Rural entrepreneurs as shareholders of equity-driven rmfis, motivated by profit sharing and access to credit.

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Risks:
Fraudulent equity mobilization (e.g., pyramid schemes) if not properly supervised.

Opportunities:

1. Massive mobilization of unequally distributed local capital in private hands.
2. Mobilization of public resources as start-up capital combined with profit-driven growth.

Proposals:

1. Study of equity-driven RMFIs (eg, BKK in Central Java, IFAD, Financial Service Associations in Benin, UNDP sanadiq in Syria).
2. Support initiatives to build equity-driven local RMFIs owned by rural entrepreneurs.

In other words: What matters in rural and microfinance?

1. First of all: client experience matters.

   Clients have experienced in donor projects that credit can make them poorer or richer:
   » Starting with large loans and term finance, as has been common among donor-supported AgDBs, is a
   guarantee for failure.
   » Only small short-term loans allow them to experiment with investments at a reasonable risk; to test their
   ability to borrow, invest, repay and save; to change to more profitable investments as opportunities emerge;
   and to grow rapidly with growing internal and external resources.
   » Once they are successful, they need a banking partner which responds to their increasing financial needs.
   This allows them not only to move beyond the poverty threshold, but also to create employment for the poor.

2. What matters in terms of origin, history and culture of rural and microfinance?

   Poverty matters: Poverty has been at the cradle of rural and microfinance:
   » The poor need financial services, savings more than credit.Informal finance matters: Informal financial
   institutions in various forms of ownership have been based, some since centuries, on the very principles
   that many credit NGOs find difficult to adopt: self-reliance, viability, outreach to the poor as owners or users,
   competition, market-driven innovations, demand-oriented financial products and appropriate risk management. » Upgrading and mainstreaming through networking, driven by incentives, is one of many ways in which donors
   can support expansion of outreach and financial deepening of informal financial institutions.
   History matters: MFIs in Ireland, 1720-1950, have demonstrated how regulation makes and breaks

savings-driven R/MF. MFIs in Germany, 1778-2002, started from informal beginnings and evolved, through appropriate regulation and supervision, to cooperative banks and savings banks (Sparkassen) with outreach to the majority of the German population in rural and urban areas, accounting for 51% of all banking assets.

Among the lessons are:

» Microfinance is not a poor solution for poor countries.

» Savings-driven microfinance institutions, in cooperative or community ownership, are equally feasible in rural and urban areas.

» If properly regulated and supervised, they have great potential in poverty alleviation and development, both in rural and urban areas.

Crisis matters: Financial innovations typically emerge as a response to crisis, which must be taken as a positive force:

» Learning from experience means: responding to crisis with innovations.

» Many MFIs in crisis are kept alive, and prevented from reform, through donor support.

» MFIs which fail to respond to crises constructively must be allowed to falter: close them or reform them!

Development matters: Microfinance is no panacea. It contributes to development, but requires a climate of broader development to be fully effective, both macroeconomically and at the local level:

» Targeting the poor only and excluding the non-poor prevents the development of a village economy, diminishing the chances of employment, self-employment and economic growth of the poor.

» Donors must respect the autonomy of R/MFIs and refrain from imposing targeting.

Culture matters: The enthusiasm over the new consensus in R/MF has led to a neglect of cultural factors, which may be of crucial importance to the clients and corporate culture. Eg, a culturally sensitive approach may arrive at two fundamentally different approaches to development:

» Development from above, through the established authorities, is more effective in hierarchical or closed societies, which are oriented towards status, tradition and the preservation of stability

» Development from below, through participatory processes, is more effective in segmented or open societies, which are oriented towards competition, experimentation, individual achievement and social change

3. What matters at the level of financial systems?

Financial systems matter: Well functioning financial systems must be in place if sustainable development and poverty alleviation are to occur. Governments and donors have to realize that financial systems and functioning networks of MFIs evolve over long periods of time:

» Donors can contribute to that evolution, but only in a long-range perspective, and in a coordinated goal-oriented manner.

Capital matters. The main functions of capital transfer should be:

The main functions of capital transfer from abroad should be:

» Bridging temporary shortages in loan capital through credit lines;

» Investing in deposit-taking institutions, providing leverage for savings mobilization;

» Strengthening the capacity of R/MFIs to generate their own resources:
savings and retained earnings. But capital transfer has undermined rural finance and development: Reliance on external resources, interest rate subsidization and outside administrative control led to misallocation of scarce resources, corruption and external debts not matched by productivity increases. Under disbursement pressure, donors continue to provide credit lines in substitution of domestic savings, undermining the growth of self-reliant financial institutions.

Savings matter at three levels, provided inflation is low and does not erode the value of the savings of the poor:

1. as a service to the poor, to deposit and accumulate their savings in a safe place
2. as a source of loanable funds and self-reliance for (rural) financial institutions
3. as the main source of domestic capital in the national economy.

Savings and credit matter but which one comes first depends on the rate of return:
» Savings-first for subsistence and low-yielding activities
» Credit-first for high-yielding activities.
Financial intermediation matters: Institutions, which offer both savings and credit services benefit twofold:
» they generate their loanable funds on a sustainable basis at a low cost;
they benefit from economies of scope; ie, the additional transaction costs of the second type of service are substantially lower than those of the first.
Financial sector policy matters: The two main instruments of financial sector policy are:
» Interest rate deregulation, with interest rate autonomy on deposits and loans
» Institutional deregulation, to freely establish financial institutions and branches.

The legal framework matters: Appropriate legal forms allow people to establish their own financial institutions in private, cooperative or community ownership:
» Donors should support the financial authorities in providing an appropriate framework
» The two most important legal forms are privately owned rural banks and financial cooperatives.
Interest rates matter: Interest rates are of crucial importance:
» Caps on interest rates cut down on viability and outreach, rob savers and investors of the value of their resources, and ruin MFIs
» Interest rates above the inflation rate on deposits prevent the erosion of capital
» Rural market rates of interest must vary widely between institutions and countries, reflecting cost of funds, risks and services
» High interest rates force the borrower into investments with high returns
» Bringing down interest rates is an internal matter within institutions.
Institutions matter (projects don’t): Institutions are the social capital of a society, providing continuity and efficiency. Financial institutions fall into three sectors:
» the formal financial sector, which is regulated and supervised by financial authorities
» the semiformal financial sector of institutions officially recognized but not regulated
» the informal financial sector of institutions which are regulated through local norms and traditional law, but are not officially recognized nor regulated by the state.
Donors may:
» support a differentiated financial infrastructure with competitive institutions

organized in networks;
» support the expansion of sustainable rural financial institutions and their outreach;
» provide opportunities and incentives for upgrading non-formal to formal institutions;
» abstain from perverse incentives which enable NGOs, AgDBs and others to maintain unviable operations.

Competition matters: An emphasis on the creation of a competitive environment entails:
» institutional diversity (eg, financial cooperatives, rural banks, AgDB branches)
» pressure to perform, through effective supervision and enforcement of standards
» procedures of bankruptcy for non-performing institutions.
Prudential regulation matters: Regulation has failed in many developing countries, but is a prerequisite for financial market development.
There are two controversial positions:

4. Regulating deposit-taking MFIs only

5. Regulating all MFIs, stabilizing the system and protecting small investors.

Effective supervision matters: Regulation is ineffective if not enforced by supervision. Donors should strengthen:
» the political will and institutional capacity to enforce standards of performance
» the restructuring or closing of nonperforming financial institutions, instead of preventing it through bail-outs - bankruptcy matters!
» bank superintendencies or central banks and, under delegated supervision, networks and auditing apexes of rural banks, SACCOs, and other R/MFIs.
Linkages matter: Through linkages with self-help groups or MFIs banks may provide the following services:
» Safe-keeping of deposits & excess liquidity, access to bank credit, channeling donor funds, liquidity balancing, equity participation, money transfer, check clearing, payments
» Capacity building, monitoring

Knowledge matters: The wealth of highly variegated institutional experience has largely escaped knowledge management: at the level of donor organizations, countries and regions:
» Donors will have to take up the challenge of establishing a system of knowledge management, perhaps in cooperation with IFAD.

4. What matters at the level of institutions?

Institutional reform matters: There are striking reform of different types of institutions, (eg, BRI, BAAC, CRDB, CARD), leaving no excuse for continual support to unviable institutions. The following lessons can be drawn:
» Financial sector policies such as deregulation of interest rates and the provision of legal forms for regulated financial institutions are conducive to financial innovations.
» Any type of financial institution can be reformed, including credit NGOs and AgDBs.
» With attractive savings and credit products, appropriate staff incentives, and an effective system of internal control, rural microfinance can be profitable.

» The poor can save; rural financial institutions can mobilize savings cost-effectively.
» If financial services are offered without a credit bias, demand for savings deposit services exceeds the demand for credit by a wide margin.
» Incentives for timely repayment work.
» Outreach to vast numbers of low-income people and sustainability are compatible.
» Transaction costs can be lowered, profitability and outreach to the poor increased, by including the non-poor and their demands for widely differing deposit and loan sizes.

Agricultural development banks (AgDBs) matter:
» AgDBs are the largest providers of RMF services.
» Unreformed AgDBs waste public resources, lack growth and outreach, undermine rural finance.
» Reform may lead to sustainable outreach to all segments of the rural population through retail or wholesale services (linkages).
Donors may support:
» Regional reform policy seminars with financial authorities;
» AgDB reform workshops through Regional Agricultural Credit Associations with FAO & other donors;
» Regular state-of-the-art reporting on AgDB reform.

Ownership matters: Credit NGOs lack ownership; private ownership is most effective, but:
» depending on culture, institutions can be sustainable and reach the poor under any type of ownership;
» individual or cooperative ownership by the poor as shareholders of MFIs, including transformed NGOs, deserve special support.

Institutional autonomy matters: Management autonomy is more important than ownership. Donors should:
» Insist on management autonomy (vis-a-vis government and donor agencies).
» Refrain from targeting.
» Respect management autonomy in customer selection and loan decisions.

Viability, efficiency, sustainability and self-reliance matter: Donors should support the enhancement of:
» the mobilization of domestic resources, such as savings, equity and borrowings;
» profitability, requiring adequate repayment and coverage of all costs from the margin;
» cost-effective microfinance products and services;
» an adequate regulatory framework.

Outreach matters - and so does truth in reporting: In contrast to a ubiquitous credit bias of donors and governments, both saver and borrower outreach matter, of small as of large institutions:
» Support both saver and borrower outreach
» Insist on the reporting of actual, not cumulative figures; the latter conceal the truth.

Outreach and sustainability matter -- together! There is strong evidence of the compatibility of outreach and sustainability, except under conditions of fixed interest

rates:
» Insist on mutually reinforcing growth of sustainability and outreach;
» Insist on adequate interest rates, allowing for profits above the inflation rate.

Sustainable outreach to marginal rural areas requires recognition of, and support for:
» The primacy of savings and self-financing, due to the absence of markets;
» Member-owned SHGs and cooperatives, operating at low costs.

MFI portfolio diversification matters as a risk management strategy:
» Support portfolio diversification of both clients and MFIs;
» Abstain from imposing loan purposes, which create undue risks

Lending technology matter -- and should not be a matter of ideology:
» The poor can be reached by either individual or group technologies, if properly applied;
» Group technologies with joint liability are more effective for small loans to the very poor;
» Individual technologies offer opportunities for graduating to larger loans and sustainable movements out of poverty.

Innovation and flexibility matter: Rigid replication of success stories is a recipe for failure.
» Support financial innovations and adjustments to local culture.

5. What matters at the operational level?

Good practices matter (not best practices): The term best practices evokes notions of optimal solutions and leads to inappropriate replications:
» Support satisfactory culturally appropriate solutions

Institutional size matters, but not absolutely: R/MFIs benefit from economies of scale, but there is no best practice in terms of size.
» Support both, small numbers of large, and large numbers of small, institutions; there is no minimum size of sustainable institutions (such as SHGs or cooperatives)

Profits matter: Profits are a source of capital and a major determinant of growth of outreach.
» Support studies of profitability of different credit and savings products
» Support organizational efficiency, bringing down interest rates or increasing profits

Incentives matter: While profits are a source of incentive payments, incentives are at the same time a major determinant of profits. Donors may support:
» the transformation of branches into profit centers;
» the introduction of systems of staff performance incentives;
» client incentives (rather than penalties) for timely repayment.

Repayment matters: There are many institutions of different types with repayment rates near 100%; however, enforcing perfect repayment may not be cost-effective and curtail outreach. Donors may support measure to attain adequate repayment based on:
» appropriate terms like size, installments, grace periods, purpose, and timely disbursement;

» sound practices of loan enforcement, insisting on timely repayment.

Information matters -- in terms of computerized data and personal knowledge of clients.
» Support adequate Management Information Systems with provide timely information.

Delivery systems matter: Institutions lower transaction costs, therefore:
» Support measures to bring the bank of MFI to the people, shifting transaction costs from clients to institutions, with cost coverage from the interest rate margin.

Financial products matter:
» Support the development of demand-oriented and cost-effective savings and credit products
» Support efficient collection services (e.g., at doorsteps).

Loan protection matters: Life (health, cattle) insurance is a service to clients, but also part of loan protection.
» Support the development of cost-effective insurance services by MFI, particularly to cover the default risks arising from AIDS/HIVS.

6. What matters to the poor?

Access to savings and credit matters -- far more than interest rates.
» Support institutions which offer both savings and credit;
» Insist on the transformation of credit NGOs into institutions collecting voluntary savings.

Rural enterprise viability matters: The viability of R/MFIs and rural farm and non-farm enterprises are mutually reinforcing.
» Promote linkages with agencies providing BDS in rural areas and to enterprising poor.

Household portfolio diversification matters: IGAs of poor households are usually highly diversified, managing the risks of diverse enterprises.
» Refrain from restricting small loans to single (productive) purposes;
» Encourage loans to IGA with high rates of return, including petty trading;
» Stay away from financing group enterprises. They have usually failed.

The poor themselves matter -- and so do the non-poor: In exploitative cultures, the poor may prefer access to financial services as a separate group depends on culture and the financial infrastructure. Banking with both the poor and non-poor may increase outreach to the poor.
» Promote financial services to the poor and non-poor in separate or mixed MFIs depending on culture
» Instead of targeting, promote financial products for different market segments.

Culture of labor division matters: Depending on culture, men, women and R/MFIs may opt for separate or mixed institutions.
» Refrain from targeting women;
» Respect the autonomy of women and men and let them decide on separate vs. mixed

institutions.

Autonomy matters:
» Abstain from targeting and other impositions;
» Respect the autonomy of the poor, women, local financial institutions and their owners;
» Support self-selection through particular financial products and services.

7. Donor policy and coordination matter

7.1 Transmitting policy to operational departments.
There is an emerging consensus on R/MF policy in the community of donors and microfinance practitioners. But transmitting policy to operational departments remains a major challenge:
» Examine the feasibility of a matrix structure, with operational responsibility in the operational units and responsibility for project design and performance in the financial sector & microfinance unit;
» Create a mechanism for monitoring the effective implementation of policy.

7.2 Cooperation, coordination and co-financing among donors
The effectiveness of development assistance can be infinitely increased through donor coordination:
» Synergies are created by donor coordination at national level, including cooperation in expert advice, policy dialogue and project supervision;
» Bilateral technical assistance agencies can complement multilateral and bilateral financial assistance agencies with grant-financed expertise;
» Standardized reporting on MFIs will facilitate implementation of policy and donor coordination.

7.3 Opening markets
The total effect of development assistance is small compared to the importance of opening markets in the developed countries for products from developing countries:
» Donors should make every effort for abolishing agricultural subsidies and opening up markets for developing countries