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A Reader for Trainers on Community Based Financial Institutions and Housing Finance

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Introduction

From 1991 to 1996, the Indo-U.S. Housing Finance Expansion Project has addressed the need for reform of the Indian housing finance sector. The goals of the project have been to:

1) Increase private sector sources of funds for housing finance;
2) Expand market-oriented housing finance institutions; and
3) Increase lending to households below the median income.

In addressing the third goal, the project explored the prospects for improving access of the poor to financial services through the strengthening of community based financial institutions (CBFIs).

From 1994 to 1996, the Project undertook a series of studies, training activities and consultations on this topic. The output of most of these activities has been published separately. This document brings together in a single package and in accessible format the materials used by and developed through the project. These materials are presented in various styles: as summary abstracts of longer papers; as simple checklists; as tables or illustrations; and as case studies. Where appropriate, the summary text is accompanied by a simple graphic, highlighting the key points. As such, this compilation will hopefully serve as a useful resource for trainers and practitioners in the field of community based finance.

The materials are presented in seven sections:

Section 1: Down-marketing of Housing Finance through CBFIs introduces basic issues regarding access to housing finance by low income households in India. This section draws largely from the study and strategy documents prepared by Dr. Meera Mehta for the Project in 1994, and covers basic principles and guidelines for linking community-based programs to the formal housing finance sector.

Section 2: Lessons from the Micro Enterprise Sector summarizes two papers that look at the successful record of institutions lending for micro-enterprise. Relevant lessons for similar initiatives in the housing finance sector are identified.

Section 3: Establishing a CBFI: Issues and Principles looks at strategic issues in the design and orientation of CBFIs. This material is largely drawn from papers and reports prepared by Robert Schall of Self-Help Ventures Fund, USA.

Section 4: **Establishing a CBFI: Issues for NGOs in India** looks at key issues such as the use of small groups as a basic unit of savings and credit organizations, the process of institutionalizing these groups, and the legal options available to CBFIs in India wishing to formally register.

Section 5: **Management of CBFIs** looks at basic issues in the financial management of CBFIs.

Section 6: **Case studies** presents a series of brief profiles and histories of CBFIs.

Appendices: These comprise a set of overhead transparency style summaries of the materials in the preceding sections. For convenience, the appendices are numbered to match the relevant section of the text, above.

The editor wishes to acknowledge that the summarizing of lengthy papers and the selection of priority issues is a very subjective exercise. As such, the responsibility for any errors, omissions or misinterpretations rests fully with the editor.

Section 1

Down-marketing of Housing Finance through CBFIs

1.1 Shifting Paradigms in Development Finance

by
Anthony Scoggins

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.

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 unable 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 identification of innovative financial technologies 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.

1.2 Formal and Informal Housing Finance in India

by
Meera Mehta

One distinctive feature of the housing finance system in India is the presence of an enormous informal sector. Estimates put the ratio of informal to formal finance at 70:30.

Institutions operating in the formal and informal sectors are listed below:

Formal (30%)	In-Formal (70%)
1) Central & State Govts.	1) Households themselves
2) HUDCO/State Housing Boards National Housing Bank	2) Friends / relatives (Mostly via Rotating Credit)
3) Co-operatives	3) Money Lenders
4) Scheduled Commercial Banks	4) Self Help Groups
5) Housing Finance Companies	5) Nidhis
6) Insurance Companies	
7) Provident Fund	
8) Employers - Public / Private	

The significance of the informal sector in India's housing finance reflects the historical inability of formal financial institutions to adequately service this market in general, and the low and moderate income market in particular.

The perceived obstacles to down-marketing housing finance are:

i) inadequate houshold income in relation to housing prices;
ii) high credit risks; and
iii) high transaction costs.

1.3 Proposed Strategy for Downmarketing Housing Finance Through CBFIs

by
Meera Mehta

The strategy proposed for downmarketing housing finance to moderate and low income groups is to link formal sector institutions to emerging and existing CBFIs.

The objectives of this strategy are:

i) to enlarge the market for housing finance for emerging housing finance institutions on commercial terms;

ii) 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; and

iii) 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 mainstream financial systems in the country.

1.4 Key Design Principles

by
Meera Mehta

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

These are listed below, along with the main design principles to deal with each constraint. This strategy rejects the conventional notions of reaching the low income groups through subsidies. Instead, it aims towards evolving more appropriate loan products and enabling larger spreads to meet the higher establishment costs.

Constraints and Key Design Principles

CONSTRAINT	DESIGN PRINCIPLES
1) **High Credit Risk**	1) Measures to cover credit risk including insurance cover 2) Delinquency Risk Fund 3) Appropriate Underwriting
2) **Affordability**	1) Design of appropriate new loan instruments 2) Selection of appropriate markets 3) Technical support
3) **High Transaction and Servicing Costs**	1) Developing CBFI capabilities 2) Adequate scale of operations 3) Spreads to cover establishment costs

1.5 Types of Linkage

by
Meera Mehta

Two types of linkages are envisaged between the formal Housing Finance sector and community based financial institutions: the CBFI as facilitator and the CBFI as financial intermediary.

1) **The CBFI as Facilitator**: In this linkage, the loan agreement is directly between the housing finance institution (HFI) and the individual borrower, though the process is facilitated by the CBFI. The latter may help in loan origination and also actually service the loan on behalf of the HFI, at a fee. The basic aim of this linkage would be to encourage the HFI to develop a working knowledge of lending to these groups directly, while limiting its costs by using the NGO - CBFI structures for loan servicing.

2) **The CBFI as Financial Intermediary**: In which a bulk loan is issued to the CBFI with specified terms and conditions for on lending to individual households. The CBFI has responsibility for loan origination and servicing and also bears the credit risk. Two forms of intermediation are visualised.

i) Multi-tier Intermediation: the loan passes through the federation or apex, which in turn lends to the primary CBFI.

ii) Single-tier Intermediation: the HFI deals directly with a primary CBFI.

1.6 Financial Guidelines For CBFI Linkages

by
Meera Mehta

For CBFIs to establish linkages with the formal housing finance sector, there shall have to be some very specific agreements between the two parties. These agreements should cover:

1) Mutually agreed upon purpose of loan, credit terms and underwriting

2) Delinquency risk fund and Group insurance to cover 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 CBFI.

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

1.7 Support Systems for CBFI Linkages

by
Meera Mehta

Linkages between Housing Finance Institutions and CBFIs will only succeed if a supportive mechanism is in place. There are three main components of a Support System.

a) Technical support for identifying and developing viable projects. CBFIs often do not have the necessary expertise to guide their borrowers and do proper assessment of proposed projects.

b) Market information: is required regarding available housing options and the related prices. A property information service would help to address this.

c) Financial Management: to strengthen the capacities of CBFIs through stronger accounting and reporting systems, better auditing services and a wide range of training.

Such a support system will need support initially through a grant. Over time, however, it must operate through a fee structure which will make it self-supporting.

Section 2

Lessons from the Micro-enterprise Sector

2.1 Lessons Learned from Microenterprise Financial Institutions

by
Vyjanti Tharmarantnam and Harry Garnett

What is the purpose of Microenterprise Financial Institutions? Clearly there is a social purpose in attempting to serve the needs of disadvantaged groups. At the same time there is a commitment to economic sustainability and profitability. These two objectives should not be viewed as diametrically opposed to each other, but as two sides of the same coin.

Recent studies of MFIs indicate that their success is attributable to many factors:

i) clear vision in the organization's commitment to its mission;
ii) charismatic and skilled leadership;
iii) loyal and effective staff (a function of effective training programs and incentive schemes, in combination with competitive terms of employment and a reasonable degree of job security);
iv) financial security (which in turn is a function of appropriate policies, good budgeting, sound accounting, and effective portfolio management).
v) the MFI's ability to network (ie. maintain fruitful relations with donors and banking partners).
vi) managing risk through "bulk" group lending.

The Issue of Sustainability:

The long term objective of all MFIs is to be self sustaining,- which can be defined in financial terms by a return on equity equal or greater than the opportunity cost of equity. This implies reduced dependence on grants, subsidies, and more dependence on clients' deposits, which in turn implies setting interest rates at market level.

There are different levels of financial self sufficiency:

Level #1: Precarious self sufficiency exists when MFIs are dependent on soft loans and grants to help cover costs and establish a revolving fund. This stage creates the conditions that make it difficult to expand.

Level #2: The MFI develops programs to raise funds by borrowing at near market rates. The interest from this lending should cover much of the cost of funds and some of the operating costs, yet some operating grants will still be required.

Level #3: The MFI operates at a level which covers the operating costs but at which subsidies are greatly reduced.

Level #4: Complete independence and full self sufficiency. The total value of the fees and interest rates will be greater than the costs of doing business.

Conclusion: Although the long term objective would be to eventually transform the organization into a full service financial institution, the key to success for MFIs is a willingness to experiment and be flexible. A market niche can often be found by an MFI through some form of innovative program or policy such as mobile banking or special incentives for prompt repayment. To ensure success, however, all such innovations require effective monitoring systems and informed decision-making.

2.2 The Common Ground Between Housing & Micro-enterprise Finance

adapted from a paper by
Pricilla M. Phelps
Microenterprise Development Office - USAID

1) Introduction: The purpose of this paper is to examine common issues in designing systems for microenterprise finance and housing finance for low income people in developing countries.

2) The Success of Microenterprise Finance Institutions In the past decade, microfinance institutions (MFIs) throughout the developing world have been making credit and savings services available to individuals previously considered unservable by the financial sector As a result, many low income people, particularly women, have gained access to financial services from which they have traditionally been excluded.

Developing financially sustainable institutions with outreach that is both broad (widespread) and deep (reaching low income levels) has become a major focus of the microenterprise finance field. The emphasis in these efforts has been on building institutions that provide financial services to support income generating activities or microenterprise development of the poor. The response of clients to the availability of small infusions of credit and low cost savings services has been strongly positive.

3) The Challenge of Housing Finance: While significant strides have been made over the past two decades to develop and strengthen the systems whereby housing is built and purchased in developing countries, strategies to provide affordable housing for very low income people on a sustainable basis have been hard to come by. Some of the techniques popularly employed to support the construction and acquisition of housing, such as subsidized credit, have been found to be regressive and not sustainable. There clearly exists the need for sustainable financial mechanisms for housing for the poor, as much as for enterprise development.

4) The Common Ground: Low income families view housing not only as a secure dwelling but also as an asset that houses a business, may directly generate revenue, and serves as savings when it appreciates in value. A loan made to a microentrepreneur may be used directly in the business or for a housing related purpose that enhances the prospect of the business. Yet microfinance institutions generally consider their loans to be business loans, and view housing loans as a separate form of credit. Microenterprise finance institutions could benefit from knowing more about the ways housing affects the economic situation of the household and enterprises to whom they are lending.

Simultaneously, housing development practitioners are realizing that while financial market development and public sector reforms are necessary to increase the efficiency and scale of housing finance, the resulting system likely does not reach the low end of the income scale. Other approaches are being considered that take their lead from the ways poor people provide for their own housing needs. This evolution in thinking on housing finance is similar to the transformation that led to the creation of many of the new microenterprise finance institutions.

5) Common Interests: Common and complementary interests between the housing and microenterprise fields are:

a) A concern with similar clients: Generally low and very low income people who are outside of the formal sphere with respect to employment, financial services, and housing. These clients are stable, productive members of the communities in which they reside, and are generally good credit risks for the organizations that finance them.

b) Informal economic activities: Low income people tend to develop their enterprises and housing in similar ways; incrementally and in ways that control the level of risk to their households. The decision-making is rational, and reflects consideration of numerous factors including costs and the legal options actually open to them.

c) Similar forms of credit: Credit is usually sought for both on a short term, uncollateralized basis. For both, borrowers can generally pay market rates of interest, especially if that helps ensure there will be additional credit available when it is needed in the future.

d) The inextricable linkages between housing and income: Home-based businesses are prevalent among the clients of microenterprise finance institutions. The home is much more apt to be a productive asset for a low income person than for someone at a higher income level.

e) Both credit and savings services are needed: Attention is increasingly being given to the need to mobilize savings to provide these services on a sustainable basis. With this realization has come the knowledge that mechanisms must be developed to ensure the safety of deposits and the soundness of the institutions taking them.

f) MFIs have the potential to provide credit for housing: Some financial institutions which work extensively with microentrepreneurs also make housing loans. Some NGO's involved in housing provision are setting up loan programs as a way to more sustainably provide financing for their efforts.

g) Providing links to the formal financial sector: In the field of microenterprise finance, significant attention has been paid to finding ways for MFI's to act as intermediaries between borrowers and the formal financial sector. There exists similar opportunities to finance affordable housing by developing intermediaries for the efficient delivery of public or private funds in the housing field.

h) Housing loans help MFIs to diversify their loan portfolios: The development field has experimented with single purpose financial institutions and generally learned that their lack of diversity presents a risk to their long term survival. The possibility of diversifying the portfolios of these institutions with the introduction of housing loans should be considered one potential benefit.

Section 3

Establishing a CBFI: Issues and Principles

3.1 Requisites for Success for a CBFI

by
Robert Schall

There are certain characteristics of successful CBFIs that seem to qualify as necessary pre-requisites for that success:

a) Management Commitment: There must be explicit organizational dedication to housing finance as an on-going, full-time function.

b) Institutional Structure: The organization must have a legal identity that can raise deposits, accept bulk loans, use governmental and foundation money, have some flexibility in its lending products, not be too limited by definitions of mutuality (ie. restrictions as to who it can accept deposits from and who it can lend to), and be relatively free of governmental meddling in its operations.

c) Capable Staff: Staff must be experienced and trained in managing a financial institution and in housing finance.

d) A Broad and Defined Market: CBFI's must define markets that are broad enough (income-wise and geographically) to provide an effective demand for market-rate housing loans. CBFI's must be open to serving different markets.

e) Start-up funding: NGO's and small CBFIs will not be able to cover startup and initial operating costs until they build a significant earning portfolio of loans. These costs can be somewhat offset with staff borrowed from other programs, training, and technical assistance, and building net worth from which to generate some earnings.

f) Adequate Loan Funds: Bulk loans and capital (equity) must be adequate to fund loans and maintain financial stability. A particular concern in most CBFIs, is the lack of equity.

3.2 The Issue of Target Markets

by
Robert Schall

Community development financial institutions (CDFIs) have some flexibility in selecting the constituencies, geographic areas, and types of needs they choose to serve. 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: 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 putting credit to work for community development goals. Some guidelines:

1) **Focus On One Development Goal At A Time**: Many CDFIs find it difficult to choose between a wide range of development impacts (hire low income people, locate in distressed area, provide employment training, etc.) But the more developmental objectives a project has, the more risk is associated with the loan. At some point the CDFI that attempts to "save the world" with each loan will find an unacceptable amount of risk in its loan portfolio and end up in financial ruin.

2) **Match Developmental Needs with Market Gaps:** CDFIs should give considerable attention to assessing and reassessing development needs and underserved credit markets. Development lending only works where development needs and credit gaps exist simultaneously. CDFIs use different means to identify potential markets. Most CDFIs start with some macro-economic analysis and then identify local demand using secondary data sources and surveys. The CDFI then uses its own knowledge of its low income borrowers to fashion a program that modifies conventional practices. Using trial and error, it modifies the practice, making it safe to offer as a standard loan product. **Experience is the best informer of effective market demand.** Through continuous monitoring, CDFIs can gauge whether they have found that place where need and market demand meet.

3) **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, can develop a much better knowledge of their borrowers and the communities in which they live. In addition, specialized knowledge of innovative development schemes (like low-cost house building techniques, self help housing efforts and land trusts) permit CDFIs to participate in projects that banks shun.

4) **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; product diversification; sectoral diversification. Many CDFIs attempt to identify profitable lending markets that are overlooked by conventional lenders. In the US, cooperative businesses are such a niche market. An alternative strategy is to is explicitly compete 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.

3.3 Key Issues for CBFIs Engaging in Housing Finance

by
Robert Schall

Organizations such as NGOs which are considering establishing a community - based financial institution for the purpose of providing housing finance services should seriously consider the following issues.

a) Is the necessary committment there to operate a CBFI?

- An NGO must decide to have a full time focus on operating a financial institution.
- CBFI's must stick to financing as their sole activity, not construction or obtaining tenure or community organizing. These activities should be the work of others.
- CBFIs must employ staff fully dedicated to financing.
- CBFIs must be able to reach a broad range of customers, geographically and by income. A traditional NGO focus on limited group of members could be a barrier to success.

b) Is the issue of land tenure clear in the local context?

- A guarantee that structures will not be destroyed is necessary to make loans. No financial institution can bear the risk of a slum clearance project wiping out a part of its portfolio.
- Title is not necessarily required, simply the elimination of property damage risk. Government could lease property on long term, for example.

c) Have the market opportunities been researched and identified?

- NGO's often have very little information about the potential market for housing loans. Costs range greatly between a very small "hut" to a standard flat in a large city. The ability to pay by low and moderate income persons is often not well known by the NGO's.
- The market research should identify which income niche can afford market rate mortgages. Keep in mind that substantial subsidies (like donation of land) change affordability estimates greatly.
- This research may indicate the need to shift attention from a group of individuals defined by NGO projects, to a slice of the income spectrum with which they have not worked.

Section 4

Establishment of a CBFI:Issues for NGO's in India.

4.1 Self Help Groups and Micro-Banking

adapted from a paper by
Malcolm Harper
Xavier Institute of Management

Introduction: Self help groups (SHGs) seem to be the "flavour of the month" for NGOs and banks throughout India. Some promoting agencies advocate direct linkages between banks and SHGs, facilitated by NGOs, while others prefer the "bulk lending" approach whereby the NGO acts as an intermediary, borrowing the money and on-lending it to the SHG, for further on-lending to its members.

The Advantages for all Parties There are a number of good reasons for this wave of enthusiasm. Most innovations in social finance require sacrifice by at least one party to the transaction, but SHGs offer every player an opportunity to play a positive development role while covering the costs of so doing. For example:

a) Members of SHGs: are able to access services from formal financial institutions at a price they can afford. The intermediation of the SHG allows them to do this at a time and place that is convenient to them, and in amounts which are appropriate for their needs.

b) The Banks: After decades of regarding recoveries of under 50% as normal, banks have found a means of lending to the rural poor where 100% recoveries are commonplace. Also the transaction costs per rupee lent are greatly reduced as the bank only has to deal with one aggregated loan for all the members of an SHG. Most of the work of appraisal and follow up can also be handed over to the SHG.

c) The NGOs: can benefit either by playing a direct intermediary role as borrowers and on-lenders (thereby earning a margin), or by generating a service fee for services rendered. Furthermore, the possibility of future loans motivates people to form groups, and encourages them to make regular savings which are so often the "glue" which holds a group together. This clearly serves to legitimise the NGO, to government, donors and the community.

The Need for Caution: In spite of all these manifest advantages, however, it is important to recognise that linking SHGs to banks is not a "quick fix", which enables banks and NGOs to solve all the problems of the rural poor. There are dangers inherent in this strategy, particularly for the most disadvantaged people, and NGOs in particular have a responsibility to guard against SHG linkages becoming another target oriented scheme which may

benefit development agencies and their employees, but provides little long term benefit to those whom it is intended to assist. Major problems observed are:

Problem # 1 - Absorption Capacity: The poorest people are usually the least able to make effective use of resources. Their poverty arises not from their lack of resources, but from the nexus of social and political constraints which prevent them from making use of available resources. There are many examples of SHG's which have accumulated substantial savings, but whose members are not able to invest in remunerative enterprises. Credit is only a positive intervention when it can be repaid, and a borrower who uses a loan to make products which she cannot sell is actually worse off as a result of having borrowed.

Problem #2 - The Impact on the Groups: There is some evidence that people regard funds which have come from a bank or other outside institution very differently from their own savings. The outside money may introduce dissension in the group. Moreover, a bank loan which increases the sum of money which members can borrow, may serve to exclude the poorer members from the benefits of membership. They may not be able to borrow as much or as frequently as their more prosperous fellow members.

Problem #3 Perpetuating Structures: There are those who argue that NGOs which are genuinely interested in social change should not perpetuate existing relationships by linking poor people with the very systems which have led to their marginalisation. This is not purely a theoretical view; there are many examples of SHGs which have relied entirely on their own savings, and built very substantial capital funds. These SHGs have come together into clusters which have themselves formed tertiary level federations. Such groups can be the nucleus of an alternative banking system, which is originated, funded and controlled by its members in a way that is totally impossible for clients of a traditional bank.

Problem # 4 Management Skills & Culture: Effective management of a savings and credit operation requires both attitudes and skills which are very different from those normally associated with activities such as health or education, in which NGOs and SHGs are commonly engaged. These include financial management and record-keeping functions. Similarily, the culture of service which is a valued foundation of many NGOs is not necessarily consistent with good management of what is essentially a micro-bank. For example, most SHGs charge very high rates of interest, and achieve high rates of recovery through a combination of mutual support and rigorous internal discipline. The NGO may have to support and encourage what appear to be draconian measures against slow payers, and if the group as a whole falls behind in its installments, the NGO worker has to act like a hard nosed banker rather than a caring community worker.

4.2 Institutionalizing Savings and Credit Groups

by
Anthony Scoggins

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

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. But **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 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. 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.

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.

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.

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.

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. 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.

4.3 Alternative Strategies and Models

by
Anthony Scoggins

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.

Within this framework, the most common models found in the field can be categorized either as **externally** managed and financed or **community** owned and financed.

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) NGOs as Financial Intermediaries: 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) NGOs as Loan Guarantors: 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.

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.

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.

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.

4.4 Legal Options for Groups Considering Community Based Housing Finance

by
V. Nagarajan

Option	Legislation	Limits on Activity
1) Nidhi-Mutual Benefit Organization	Companies Act 1956 Sections 12; Sec. 25 optional; Sec. 620A	Can deal only with members
2) Public Charitable Trust	Indian Trust Act	As per Trust Deed. Finance activity OK
3) Public Limited Company	Companies Act, 1956 Sec. 12	As per Memorandum of Association.
4) Section 25 Companies	Companies Act 1956 Sections 12 & 25	Restricted to charitable activities. Finance activity OK
5) Society	Society Registration Act 1860 as amended or as administered by the respective states.	As per by-laws. Finance activity is permitted RBI non-banking finance co. guidelines do not apply. Housing activities could be organized as for profit division to meet the main charitable purpose of the society.
6) State Cooperative Society	Cooperative Society Act as applicable to each state.	Should be organized for a single or narrowly defined common purpose. Otherwise, by-laws govern activity.
7) Unregistered Self Help Group	Unregistered	None, as long as membership is limited to 20 persons
8) Urban Cooperative Bank	State Cooperative Society Act 1972, Multi-State Coop Society Act 1984, secs 2 or 7 Banking Regulation Act, Section 45	60% of loans must go to Priority Sector. Otherwise by-laws govern.

Section 5

Management of CBFIs

5.1 The Great Balancing Act: Mission vs. Money

by
Robert Schall

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

A CBFI must be successful in achieving its overall mission: to create housing or jobs. If the CBFI is not able to show tangible results it will lose credibility with its customers, depositors, and funders. Ultimately, it may become irrelevant and ineffective. On the other hand, a CBFI 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 eventually collapse.

The CBFI 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 median income families will provide a stable source of income for the CBFI. No one gains when a CBFI goes bankrupt, so it is crucial for these institutions to learn to accurately assess and manage the risk inherently associated with community development projects.

5.2 Rules of Thumb for the Management of CBFIs

by
Robert Schall

There is no doubt that the provision of development credit is a costly undertaking. No matter how efficient and productive a CBFI is, there will always be extra costs that a conventional financial institution will not have to bear. Compared to a bank, CBFIs 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 CBFI. Consequently, CBFIs must be even smarter than conventional banks in their financial management in order to operate successfully.

If CBFIs are managed wisely, interest derived from loans can support much of their operating costs. A common practice is to cover loan related expenses with interest revenue and allocate any available subsidies to technical assistance, development of new programs, and advocacy work. Some basic financial management "rules of thumb" are described below.

1) 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. 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 CBFIs are able to charge a "market" rate and still serve a low income target population is because disadvantaged people need access to credit more than they need low cost credit. In most economically distressed communities, the availability of credit is the issue, not the interest rate. What makes the difference to low income borrowers is the fact that they have a reliable source of credit when they need it.

There are two other reasons that interest rates should not be subsidised. First, interest should be the major source of revenue for a CBFI. If a CBFI is to remain financially solvent, it must maximize its interest revenue. Second, credit programs offered by CBFIs 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 to ever be more than a small demonstration project.

2) Keep the Cost of Funds Low: The corollary of charging market interest rates is keeping the cost of funds to the CBFI 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.

3) Build Significant Net Worth in the Organization Even better than low cost funds, net worth (equity, permanent capital) offers CBFIs a permanent source of no cost funds. Internationally, banks maintain a ratio of net worth to assets of 8%. CBFIs, through a long term strategy of seeking permanent capital generally, seek a ratio of 10%-20%. These funds are generally provided from capital grants, charitable sources, and retained earnings. In this manner, external subsidies can enhance the institution's long term financial stability.

4) Match Assets and Liabilities: Like any financial institution, CBFIs must pay attention to maintaining a base of savings deposits, bulk loans and net worth to fund their loans. There are two features of liabilities and assets that must be matched. The most obvious is interest rate. CBFIs 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 change over time, the CBFI must take steps to ensure that it can vary the interest on loans accordingly.

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 long term liabilities. Since an institution's net worth has no maturity, it is ultimately flexible when it comes to lending long or short term.

In short, CBFIs should 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, CBFIs can provide loans with terms much more favourable to the borrower, enabling them to reach lower income families with their loan products.

5.3 Key Issues in the Financial Management of CBFIs

by
A. P. Scoggins

Community-based financial institutions, have different objectives and priorities from commercial or government-owned banks. But to be successful, all of these institutions have to respect certain basic principles of financial management. These principles relate to four general areas of management:

1. Asset-Liability Management
2. Cash Management
3. Income Management
4. Risk Management

1) **Asset-Liability Management:** Asset-liability management is the combined planning and managing of assets and liabilities. The purpose of asset-liability management is to ensure that the financial institution provides a mix of services and produces a level of income in keeping with its plans and objectives.

There are two major components of asset-liability management:

i) matching the <u>maturity term</u> of the liabilities and assets; and
ii) managing the <u>interest rate</u> spread between the assets and liabilities.

2) **Cash Management:** Cash is defined in financial institutions as all money that has immediate purchasing power, such as physical currency, plus current and savings accounts. Cash management is therefore the planning and management of cash inflows and cash outflows such that adequate cash reserves are maintained while not unduly constraining the income earning capacity of the society.

Cash flow management is closely linked to the concept of liquidity. Liquidity is defined as the ability to meet demand for funds. Liquidity management is therefore the process of ensuring that demand for funds is met. Since liquid or convertible assets (those that can be converted into cash within three months) usually receive a lower rate of return than do longer term assets (like loans or term deposits), the desire to keep a good reserve of cash must be balanced with the need to earn income.

3) **Income Management** In order to prosper and grow, any business enterprise must generate sufficient income to cover its expenses and provide a reasonable return to the owners' capital. The purpose of income management is therefore to plan and manage the earnings of an enterprise such that earnings generated are

adequate to cover all expenses, pay a return on capital and enable future growth and development.

For financial institutions, the major income and expense items relate to the mobilization of funds and the subsequent application of these funds as loans or investments. These costs and incomes are listed below:

Cost of Funds	Income from Funds
- interest on savings	- interest received on loans and deposits
- interest paid on loans	- income from investments
- dividends paid on shares	

Financial institutions must therefore manage their resources such that the income generated from their loans and investments is adequate to pay the cost of funds and cover all the administrative or overhead costs of doing business. The key to this process is maintaining an appropriate spread between the interest rate paid for funds and the interest rate received. The net income that this generates is known as the financial margin.

3.5) **Risk Management** Risk simply means the uncertainty of loss, and CBFIs face a variety of risks in the course of doing business. Risk management is therefore defined as the process of protecting the society's assets and resources from loss. There are four alternative strategies comprising risk management:

i) **absorbing the risk:** essentially accepting the risk and being prepared to pay the cost of loss. For example, building up internal reserves to cover bad debts is a form of risk absorption;

ii) **spreading the risk:** in which a range of activities are under taken (or products offered) with variying degrees of risk. This process of diversification allows a balance to be struck between higher risk and lower risk activities or products;

iii) **transferring the risk:** usually done through insurance agreements through which another party agrees to accept (for a set price, i.e the premium) the risk of loss. Life insurance or fire insurance are two examples;

iv) **avoiding the risk:** in which the society decides not to undertake a certain activity, due to the high risk of loss. For example, discontinuing a certain loan program, refusing to make speculative investments, or deciding not to retain any cash in hand at the end of the day are all illustrations of risk avoidance.

(See below "5.6 The Issue of Risk in CBFIs", where various types of risks are described).

5.4 Financial Planning for CBFIs

by
Anthony Scoggins

A budget is a financial plan showing how resources will be acquired and deployed in a set time period in order to accomplish certain objectives. Budgeting is thus only one component of the overall planning process within a CBFI. As money is the means to an end and not the end itself, then the financial plan should follow after the broader plan for the organization has been completed. This broader organizational plan usually comprises three distinct elements:

1. The defining of the CBFI's mission and vision. The mission is a brief and simple statement of the overall purpose of the organization; from this can be developed a statement of what the organization should look like in the future. This is the vision statement and it too should be brief and simple.

2. The strategic plan of CBFI is the plan for the mid to long-term future. Nowadays, in a world of rapid social, economic, political and technological change, the "long-term" is defined as five years or so. Many organizations are therefore elaborating their strategic plans in terms of where the organization will be in the year 2000. These plans are not detailed operational plans, but outline the general strategies, organizational priorities and directions for the next five years. This plan will help the senior management of the organization allocate its scarce resources in a manner which most effectively moves the organization towards its stated vision.

3. Each year, every CBFI should put in place a detailed operational plan that is elaborated in the context of the broader strategic plan. This plan should have specific and measurable objectives, along with detailed action plans. The annual budget of a CBFI is developed in terms of this operational plan, as are departmental and individual workplans.

The budget is not only a planning tool to be looked at on the first and last day of each year. A budget can also be an important tool in the on-going management of an enterprise, particularly in terms of monitoring performance and exercising financial controls.

5.5 The Budgeting Process

by
Anthony Scoggins

Step 1: Taking Stock: This comprises two activities; firstly, a review of last year's performance compared to plan targets and budget projections. This is followed by an analysis of the current situation. The situational analysis should include an assessment of:

a) forces in the external environment (eg. economic trends, legislative changes, new players in market, etc.); and

b) factors in the internal environment (membership, financial position, staff relations, policy issues, etc.).

From this review, and keeping in mind the organization's long-term strategic plan, a set of priority areas for action are identified.

Step 2: Setting Financial Objectives: Once the Board and Management have completed their year-end review and situational analysis, they establish a set of priorities for the upcoming year. These priorities must be translated into specific operational and financial objectives. Sometimes the Board does this task itself; sometimes it is delegated to the management staff.

Step 3: Developing Action Plans: This is described as the tactical planning stage of financial planning. At this stage the personnel responsible for achieving the set objectives identify and assess the alternative courses for action to reach these targets. The Manager must then oversee the consolidation of these various action plans into a realistic plan for the entire organization.

Step 4: Developing the Budget: At this stage a preliminary budget is developed. In keeping with the flow of funds in a CBFI, the budget is developed in a step-by-step, logical sequence, beginning with the balance sheet and then moving to the income and expenditure statement.

Step 5: Approving the Budget: Once all the various budget figures are calculated, a narrative summary is generally provided, highlighting the main issues. This report is then provided to the Directors before the end of the year so that they can make the final decisions prior to presenting the budget to members at the Annual General Meeting.

Step 6: Implementation: Implementing the approved budget is the responsibility of the manager. Here, effective communication is vital. Employees must be made aware of their responsibilities and management's expectations of their achievements.

Step 7: Monitoring Budget Performance: A well prepared budget provides a useful standard against which performance can be monitored and controlled. Monitoring involves comparing the actual results with the budgeted so as to identify variance (divergence) from the plan. This gives rise to the practice of "management by exception", in which budget monitoring focusses upon those line items where the variances between budget and actual is considered unacceptable (for eg. + or - 10%). The remaining items are reviewed only in passing.

5.6 The Issue of Risk in CBFIs

by
C.A. Glover and A.P. Scoggins

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 level of risk (ie. exposure to loss) is within acceptable limits.

2) **Key Risks in CBFIs**: The five major risks that a community based financial institution faces are:

* credit risk
* financial risk
* operational risk
* technological risk
* pricing risk

It is important to understand these risks, as the management of risk is a key factor in day to day decision making.

3) **Credit Risk:** The most obvious risk in lending is the risk of non-repayment. But despite the term and 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; ie. a mortgage on the property itself.

Most institutions active in housing finance generally lend no more than 75% of the assessed market value of the house, and will take a legally registered mortgage (with appropriate insurance) on that property. The relative security of well administered housing loans is reflected in the fact that in many countries, the statutory requirements for loan loss reserves on housing loans are significantly lower than those required for other, less secure loans.

That said, CBFIs which provide loans to low income housholds in marginalized communities are operating in a relatively high risk market. The evaluation of applications for credit should include the following factors:

* 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
* 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

To manage credit risk, a CBFI also requires an adequate system of documentation and information management to ensure full compliance and regular monitoring. A set of follow up procedures for overdue or "at risk" loans is also necessary. Furthermore, the CBFI should have policies and procedures for making financial allowances (provisions) for loan losses on a regular basis.

4) **Financial Risk**: The second type of risk is financial risk, which relates to the matching (or mis-matching) of the term and cost of liabilities with the term and yield of its assets.

The key concern regarding the matching of terms of assets and liabilities is, **liquidity**. Simply stated, the risk is that a CBFI undertaking housing finance will lend long term with short term money. A sudden withdrawal of savings or increase in loan demand could mean a short fall in liquidity. The implication for CBFIs engaging in long term lending such as housing finance is 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 CBFI'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 loans) rarely coincide exactly, the CBFI is exposed to the risk of increased costs of savings not being matched by increased yields from loans.

5) **Operational Risk:** is defined as the risk of loss due to inadequate performance of staff, in terms of proficiency, speed, accuracy etc. Many emerging CBFI's, because of their scale and youth are exposed to operational risks. A frequent element of this risk is the enormous skill gaps between CBFI managers and second-tier staff. Another significant factor is the inclination of CBFIs to rely upon staff with a social work rather than business orientation. Strategies for dealing with operational risk include staff training and development, mentoring, succession planning and systematic documentation of procedures.

6) **Technological Risk:** is defined as the risk of loss due to inadequate systems. Systems (mechanical or electronic) are deemed to be inadequate if they do not generate the information required as and when necessary to make informed decisions. For CBFIs, the most suitable electronic data processing systems are integrated (ie. less opportunity for error), simple (re. staff skills), and flexible, allowing for a wide range of operating situations.

7) **Pricing Risk**: The risk in underpricing a financial product is key to a CBFI's survival. Calculating the appropriate price of a loan product must take into account the following factors:

* cost of money
* risk
* take on costs
* collecting costs
* reporting costs
* the size and term of the loan.

The topic of Pricing Risk is addressed more fully in 5.7, below.

5.7 Pricing Products in CBFIs

by
C.A. Glover
Credit and Savings Help Bank, South Africa

The pricing of financial products is a key determinant of the viability and sustainability of a community based financial institution. Most CBFIs tend to use simple rules of thumb for setting interest rates on loans, (eg. the cost of funds + 5%). The CSH Bank in South Africa has developed a more rigorous approach to the pricing issue, based upon its experience that the price of a loan should reflect the following factors:

a) cost of money
b) risk
c) take on costs
d) collection costs
e) reporting costs
f) loan size and term

a) Cost of Money: This is the most direct and easily monitored cost, and varies according to the source and type of financing (equity, savings, loans, grants, etc)

b) Risk: This factor is a mix of perception and experience, and must take into account the amount and quality of security provided for the loan. For example, in the case of CSH Bank, the price of loans includes a 1% charge for risk for fully secured housing loans; 6% for unsecured general purpose loans; and 12% for unsecured community loans.

c) Take-On Costs: Lenders have several up front costs before loans are even issued, such as marketing costs and writing up costs of the loan applications. In the case of CSH Bank, which often works with groups of employees through payroll deduction schemes, take-on costs vary in relation to the number of members in each workplace.

d) Collection Costs: The cost of administering collections relates to the amount of labour or system time that it takes to ensure payment. In the case of CSH Bank, the less secured the loan and the more individual the scheme the more labour intensive, and expensive it becomes. By contrast, the larger the number of debtors one can group together, the cheaper the administration of these loans. A related factor is the issue of security: the less secured the loan, the more uncertain the collection costs.

e) Reporting Costs: The same simple principle applies in that the more one has to generate individual statements at a regular and frequent interval, the more costly it is.

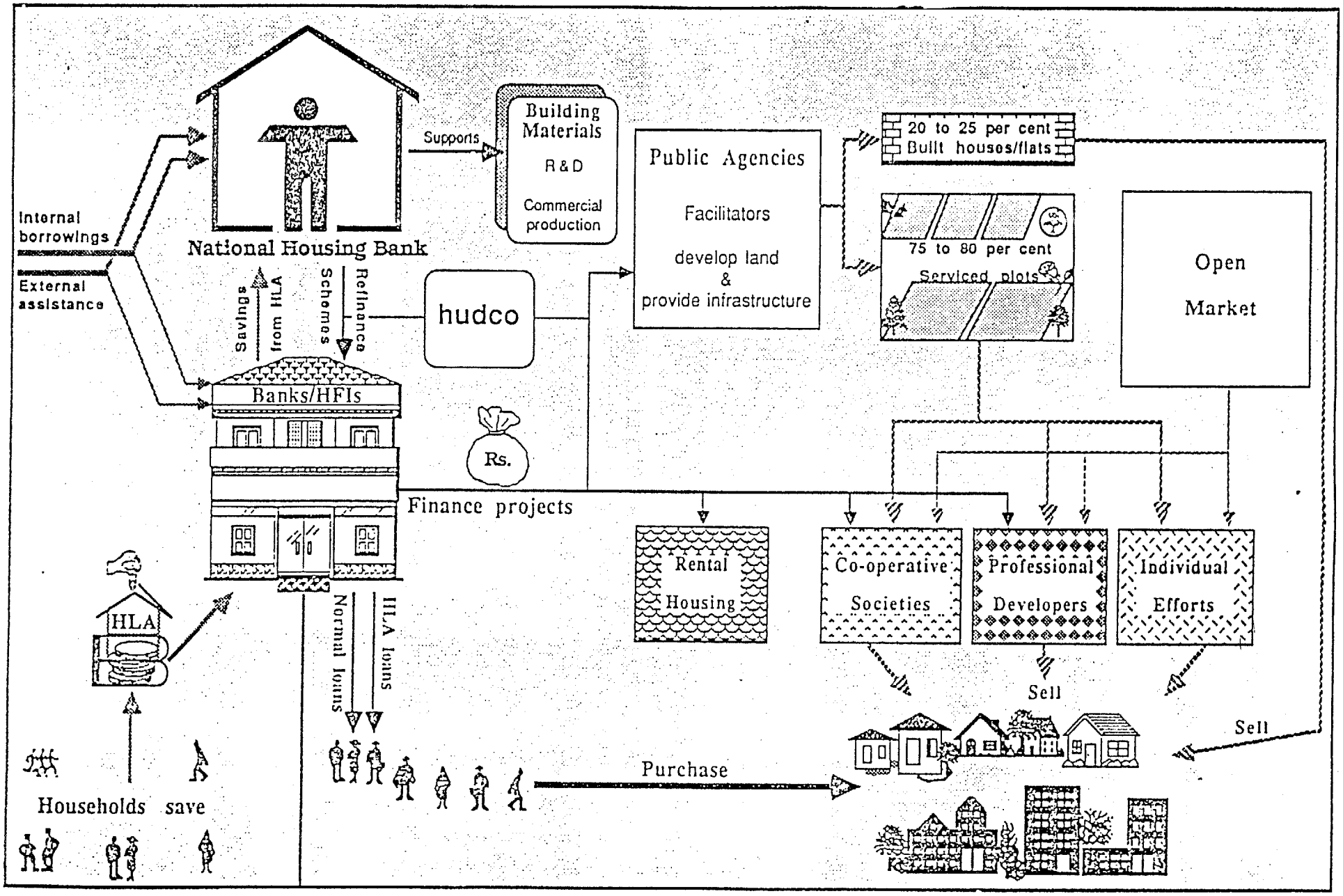
f) Size and Term of Loan: The influence of these factors on the setting of interest rates is self-evident: shorter term and smaller size loans involve proportionately greater administrative costs than longer term and larger size loans. At the CSH Bank, costs are calculated for a set loan standard (size and term) and then additional charges are added to shorter term or smaller loans.

Conclusion: A rigorous pricing process such as the one described here allows for accurate pricing of products that reflect their different characteristics. However, many NGOs and CBFIs may have some difficulty with the "user pay" concept that this strategy implies, choosing instead to keep prices (ie. interest rates) equal across a broad range of products, clients and circumstances. This approach is fraught with dangers, and managers of CBFIs should develop the commitment and skills required to more effectively address the pricing issue.

Section 6

Case Studies: Housing Finance and CBFIs

6.1 NHB's Strategy for Tackling the Housing Finance Problem



HFIs – Housing Finance Institutions. HLAS – Home Loan Account Scheme. R&D – Research & Development.

6.2 Loyalam Bank: A Grameen Replication Project

Loyalam Bank was set up by the Rural Development Organization (R.D.O.) of Manipur with the express objective of raising the living standards of the most disadvantaged section of the rural community, in particular women, through providing access to credit. It was launched in 1992 and is based on the model of the Grameen Bank in Bangladesh.

It took 3 months to complete the foundation work of identifying and selecting members, and conducting an awareness and motivational campaign. The area of operation of the Loyalam Bank was initially confined to 100 villages where RDO has been actively working for more than 18 years in various social development activities. In the first year, 3,000 rural women were identified through field visits, and group meetings.

Through the existing network of Community Health Volunteers (CHVs) operating in every village, rapport was established with the target group by the Bank Staff. Under RDO, there are around 100 trained female CHVs who are responsible for organization of RDO's health education, water & sanitation programme. The CHVs know the village women well and are readily accessible.

The bank has adopted the standard operational guidelines of the Grameen Bank model. A group is formed with five members. In most cases, the health workers are the chairpersons/centre chiefs. Only poor, landless women are eligible to form a group. Any member from a family owning less than 0.4 acre of cultivable land will be considered to be eligible. A group shall be formed with persons who are like minded, are in a similar economic condition and enjoy mutual trust and confidence. There shall not be more than one member from the same household in any one group. There shall be a chairman and secretary in each group, elected by the group members. All loans taken from the bank shall be repayable in fifty installments, at an annual interest rate of 20%.

By January 1996, the bank had 8,000 trained members with 4,400 borrowers. There are 112 centres at present linked to one bank branch. The average loan size is US $29 per new member borrowers, while those who were deemed to be "old" members were borrowing an average of US $58. The amount disbursed was US $ 170,713 while the amount repaid was US $123,196. The rate of repayment was 97%. Group savings plus accumulated group tax totalled US $21,451.

6.3 SPARC and Cooperative Housing

by
Sheela Patel

SPARC (the Society for the Promotion of Area Resource Centres) is a registered non-profit society which began work in 1984. Its objective has been to create an information base on the poor and their problems in order to form a basis for informed dialogue, planning and action. SPARC works closely with the National Slum Dwellers Federation, which has members throughout India.

The three cooperatives with which SPARC works, are all members of the Bombay Slum Dwellers Federation. In each of the communities in which the cooperatives are located, there are local slum dwellers organizations which have supported their development.

The **Markhandeya Housing Cooperative** is located in the low income residential area of Dharavi. The cooperative received special funding from the Prime Minister, and planned to build 94 dwellings. The house design has been developed by residents to reduce the risk of gentrification (ie. of house prices being pushed up by the entry of middle and upper income households in the local area.) The project has been delayed due to the inability of state institutions to deal directly with the poor. The Bombay Municipal Corporation owns the land on which the development is planned but it has not yet approved the lease which will transfer ownership. A loan has been agreed by the federal government's Housing and Urban Development Corporation (HUDCO) which will provide about 65 per cent of the finance. About 20 percent is being paid directly by residents and a government grant will cover the remaining costs.

The **Adarsh Nagar Cooperative Housing Society** is based in Dindoshi, Goregaon, a resettlement site 15-28 kilometres from the centre of Bombay. Many residents have already left the site because of inadequate amenities including poor transport service and no electricity. Some 52 houses are planned in an area within this settlement. At present, residents pay the government a "fine" for the use of the land and the cooperatives are presently negotiating with the corporation for this payment to be accepted as rent. The Housing Development Finance Corporation has agreed to give both this cooperative and the Jan Kalyan cooperative the loans they require.

In 1988, the Indian railway intended to clear squatters from land adjacent to the tracks in Bombay. The **Jan Kalyan Cooperative Housing Society** was formed by some of these squatters who rejected the alternative housing offered to them by the state. The society is to build 104 dwellings on land which has been allotted to the cooperative by the government, although they too

have not received with the lease, which was to be free of charge in compensation for having been moved from their previous site.

In all three cases, the land will be owned by the cooperative. Individual houses can be sold by the cooperative which has first right to purchase the unit. All building is supervised by the cooperative. Members of the cooperative are actively involved as construction workers on the sites, and women have taken advantage of this opportunity to improve their skills. Each cooperative has been offered a loan for 22 years and the cooperative itself is responsible for collecting individual contributions and making repayments to the lending agency.

NOTE: This case study is abridged from an article in the journal Environment and Urbanization, Volume 5, No. 1, April, 1993.

6.4 Youth Charitable Organization

by
Prem Kumar

The Youth Charitable Organization was established in 1981 by local unemployed but educated youth, with the intention to facilitate local development through organizing the weaker sections of the community. The organization began work in four villages and is now active in thirty. Its main aim is to undertake area development plans focusing on providing employment to the poor.

The Y.C.O. housing project is in four villages of Andhra Pradesh, where the NGO has been undertaking agricultural initiatives. The project has involved the construction of 130 houses. Fifty per cent of the cost of the houses will be repaid by the beneficiaries with the money going into a community fund held by women's associations. This money can only be used for other development projects. The main beneficiaries of the project are poor households which have been selected by the communities.

The land had been allocated to the households under the government housing project. The titles to the land are held by the women. The sites are vulnerable to flooding and the houses have been built to resist flood waters. Fire is a problem in houses built with thatched roofs so the new houses will use tiles. The Youth Charitable Organization encouraged the villagers to participate in the design process and the construction is closely monitored by the women. As far as possible all the labour used is recruited locally. Individual households contribute unskilled labour while YCO provides technical assistance.

Neither the government nor commercial banks responded to a request for financing the project. The government has since agreed to provide roads, water and electricity. An international agency, Homeless International, has provided funding. No collateral was required from the borrowers as it was believed that community pressure would be sufficient to secure repayment. Monthly payments are made to the secretary of the women's association in each village; this money is deposited in a joint account held by the Y.C.O. and women's associations. The organization has taken out insurance against the death of any loanee. The repayment period is seven years.

No major problems have occurred during the project. However, inflation has been significant and the cost of units is now nearly twice that originally anticipated. As a result, the repayment periods have been extended to facilitate payments.

NOTE: This case study is abridged from an article in the journal Environment and Urbanization, Volume 5, No. 1, April, 1993.

6.5 Pragathi Thrift Society

by
A.P. Scoggins

1) Origins: In 1971 the people of Mylardevpally village initiated a thrift and credit society in an effort to help them access credit at a reasonable interest rate. Local people found it impossible to borrow from the established cooperatives, and the only alternative was money lenders who charged an exorbitant rate of interest. Membership in the society is open to permanent residents in Mylardevpally, irrespective of caste, political affiliations, occupations etc., Today 400 families are members, representing about 30% of the local population which is rapidly expanding due to influx from outside.

2) Thrift: Since inception, the society has had a policy of compulsory monthly savings. This began as a flat rate for all members, but is now adjusted for income levels and loan payments. Initially, very little interest was paid on savings, but now the society attempts to encourage thrift by paying savers a competitive rate of interest. Savings are considered long term savings by members (ie. for old age needs) rather than as working capital. Pragathi has also introduced a range of new savings instruments including fixed deposits and childrens savings accounts.

3) Loan Services: The society provides loans to members from deposits mobilised to a maximum of three times of members thrift deposits. At present the society is offering loans for various purposes like Business, Agriculture, and Domestic needs.

4) Additional Services: The society has also introduced various other services, including a simple life insurance scheme, funeral assistance, and scholarships. Recently, the society built a shopping complex and a hall which is rented out for community and private functions.

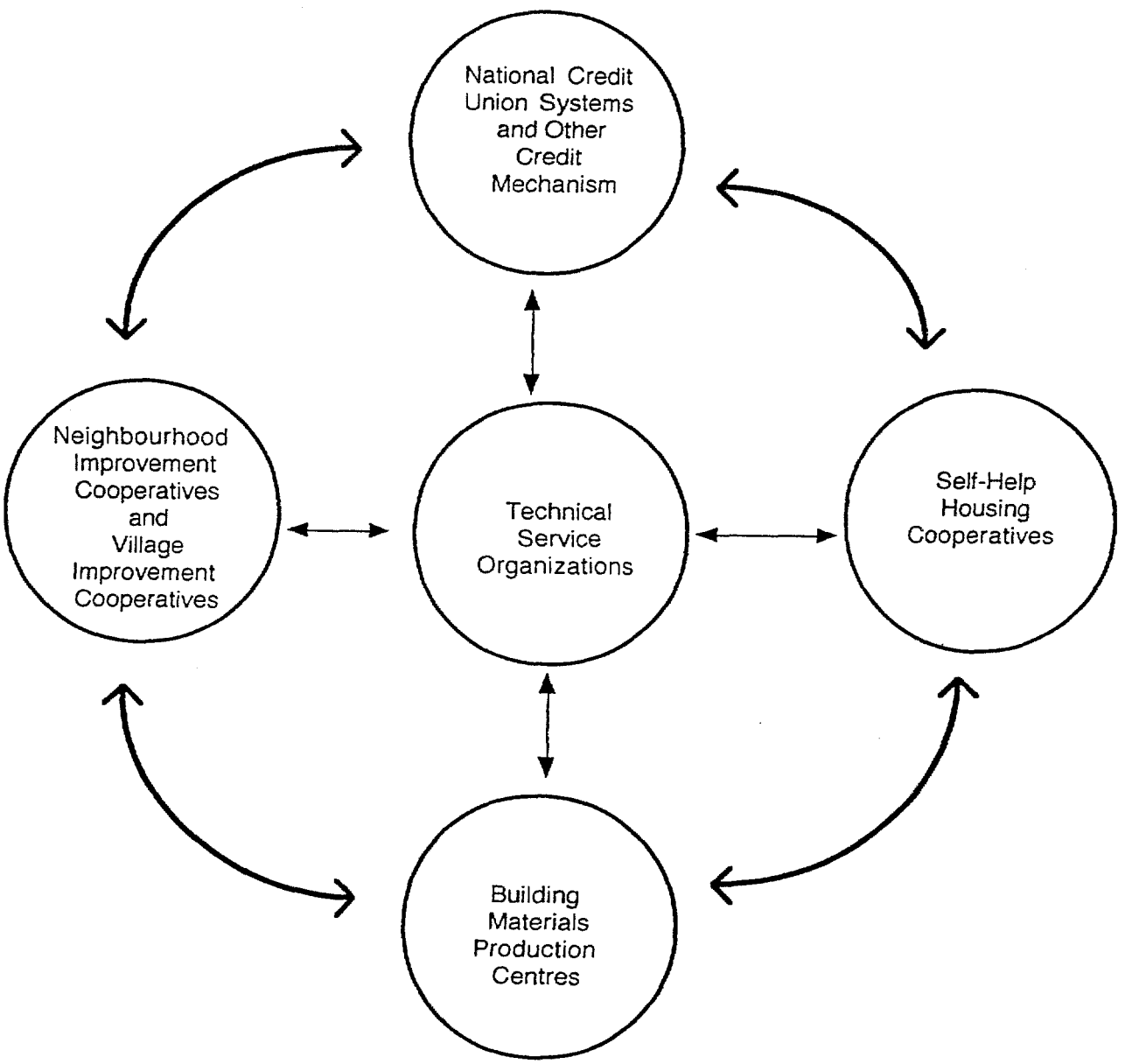
5) Housing Programs: There is increasing demand among members for access to improved housing. The society is planning to develop a housing colony for its members. It has taken an option on a large plot of land, and had a set of model plans and estimates prepared. The society does not have adequate financial resources to finance the proposed number of units, - there are already thirty applicant families. The Board of Directors are proposing a four way partnership, - with the member, society, federation and external source each contributing 25% of the required capital.

6.6 Credit Unions and Housing Finance: Three Models

Credit Union Case #1: An Integrated Approach to Housing Finance

Through the 1980's, 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 cooperatives. From their various experiments, the CHF developed a model of an integrated approach to housing finance which involved a broad mix of partner organizations.

The Cooperative Development System:



Credit Union Case #2: 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:

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

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

c) Housing loans made up to 35-40% of the loan portfolio of the credit unions.

d) 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.

e) 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.

Credit Union Case #3: 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.

Note: These three cases are extracted and adapted from "Home Financing", World Reporter, World Council of Credit Unions, Madison, WI., 1987.

6.7 The Experience of Community Development Financial Institutions in the USA

by
Robert Schqll

Most American Community Development Financial Institutions (CDFIs) identify finance for low income housing as a priority sector of activity. There are four major strategies for programming in this field.

1) Provision of Housing Loans: In an effort to improve and increase the housing stock in low income communities, many different types of loans are offered. The four main types of housing loans offered by community development banks are:

1) Land Acquisition & Construction
2) Loans Home Improvement Loans
3) Long Term Occupied Mortgages
4) Long Term Rental Property Mortgages

Specific terms and conditions for each product vary depending on local market conditions and practices.

2) Housing-Related Technical Assistance: CDFIs in the United States generally provide home ownership counselling for first-time home buyers. Development assistance is often provided for estimating construction or rehabilitation costs, compliance with building regulations, etc. In addition, many CDFIs help groups manage their properties while a few operate their own subsidiaries to build or manage 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. CDFIs often utilize NGOs to provide these related housing services, in order to reduce costs and build the capacity of local organizations.

3) Credit Enhancements: A few CDFIs use or create housing credit enhancement programs to support their housing finance efforts. Many use government and private mortgage insurance companies to protect themselves against mortgage losses. CDFIs also negotiate bulk insurance coverage, resulting in more affordable mortgages for low income borrowers. Several CDFIs have established their own internal mortgage insurance pools.

4) Secondary Mortgage Markets: Secondary mortgage market institutions purchase large quantities of mortgages from banks and housing finance institution, bundle them into some form of security, and resell them to investors. They seldom serve low income housing markets, however, so several CDFIs have attempted to create a viable secondary market for downmarket mortgages. They fashion mortgage underwriting terms that work for low income families and then sell them to secondary market institutions or directly to investors.

6.8 The Group Credit Company of South Africa

The Group Credit Company (GCC) has gone through a series of distinct development phases over the last eight years. Each of these phases has been accompanied by differing principles, strategic thinking, preconditions for success and therefore also different results.

Phase 1 - Research & Feasibility: The initiative for the GCC came from the Urban Foundation (UF) in 1987. The UF is the largest NGO in South Africa and was set up by big business after the 1976 riots to facilitate and indeed engender change in the country. The original research was undertaken as part of the UF's strategic thrust to develop access to housing finance for all in South Africa.

It was agreed that the focus of the proposed institution was to be exclusively housing: housing was to be the end and finance the means. The research project was designed 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.

However, the research also underlined the express lack of interest by formal banks in this market. As a result, the GCC was oriented towards offering housing finance through existing informal infrastructure such as stokvels.

Phase 2 - Pilot Project: The Urban Foundation agreed to provide a loan of R600,000 worth of interest free working capital to support GCC's pilot project. The pilot was to run for three years and then be evaluated. The agreed strategy was to stimulate the supply and upgrading of low income housing stock through the extending of small, short term loans to savings associations at market related interest rates.

The GCC started advancing loans in November 1989. By October of 1990 it had 57 groups (919 individuals) which were performing well. 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 term of each advance was 60 months with a maximum amount per individual of $2,000. Generally, the product and staff seemed to be performing well, although the experiment was not yet a year old.

Phase 3 - Expansion: This encouraging performance prompted discussion of scaling up the experiment. This inclination was reinforced by the concern expressed by the formal banks that the scale of the initial pilot was too small to be definitive. However, two problems had to be resolved before expansion:

i) from whom to raise the money and under what conditions it could be raised; and

ii) from whom to raise the reserves required to off-set the wider risks involved.

In late 1990, the government-sponsored Independent Development Trust gave GCC a grant to begin expansion. This enabled GCC to raise a R20 million ($7 million) facility from four formal financial institutions. The GCC geared up for expansion: new loan officers were employed and regional offices opened.

But in October 1991, as the oldest debtor reached the 24 month mark, a disturbing trend began to emerge. Amongst the older debtors there was a strong increase in arrears at the 16 month mark, i.e. six months after the last advance. This trend had been obscured in the overall figures due to the increasing level of advances undertaken during the expansion phase.

Further analysis revealed that the GCC had four related problems occurring simultaneously:

a) product failure,
b) the change of scale in the organisation,
c) the rapid expansion of staff, and
d) the scale-induced lowering of supervision.

Furthermore, the major sensitivity was clearly the term of the loans. Group loans with a 12 month or less term had a very good recovery rate. But arrears increased steadily for longer loans,- to 32% for 24 month loans and then to 69% for 60 month loans. Related concerns were the size of the loan, affordability (a function of insecurity of client's income) and the diminishing effectiveness of peer pressure.

In an effort to salvage the initial program, GCC management decided to allow good clients to convert their loans from group loans to individual loans if they so wished: 42% of all clients made the switch.

Phase 4 - Re-Direction: In 1993, GCC underwent a major transformation. A new set of financial products were developed, that responded to the perceived weaknesses of the initial product and the demands of the market. This translated into:

- products with a lower risk profile,
- various non-housing products,
- more flexible, individual products, and
- short-term products for unsecured lending.

This was followed by change in GCC's organisational structure, with a move to a more centralised servicing structure based on a modular system which allows for easier replication and on site training. Efforts were also made to address concerns with and of staff, in the form of improved training, a more effective compensation structure and clear career paths.

The final component of the re-structuring process is currently a work in progress. The GCC has elaborated a plan by which it shall be transformed into a mutual bank. This will require the organization to meet very rigorous financial standards, which will in turn oblige considerable changes in operational performance. Nonetheless, this challenge is embraced by the Board and Management as a necessary step to moving the organization towards a secure and sustainable future.

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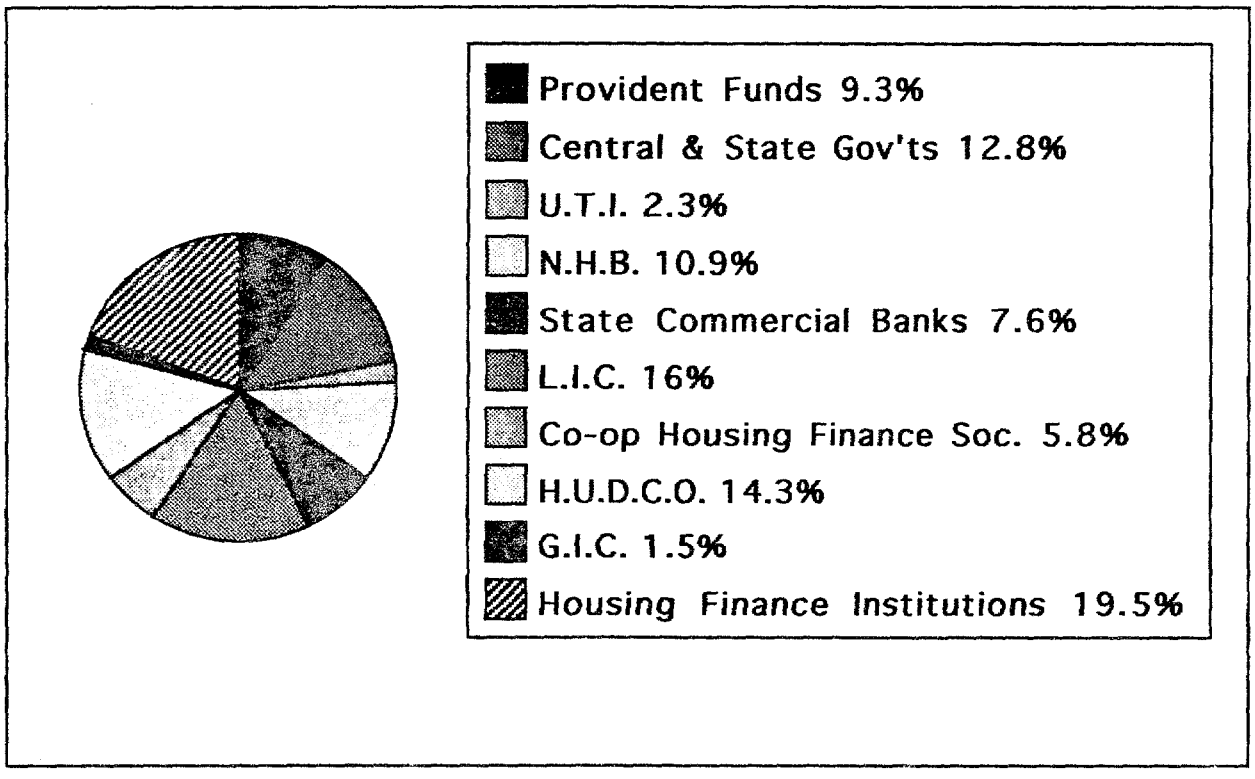
1.2 **Housing Finance Provided by the Formal Sector: Broken Down by Source**



Source: Planning Commission, 1991

1.3a Objectives of a Down - Marketing Strategy

A down-marketing strategy that works through community based financial institutions would have three objectives:

1) to enlarge the market for housing finance for the emerging housing finance institutions in the country;

2) to enable large segments of the urban population to improve their living conditions through a better access to credit; and

3) to consolidate the different forms of community based organizations into a financial system.

1.4 Constraints and Key Design Principles

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

1.5 Types of Linkages for Down - Marketing

1) The CBFI as Facilitator

2) The CBFI as Financial Intermediary

Model 1: Multi-tier Intermediation (though an apex or federated structure)

Model 2 : Single - tier Intermediation (directly from HFI to local CBFI)

Source: M. Mehta

2.2 Common Interests Between Housing and Micro - Enterprise Finance

1) A Concern with Similar Clients

2) Informal Economic Activities

3) Similar Forms of Credit

4) Linkage Between Housing and Income

5) Both Credit and Savings Services are Needed

6) MFIs Have the Potential to Provide Credit for Housing

7) Providing Links to the Formal Financial Sector

8) Housing Loans Help MFIs to Diversify Their Loan Portfolios

3.1 Requisites for a Successful CBFI

1) Management Commitment

2) Institutional Structure

3) Capable Staff

4) A Broad and Defined Market

5) Start Up Funding

6) Adequate Loan Funds

Source: R. Schall

3.2 **Target Markets for CDFIs**

1) Guidelines

a) Focus on One Development Goal

b) Match Needs with Market Gap

c) Develop Specialized Knowledge

d) Cross Subsidizing Through Diversification of Lending Niches

2) Types of Diversification

a) Geographic (urban/rural, multi-state)

b) Product (loans, savings, insurance)

c) Sectoral (residential, commercial,consumer)

d) Market (niche, up-market)

3.3 Key Issues for CBFIs Engaging in Housing Finance

1) Is the necessary committment there to operate a CBFI?

2) Is the issue of land tenure clear in the local context?

3) Have the market opportunities been researched and identified?

4.1 Self Help Groups & Micro Banking

1) **Possible Advantages for:**

a) Members of SHGs

b) Banks

c) NGOs

2) **Possible Problems:**

a) Limited Absorption Capacity

b) Negative Impact on Groups

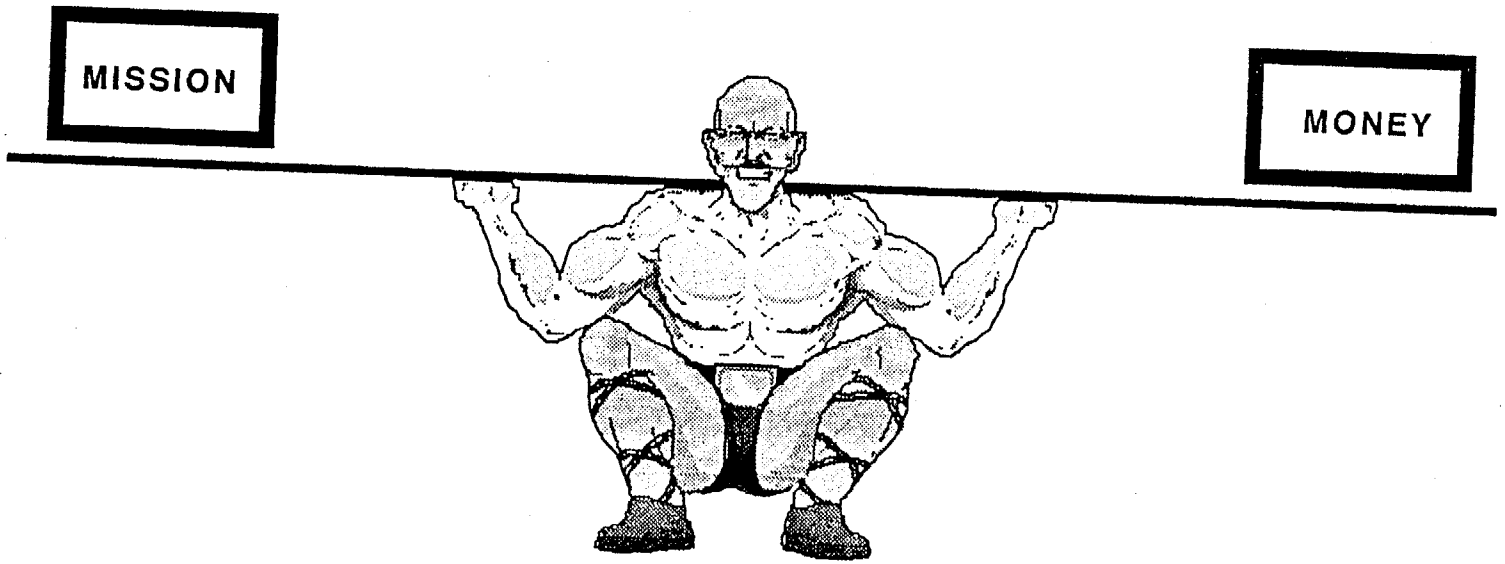
c) Perpetuating Exploitative Structures

d) Inadequate Management Skills & Culture

Source - M. Harper, Xavier Institute Management

5.1

The CBFI Balancing Act



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5.2

Financial Management Rules of Thumb

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

2) Keep the Cost of Funds Low

3) Build Significant Net Worth in the Organization

4) Match Assets and Liabilities

Source: R. Schall

5.5 An Overview of the Budgeting Process

1. Review and confirm organization's mission and vision.

2. Review strategic plan

3. Review last year's operational plan. Identify priority areas for action.

4. Conduct situational analysis: external & internal environment. Identify priority areas for action.

5. Set organizational and operational objectives. Elaborate simple plans.

6. Elaborate detailed budget.

7. Assess budget realism.

8. Adopt operational plan and budget.

9. Begin implementation and monitoring.

5.6

Key Risks in CBFIs

1) Credit Risk

2) Financial Risk

3) Operational Risk

4) Technological Risk

5) Pricing Risk

5.7 Factors Affecting Pricing Policy

1) Cost of Money

2) Risk

3) Take on Costs

4) Collection Costs

5) Reporting Costs

6) Loan Size and Term