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COMMUNITY-MANAGED LOAN FUNDS: WHICH ONES WORK?

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The Consultative Group to Assist the Poor (CGAP) is a consortium of 33 development agencies that support microfinance. More information is available on the CGAP Web site (www.cgap.org).

Government and donor projects that deliver microfinance—that is, credit and other financial services for poor and low-income people—usually involve microfinance institutions (MFIs) with professional staff.[1] However, an increasing minority of microfinance projects rely instead on community-managed loan funds (CMLFs). In CMLFs, credit to the members of a small group is managed by the members themselves, with no professional management or supervision of the approval, disbursement, and collection of loans. These funds are referred to by a variety of names, including revolving funds, self-managed village banks, accumulating savings and credit associations (ASCAs), and community-based finance.

This Focus Note presents conclusions from a performance review of dozens of CMLF projects established or supported by donors and international nongovernment organizations (NGOs) over the past 15 years. It turns out that success is strongly linked to the source of funding for the loans group members receive.

- **Externally funded groups.** When loans are financed by an early injection of external funds from donors or governments, CMLF projects appear to fail so consistently that this model of microfinance support is never a prudent gamble.
- **Savings-based groups.** CMLFs are often successful when loans are financed by members' own savings, and there is either no external funding, or such funding arrives in modest amounts after the group has a solid track record of lending and recovering its own savings.
- **Self-help groups (SHGs).**[2] When groups start by collecting and then lending members' own savings, but subsequently receive large loans from a bank that is serious about collection, performance has been mixed so far.

Of the three models, only the savings-based and the SHG models appear to be viable.

In addition to the funding source, the other factor that seems to be a strong predictor of success is the quality of external support community groups receive. Such support is important on a continuing basis, not just at the inception of the groups.

[1] In this Note, we use the term "donor" as shorthand for a wide range of development funding agencies, including bilateral government aid programs, multilateral development banks, and private philanthropic funders, such as foundations.
[2] This Note discusses the SHG model as practiced in India. Many Indian SHGs are externally funded (by bank loans, not up-front donor or government infusions), and many are savings based. We treat them as a separate category because, despite some common characteristics, they tend to behave differently from the other CMLFs. It appears that a bank loan creates dynamics that are different from those created by an initial grant or loan from a donor or government program.

This Note begins by describing the study's methodology, including sources and criteria for evaluating CMLFs. Then it reviews the performance of the three types of CMLFs, addresses whether CMLFs need long-term external support, and reviews the debate over the relative merits of community-managed and professionally managed approaches. It concludes with a brief summary of the implications for development agencies that support CMLFs.

Methodology

Sources

We found an evaluation or some other implementation report for 60 CMLF projects funded by 23 agencies (13 bilateral or multilateral agencies and 10 NGOs) between 1990 and 2005. Where possible, we supplemented this documentary information by discussing the projects with knowledgeable development agency staff. Many of these projects produced less concrete performance information than one would hope. Only about half of the projects could be graded as a success or failure with a reasonable level of confidence, as shown in Table 1.

Table 1 Number and type of CMLF projects evaluated

	Externally funded projects	Savings-based projects	Total
Graded Projects	20	11	31
Ungradable Projects	22	7	29
Total	**42**	**18**	**60**

The general pattern in microfinance is that there is a correlation between careful reporting and good results. In other words, projects that produce meaningful performance information are more likely to be successful. If this pattern holds true for CMLFs, then the sample of projects we were able to grade may be better performers on average than the universe of CMLF projects as a whole.

We did not research the performance of Indian SHGs. Rather, observations about SHGs are drawn from two other CGAP studies, as yet unpublished (Christen and Ivatury forthcoming and Prakash et al. forthcoming).

Success Criteria

CMLFs are often referred to as *revolving funds*, on the premise that their money will be lent out, collected, and re-lent. The primary criterion we used to judge the success of a CMLF program was whether the funds did in fact revolve.[3] In other words, were loans repaid well enough to maintain the fund for more than a few years?

Other indicators of success were used, especially in cases where loan collection was not meaningfully reported. Programs where the majority of the groups disbanded within a few years were judged as failures. Evidence of "elite capture," where a few powerful members expropriate for themselves the resources that were meant to be at the service of the whole group, was a negative indication, though no project was graded as unsuccessful solely for this reason.

The ideal criterion for measuring success would be demonstrable impact on the lives of group members. Reliable measurement and attribution of the impact of financial services is surprisingly complex, expensive, and time consuming. Credible impact studies are virtually never available for CMLF projects. However, there is a growing body of good impact studies for microcredit in other settings, most of which find that access to the financial service produces important welfare benefits for clients and their households (Littlefield et al. 2003). The studies tend to find that these benefits are associated with *continuing* access to services, not just one or two loans.[4] In this sense, loan collection performance is strongly

[3] Projects with repayment rates of 85 percent or lower were considered unsustainable and therefore unsuccessful for the purposes of this Note. This is a very generous standard. If a portfolio of 6-month loans payable in monthly installments has an 85 percent repayment rate, it will lose about half of its lending capital in a single year. Cf. Rosenberg (1999).

[4] E.g., Dunn and Arbuckle (2001).

linked to client impact, because groups who lose their capital through default can't provide continuing services.

One sometimes hears an argument that loan collection should not always be used as the criterion of CMLF success. The contention is that the main objective of some of these projects is not financial service delivery *per se* but rather the transfer of capital into poor communities, an objective that can be achieved even if loans are not repaid and groups fall apart. This reasoning has been used in several CMLF projects in East Asia, following the 1997 financial crisis. Donors wanted to transfer money to poor communities during the crisis and set up CMLF groups without worrying too much about repayment of the loans or the long-term survival of the groups. We do not find this rationale convincing, though we admit that our objections to it are based on anecdotal experience rather than specific evidence found in the documents we reviewed for this Note.

- If a project proposal were to state candidly that loans within the groups were likely to experience high default, and that the groups would be likely to collapse as a result, the project probably would never be approved in the first place.
- Social capital within the community is more likely to be hurt than helped when a few members are able to capture the benefits intended for the whole group, by the simple expedient of defaulting. These situations can create friction, resentment, and mistrust among individuals, and can reduce the community's confidence in its ability to work together for shared goals.
- Some assert that when a community gets used to defaulting on poorly managed loans, it becomes harder for a competent MFI to do business in that community.
- Redistribution of capital into poor communities is a thoroughly worthwhile objective, but there are many other ways to do this besides setting up local loan funds.

There is wide consensus in the microfinance community, including both financially oriented "hawks" and poverty-focused "doves," that lending where default is likely is not the preferred tool for any development purpose.

Three Types of CMLFs

In his classic study *The Poor and Their Money*, Stuart Rutherford (2000) distinguishes between "provider" and "promoter" approaches to poor people's finance. In the provider model, a specialized, professional financial institution delivers loans, deposit facilities, and other retail financial services to its clients. In the promoter model, communities are taught how to organize themselves so that community members can offer such services to each other.

Rutherford argues that most poor people prefer the provider model, if it is available, because it tends to be more reliable and require less organizational effort and risk on the part of customers.[5] Middle-class customers in rich countries are no different. They normally would rather not have to concern themselves with the organization and management of the firms that provide them with goods and services.

Most donor support for microfinance goes to providers: formal, specialized, professional microfinance institutions (MFIs). However, there are limits to the outreach of these MFIs. In particular, they may find it difficult to serve remote or sparsely populated areas, where the combination of low client density and high transport and communications costs can make it impossible for them to operate viable branches.

In the face of such constraints, a substantial minority of microfinance interventions take a decentralized approach, forming small community-managed groups that lend to their members and often mobilize members' savings as well. CMLFs tend to have 5–40 members. Groups are usually

[5] While noting this preference, Rutherford (2000) acknowledges that self-managed ROSCAs, savings clubs, and savings-led CMLFs play a useful role in many communities.

organized for the specific purpose of the revolving fund, though sometimes pre-existing groups are used. The nonprofessional and sometimes illiterate members both own and manage their fund. They collect the savings (if any), decide on individual loans and loan terms, disburse the loans, and handle collections, all without authoritative supervision by an outside MFI and its professional staff.

There is no way to develop an accurate estimate of the amount of donor funding that goes to CMLFs, but the volume of such funding is large. Recent CGAP evaluations of microcredit projects in the World Bank and the United Nations Development Programme (UNDP) found that about 30 percent of those projects used a CMLF model. CGAP's very rough global estimate of funding agency flows for microfinance is about US$ 800 million per year. If other agencies use CMLFs as heavily as the World Bank and UNDP use them, then CMLF funding would be well over $200 million every year.[6]

Donor-supported CMLFs use a wide variety of approaches, and it is hard to separate them into completely watertight categories with no ambiguity at the edges. We found that the most powerful framework for analysis was to group the projects based on the source of the funding for loans within the community groups.

In externally funded groups, loans are financed predominantly by capital that a donor or government agency has injected early in the life of the group. Savings-based groups fund their loans mainly with members' deposits. In the SHG model, most groups begin by collecting and lending out their own savings. Later in the process, some but not all of the SHGs secure an external loan from a bank, which tends to be considerably larger than the amount members have saved. Banks are typically serious about collecting the loans they have made to SHGs.[7]

Advantages and Drawbacks of CMLFs

In remote, rural communities that are not served by MFIs or the formal banking sector, the CMLF model is sometimes the only feasible method of expanding basic financial intermediation beyond traditional informal mechanisms, such as family lending or moneylenders. Internal transaction costs tend to be lower for CMLFs than for MFIs or other formal financial institutions, including banks. Unpaid members of a CMLF perform functions that an MFI would have to pay professional staff to carry out. As a locally self-contained operation that needs no building or regular office, a CMLF avoids most of the infrastructure, transport, and communications costs incurred by an MFI branch office. Even when taking into account the cost of group promotion, training, and monitoring, cost per borrower tends to be much lower for a CMLF than for an MFI (Ashe 2002, Allen 2006, Christen and Ivatury forthcoming, and Prakash et al. forthcoming). However, the fact that the group is not paying professional staff to perform certain functions does not mean that those functions are cost-free. Instead of paying someone to manage their fund, the members have to contribute their own time and negotiating energy, and assume risks they would prefer to avoid, especially the risk of losing their savings when neighbors default on loans.

Speaking in broad averages, CMLF members tend to be poorer than MFI customers, at least on the plausible assumption that rural location and the size of loan or savings balances correlate with poverty to some extent. Because of their relative cost structures, CMLFs can often handle transaction sizes that are below what is feasible in more formal, professionalized institutions. CMLFs have relatively few members, and the members usually know each other well,

6 This estimate does not include lending to Indian SHGs by government banks.

7 To keep this research exercise within manageable bounds, we did not include community-managed credit unions in its scope, though we recognize that there can be significant overlap between credit union and CMLF methodology.

so these groups can sometimes be more flexible about adjusting the timing of repayment to accommodate poor borrowers' unstable cash flows.

Commercial banks and MFIs often find it impossible to operate in regions experiencing conflict or post-conflict rebuilding. In contrast, CMLFs can continue to work in settings of political or economic crisis, when most other financial services collapse. CMLFs have no institutional headquarters and no branches that can be robbed or destroyed in times of conflict or insurgency. The money is often spread out among members, lowering the risk of wholesale theft. Even groups that cannot continue during a crisis are often able to convene again quickly when an immediate threat subsides.

CMLFs are sometimes used to reach members for nonfinancial activities. Group meetings may include education about health, human rights, or other social topics. Groups sometimes take on development projects, such as establishing schools, building water pumps, or constructing roads.

Finally, and very importantly, CMLFs can provide a service that many MFIs cannot offer: savings. Because these groups are largely informal, they usually do not have to comply with regulatory requirements that prevent many MFIs—at least temporarily—from accepting voluntary deposits.[8] Savings is a service that is highly valued by the poor. Many of them are even willing to pay for a safe place to save their money. In addition, savings-based CMLFs can generate dividends for their members as savings are lent out and repaid with interest.

The major limitations of the CMLF approach are linked to the absence of professional management. It is easier for a formal, professionally run MFI to institutionalize good recordkeeping, careful follow-up on loan repayments, and sound financial management. It is no surprise that CMLFs tend to be less stable than MFIs, though some CMLF models can achieve stability when they receive adequate external support.

Another limitation is that CMLFs cannot provide the range of services (including varied loan and savings products, or payment and cash transfer services) that can be available when microfinance is offered by an institution with a banking license.

Externally funded CMLFs. Except in India, most of the CMLFs supported by donors and governments receive a substantial infusion of capital at, or soon after, the formation of the group. The capital can come in the form of a grant to the group, or a loan on very subsidized terms. Some of these groups do not collect members' savings at all, so that the loans to group members are entirely financed by external funds. In other programs, groups also collect and lend out members' deposits, but these are small in relation to the external capital. In either case, loans are financed mainly by money that the members themselves have not provided. These CMLFs are initiated and organized more often by the funder than by the community, and members' main motivation to join them is based on wanting access to the external funds.

Externally funded CMLFs almost always fail, mainly because of high rates of default. Of the 20 externally funded CMLFs in this study that produced enough information to support a judgment about performance, only one was successful.[9, 10]

Why do externally funded CMLFs fail (while savings-based CMLFs often succeed)? There are several

8 In many countries, MFIs without a license from banking authorities can require clients to make savings deposits in order to receive loans. These obligatory deposits are best thought of as a cash collateral feature of the loan contract, rather than as a true savings service.

9 The single successful externally funded CMLF we found was a 1993 World Bank project in Albania. The community groups formed by this project maintained very good loan collection. However, these groups had a considerably higher level of professional support than was the case in most other projects. Decisions and responsibilities about collection and support were in the hands of members, but a professional loan officer paid by the funding apex organization was an *ex officio* member of each group's loan committee and participated in all meetings with voice but no vote. The World Bank project manager described their role as "prominent" and "influential" but not "authoritative."

10 For each project whose success we graded, we also assigned a confidence level to the grade. Of the 20 grades for externally funded projects, one was characterized as low confidence, four as medium confidence, and 15 (including the single successful project) as high confidence.

reasons, the main one being members' perceptions about what Richard Montgomery (1995) describes as "hot" and "cold" money. Capital generated through local savings feels hot because it comes from one's neighbors. Defaulting on loans that are savings based feels like stealing from neighbors, with the result that borrowers are more likely to take repayment seriously.

Cold money is outsiders' money, usually from donors or governments. Cold money is often treated with less respect. If there is little negative reinforcement preventing people from defaulting, such as the fear of losing collateral, then repayment of cold money may not be a priority, even if the money will go back into a revolving fund for other members of the community to use. When a member defaults on a loan funded by cold money, the other members are no worse off than they were before the fund was established. Furthermore, people in many places are conditioned by past experience to assume that repayment expectations are low for any money received from donors or the government. These core incentive problems are exacerbated when systems and controls are weak. Not surprisingly, loan funds that are administered by nonprofessional (and sometimes illiterate) community members are more likely than professional MFIs to have disorganized recordkeeping, poor follow-up on loan collection, and weak financial management.

In externally funded groups, members are likely to experience savings not as a valuable service but rather as a hurdle they have to clear in order to get loans. This kind of environment is seldom effective at encouraging good savings habits.

Many experienced microfinance practitioners have expressed skepticism about externally funded CMLFs for years. This study fully confirms their view. The track record of externally funded groups is so poor that funders should simply abandon them as a vehicle for poor people's finance. We found two examples of CMLF projects that started out providing external capital to groups, and then stopped after realizing that external funding distorted incentives and jeopardized the success of the project:

- CARE's Kupfuma Ishungu program in Zimbabwe experienced false expectations and distorted savings behavior as a result of promising external credit while promoting the project. After watching two thirds of the groups disband after receiving their loan, CARE stopped injecting capital into the groups. Since then, new group start-ups have been nearly three times as large as the original program of 270 groups, and an additional 1,462 groups were created through a savings-led sister program (Allen 2002).
- The Mexican government's 1997 Rural Development in Marginal Areas program helped farmers' groups start revolving loan funds using capital provided by the government. After finding that the funds were not being recovered, the government received support from the World Bank to develop a savings-led alternative. Members were taught to save their own funds and lend them to other members. The savings-led project proved to be successful, with a repayment rate of nearly 100 percent (Zapata 2002).

Savings-based CMLFs

Communities all over the world can and do form loan funds based on their own savings without any external support. The most common type is the rotating savings and credit association (ROSCA). ROSCA members meet regularly, the number of meetings in a cycle usually being equal to the number of members. At every meeting, all members deposit an agreed contribution. Each member in turn receives the total amount collected at one meeting.

ROSCAs require a high trust level, because a member who receives her distribution late in the cycle has to depend on the continued contributions of members who have already taken their payout. However, ROSCAs are relatively easy to administer, because transactions are completely standardized and no money needs to be kept safe between meetings. The ROSCA model propagates itself by spontaneous replication, and presents little scope for external support. ROSCAs do not revolve; groups are meant to disband after every member has received their allocation. For these reasons, ROSCAs are not considered CMLFs for the purposes of this study. They are, however, a much simpler form of community-managed finance, whose principles form the foundation of many CMLF models.

Accumulating savings and credit associations (ASCAs) do not distribute all the money at each meeting, and are able to offer more flexible loan and savings options. Some members join because they want to save, while others are mainly interested in borrowing, although every member must save regularly. ASCAs, the most basic type of savings-led CMLF, pose greater risk than ROSCAs and are more complicated to manage. While they use no external capital, they are more likely candidates than ROSCAs for outside administrative and technical support. This means that donors can play a useful role, for instance by promoting and organizing groups, training members how to operate the fund, and helping set-up appropriate record-keeping systems.

Thus far, donors have used the savings-based CMLF model much less often than the externally funded model. This may be because, although savings-based CMLFs mobilize local funds and allow members to use those funds more productively, this model does not involve transfers of capital into poor communities, which may be a donor's principal objective. Also, public funding agencies and their staffs often have strong incentives to move large amounts of money, but savings-based CMLFs (where the donor is financing only support functions) cannot channel as much money as externally funded CMLFs can (where the donor is financing most or all of the lending capital). A further factor is that some donors think of microfinance exclusively as a support for enterprises, not as a multipurpose household financial management tool. Many believe that savings-based groups cannot mobilize loans that are large enough to create or develop microenterprises.[11] Finally, there is a common misperception that the poor do not or cannot save.

Table 2 Illustrative loan repayment rates in externally funded and savings-based CMLFs

Country	Loan Repayment Rate (%)
Externally funded CMLFs	
Albania	99
Indonesia	45
Indonesia	77
Indonesia	50
Kyrgyz Republic	85
Lao PDR	16–60
Lao PDR	68
Malawi	40
Mexico	80
Rwanda	55–83
Zanzibar	50
Savings-based CMLFs	
Nepal	96–100
Niger	100
Mexico	100
Syria	99.7
Uganda	95–98

Note: Stable microlending usually requires repayment rates higher than 95 percent, often much higher, depending on the length of the loans. For a portfolio of 3-month loans payable weekly, a 95 percent repayment rate entails an annual loss of 37 percent of the lending capital. For an explanation of this surprising result, see Rosenberg (1999). This analysis assumes that the repayment rate is being measured conservatively: cash received during some period divided by cash due during the same period. Few of the reports were specific about how repayment rates were calculated. A 95 percent repayment rate using a less conservative definition would be associated with even greater actual losses.

Our research found enough performance information to grade 11 savings-based CMLF projects. Surprisingly, every project in this sample appeared to be successful.[12]

The basic reason why this model performed better than the externally funded model was discussed in the previous section. When members, rather than outsiders, provide the funds that are being lent, the incentives favor more careful management of the money and better repayment of loans. Table 2 shows repayment rates reported by graded CMLF projects.[13]

11 We cannot confirm or contradict this assertion.

12 We assigned a high confidence level to seven of these grades and a low confidence level to four.

13 The graded projects not shown in Table 2 used other performance indicators, such as timeliness of loan payments, or the net return members earn on their savings. For example, participants in CARE's MMD program in Niger earned about 76 percent on their deposits annually, after accounting for loan losses (Allen 2002).

The table highlights the general conclusion that savings-based CMLFs are more successful than externally funded groups at collecting their loans, maintaining their capital, and thus being able to keep the fund revolving.

When a donor is supporting a savings-based CMLF, it does not fund the loans to the groups' members. The donor funds auxiliary functions, such as promotion, organization, training, or bookkeeping assistance. This nonfinancial support has often proved critical to success. When such nonfinancial support is the donor's *only* role, we suspect that the donor is more likely to pay close attention to these functions and ensure that they are performed effectively.

The list of savings-based CMLF programs for which we found evaluations is not a long one—only 11 projects. But every one of these appeared to be successful. Of course, this does not mean there are no failures: projects with good results are more likely to be documented than projects with bad results. But the consistent success of the projects we were able to grade is striking, to say the least.

One interesting example is the Women's Empowerment Program (WEP), funded by USAID and implemented by PACT in Nepal. In only one year, this savings-led CMLF project provided training and support to 130,000 women in 6,500 groups. The program focuses on literacy and savings, with 96 percent of groups reporting perfect repayment rates on loans. Since joining WEP, many of the participants started businesses, improved their literacy, and experienced greater decisionmaking authority in the home. About 800 new groups were spontaneously replicated through word of mouth, and a market developed for second-hand training materials. Such replication increases outreach without requiring additional donor funds, and offers a tangible demonstration of the participants' belief that the CMLFs are making their lives better (Ashe and Parrot 2001).

Self-help Groups and Bank Linkages

As mentioned earlier, we did not review individual SHG programs for this Note. The description of SHGs and their performance is drawn mainly from other sources, including two forthcoming CGAP papers (Christen and Ivatury and Prakash et al.).

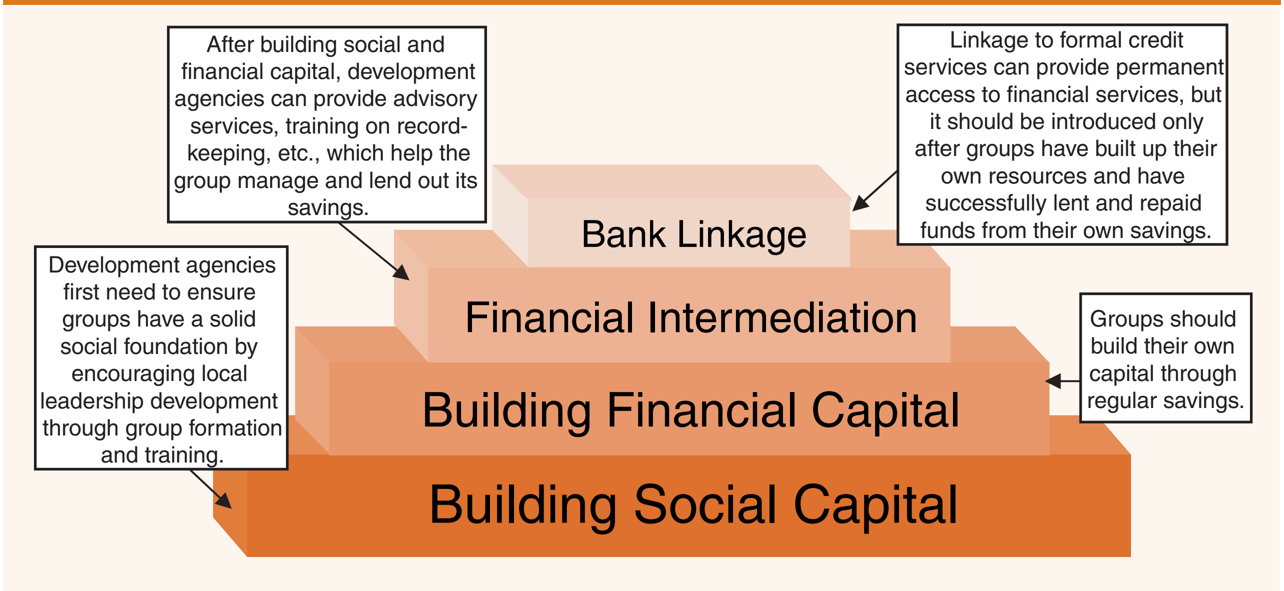
When donors inject capital into CMLFs, their main reason is a belief that the members can manage, and benefit from, loans that are bigger than what the members' savings alone could fund. In many cases this belief is true. But a better option exists. Once a group's credit needs outweigh their local resources, donors can help link the group with commercial banks or other formal financial service providers. The individual members usually cannot use the bank because their balances are too small, or they have no collateral for loans, or the bank branch is too far away. But once the group has built some savings assets and has a track record of managing their internal lending, its members can sometimes get access to the bank as a single collective client, which lowers the bank's transaction costs in dealing with them.

In India, SHGs serve many more people than conventional MFIs do. The model is being picked up elsewhere, but the vast majority of SHGs are still in India. In this model, an NGO, government agency, or bank promotes the formation of the groups and gives them a greater or lesser degree of support services. The groups collect members' savings and lend them out. Some of the groups—perhaps about a third—continue to function with no capital beyond their savings, but the majority of them eventually move on to borrow from a bank. The bank linkage seems to work best if it is delayed until the groups have gone through several preparatory stages, illustrated in Figure 1.

The first stage is building social capital. The SHG needs leadership, trust among members, and training on group management, collection methods, recordkeeping, and other topics.

The second stage is building internal capital through savings. Regular deposits test and

Figure 1 The building blocks of successful CMLF bank linkage



demonstrate members' ability to make loan payments at a later point.

The third stage is financial intermediation, when the group members lend out their savings internally and collect the loans with interest. External support is important at this stage, because recordkeeping becomes complex and enforcement of rules more challenging.

After groups have enough experience successfully repaying loans from their own savings, they can handle a bank loan relatively safely, as long as they do not commit to payments that are larger than they can handle.

The crucial question, of course, is the bank's willingness to lend to the group. In India, the initial reason that almost all of the banks made these loans was a government mandate. Under "priority sector" lending rules, banks in India—most of which are government owned—have long been required to allocate a certain percentage of their assets to loans for poor, rural, or otherwise disadvantaged target groups (Prakash, et al. forthcoming). The banks may not have had great confidence in the SHGs, but they saw SHGs as preferable to the even riskier target groups that were their alternatives under the priority-sector rules. After some years of experience, a few of the banks have come to view SHGs as having commercial potential, and have exceeded their priority-sector lending quotas.

Even though reliable information on most SHG programs is hard to come by, experience to date indicates that SHGs can be a viable model, if implementation is competent.

Use of the SHG model is certainly no guarantee of success. APMAS, a respected and experienced SHG support institution that has evaluated hundreds of SHGs, estimates that a majority of Indian SHGs are of poor quality (Christen and Ivatury forthcoming). But a number of SHG programs, including some of the largest, appear to be doing quite well. Prakash, et al., (forthcoming) and Christen and Ivatury (forthcoming) describe a half-dozen large SHG programs that are keeping loan default at very low levels and doing a good to excellent job of collecting enough interest income to cover all the operating costs involved, including the costs of external support.

What distinguishes successful SHG programs from the rest? The clearest pattern that seems to be emerging is that success tends to correlate with the quality of external nonfinancial support for the groups, including standardized products and norms, training, help with member acquisition and retention, bookkeeping and administration, and in some cases direct authoritative supervision of the group's operations. Likewise, careful phasing is important, as described earlier.

Most SHGs receive external capital from banks. Why, then, are some SHG programs able to operate more successfully than the other externally funded CMLFs described earlier? Three factors may account for the difference:

- Compared to a typical CMLF that is financed by an early one-time injection from a donor or government agency, the SHG funding structure creates stronger incentives for responsible lending and borrowing. SHG members know that the external funds come from a regular bank, which they assume is serious about collecting its loans. They expect that the bank will continue to provide future—and perhaps larger—loans as long as the group collects its own loans and repays the bank responsibly. They know that they may lose their own savings if the bank loan is not repaid.
- As mentioned earlier, SHGs usually begin by collecting and lending out their own savings, sometimes for an extended period, before they receive a bank loan. This tends to produce more disciplined groups.
- It appears that groups in the better SHG programs receive external nonfinancial support and guidance that is stronger than what is typically found in the externally funded CMLFs discussed earlier.

India's SHG model is relatively young. Before making final conclusions about the model, one would want better information about the majority of the programs, and more experience with long-term performance. But the weight of present evidence suggests that it is a viable model that deserves support, expansion, and refinement. True, most Indian SHGs are probably weak. The same is true of the majority of the world's individual MFIs, but this does not prevent the better MFIs or SHG programs from growing rapidly and dominating the field.

Indian SHGs aren't the only CMLFs linking groups with banks after successful financial intermediation from member savings. CLASSE-B in Rwanda, a project funded by IFAD and implemented by CARE International, organizes and trains CMLF groups of 15 to 30 members. Groups are trained to mobilize savings and make loans to their members. Once they have finished the 8-month training period and have shown a satisfactory repayment history (most groups have a 100 percent repayment rate so far on their internal loans), they are invited to submit proposals for bank loans. More than 50 percent of the submitted projects were returned to the groups to revise and reformulate before approval was considered. As of June 2005, the repayment rate on bank loans is 100 percent (Vita 2005).

Although SHG replications do exist outside of India, they are not nearly as prevalent in countries where banks do not have government-imposed social lending targets. SHGs can work without a bank linkage, though without the linkage there is little to distinguish them from other savings-based CMLFs.

Continuing External Support

Although CMLFs are not themselves professionally managed, they seem to do better when they get external support from professionals. Does that support need to be permanent, or can the individual groups be expected eventually to continue successful operations entirely on their own? It is hard to answer this question solely on the basis of the evaluations we could identify for this study, because most of the programs evaluated were fairly young, so that few of the evaluations were able to look at long-term experience. However, the overall history of donor- and government-supported community finance strongly suggests that permanent external support structures are needed.

When new community finance models are developed, there has been a tendency to underestimate the degree of continuing external services community groups would need. For instance, when FINCA International first designed its "village banking" approach two decades ago, it hoped that its support to each group would be limited to initial formation and training, and that groups could spin off into fully independent operation after a few three-month loan cycles. However, groups experienced a high rate of collapse after external support ended, so FINCA altered its approach. Now, FINCA stays heavily involved with all of its groups, to the extent of providing not just support but authoritative external management.

Another example can be found in credit unions and other forms of cooperative finance, where, after decades of experience, prominent promoters and technical advisors are practically unanimous in the view that the groups do better with continuing external support. This pattern holds not just for tiny savings and loan cooperatives in poor countries, but also for large and highly sophisticated credit unions in rich countries that may not need institutional development support but do need external regulation and supervision.

So funding agencies, governments, and NGOs that assist CMLF programs need to plan for the structures that will provide the needed long-term support. Of course, continued external support for groups does not necessarily mean continued presence of international donor or promotion agencies: member-owned federations or other domestic support structures will be the normal permanent arrangement.

CMLFs versus Professionally Managed Finance

CMLFs can reach some locations and clients that would be impractical for a professionally managed MFI or credit union to serve. But there are plenty of situations where either of the two models could be viable. In such cases where there is a choice between the two approaches, should development agencies have any general preference for one or the other? As mentioned earlier, Rutherford argues that, all other things being equal, most poor people would rather get financial services from a professional "provider" than be told by a "promoter" how to manage such services for themselves. Many practitioners concur, but others do not. Which model should be preferred when both are feasible is a controversial question whose answer would require evidence far beyond the scope of the CMLF evaluations we reviewed for this Note. All we can do here is to outline some of the issues and arguments.

The evidence so far suggests that the cash costs of administration tend to be lower—often much lower—on average for CMLFs than for MFIs, even after factoring in costs of promotion and external support. However, this analysis does not include the noncash transaction costs for CMLF members who are performing some management functions, and perhaps assuming some risks, that they would not be burdened with if they were MFI clients. On the other hand, MFI clients incur transaction costs, too, and there are certainly cases where dealing with the group in one's own village is easier than dealing with the MFI branch in the next village.

In most countries, professionally managed MFIs that do not have a deposit-taking license from financial authorities cannot provide voluntary savings services to their clients.[14] Informal CMLFs do not face this constraint, so they can provide both savings and loans. But MFIs that do have deposit-taking licenses already account for the majority of MFI clients worldwide, and the percentage of clients served by unlicensed MFIs will continue to shrink. Licensed MFIs can offer services that are unavailable in a CMLF, such as larger and longer-term loans, long-term savings instruments, or payment and cash transfer services.

14 Unlicensed MFIs often collect obligatory deposits as a condition to making loans. These mandatory arrangements should be thought of as a cash collateral requirement for the loan, rather than as a savings service to help clients manage their liquidity.

Some people favor CMLFs because they are democratically governed, and thus empower members to take more control over their own financial lives. At the same time, other observers argue that client ownership and governance tends to hurt rather than help management of financial services, especially where there is a one-person-one-vote rule. They point out, for instance, that governance of large, efficient credit unions is usually not democratic in practice.

The core of the discussion should probably concern the longer-term stability of the two models. Proponents of formal institutions acknowledge that professional management is costly, but argue that without such management, community groups will have a hard time preventing losses of members' savings and maintaining continued access to services. The only way to resolve this question will be better research into the long-term performance of community-managed models, viewed over decades rather than years.

Finally, it is important not to let this discussion create a false dichotomy. Professional and nonprofessional finance can and do coexist in many settings. Clients often use both of them simultaneously to deal with different financial needs.

Conclusions for Development Agencies

There will continue to be questions about whether to use a community-managed approach to finance in a given situation. But once one has decided to develop a community-managed program, there seem to be some straightforward lessons about sound practice.

- **Externally funded CMLFs practically never work,** because they have to swim against the stream of the natural incentives of group members. The odds of success are so low that development agencies should abandon them completely and rely on the other two models when they want to do CMLFs.
- **Savings-based CMLFs that use no external capital perform surprisingly well,** at least based on the sample of eleven that we were able to analyze in this review.
- **SHGs, most of which have bank linkages, have shown mixed performance,** but results obtained by the bigger and better programs suggest that the model itself is effective when it is implemented competently.
- **CMLF projects need to do a much better job of reporting performance,** not least of all because reporting performance tends to improve performance. CMLFs cannot be burdened with elaborate recordkeeping, but it is critical that projects report at least (1) outreach—numbers of clients and groups; (2) loan repayment, using industry-standard measures, and (3) group survival.[15] Other indicators that have been used in good CMLF programs include financial return on members' savings, reasons for group disbandment, frequency of staff visits, source and amount of members' outside borrowings, and members' perceptions about quality-of-life changes as a result of the fund.
- **Instead of injecting loan capital into CMLFs, funders should use their resources to provide support services for the groups.** The cases reviewed for this study as well as decades of experience with other community finance models indicate that CMLFs need competent, continuing external support for a range of functions, including promotion, organization, training, bookkeeping, networking, liquidity management, and performance monitoring. In some cases, the groups do better when they are subject to some degree of control by external management.

CMLFs can provide savings and loan services for millions of poor people, including many who are beyond the practical reach of formal, professional MFIs. Development agencies should, and no doubt will, continue to support CMLFs. As the lessons from past experience are better documented, more widely understood, and appropriately reflected in project designs, we can expect a strong improvement in the overall effectiveness of these projects.

15 Measurement of microcredit repayment is a notorious minefield. Some commonly used indicators cloud more than they clarify, and there is little consistency in terminology or calculation methods. For CMLFs that receive external loans, repayment reporting should include both the external loans to the group and internal loans to group members. For a guide to meaningful repayment reporting, see Rosenberg (1999) and Bruett (2006).

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Annex I. List of Projects Reviewed

Externally Financed (graded projects)		
Location	**Agency**	**Project Name**
Albania	World Bank	Rural Development Project
Bangladesh	SDC (Swiss)	Ashrai (portion with external credit)
Cambodia	UNICEF	Seth Koma Program
Ghana	FAO and Dutch Government	People's Participation Program
Global	FAO-sponsored evaluation	Small Farmer Groups (with external credit)
Indonesia	World Bank	Bengkula Regional Development Project
Indonesia	World Bank	Integrated Swamps
Indonesia	World Bank	Kecamatan Development Project
Indonesia	World Bank	Nusa Tenggara Area Development Project
Indonesia	World Bank	Urban Poverty Project
Kyrgyz Rep.	World Bank	Rural Finance Project
Lao PDR	SIDA	Lao Swedish Forestry Programme
Lao PDR	UNDP/UNCDF	Small Scale Irrigation Schemes in Oudomxay and Luang Namtha
Malawi	CARE International	Village Savings and Loans Program (portion with external credit)
Mexico	Mexican Government	Rural Development in Marginal Areas Program (precursor to Community Savings Funds)
Mexico	World Bank	Rural Development in Marginal Areas Project
Nepal	GTZ and ADBN	Small Farmer Cooperatives
Rwanda	World Bank	Community Reintegration
Zanzibar	CARE International	JOSACA
Zimbabwe	CARE International	Kupfuma Ishunga (portion with external credit)

Savings Based (graded projects)		
Location	**Agency**	**Project Name**
Bangladesh	SDC (Swiss)	Ashrai (portion without external credit)
Eritrea	USAID	Community-Managed Savings and Credit Associations
Global	FAO-sponsored evaluation	Small Farmer Groups (without external credit)
Malawi	CARE International	Village Savings and Loans Program (portion without external credit)
Mexico	World Bank	Community Savings Fund (portion without external credit)
Mozambique	CARE International	Ophavela
Nepal	USAID/PACT	Women's Empowerment Program
Niger	USAID/CARE International	MMD Program (portion without external credit)
Syria	UNDP	Rural Community Development at Jabal al Hoss II
Uganda	DFID	Financial Sector Deepening Project (FSDU)
Zimbabwe	CARE International	Kupfuma Ishunga (portion without external credit)

Ungraded Projects (both externally funded and savings based)		
Location	**Agency**	**Project Name**
Albania	UNDP	Village Development Fund for Income Generating Activities
Cambodia	PACT	Worth Program
Ethiopia	World Bank	Women's Development Initiatives Project
Global	IFAD	Revolving Funds
Honduras	UNDP/IFAD	National Programme of Local Development
India	CARE International	Community Managed Revolving Loan Funds—CASHE Program
Indonesia	UNDP	Support to the Implementation of the Indonesia Community Recovery Programme
Jordan	European Commission	Social Development Project/ Development and Employment Fund
Lao PDR	ADB	Community-Managed Livelihood Improvement Project
Lao PDR	FIAM (Thai NGO)	Women in Development
Lao PDR	German Agro Action	Community-Based Rural Development to Reserve Watershed Project
Lao PDR	GTZ	Rural Development Project
Lao PDR	Mennonite Central Committee (MCC)	Village Development Committee Credit Funds
Lao PDR	Oxfam Solidarity	Cattle Banks
Lao PDR	Quaker Services	Revolving Loan Funds
Lao PDR	World Concern	Village Revolving Funds
Lao PDR	ZOA	Village Credit Associations
Madagascar	World Bank	Rural Development Support Project
Mali	CARE International	MJT (Musow Ka Jigiya Ton)
Nepal	UNDP	Participatory Development Project
Niger	World Bank	Agro-Pastoral Export Promotion Project
Panama	UNDP	Desarrollo Rural Sostenible en el Darién
Rwanda	World Bank	Agricultural and Rural Market Development Project
Senegal	Oxfam America	Oxfam America Self-Help Group Model
Senegal	UNDP	Programme Elargi de Lutte Contre la Pauvrete
Uganda	CARE International	JENGA
Zimbabwe, Mali, Cambodia	Oxfam	Banking on the Poor

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