have to be pre-negotiated with the various donors who in turn have to negotiate them with their extensive internal bureaucracies. Secondly, the NGO's will frequently be peopled both at staff level as well as on the Board of Directors by people who primarily have a mission and little market exposure. To be imbued primarily with missionary zeal can be one of the more blinding of visions.

For long-term survival and sustainability of an organisation and its ability to both achieve a particular mission but become commercially viable, it is important from the outset to gradually change the funding sources from an initial predominantly grant base to one which is exclusively from commercial sources. Commercial investors look for financial returns and its second interest is the mission of the company. This allows the freedom to run a flexible, responsive operation that could be the market leader in its area of operation. The senior management spends its time managing the business of the day not managing donors.

It is also important over time to mix the staffing of the organisation at all levels (including the Board of Directors) with people with commercial skills one can draw on. The mixing of skills gives real benefits in the form of the shortening of some expensive learning curves. It allows the organisation to tackle a range of operational risks with eyes open and not blunder into them.

A Business Plan is an important tool to thinking through all these issues and having a provisional stab at looking for routes to develop a successful company in areas of the market where neither donors nor existing commercial operators are successfully operating.

7.3.1 MISSION & OBJECTIVES

CASH BANK
MISSION STATEMENT

The Credit And Savings Help Bank seeks to promote economic growth within low income communities by promoting savings and productive investment. The Credit And Savings Help Bank will be a commercial provider of appropriate banking services to the lower income communities through the provision of savings facilities, as well as credit predominantly for housing, small business, education and personal loans. The Bank wishes to serve the community that has restricted access to the large banks by encouraging savings and the responsible use of credit.

CASH BANK
OBJECTIVES

⇒ To offer an effective and efficient intermediation service to the low income market.
⇒ To innovate with regard to product development in order to meet the requirements of the low income population.
⇒ To become a viable national institution focused on the lower income client market.
⇒ To sustain our asset base and our profit growth.
⇒ To develop an institution which both clients and staff have a stake.
⇒ To provide an adequate return for institutional investors and shareholders.
⇒ To develop a staff who are respected by clients for their competence, efficiency, integrity and advice

7.3.2 MARKET ANALYSIS

These praiseworthy objectives needed to be more tightly defined within the operating experience of the organisation. In order to do so, we needed to understand the market we were successfully servicing and the wider opportunities that sector of the market offered us in terms of potential new products while simultaneously assessing whether we were capable of taking these opportunities.

It was felt that the following key categories were the sector of the market that the GCC/CASH Bank could most successfully service.

OCCUPATION PROFILE	INCOME LEVEL	AGE	SEX	GEOGRAPHIC/ LOCATIONAL NICHE	MATCHING PRODUCTS
Self-employed Domestics and gardeners Unskilled employed	< R2,000 p.m < R1,000 p.m. Disposable ± 10% of income	35 - 60 years average of 45 years	Predominantly female	Predominantly informal settlements	• **a very short-term individual or group loan that is unsecured** and can be used for the priorities perceived for that market i.e housing, housing security, small business, education, needs associated with fulfilling traditional or customary requirements and funeral needs • **a flexible savings product** that allows for maximum liquidity so that it matches the ad hoc business requirements and cash-flow emergencies • **a dedicated savings and loan package** aimed at a specific purpose e.g educational costs or the purchase of some capital asset
Unionised Employees	< R3,500 p.m. Disposable ± 20% of gross income	20 - 60 years Average age 35 years.	Predominantly male	Formal dwellings Hostels Limited informal dwellings	•**housing loans secured by either the employer, a third party or the Provident Fund** which enables the client to extend or renovate existing houses. The size of the loan demanded would vary from R3,000 to R45,000 •**non-housing loans** for use to purchase consumer goods and second hand vehicles. The expressed need is for loans of around R5,000. The loans are linked to payroll deduction. •**group saving schemes** linked to payroll deduction with ability to draw the money out for emergencies and once a year for Xmas
Non-unionised frequently smaller companies	< R2,000 p.m. Disposable ± 20% of gross income	30 - 60 years average age 50 years	Predominantly female	Formal dwellings Limited informal dwellings	• the same as above but with a lesser demand for housing loans and a greater demand for smaller non-housing loans.
Various Large Groups of people e.g. a union or funeral group or church group who have collective assets and either employees or members.	between R1,000 and R2,500p.m.	•for unions between 20 and 40 years average age 30 years. •for social groupings the age would mainly be between 40 and 60 years average age 45 years	Male Female	Formal dwellings Hostels Informal dwellings	•schemes both **saving as well as loan** are requested for the organisation as opposed to dedicated schemes for the members. The **group assets are offered as security.** •the loan schemes requested include instalment sale finance for vehicles, as well

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Formally employed Provident Fund Members	between R1000 and R2500 pm Disposable 20% of gross income	25 - 60 years	Predominantly male	Formal dwellings Hostels Informal dwellings	*housing loan and saving schemes that are organised as part of a benefit offered to provident fund members together with the pension benefits. Payroll deductions are organised via the Provident Fund.
Formally employed people	< R2,000 p.m. Disposable 15% of income	30 - 60 years	Both	Formal dwellings Hostels Informal dwellings	*payroll linked loan schemes on an individual basis. Essentially short-term small loans used for education, consumer goods, housing and family emergencies. *personal financial management services
Employees of large AAA companies	< R4,000 p.m	25 - 50 years	Predominantly male		*payroll linked long term loan scheme for housing against a registered mortgage bond

7.3.3 SWOT ANALYSIS

However, the following abbreviated SWOT analysis identified key weaknesses which would have to become key management focus areas. Otherwise they would result in the failure of the organisation.

Strengths

The GCC's key strengths are its closeness to its market and its ability to be responsive and flexible in terms of the market needs. The ability for the GCC to introduce specific requirements into its overall system, gives the GCC a competitive edge.

A further strength lies in the GCC's aggressive marketing ability.

The GCC's current competitive advantage with its major product (the employer based lending) lies in the following factors:

- *the ability to provide on-site service which is combined with a counselling service.
- *the offering of fixed interest rate loans
- *geographically mobile servicing team.
- *the perception of being a "New S.A." bank.
- *the first third party (other than employer or Fund itself) to offer loans in this market.

Its current competitive advantage with the high-risk community loans lies exclusively in its:

- *experience
- *discovery of two successful products for that market and its ability to manage that product successfully.

Weaknesses

MARKETING
- * speed of concluding big deals
- * need to increase number of deals in pipeline so that monthly advances can increase.

PRODUCTS
- * increase range of products to spread risk
- * urgent need to introduce savings so that the funding problems can be softened

OPERATIONAL EFFICIENCIES
- * speed of assessments for loan advances
- * paperflows and controls to improve speed of access to data
- * systems not fully developed yet

STAFF
- * low staff skill level at the lower levels in the company

Opportunity

Major opportunities exist for the Credit And Savings Help Bank as a result of GCC's initial work in this area to take advantage of the ability to respond to market needs quickly. Furthermore, to introduce package schemes for employers satisfying all round needs in terms of loans, savings, insurance and counselling on-site. This allows both employers and provident funds to improve the fringe benefits they can offer employees without multiplying the administration load for employers or the number of people with whom they are obliged to interact.

The GCC is alone in the market of offering non-housing employer schemes. There is tremendous demand and the risk is limited through the utilisation of payroll deduction and restricted terms. The potential margin on these loans is also considerably higher than with housing loans. The GCC could expand extensively in this market.

The GCC after five difficult experimental years has started finding appropriate products for the high risk unsecured market which can be managed within profitable parameters. If this proves consistently correct over the medium term there is unlimited opportunity for the GCC to gradually grow this section of its portfolio until it becomes a more significant part of its portfolio.

Threats

The greatest threat to the GCC is undoubtedly that certain legislative changes concerning maximum rates that can be charged for particular loans e.g. any housing loan may only attract an interest rate equivalent to the mortgage rate regardless of the instrument.

The second greatest threat is for actors such as the Community Bank to attack the same market but offering reduced rates because of beneficial funding sources such as deposits from development institutions at preferential rates.

The third is if any of the major institutions enter this particular market matching the services we provide as they have an ability to mix their funding and achieve a lower cost of funding than the GCC.

7.3.4 KEY RISKS

The three major risk areas at present that the GCC/CASH Bank face are credit risk, operational risk and technological risk. Interest rate risk is a key risk area normally but because the GCC fixes its interest rate at both ends (to the borrower and from the investor) it is a contained risk assuming that the product was priced correctly in the first place.

It is important to understand the risks involved in every business as the risks must be the daily focus of all the operationally active management. For this reason I include some detail on the key risks in particular credit risk.

Credit Risk

Responsibility: The Executive Sub-Committee of the board will have the responsibility of approving the overall credit policy which will contain the credit risk philosophy to be followed over any twelve month period as well as the general areas of credit in which the institution is allowed to operate. It will establish the appropriate levels of delegating credit approval authorities as well as write-off policies and approvals.

The Executive Sub-Committee of the Board will review the credit policies bi-annually with regard to credit limits allocated for particular staff. As the nature of the existing products is fairly restricted within this phase i.e. a maximum of R6 000 for community loans and R45 000 for employer loans, the evaluation of credit limits is of less significance than the risk of exposure to particular employers, sectors and geographic areas.

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On an on-going monthly basis, management will report to the Sub-Committee of the Board on exposures to:

- geographic areas
- employers
- sectors of industry
- unions; and
- provident funds/managers.

On a monthly basis the Sub-Committee of the Board will monitor these areas and adjust policy as and when required. Credit risk will be the primary risk for a while as the Bank operates in a relatively high risk market. Because of its limited product range, the Bank has limited risk diversification and therefore faces greater exposure than a more mature operation. The Bank is also primarily a credit operation as opposed to for example a trading operation.

The Managing Director will where appropriate check risk levels daily. Weekly meetings with key managers (The Management Executive) will be held to ensure the credit policy is followed and that the risk levels are not rising without corrective action being taken.

Policy: During the first phase the Credit And Savings Help Bank will maintain a portfolio mix of a minimum of 70% of advances into secured lending and no more than 25% of advances into payroll based unsecured loans and no more than 4% of advances into the high risk community market.

The Bank will move towards the following exposure limits during this phase:

AREA OF EXPOSURE	EXPOSURE
• GCC	• No more than 10% of capital
• Staff and Management Trust	• No more than 10% of capital
Single Individual Borrowers	No more than R45 000 (adjusted annually)
Associated Parties --- Employer (Company) Scheme - Unsecured Loans	Maximum 5% of capital
Associated Parties --- Employer (Company) Scheme - Provident Fund Secured Loans	Maximum 20% of capital
Industry	Maximum 25% of advances
Trade Union	Maximum 30% of advances
Any particular Provident Fund	Maximum 70% of advances for loans that are fully secured with easily realisable security
Geographic Area	Maximum 30% of advances in any particular region and 10% in any particular suburb. The Transvaal region is an exception to this as it is by far the most populated and economically dominant region in S.A. In the case of the Transvaal the maximum exposure is 50% of advances.

Evaluation: The evaluation of all applications for credit will always include the following principles:

- the borrowers current capacity to repay and the potential for the capacity to remain unchanged for the duration of the loan.
- the source of income used to repay the loan will remain a critical part of evaluating the individual risk.
- the assessed willingness to repay debt and fulfil contractual obligations.
- the purpose of the credit.
- the perceived integrity and character of the individual.
- the adequacy of the collateral.

The Bank will always follow the principle that the marketing/sales person does not have the authority to approve loans. Further, a proportion of the approved loans will always be randomly checked by a third person.

Documentation: All documentation completion procedures will be regularly monitored and the completed documentation audited internally.

The Bank will always ensure that the documentation includes the following information:

- the borrowers identity and a series of traceable contacts/addresses.
- evidence regarding the individuals general financial standing i.e. income and creditworthiness.
- any suretyships taken whether from a Provident or Pension Fund or another individual as well as documentation indicating the recording of any pledges to the Bank by any other institution.
- a description of any further collateral.
- evidence of the approval of the credit.
- a history of the individual's credit record with the Bank or external parties via Information Trust.

Portfolio Monitoring and Control: The information systems currently used produce detailed aged arrears reports. These reports indicate the debtors given situation on any day (in other words debtor information is updated daily if any movements have occurred on the account).

Management has the ability to interrogate the system regarding particular clusters of loans e.g.

- loan officer portfolio
- branch
- product
- region
- employer
- matched funding
- term of loan
- performance over term to date
- union
- provident fund
- written-off loans

Each key lending area e.g. employer or community or geographic area has a dedicated person or team who manages arrears on the particular portfolio.

Provisioning Policy:
The following policy will be the initial policy followed. The Directors will however review this policy from time to time.

- once a loan is 120 days in arrears, the full outstanding capital is provided for.
- further provision is made in particular circumstances which in management's opinion increase the risk e.g. political violence occurs in a particular area, a particular staff member is perceived to have made a series of poor decisions in either the granting or management of loans.
- a further general provision will be made at a level set by the Board of Directors from time to time dependent on the nature of the products the Bank is focussing on at any particular time

- when a loan reaches 120 days, all interest charged on the loan is no longer brought to income but suspended and accumulated in a suspense account.

In the financials attached to this business plan both general and specific provisions are kept at 2% of outstanding debtors book.

Write-off Policy:
- the Managing Director will have the authority to authorise write-offs within the policy stated above.
- loans will be written off at 180 days if not assessed to be collectable.
- the sum total of monthly write-offs will be presented to the Board as part of the monthly accounts

Review: The Executive Sub-Committee of the Board receives monthly age reports on the performance of debtors. Should any negative changes be perceived in the quality of any particular portfolio, a full analysis of that portfolio is produced with a view to:

- increasing the provisions against the portfolio;
- introducing different techniques into the management of the portfolio;
- introducing staff changes if perceived necessary;
- limiting further lending in a particular area or product;
- authorising the sum of any rescheduling undertaken.

Monthly reporting on each portfolio includes reporting on the margin per product.

Internal Audits: Internal supervision as well as both the internal audit and external audit will monitor and evaluate the extent to which:

- advances are in compliance with policy.
- debtors exist (validate debtors).
- management reports accurately reflect the status of debtors.
- client credit files are complete and accurate.

Operational Risk

The Bank, because of its scale (60 staff members) during this phase and also because of its youth as a company is exposed to operational risks. There is a key employee risk with a significant dependence at this stage on all key managers as the difference in most cases between managers and the next level person is significant. Few managers have deputies. Managers do however overlap in skills and off-set the risk of the loss of an individual in the short-term.

Responsibility: The Sub-Committee of the Board will monitor key areas of operational risk.

Policy: Succession planning for management is constantly on the agenda. Succession planning for all key managers remains a central concern, however, the following steps are taken to minimise this lack of depth in management by:

- approaching a senior banking person to join the Bank in order to facilitate the transformation and to back-up key personnel;
- recruit two branch managers with a large amount of general banking experience to firstly act as deputy to the operations manager and secondly to run the Port Elizabeth office;
- two sales consultants have already been recruited to shadow the marketing manager in particular areas which should ensure a steady flow of business which is not exclusively dependent on the marketing manager.

The Bank will also undertake a thorough documentation of all procedures to offset operational risk as its procedures are currently not adequately documented.

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The GCC has always done its own in-house training utilising a staff member who is experienced in credit training. The Bank will inherit this process and follow the same approach. Due to the considerable difference in the target market of the Bank and therefore the nature of staff who interact with clients, training has to enjoy a high priority in the Bank. Training material utilised is a mix of material acquired from external sources and material that has been developed internally and specifically for particular job functions.

The outline above grossly underplays the risks in this area. Organisations at this level are frequently very thin on key personnel who are forced to perform a range of functions much wider then in more stable commercial operations. The gaps in skills between the various levels of the organisation are also signifant. The lack of depth in skills provides a very real limit to expansion possibilities.

Technological Risk

This is another key risk as inadequate systems preclude firstly the effective managing and servicing of existing debtors and secondly, the ability to introduce new products speedily and scale-up the operation.

It is of key importance to ensure that an organisation has adequate software to allow for a future vision and the hardware to carry the system at scale.

The more integrated the system the less opportunity for error and the greater the possibility of operating the system without an enormously high level of skill. A system should preferably be written on a form of relational database that can allow for the integration of client information files with product profiles, the general ledger, bank wide management information and a very good report writer.

A package with high levels of flexibility allows for a wide range of operating situations that are not simply those of retail banks. Since at the micro-credit and small loan level the products utilised are fairly different to those of a normal bank, this flexibility is important.

Pricing Risk

The pricing risk in underpricing a product is obviously key to one's survival.

In our experience the interest that one must charge is a function of:

- cost of money
- risk
- amount of administration at take on point
- amount of administration in collecting payment
- amount of administration required in generating the standard monthly information to manage and inform debtors of current status.
- the size and term of the loan.

Cost of Money

In general the higher the risk profile of a particular product the higher the cost of money one can afford to pay. That end of the market, one is operating in a market which is not particularly price sensitive, where competitors do not exist and where financially numerate people are not two a penny and compare all rates to standard mortgage rates.

The average cost of our money across all books is 14.60% while the range is from 16.5% to 13.25% What we need to move towards is to have an average cost of funding which is closer to the funding structure of a bank for example a small bank in S.A. had an average cost of funding ("deposits") of ± 10.5% round about mid-year 1994.

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Risk

We price each product according to how we perceive and have experienced the risk e.g.

• fully secured housing loans	1% for risk
• partially secured housing loans	2% for risk (our current feeling is this might be too low)
• unsecured payroll deduction general purpose loans	6% for risk
• community loans	12% for risk

Take-on Administration

We have several up-front costs before the loans are written normally:

- marketing costs (a staff of six people)
- legal costs in the preparation of umbrella agreements
- writing up costs of the actual loan applications.

In all three of these aspects the smaller the scheme the higher the costs. In other words the fewer the number of employees per scheme that we negotiate the higher our cost for that scheme and the fewer the number of people we can spread the costs over.

The extreme end of this is clearly the single employee per company who is the sole beneficiary of the marketing and the negotiation with employer for payroll deduction and who might even have had a site visit to fill in the application form.

We therefore price each scheme according to the anticipated scale or number of applicants in each scheme.

We have set up our payroll deduction systems largely on a mass production basis. They are not ideally suited for individual advances. We do mass clearances on ITC, with employers, with provident funds and the actual advancing of these loans including the informing of clients of issues pertaining to their loan.

Collection Administration

The cost of administering collections relates normally to the amount of labour or system time that it takes to ensure payment. In other words:

- the larger the number of debtors one can group under one employer (the more one can bulk repayments and the information on repayments) the cheaper the administration on these loans. Conversely the more individual the loan the greater the proportion of management time in relation to the loan.
- the more the security is linked to the site of employment and provided the loan becomes due and payable on leaving the company, then one is ensured of no collection costs after the person leaves the employ as the security is accessed. The less secured the loan, the more uncertain the collection costs are once the person leaves the employ of a particular company.
- with scale and security ensured, one manages the debtors by exception and it consists mainly but <u>not</u> exclusively of sorting out administrative errors with payroll departments.
- the less secured the loan and the more individual the scheme the more one moves to a labour intensive, multi-site collection method and the more expensive it becomes. Consequently, for small unsecured payroll schemes, we automatically peg the loan at top of Usury (were Usury to apply). This is not for <u>individual</u> payroll deductions which are not part of a scheme. In the latter case, we would add a minimum of an additional 5% but more likely 10%.

Reporting Administration

The same simple principles apply:

- the more one has to generate individual statements compiled with a need to generate such information at a regular and frequent interval the more costly.
- if quarterly mass listings to human resources departments are the totality of client reporting needs the scheme is much more economic for us.

Size and Term of Loan

The influence of these factors on the setting of interest rate is self-evident within the context of the GCC's experience and the cost of administering these loans.

On an absolutely ball park level we would on a fully secured (by a fairly liquid good quality security) housing loan product add between 1% and 2% for the loss of a year on the term. In other words if the 7 year loan is 19%, the 5 year loan would be 19.5% to 20%, the 3 year loan 22% and given that we have primarily priced for administration cost differences on such fully secured loans.

Current Products

• fully secured 5-7 year loans for companies with more than 400 workers who fit into our client profile (anticipate 100 loans)	19%
• similar loans but companies of only 150 workers (anticipate 40 -50 loans)	22%
• unsecured 1-2 year loans for companies with more than 400 workers	25%
• similar loans smaller number of workers (<50)	30%
• individual fully secured loan with payroll (3-5 year term)	25%
• individual unsecured loan with payroll (1-2 year term)	35%
• individual unsecured loan in high risk community market (1 year term)	we charge 70% with 25% returned for good performance.

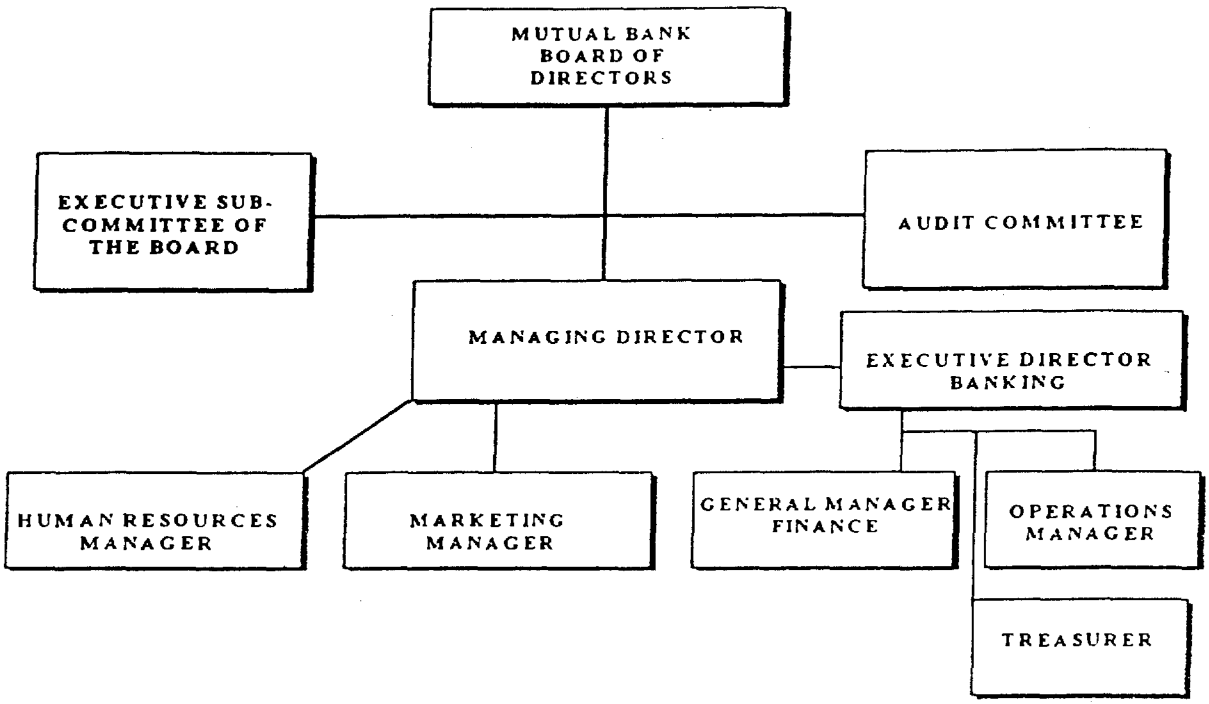
7.3.5 ORGANISATIONAL STRUCTURE

Having analysed the mission, market, organisational ability and risks, it is clear that the products need to be tightened up. The next step is to work through the appropriate structure to manage the organisation and the people needed to resource that structure.

That done, one has to face up to the most important of tasks - working out the costs, the key assumptions and then doing the forecasting in order to make sure that the vision at least on paper appears workable and can reach break-even.

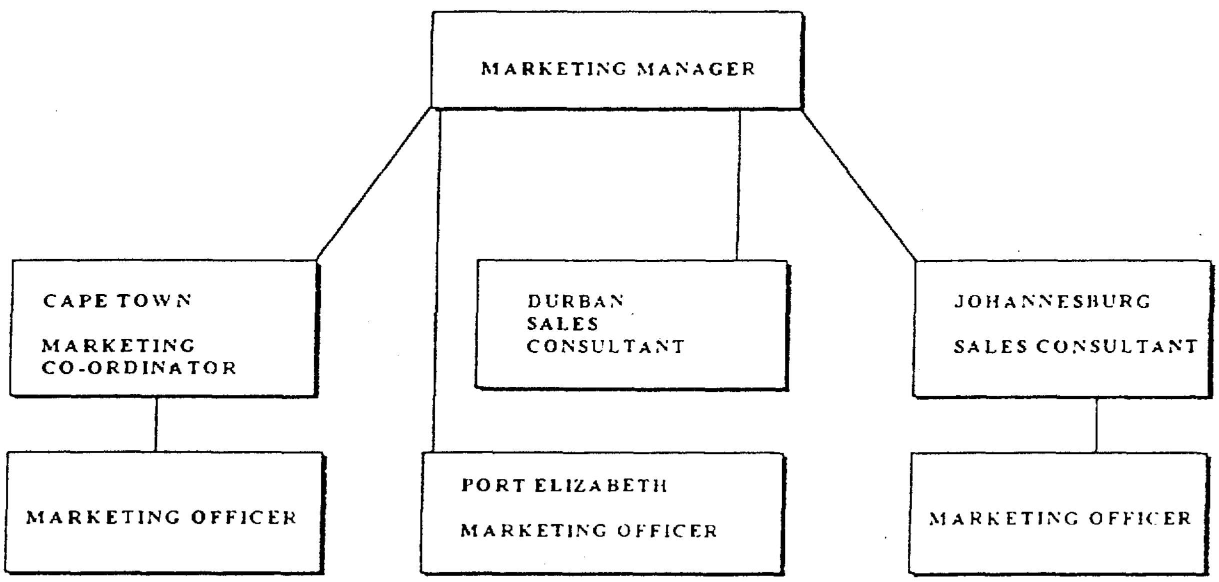
The following structure is currently used in GCC/Cash Bank.

- Executive and Senior Management Structure

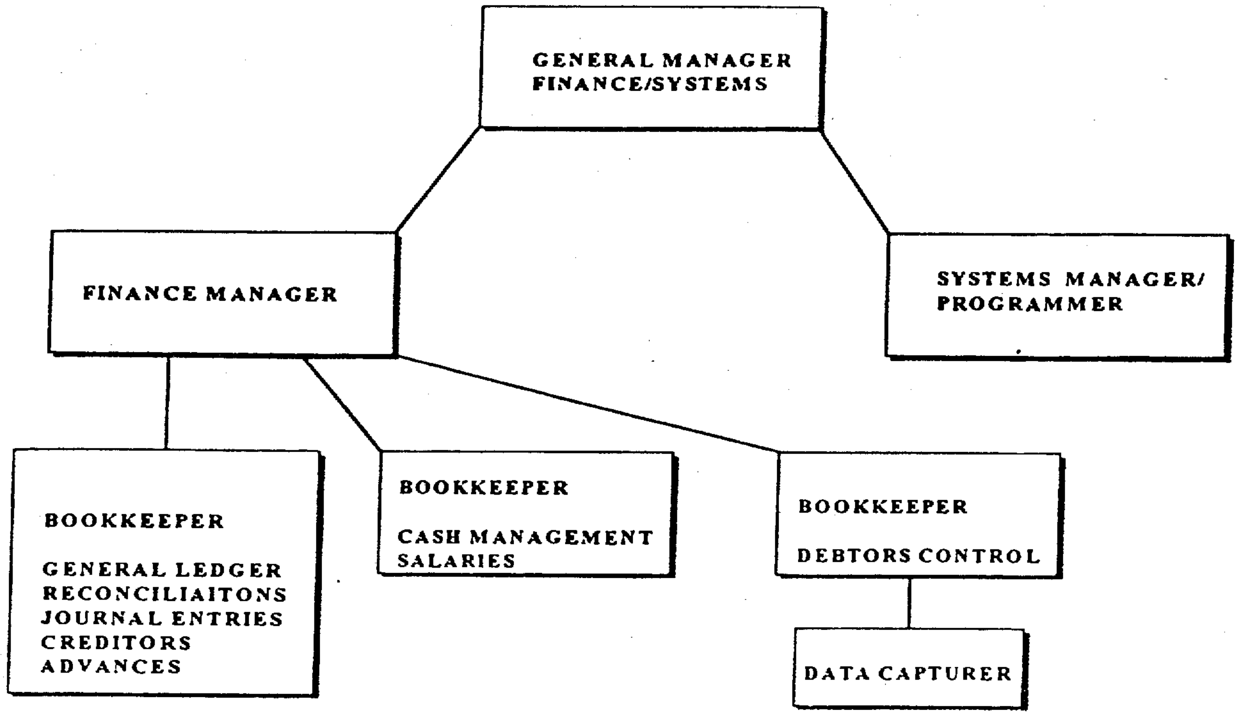


The operational structure is expanded where applicable as follows:

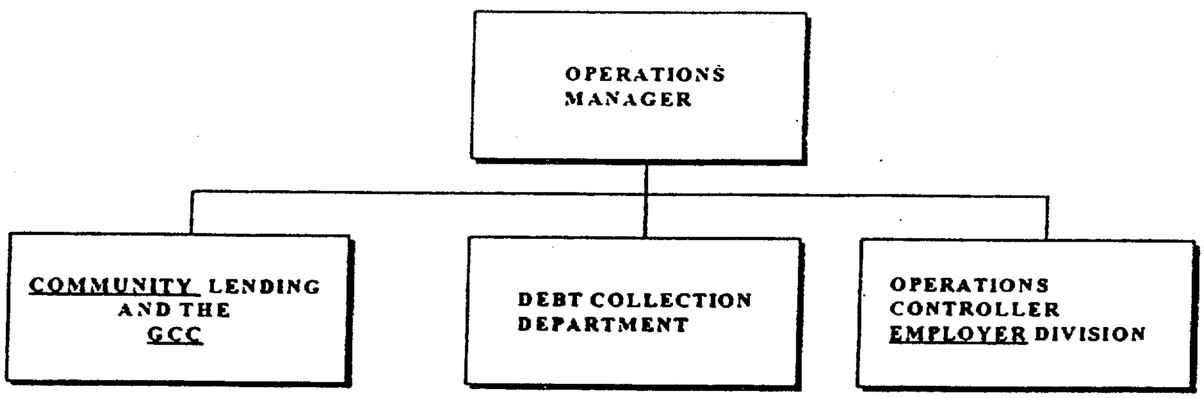
- Marketing



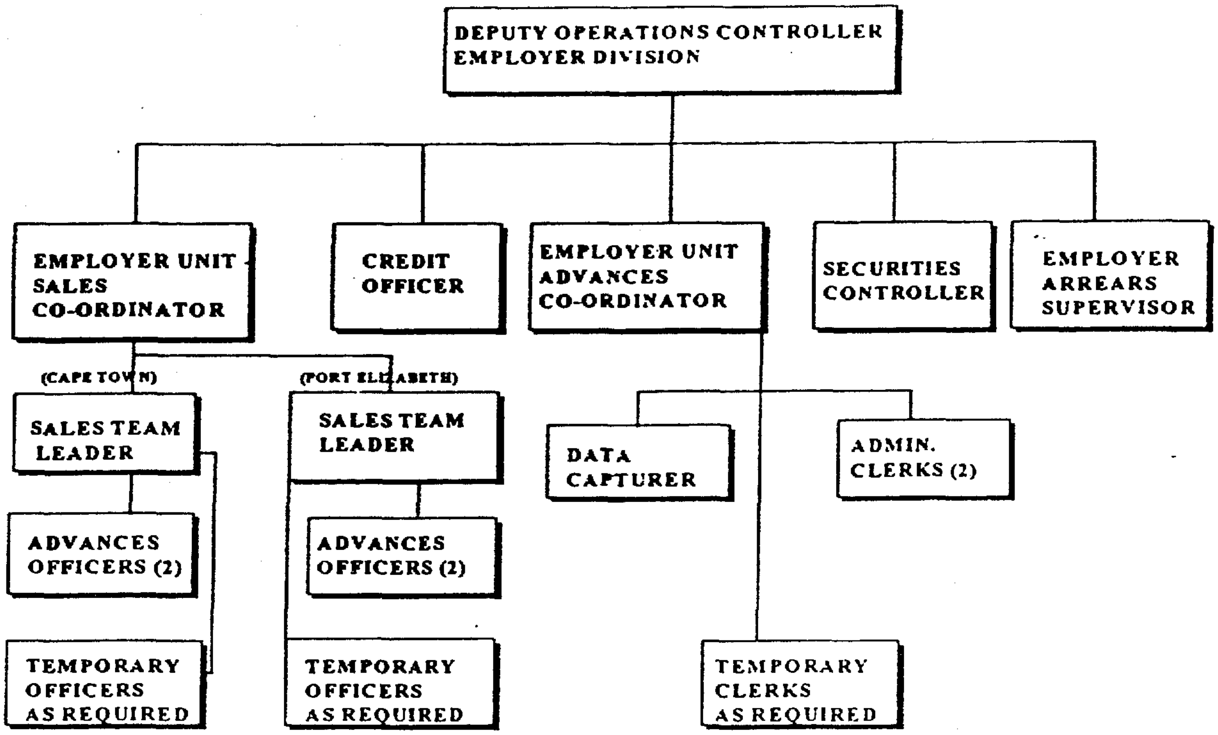
- Finance/Systems



- Operations



This in turn is expanded as follows underneath.



The GCC comprises of two units as described in Phase 5 while the debt collection section comprises a supervisor and four collectors.

7.3.6 BUDGETS AND FORECASTS

7.3.6.1 Budgets

The best budgets in terms of ultimate accuracy and effectiveness are these that are worked through at a relatively high level of detail. It is best if one explores item by item every possible expenditure - contemplates whether it is a recurring expenditure, a once-off (in which case when is it likely to occur) or a periodic expenditure (again which periods).

Having put together a budget of the costs of the company and an idea of the cash-flow demands on the cash side, the next step is to forecast what the cash-flow projections look like on the earning side.

7.3.6.2 Forecasts

Forecasting is again at the initial stage an issue of answering questions.

- what is the average value of the loans advanced?
- are the same number of loans advanced each month?
- when is money earned on the loans advanced - one month later or one week later?
- on what basis is interest charged and therefore taken to income?
- on what basis is the cost of money worked out - are the payments on the money monthly or six monthly?
- what is the anticipated arrears percentage and what impact do they have on the cash-flow projections?

- what is the inflation factor - do costs increase at the rate of inflation or above - do the average size loans increase at the rate of inflation or not?
- is interest income the sole source of income or is it augmented by fee income as well?

Here again, it is best to really test and find out all the possible questions one must ask.

Answers thought through on the assumption side, these need to be put into one's financial model and then the results assessed.

With a bit of luck and hard thinking, one does not have to return to the drawing board.