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From Savings and Credit Groups to Community-Based Financial Institutions: The Issue of Institutionalization

Anthony Scoggins
Coady International Institute
Antigonish, Canada

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Abt Associates Inc.
Management Support Services Contractor
B2/13 (2nd Floor)
Vasant Vihar
New Delhi 110 057

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PART A: Introduction

1. Building Sustainable Community Organizations

Every development agency and practitioner has her own definition of development. However, there is a consensus emerging from almost all sectors of development activity that institution building is a key component of any development initiative that aspires to be sustainable.

For those agencies that work specifically with low-income communities, the challenge of building sustainable organizations is enormous. The multi-layered and complex needs of target communities often seem to overwhelm their limited resources and capacities.

Limited local financial resources often leads to over-dependence upon external, time-bound subsidies. Limited local skills in organizational development and management can similarly lead to over-dependence upon the personnel of the promoting agency.

In the savings and credit sector, one widespread organizational strategy has been the formation of small groups of participating beneficiaries. In different programs and models, these groups either mobilise savings, serve as a conduit for delivery and collection of external credit, or act as simple financial intermediaries and engage in both savings and credit activities. However, although some of these programs and groups have been operating for over a decade, there has been only limited thinking applied to the sustainability of this approach. Today, many NGOs, INGOs and government agencies express a desire to gradually phase out their active support for savings and credit groups. But the viability of these groups often seems doubtful, particularly for the smallest groups and for those most dependent upon external credit and field support services.

This package of notes was prepared for a workshop sponsored by Abt Associates, the executing agency for the USAID-funded Indo-US Housing Finance Expansion Project. The notes attempt to present the background issues which that face those development agencies which are attempting to facilitate the graduation of small-scale savings and credit groups into viable and dynamic community-based financial institutions.

As always, any opinions expressed herein and any errors of fact or interpretation are solely the responsibility of the author.

2. Institutionalization Defined

Institutionalization, simply defined, is the process by which an organization becomes an institution.

Such a simple definition clearly begs a series of questions:

- What is an organization?
- What is an institution?
- How is an institution different from an organization?
- How does an organization become an institution?

And perhaps most importantly in the context of community-based savings and credit groups -

Why might an organization <u>want</u> to become an institution?

These questions are the stuff of lengthy sociology lectures and obscure academic dissertations. The debates they generate rarely shed much light upon the problems that are faced by those of us engaged in practical development work. But let us try to clarify some basic concepts such that we negin with a common frame of reference.

Of the two terms, **organization** is the broader, more encompassing. Organizations are structures of recognized roles and functions. They can be large or small; simple or complex; informal or formal.

Institutions are more than organizations. They are those organizations that have acquired special status and legitimacy over time through having successfuly met people's needs and expectations. As such, institutions have **value and stability** that is greater than that of ordinary organizations.

It is the process of building this value and stability that is meant by the term "institutionalization". Indeed it has been argued that -

" to institutionalize an organization is to infuse it with value beyond the technical requirements of the task at hand [such that it] is valued by persons over and above the direct and immediate benefits they derive from it."[1]

It is therefore necessary to dispel the popular notion of "institutions" to be synonymous with large, bureaucratic, lethargic and ineffective. In applying the concept of institutionalization to community-based organizations one is not suggesting that they should be bureaucratized or ossified. Rather, it is to propose a process by which these organizations successfully establish themselves as central and significant actors in the lives of the community.

3. The Nature of Groups:

A **"group"** is usually defined in terms of the nature of the relationship amongst its members and between the members and the group itself. As such, groups have two defining characteristics:

i) each and every member has a face-to-face relationship with every other member; and

ii) the relationship between the individual member and the group tends to be relatively informal (as opposed to formal or bureaucratic).

By definition, these features limit the **size** of a group. Both research and experience suggests that in order to retain these characteristics, group size is usually no more than about 15 members. Beyond that number, the group must begin to adopt some of the more formal features of organizations.

A further feature of most groups is that the members share a definable **common bond**, above and beyond their membership in the group itself. Examples of typical common bonds include residing in the same village or neighbourhood, working in the same sector or for the same employer, and membership in the same association (social, religious, etc.). These bonds are then often re-inforced by bonds of age, gender, ethnicity, caste or class.

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[1]. Norman Uphoff, citing Selznick, in Development of Local Institutions, Cornell University, Ithaca, N.Y.

4. The Rationale for Groups in Savings and Credit Promotion:

Financial intermediation (the mobilisation of savings and delivery of credit) involves the most sensitive and complicated of commodities: money. For that reason, maintenance of trust and confidence is critical to the success of all financial intermediaries, from the largest of commercial banks to the smallest savings and credit groups.

Large banks ("**financial institutions**") apply various techniques to build that image of trust and reliability within the public eye. External audit reports, rigorous collateral requirements and the presence of security guards at the door all serve to build an image of financial security and stability that will re-assure depositors.

But such techniques are not easily applied by new, community-based savings and credit organizations which aspire to serve low-income groups. For them, trust and confidence is largely a product of the personal relations and social solidarity possible amongst people who know each other well. This in turn usually translates into small groups of individuals sharing a common bond[2].

A second advantage of working through small groups is the cost savings realized in comparison to the cost of serving members on an individual, one on one basis. While the economies of scale may seem relatively small, they can be significant when a promoting agency or lender has hundred of such groups containing thousand of individual members.

Furthermore, working with and through small-scale groups responds to another requisite of working with disadvantaged groups: it obliges one to keep procedures and record-keeping as simple as possible. For these three reasons, it is now widespread development practice to deliver savings and credit programmes through the agency of small-scale groups.

5. Savings and Credit Groups: a Means or an End?

What is not agreed upon by development practitioners, is whether these small groups are ends in themselves, or simply a stepping stone to a larger, more sophisticated form of organization.

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[2]. As a result, such groups are often referred to in the development literature as "solidarity groups"

Some savings and credit promoters (such as the Grameen Bank model) argue that small groups of 5 to 10 members should always be the basic unit of the organization, although there are procedures for clustering such groups into joint meetings and wider structures.

Other agencies promote the idea that once these small groups are firmly established, they should be encouraged to open themselves up to new members and gradually build their internal capacities and resources. By so doing, it is suggested, that these groups can evolve into free-standing, sustainable savings and credit organizations.

6. Two Basic Questions:

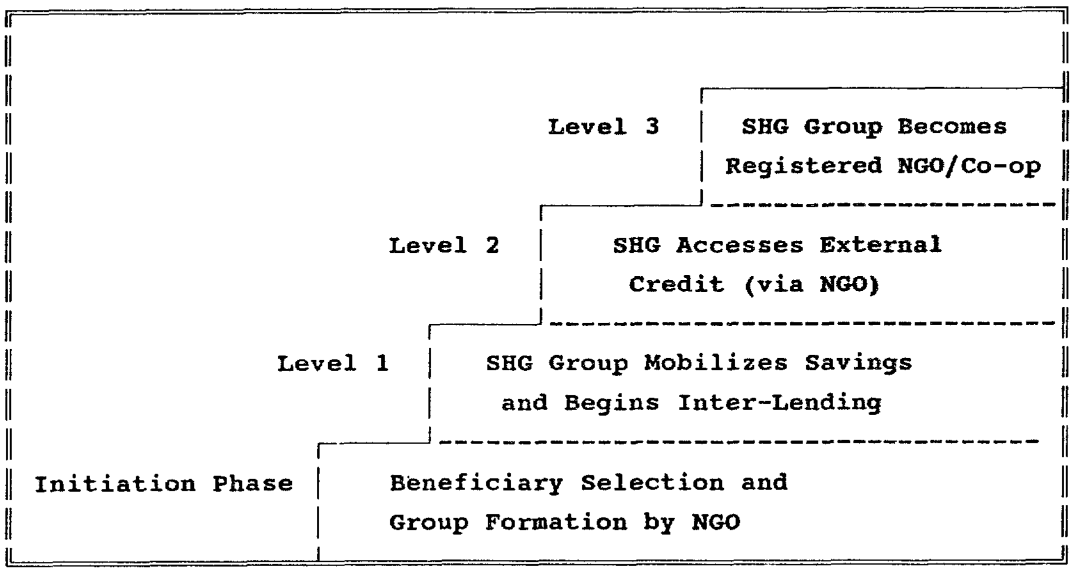
At the heart of this workshop are two basic questions.

Firstly, is it possible to foster the evolution of small scale savings and credit groups into viable community-based financial institutions (CBFIs)?

That is to say, is there an incremental process by which these SCGs can be initiated, strengthened and scaled up such that they mature into CBFIs? Two possible models are presented below: both are drawn from the Micro-Credit Project for Women, a project financed by the Asian Development Bank in Nepal with the expressed purpose of developing an alternative financial system that would respond to the specific needs of low-income women.

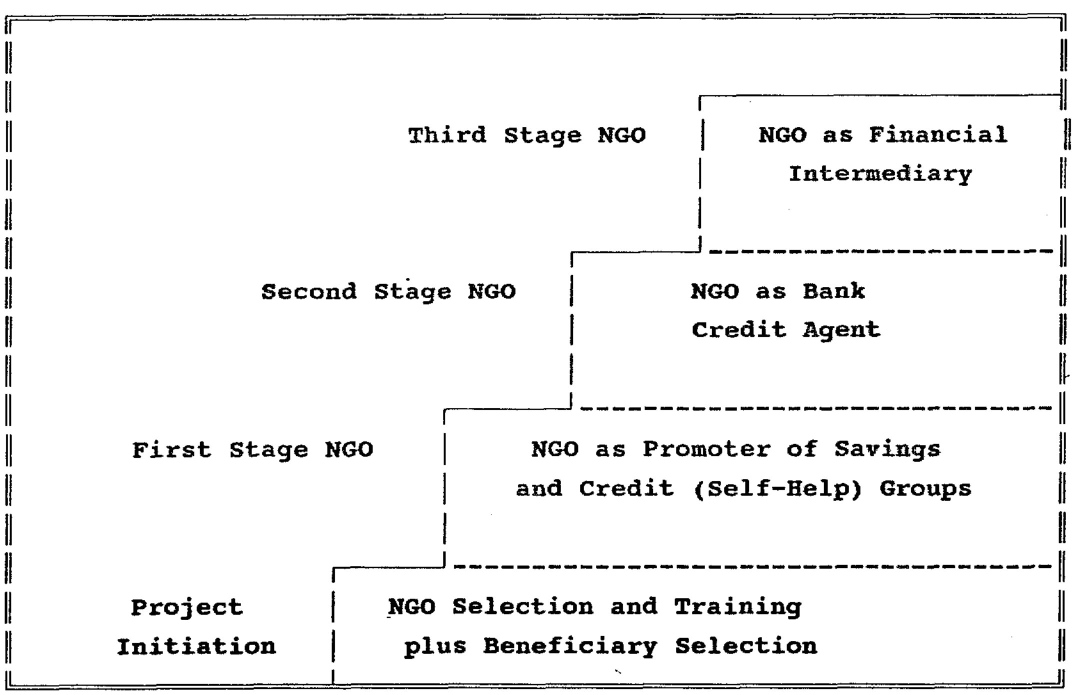
The first strategy focuses upon strengthening the internal capacities of local savings and credit groups such that they themselves develop into viable, community-based financial institutions.

Figure 1: Proposed Organizational Development of Local Savings and Credit Organizations: the Model of the Micro-Credit Project for Women



The second strategy focuses upon the intermediary NGOs and presents a simple model for how they can be strengthened such that they develop into viable financial intermediaries.

Figure 2: The Sequence of NGO Organizational Development: the Model of the Micro-Credit Project for Women



The second question (assuming an affirmative answer to the first question) is "what is the most effective and efficient to foster this transition, from SCG/NGO to financial institution? "

7. A Learning vs. Blueprint Process:

The purpose of this workshop is not to reveal and then sell a pre-planned blueprint style answer to the preceding questions. Rather, the intent is to provide an opportunity for those agencies engaged in savings and credit promotion with the poor to critically reflect upon -

i) the pros and cons of promoting the institution-alization of SCGs; and

ii) alternative strategies for promoting institution-alization.

The workshop will attempt to frame questions, present models and facilitate sharing around the issue of institutionalizing SCGs. Out of this process will hopefully emerge both a collective learning and some new insights into the strategic choices that our own agencies face.

One of the objectives of the Indo-US Housing Finance Expansion Project is to improve access of low-income households to housing finance through institutions that are market responsive and sustainable. It seems clear that the provision of financial services and products to low-income households requires the engagement of organizations with a rare mix of vision, managerial competence, technical skills, financial resources, and developmental commitment.

At community-level, such attributes can be found in intermediary development agencies such as NGOs. They can also be found in membership-based organizations such as savings and credit co-operatives. Whatever the model, it seems likely that securing the long-term access to financial services required by poor communities will require the emergence of new, innovative and responsive financial institutions.

In this workshop we will explore the prospects for fostering the emergence of such institutions from the tens of thousands of small-scale savings and credit groups and NGOs that dot the Indian landscape.

PART B: The Savings and Credit Sector

1. Shifting Paradigms in Development Finance

In the new realities of a rapidly liberalising, globalizing, and market driven world, thinking about development theory and practice has undergone a considerable shift in recent years.

Today, development agencies and workers are obliged to achieve ever better results with ever fewer resources, while the needs and the numbers of low-income households continue to expand. Meanwhile, the role of the state in both the economy and in social programs continues to decline.

This conjuncture of forces, combined with the acknowledged and widespread failure of so many earlier different development strategies and programs has prompted a re-thinking of what constitutes effective development. (See the following page for one perspective on the "new vs. old" development paradigms and the changing role of NGOs.)

In the development finance (savings and credit) sector, the "old" and largely discredited paradigm was based upon the following principles:

i) the poor are unable to save and therefore resources for credit must be provided by external sources (i.e. supply-led, from government or donors); and

ii) the poor are either <u>unable</u> to pay market rates of interest,- or to oblige them to pay such rates is a form of exploitation.

The net result was the proliferation of subsidised credit programs, most of which suffered from low repayment rates and operating deficits, and therefore required continuous and considerable subsidies. Of even greater concern was the fact that the benefits of such programs were widely expropriated by better-off and politically-connected housholds rather than the poor.

The "new' thinking on development finance is based on the following set of principles:

i) savings mobilization amongst the poor is as important as credit delivery;

ii) savings and credit services and programs must recover their costs if they are to become sustainable;

iii) rather than work <u>against</u> market forces, such programs must work <u>with</u> such forces;

iv) the key to successful program design is the identi-fication of innovative financial technologies[3] that are appropriate to the local context; and

v) the ultimate goal is the emergence of sustainable programs that meet the needs of the poor from within sustainable institutions.

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[3]. Financial "technologies" in this context simply means the mix of financial products, policies and systems that combine to comprise the services of a financial institution.

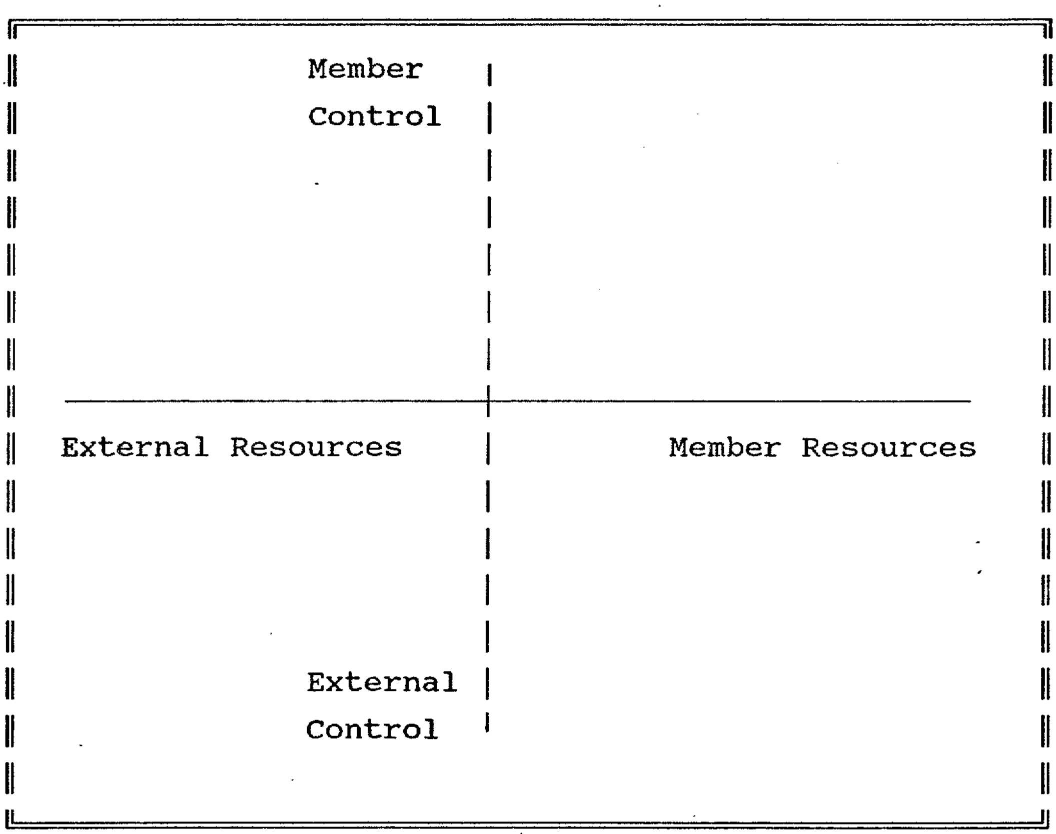
2. Alternative Strategies and Models

2.1 The Variables: In examining alternative strategies for providing financial services to low-income households, two basic variables seem to prescribe the main set of options:

i) the source of the finance: what is the balance between internally generated funds (usually in the form of savings) and externally accessed funds (usually in the forms of loans or grants); and

ii) ownership and control of the program/institution: to what extent does decision-making (and related costs and benefits) lie with the beneficiaries or with external agents.

Figure 3: A Framework for Examining Financial Institutions Working with Low-Income Communities



Within this framework, a number of the most common models found in the field are described below.

2.2 Externally Managed and Financed:

i) Commercial Bank Programs: Banks tend to be conservative by nature and averse to undue risk-taking. Furthermore, existing bureaucratic procedures and collateral requirements, combined with the cost-inefficiencies of small-scale transactions and community outreach services combine to make banks less than enthusiastic participants in programs targeted at the poor.

As a result, for banks to make a significant institutional commitment to serving the poor usually involves legal or political compulsion, financial subsidy, or a combination of the two. In the current economic and political framework, these two policy levers of the state are being less widely applied to the banking sector.

The most notable contemporary success story in this regard is considered to be the Bank Rakyat Indonesia (BRI) which is government-owned but operates on a commercial basis in rural Indonesia. In recent years, BRI has re-engineered its entire operations (administrative procedures, interest rates, credit delivery, etc.) to improve both its financial performance and its services to small scale rural entrepreneurs. While BRI's high interest rates and collateral requirements are criticized by some observers as being obstacles to "the poorest of the poor", the Bank has shown that it is possible to provide services to tens of thousands of low-income, rural households and generate a profit in the process.

ii) NGOs as Social Intermediaries: A number of credit programs (particularly those engaged in the micro-enterprise sector) involve NGOs as "social intermediaries" between the financial institution and low-income households. The function of social intermediation can include a range of activities: beneficiary selection, group formation, savings mobilization, skill training, loan proposal development, presentation to the bank, loan supervision and follow-up. Usually NGOs provide these services as part of their core program with the target community; occasionally they will receive an agent's fee from the concerned bank.

iii) <u>NGOs as Financial Intermediaries</u>: In the past decade, a number of NGOs have directly assumed the function of financial intermediary. In most of these cases, the funds for on-lending to the poor through the NGO are either in the form of

a) loans from a financial institution; or
b) grants from donor agencies.

In relatively few cases do NGOs directly manage members savings or client deposits, due to both legal restrictions and a philosophical predisposition to have beneficiaries manage their own funds.

As a financial intermediary, the NGO now bears the financial risk of the lending service. Similarly, it now stands to retain the income generated from the financial operations. There is at least one example of an NGO that gradually transformed itself (legally and functionally) into a bank: the case of Bancosol in Bolivia, which specialises in small enterprise lending. And of course there is the internationally reknown example of the Grameen Bank of Bangladesh which graduated from a small university based, action-research project into a full-fledged national bank.

It should be noted that a number of the NGOs which act as financial intermediaries have built into their long-term planning statements a commitment to gradual transition into a membership-based, community-owned financial institution. Others, however, advocate retaining control within the NGO and engage the beneficiaries only in limited decision-making.

iv) <u>NGOs as Loan Guarantors</u>: A third model of NGO engagement in financial systems is to directly address the obstacle of loan collateral by having the NGO serve as loan guarantor to the lending institution on behalf of low income borrowers, either individually or as groups. The intent of this model is to enable borrowers to establish their credit worthiness directly with the bank, through the successful completion of a number of loan cycles. This approach is widely applied by various affiliates of Women's World Banking. Experience to date, however, suggests that the "graduation rate" of low income borrowers in such schemes is very low. i.e. once the guarantee is withdrawn by the NGO, the bank generally stops providing credit to the beneficiaries (regardless of their credit history) unless tangible securities are provided.

2.3 Community Managed and Financed:

i) Community-based Savings and Credit Groups: The most popular model of member-based savings and credit organization is the small scale, semi-formal and unregistered group. Given these basic structural features, however, there is wide variation in both function and intent:

a) **the simple savings group**, which often emerges from other development programs (literacy training, sanitation projects, etc.) in which savings mobilization is introduced not so much for its inherent economic benefit, but to enhance group solidarity and cohesiveness.

b) **the multi-purpose community development organization** in which savings and credit is only one of many activities of a community organization that is being fostered by a promoting agency into emerging as a local NGO.

c) **the lending group** in which Grameen Bank style small-scale solidarity groups are promoted primarily as conduits for credit.

d) **the nascent savings and credit co-operative** in which the small group is envisaged as the kernel of what will gradually develop into a formal co-operative (see below).

ii) Savings and Credit Co-operatives: Also known as credit unions in some countries, savings and credit co-operatives (SCCs) are legally registered, member owned, controlled and financed institutions. They are usually single-purpose co-operatives and have generally retained greater independence from governmental and political interference than have other branches of the co

-operative system. In many countries, SCCs are the only significant model of community-based financial institution and over time have developed sophisticated multi-tier structures and subsidiary organizations. Indeed, in some countries, including India, SCCs that have reached a certain size and sophistication have the option (or are obliged) to register as co-operative banks.

The most frequently expressed criticisms of the SCC model from within the development community are twofold:

a) the self-help ethos underlying the model is most suitable for salaried employees and better educated members of the middle or lower income groups; and

b) the single-purpose nature of the organization results in members adopting a narrowly defined operational focus rather than a broad development agenda.

That noted, there are numerous examples of successful SCCs, organized amongst the poor and fully engaged in a broad program of social change,- not least of all the case of SEWA.

2.4 Conclusions: As this brief overview of savings and credit institutions indicates, the promotion of small savings and credit groups is a technique that can be incorporated into a variety of organizational strategies and settings. This is because the advantages associated with group formation are generic rather than program specific. (See Appendix 1)

The prospects for assisting these groups to be promoted or gradually evolve into viable savings and credit organizations and then into financial institutions (with all that term implies about perceived value and stability) will clearly vary from case to case.

APPENDICES

1. THE ADVANTAGES OF SAVINGS AND CREDIT GROUPS

(Extracted and adapted from "Women and Credit", IFAD, 1992.)

A. Role Performed for the Promoting Agency

For the promoting agency the group extends outreach at the village level, assuming several functions which are very difficult and costly for the agency itself. These can include:

- facilitation of the delivery of information and promotion of available financial services;

- assistance in decision-making on the design of the credit operation, through members' own knowledge of what is suitable to their needs and can be expected to operate well in the local context;

- screening and pre-selection of potential borrowers on the basis of personal knowledge of their creditworthiness and through their very acceptance by group members;

- designation of lead borrowers, based on members' knowledge of what is most innovative among them and most likely to succeed;

- review and pre-assessment of the financial and technical feasibility of members' proposals through discussion of the proposals in group meetings;

- mobilization of peer support and pressure for saving, borrowing and repayment by memebers;

- supervision of appropriate loan utilization;

- promotion of the programme to help to set up new groups themselves, to encourage additional groups to establish themselves.

B. Role Performed for the Group Members

For group members, the group usually performs the following functions:

- providing a constant source of encouragement and confidence to assist tem in going against social norms or family pressures or community power structures;

- providing an alternative to fixed assets as collateral;

- strengthening their skills in decision-making and leadership;

- motivating them and providing the necessary discipline to save or take and repay loans;

- developing a structure for group action, such as bulk or wholesale purchase of raw materials of agricultural inputs or collective marketing of produce;

- creating a basis for group borrowing for more major investments when desired.

- providing a basis and location for social interaction with their peers; and

- facilitating access to training programmes, social services, and general information flow from the government or private sector.