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Community-based Financial Organizations: A Solution to Access in Remote Rural Areas?

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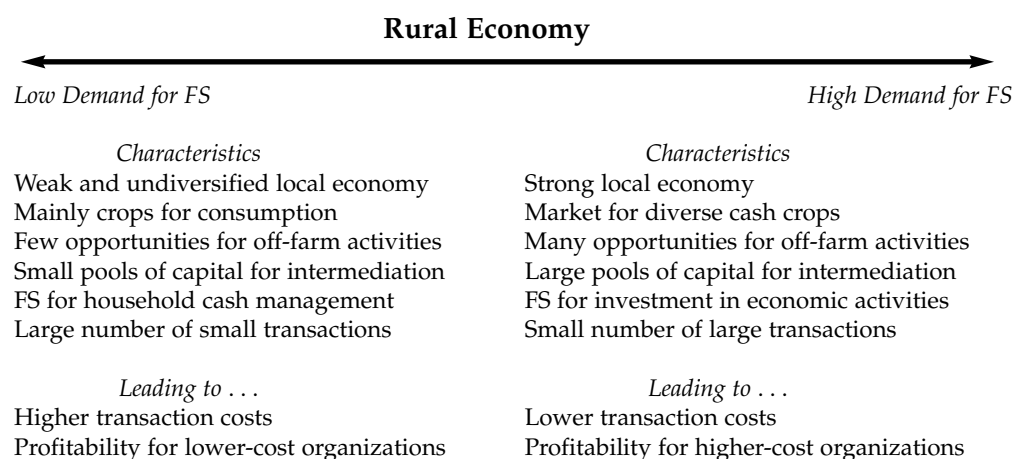
Abbreviations and Acronyms

ADP	Agricultural Development Project
APMAS	Andhra Pradesh Mahila Abhivruddhi Society
AP-RPRP	Andhra Pradesh Rural Poverty Reduction Project
ASCA	Accumulating Savings and Credit Association
BNDA	Banque Nationale de Développement Agricole
CBFO	Community-Based Financial Organization
CDD	Community-Driven Development
CDLIP	Community Development and Livelihood Improvement Project
CFI	Cooperative Financial Institution
CGAP	Consultative Group to Assist the Poor
CIDR	Centre International de Développement et de Recherche
CVECA	Caisses Villageoises d'Épargne et de Crédit Autogérées
FFI	Formal Financial Institution
FS	Financial Services
FSA	Financial Services Association
FSS	Financial Self-Sufficiency
LSA	Livelihood Support Activities
MFI	Microfinance Institution
MMS	Mandal Mahila Samakhayas
NABARD	National Bank for Agriculture and Rural Development
NBFI	Non-Bank Financial Institution
NEIAP	North-East Irrigated Agriculture Project
NGO	Nongovernmental Organization
PAR	Portfolio At Risk
RDD	Rural Development Department
RLF	Revolving Loan Fund
ROA	Return on Assets
ROE	Return on Equity
ROSCA	Rotating Savings and Credit Association
SACCOS	Savings and Credit Organizations
SC	Services Communes
SHG	Self-Help Group
TNEPRP	Tamil Nadu Empowerment and Poverty Reduction Project
VO	Village Organization
VS&LA	Village Savings and Loan Association
VSCC	Village Savings and Credit Committee
VSCO	Village Savings and Credit Organization
VSHLI	Village Self-Help Learning Initiative
WRDS	Women's Rural Development Society
ZS	Zilla Samakhayas

Executive Summary

Access to financial services is important for poor people, enabling them to better manage risk and take advantage of opportunities. The availability of financial services for poor households also affects the ability of countries to achieve the Millennium Development Goals: access to financial services reduces vulnerability and helps poor people increase their income, so families are able to improve their well-being, including access to better nutrition, health care, and education. Thus, improving access to financial services has become an important part of many World Bank development initiatives that seek to reduce poverty and improve the social and economic security of the poor.

The characteristics of demand for financial services, as well as the costs of providing those services, influence the types of financial services providers that can operate profitably in a given area. At one end of the spectrum, effective demand for financial services is low, with smallholder households mainly producing crops for consumption and few opportunities for off-farm economic activities. These characteristics produce a need for low-cost organizations that can cover the costs of intermediating small pools of capital for large numbers of customers with small transactions that satisfy their household cash management needs. At the other end of the spectrum, better and more diverse economic opportunities lead to a higher demand for financial services, which can be serviced profitably by higher-cost organizations intermediating larger pools of capital for a smaller number of customers who make larger transactions. This dynamic¹ is shown below:



Source: Author.

Note: FS = financial services.

These characteristics of demand and cost are the principal reasons that banks and professionally operated microfinance institutions (MFIs) are not able to reach the majority of people living in the sparsely populated rural areas of many countries. Even MFIs with methodologies that enable them to reach the poor are seldom able to serve clients living in villages located far from secondary towns because transaction costs are too high relative to the small size of most transactions. Technologies such as mobile banking and point-of-sale devices in rural shops can deepen the reach of financial institutions that have a mandate or see a business opportunity in the provision of financial services to the rural poor but they are only emerging now and may not prove to be a universal solution.

In response to these realities, many development agencies including the World Bank have sought to develop Community-Based Financial Organizations (CBFOs) that could cost-effectively provide financial services to a clientele at the “low demand” end of the spectrum. Many projects provide grants to CBFOs to establish revolving loan funds (RLFs) to support the development of rural livelihoods; it is expected that these funds will be repaid by initial recipients and then be recycled to other members. The experience has been that such funds usually decapitalize, benefiting few people and encouraging a culture of default. In recent years, however, several models of savings-led community finance have emerged that seem to offer better prospects for long-term sustainability than the credit-led RLF model. Savings-led CBFOs are those that initiate their financial intermediation activities with members’ savings and access external funds from bank-linked or donor-funded RLFs only after members have gained experience managing the lending of their own savings. In some cases, there is no external funding.

Success Factors for Effective and Sustainable Financial Services through CBFOs

The key finding of this paper is that CBFOs can be sustainable entities, provided that the following success factors² are built into the design:

- *Mobilization and intermediation of member savings before accessing external loan funds.* Savings provide poor people with a buffer against unforeseen expenses, thus lowering their household risk; small, regular savings help to develop financial discipline; and intermediation of savings into loans by CBFOs enables borrowers to establish creditworthiness before the introduction of external credit.
- *Vision for the development of a financial organization that is autonomous, financially independent, and able to provide financial services to its members over the long term.* Many development interventions have treated CBFOs mainly as a short-term mechanism to channel donor-funded loans for the improvement of livelihoods. It is important to focus on the sustainability of both the financial services and the organization delivering the services.
- *Clear ownership of donor loan funds, if they are provided.* In some cases, there has been confusion over who owns loan funds provided by a project, thus removing natural incentives for strong stewardship of the resources.

- *An organizational structure that facilitates management by members.* In many sparsely populated rural areas, people with suitable skills to manage a financial intermediary do not exist. The larger the organization, the more it needs professional management to be successful, because management complexities grow with size, but members cannot realistically be expected to be involved in the day-to-day management of a large organization. Success appears to be more prevalent among CBFOs with a small membership or larger ones that are organized with a division of management roles and responsibilities among smaller units.
- *Appropriate loan policies and processes.* Repayment capacity should be used to determine who gets loans and on what terms, rather than a prioritization based solely on poverty level. This is prudent for the CBFO and the member: the CBFO manages for sustainability only if it provides loans to the creditworthy, and members who cannot repay loans are not burdened by a situation of overindebtedness. Often, loans are not appropriate for the poorest, increasing their risk and vulnerability rather than reducing it. If a grant facility for the poorest is included in the project, it should be managed separately from the savings and loan component.
- *Simplified systems, including financial management systems.* CBFOs operating in sparsely populated rural areas usually cannot obtain the services of people with experience managing financial services; thus, these organizations need simplified systems that can be managed by local people. However, developing simplified systems, particularly financial management systems with appropriate checks and balances, is not a simple task. It requires an understanding of the most essential elements needed to ensure security and transparency, and in many cases, a willingness to introduce nontraditional elements, such as memory recall of financial transactions rather than written records for CBFOs with mainly nonliterate members.
- *Appropriate and high-quality capacity building.* In many cases, failure of CBFOs can be traced to unqualified support organizations that have not been properly screened and trained before they are given technical assistance assignments. Support organizations with expertise in rural development do not necessarily have strong capabilities in the development of savings and loan organizations.
- *Continuity of technical support.* In many cases, CBFOs could better manage more aspects of their operations if the initial support included appropriate systems and training. However, there are genuine concerns about the ability of CBFOs to function effectively over the long term without external support in certain key areas, such as auditing, performance monitoring, and bank linkage. These functions can be provided by support organizations, networks, or federations of CBFOs, but attention must be paid to the type, value added, and pricing of the services to be provided, so that a plan can be developed to cover the costs. Ensuring the sustainability of ongoing technical support is still a challenge in most cases.
- *Accountability through appropriately designed internal regulations and controls.* These must be transparent, with rules and processes understood by all

members, and clear roles and responsibilities for office holders and staff. Above all, savings must be protected against fraud and mismanagement.

- *Development of sustainable links to banks or MFIs.* CBFOs linked to banks or MFIs can potentially access a more diverse range of financial services for their members than those they are able to provide themselves. Because CBFOs serve poor people who can amass only small pools of capital, their resource constraints may limit the usefulness of their lending. For example, people may borrow at high interest rates for emergencies but not be able to do so to finance a low-return economic activity. Thus, linking CBFOs to banks or MFIs in geographic areas where such links are possible would enable members to source larger loans as well as possibly cheaper loans than what is available from the group's internally generated savings. In such cases, CBFOs can be considered as basic building blocks of financial intermediation in areas where more formal financial institutions find it difficult to operate profitably.

Recommendations for Project Design and Implementation

Following are recommendations for CBFO project design and implementation:

- *Determine the most suitable type of financial intermediary.* CBFOs, including village-based financial cooperatives, can be appropriate solutions to the problem of lack of access to financial services in areas with relatively low productive capacity, low monetization of the economy, and poor infrastructure. As economic conditions and infrastructure improve, possibilities emerge for outreach to the rural poor by banks and professionally operated MFIs. In rural areas that include both secondary towns and villages that are located far from these towns, it may make sense to use a two-pronged approach that builds the capabilities of banks and MFIs to deepen their outreach, but at the same time develops CBFOs in villages that currently cannot be served by these intermediaries. This foundation may offer possibilities for future links with the formal financial sector, either directly or through federations and networks.
- *Develop a plan at the outset for the sustainability of the CBFOs.* Members should not be viewed as beneficiaries, but rather as prospective owners of a financial institution. Those who decide to participate should have invested in the institution, through member shares and savings.
- *Empower members through a participatory process to develop their own set of rules within a defined institutional model and set of recognized best practices.* All the models reviewed in this paper have some elements of member design, such as decisions on savings amounts, interest rates, and loan repayment terms. However, most poor villagers who become members of these organizations are not skilled in managing savings and credit activities; thus, it is essential to develop a robust model based on local precedent that establishes a framework within which these decisions can be made.
- *Have a pilot phase in which a model suitable for the local context can be developed and fine-tuned with high levels of participation.* Based on lessons from the pilot, prepare an operations manual outlining the details of the model before large-scale implementation.

- *Develop an effective monitoring and evaluation system.* It is essential to set up and manage a system of support and supervision, starting with a baseline survey and development of a management information system that tracks key performance indicators on organizational sustainability.
- *Ensure that appropriate technical assistance is available from qualified service providers.* During the project design, conduct a needs assessment of local service providers to determine their capacity to provide effective support and ensure that the project implementation plan allows for training and supervision of these service providers so that they can properly support the development of CBFOs. Use international service providers as appropriate to help with the preparation of detailed training guides, training of local service providers, and development of simplified accounting and financial management systems. Build local capacity, such as developing a cadre of skilled community facilitators and sponsoring workshops where community members can share their experiences.
- *Above all, facilitate mobilization of savings and intermediation by members of these savings at project inception.* Repayment of internal loans made from member savings is one measure of capacity and willingness to repay credit, as well as an indicator of financial discipline and trust. Only members with a consistent savings history as well as strong repayment of internal loans should be allowed to access credit from external sources.

1. Introduction

Access to financial services is important for poor people for the following reasons: (1) *savings* provides a cushion that enables people to cope with unexpected events, as well as to gather usefully large sums of money for investment in livelihood activities or payment of expenses such as school fees; (2) *credit* enables people to acquire income-producing and household assets; (3) *insurance* enables people to protect their assets against losses and to cover major medical expenses and loss of life; and (4) *payments* services enable people to send and receive remittances from family and friends, receive pensions and social benefits, and pay bills. In short, access to financial services enables people to better manage risk and take advantage of opportunities through access to useful lump sums, available in the right amount, at the right time, from a variety of financial instruments.

A mounting body of evidence shows the availability of financial services for poor households can contribute strongly to the achievement of the Millennium Development Goals (Littlefield and Hashemi 2003). Access to financial services translates into better nutrition and improved health outcomes, allows poor people to send more of their children to school for longer, and makes women clients more confident and thus better able to confront gender inequities. As access to financial services reduces vulnerability and helps poor people increase their income, improving this access has become an important part of many development initiatives.

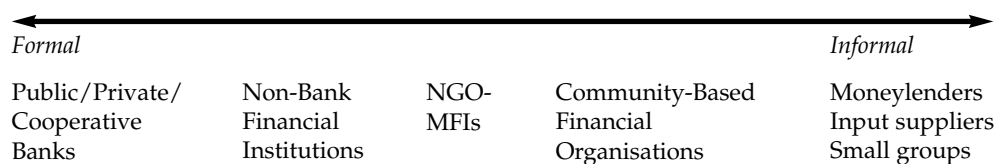
It is widely recognized that, in many countries today, the rural poor are still mainly left out of formal markets for financial services and frequently rely on informal mechanisms at the village level, such as moneylenders, supplier credit, and small savings and credit groups. A poor regulatory environment or policy framework, deficient financial infrastructure, including financial institutions, and a lack of institutional know-how contribute to the dearth of rural financial services. Even when an appropriate enabling environment exists, however, it is difficult for financial institutions to achieve scale economies and to cover their costs when they are providing financial services to poor clients who are spread out across large distances. In “Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance” (2004), the Consultative Group to Assist the Poor (CGAP) identified the extension of financial services into sparsely populated areas that are not served by professional financial services organizations as a frontier issue in the development of more inclusive financial systems.

Within the development finance community, a broad body of knowledge now exists on sound practices for banks and professionally operated microfinance institutions (MFIs) providing financial services to the poor. Clarity and consensus are lacking, however, on what the appropriate options are for the

development of financial services in dispersed rural communities that cannot at present be cost-effectively served by banks and microfinance institutions (MFIs). Technologies such as mobile banking and point-of-service devices in rural shops can deepen the reach of financial institutions, but they are not yet well tested or in widespread use. The lack of clarity has led many World Bank task teams to use a trial-and-error approach when designing and implementing rural financial services interventions and has discouraged many task teams from entering this area of development programming. In many client countries, however, tackling the multiplicity of issues surrounding rural poverty is difficult without the development of financial intermediaries that can deliver sustainable financial services to poor people who live beyond the reach of formal institutions.

Financial services are delivered to rural and low-income populations by organizations that exist along a continuum from formal to informal,³ high cost to low cost, and complex to less complex in terms of the need for professional management. Formal financial institutions (FFIs) are professional entities such as licensed banks or NBFIs that are regulated and supervised by a central authority. They include public and private commercial banks, state-owned agricultural and rural development banks, cooperative banks, microfinance banks, and special purpose financial institutions such as leasing, housing, and consumer finance companies. *Informal* providers of financial services include moneylenders, small shops, and input suppliers that provide goods on credit, as well as informal savings and credit groups. In between stand the *semiformal* institutions such as microfinance institutions operated by non-governmental organizations (NGOs), financial cooperatives, and community-based financial organizations (CBFOs). The key features, advantages, and disadvantages of each category are shown in annex 1 and a linear representation is shown in figure 1:

Figure 1. Continuum of Financial Services Providers



Source: Author.

This paper reviews the evidence to date on the sustainability of CBFOs, with a view toward determining whether they are a viable option for the provision of financial services to the rural poor who live in sparsely populated rural areas. CBFOs can be defined as *autonomous* organizations owned and managed by members of a particular community. They differ from the “village banks” in Latin America and the “solidarity groups” in countries such as Bangladesh in that such groups are usually not autonomous; they have been set up by MFIs as a cost-effective way to provide services to the poor.

Although such entities may manage their own affairs to a certain extent, they receive technical support, as well as funding, from the parent MFI and thus may not be subject to the same governance and management issues as fully autonomous groups.

The membership of CBFOs varies from small groups with as few as five members to entities with hundreds, or even thousands, of members. They may be informal, registered as associations or cooperatives, or part of a larger village organization, such as a company or women's organization. The central characteristics of these entities, which drive their governance and management, are their financial and institutional independence, and mobilization and management of their own resources. For CBFOs located in remote rural areas, lack of professional management can be a defining characteristic, because such groups are rarely able to employ staff who are skilled in the management of a financial organization.

Cooperative financial institutions have been excluded from this analysis, because they are the subject of recent work in the World Bank (see Cuevas and Fischer 2006; and Turtiainen forthcoming). Nevertheless, many of the lessons from this review of CBFOs also apply to village-based savings and credit cooperatives.

2. Objectives, Key Issues, and Methodology

Objectives

This review assesses the extent to which CBFOs are able to provide sustainable financial services to the rural poor. The objective is to provide clarity to World Bank task teams on whether, and how, such entities can be part of a strategy for the economic development of the poor living in rural areas who are not well-served by financial institutions.

First, a brief overview is provided of community-based financing models. Then the record of experience on the sustainability of CBFOs is assessed and critical factors for success or failure identified. The potential for CBFOs to link with FFIs, such as banks and MFIs, is explored, as well as issues of accountability to members. Factors are identified that World Bank task teams working on finance for the rural poor should consider in determining the most suitable types of financial intermediaries to support in a given project context, and steps are suggested for the development of a strategy for the provision of financial services to underserved rural populations.

Key Issues

The paper reviews the record of experience in the following areas:

- What evidence exists to show whether CBFOs can provide sustainable financial services?
- What are the appropriate benchmarks and indicators of performance for CBFOs compared with FFIs?
- How cost-effective is it to support the development of CBFOs compared with other types of financial service providers such as MFIs?
- How do sustainability measures compare across different types of financial service providers?
- Where CBFOs have shown positive results, what were the critical success factors? Where they have failed, what were the key flaws in program design or implementation?
- What does the record of experience indicate with respect to the potential for CBFOs to link to other institutions in the formal financial sector, and what is the nature of this linkage?
- What precedent is there for building accountability into the community-based approach to deliver financial services or develop appropriate supervisory mechanisms?
- What factors or conditions might determine whether rural communities would be best served by (1) CBFOs, (2) other types of financial

intermediaries such as banks, MFIs, or cooperatives, or (3) a combination of these?

The report is organized based on these key questions.

Methodology

The report assesses the record of recent experience on community-based finance in World Bank projects and supplements this learning with findings from other agencies implementing community-based models, as well as findings from several recent external analyses.

The World Bank projects included in this review are those that are sufficiently well-documented to provide evidence on sustainability and success factors. Unfortunately, many World Bank projects with community finance components have not assessed the results from the point of view of the sustainability of the organization providing the financial services or the sustainability of the financial services themselves. Many of these projects provide revolving loan funds (RLFs) to communities, with the objective of enabling community members to improve their livelihoods through loans for income-generating activities. Success is often measured in terms of livelihoods created or improved, rather than the ability of the RLF to continue to revolve within a sustainable organization. Many of these RLFs are small components buried within large projects; consequently, they are hard to identify and are unlikely to be closely tracked. Even those that can be identified seldom have quantifiable performance information.

The World Bank projects included in this paper are those that have provided meaningful information, through site visits,⁴ project monitoring, or evaluations. They include the Andhra Pradesh Rural Poverty Reduction Project (AP-RPRP), also known as “Indira Kranthi Patham,” and the Tamil Nadu Women’s Development Project, “Mahalir Thittam,”⁵ in India; three Agricultural Development Projects in Indonesia; and the North-East Irrigated Agriculture Project (NEIAP) and Community Development and Livelihood Improvement Project (CDLIP), “Gemidiriya,” in Sri Lanka. These projects offer significant lessons on two different approaches that the World Bank has used when supporting CBFOs: credit-led versus savings-led approaches.

The review also includes several CBFO models that have not yet been supported by the World Bank, but that have been extensively tested, implemented, and refined in Africa over the past two decades: Village Savings and Loan Associations (VS&LAs) and Caisses Villageoises d’Epargne et de Crédit Autogérées (CVECAs), which can be translated from French as Self-Managed Village Banks for Savings and Credit.⁶ These models are particularly relevant for this study because they have been widely disseminated in Africa, a part of the world where vast numbers of people live in sparsely populated rural areas without access to formal financial services. Both of these models were born in countries with very poor people who are dispersed thinly over large geographic areas.

VS&LAs were developed by CARE International in Niger in 1991 and have since been replicated by CARE⁷ with adaptations for the local context in 17 African, 2 Asian, and 2 Latin American countries. These countries include Angola, Burundi, Eritrea, Ethiopia, Kenya, Lesotho, Malawi, Mali, Mozambique, Niger, Rwanda, Sierra Leone, South Africa, Tanzania, Uganda, Zambia, Zimbabwe, Vietnam, India, Peru, and Ecuador. CVECAs were developed by the Centre International de Développement et de Recherche (CIDR) in Mali in the 1980s and have since been replicated, again with refinements according to the local context, in Burkina Faso, Cameroon, Chad, Guinea, and Madagascar. In addition, lessons have been drawn from Financial Services Associations (FSAs), which have been implemented since the late 1990s in Kenya, Tanzania, and Uganda.

3. Overview of Community-Based Financial Services Models

The overview of CBFO models presented in this section uses a typology based on the initial source of funds; the models described are categorized as *credit-led* or *savings-led* CBFOs. *Credit-led* CBFOs are defined as those that receive outside funding early in their life with few, if any, requirements for savings. *Savings-led* CBFOs are those that initiate their financial intermediation activities with members' savings and access external funds from bank links or donor-funded grants *only after members have gained experience managing the lending of their own savings*. In some cases, there is no external funding.

Funding for credit-led CBFOs usually is provided in the form of an RLF, which is provided as a grant to the community, with the expectation that the funds will revolve and ultimately benefit many community members. The World Bank's Agricultural Development Projects (ADPs) in Indonesia created 1,200 village-based CBFOs, called UPKDs, in five provinces of Indonesia from 2000 through 2004. The ADPs began as agricultural input projects, with the distribution of packages of agricultural inputs and cattle through government agencies. Because implementation was slow, and the country was experiencing a financial crisis, the projects were restructured in 1999 and transformed into community-managed microfinance projects. UPKDs were set up to manage loans to villagers, using a World Bank-funded RLF of about \$25,000 per village. Savings were not promoted on a regular and consistent basis. The villagers selected local leaders to manage the UPKDs and all villagers were eligible to become members, although not all did so.

Sri Lanka's NEIAP is an irrigation rehabilitation project operating in the conflict-affected northern and eastern regions of the country. A women's economic development component was added midway through the first phase (NEIAP-I), when it was realized that irrigation infrastructure improvements tended to benefit mostly the better-off members of the communities, because the poor did not have ownership of irrigated land. The project uses RLFs to finance the economic activities of poor women in project villages, channeling the funds through Women's Rural Development Societies (WRDSs). NEIAP-I did not require group members to save before receiving a loan; indeed, it had no savings component at all, based on the premise that members were too poor to save. Savings have recently been introduced in NEIAP-II, and the project has found that the poor, in fact, are able to save. The NEIAP experience highlights the difficulties of finding appropriate solutions for the development of financial services in an area that is both sparsely populated and postconflict. These experiences are highlighted in annex 2.

Savings-led CBFOs have been supported most extensively by the World Bank in Andhra Pradesh and Tamil Nadu, India, using the self-help group (SHG)

model. SHGs are autonomous groups of 10 to 20 people who save money and lend those savings among members of the group. SHGs are often linked to banks or MFIs that provide additional loan capital. The SHG model has been extensively tested and supported over many years by the government-owned National Bank for Agriculture and Rural Development (NABARD) and has been implemented by many other development agencies. In Andhra Pradesh, the World Bank-funded AP-RPRP provides an RLF to federations of SHGs for on-lending to SHG members. In Tamil Nadu, SHGs receive small amounts of seed capital directly from a Bank-financed program. In both cases, SHGs make their own decisions regarding savings and lending policy, and receive training and follow-up from project staff and, in some cases, other support organizations. Federations of SHGs are developed that enable them to obtain services, such as audit and training, that would otherwise be difficult to procure. Annex 3 provides an overview of these World Bank-financed initiatives.

The savings-led model has also been used in Sri Lanka's CDLIP, also known as "Gemidiriya." This model is only three years into implementation, so findings are tentative. The model follows a savings-led approach and links groups to banks, but also provides significant external funding through an RLF to a village company. The Gemidiriya model grew out of a failed RLF in the pilot Village Self-Help Learning Initiative (VSHLI) and, despite its relative youth, offers some valuable lessons on what does and doesn't work. The most significant features of the Gemidiriya model that set it apart methodologically from SHGs are the large number of members—commonly 300 or more—of each Village Savings and Credit Organization (VSCO) and participation of members in a multipurpose village company that is separately managed. The village company provides a variety of infrastructure and livelihood support services to community members. The RLF is owned by the company but managed by the VSCO, with representation from the company's board of directors. The fundamental building blocks of VSCOs are small groups of five to seven people, who regularly save an amount determined by the members of the small group and lend these savings to each other. Members can save amounts above these regular savings, and many do. Clusters of small groups are formed; these clusters have a maximum of 40 members, are governed by the leaders of the small groups, and establish links with a local bank to hold any savings that have not been retained by the small group members for their internal lending. The clusters in turn elect leaders, who represent the clusters at the highest governance level, the Village Savings and Credit Committee (VSCC). The VSCC manages the RLF on behalf of the company, but it has no role in managing members' savings. An overview of the VSCO model is provided in annex 4.

CARE's VS&LA model is another savings-led model. VS&LAs are autonomous groups of up to 30 people within a village who save money—either a fixed amount per person per time period or through multiple share purchase—and lend these savings to members. The key differences between this model and SHG-VSCOs are that (1) most VS&LAs do not access external funding; (2) at the end of a predetermined period, usually a year, the groups distribute all savings as well as earnings in proportion to individual investment, and the cycle starts

again; and (3) the VS&LAs are not aggregated into federations. The VS&LA methodology is a refinement of a traditional model that is found in many parts of Africa, the Accumulating Savings and Credit Association (ASCA).⁸ Annex 5 provides an overview of VS&LAs.

The CVECAs are village-based, but unlike VS&LAs, they do not have a size restriction and savings are not compulsory. Members pay a small membership fee, then save money within the base unit, the village caisse, and may borrow from it. In some cases, links have been developed with banks, which lend to the caisse for on-lending to members. The CVECA methodology has evolved over the years to include the establishment of networks⁹ that have overcome some of the constraints of operating small entities without professional management. External loan funds from banks are obtained through unions, which are networks of caisses. In addition, local technical service providers have been developed to provide ongoing technical assistance.

FSAs were established in East Africa to test the proposition that a company model, rather than a cooperative model, would provide better incentives for good governance and management of a group with 100 or more members. In the FSA model, members bought shares; these shares could not be withdrawn (but could be sold if the member could find a buyer) and were used for on-lending. Intermediation of shares is similar in nature to intermediation of savings; hence this model has been placed in the savings-led category. Voting rights were proportional to shareholdings, as opposed to the cooperative one-person, one-vote system.

4. Sustainability

To provide sustainable financial services, an organization—whether it is a bank, MFI, cooperative, CBFO, or any other type of financial intermediary—must be able to cover *all* of its costs, including the cost of loan losses and any recurrent costs that may initially be covered by subsidies. This section seeks to answer the following key questions:

- *What are the appropriate benchmarks and indicators of performance for CBFOs compared with FFIs?*
- *What evidence exists to show whether CBFOs can provide sustainable financial services?*
- *How do sustainability measures compare across the types of financial services delivery mechanisms?*

Core financial performance indicators for MFIs recommended by CGAP include *collection performance, profitability, and efficiency*. An MFI is generally considered to have good performance if it is able to (1) limit its annual loan losses to 5 percent or less of its average outstanding portfolio and (2) cover all its costs as defined above. Efficiency is more difficult to benchmark, because costs vary significantly across countries and are strongly affected by loan size (small loans may cost as much to administer as large loans) and geographic location (rural villages are more expensive to serve per client than towns and cities).

The World Bank's Operational Policy OP8.30 and recent guidance notes for lines of credit in Bank operations outline the key performance indicators that should be assessed for all Bank credit lines to participating financial intermediaries. In addition to the loan performance, profitability, and efficiency indicators recommended by CGAP for MFIs (Rosenberg 2006b), they include indicators for capital adequacy and liquidity.

One of the problems encountered when assessing the financial performance of CBFOs is the difficulty of collecting and analyzing information on large numbers of small groups. Even large CBFOs with hundreds of members are small when compared with the clientele of an FFI. This means that performance is difficult to assess on a continuous basis unless a support organization, federation, or network stays involved with the groups, and has the capacity, mandate, and funds to collect and analyze performance information. As a result, availability and quality of performance information is uneven.

In addition, it is difficult to compare the overall financial performance of CBFOs with that of other types of institutions. The *MicroBanking Bulletin* is a publication that collects, analyzes, and reports the performance of leading MFIs, so that they can compare their performance against other MFIs. The April 2006 edition of the *Bulletin* includes performance information and trends from 2001 through 2004 for more than 300 institutions in 67 countries.¹⁰

Participation is voluntary, however, and thus is limited to successful organizations that are willing to report their performance to an external body. Among the four types of institutions analyzed—banks, credit unions, NGOs, and other NBFIs—all categories reported positive earnings and trend lines showed increasing profitability.

Collection Performance

Collection performance is especially difficult to assess, even in CBFOs that have record-keeping systems. This is illustrated by an institutional assessment of SHGs in Tamil Nadu (Ferguson & Co. 2005) that found that nearly 50 percent of the SHGs sampled did not have financial statements, and those that did have them did not maintain a loan-tracking system that permitted an assessment of portfolio quality. Even when loan-tracking systems are in place, interpreting the findings may require qualitative judgments. Several studies have shown that indicators for overdue loans are not a good predictor of eventual repayment by members of CBFOs. Andhra Pradesh Mahila Abhivruddhi Society (APMAS), an Indian NGO that has extensive experience evaluating and rating SHGs, has found that SHGs eventually collect a substantial portion of late loans (Isern et al. forthcoming). This finding is supported by Allen (2005b), who found that portfolio at risk (PAR),¹¹ a standard indicator of MFI collection performance, is not a reliable indicator for VS&LAs. For example, although PAR for VS&LA groups in Uganda ranged from 19 percent to 39 percent, depending on how it was calculated, most VS&LA groups were able to secure repayment of 95 percent to 98 percent of the originally disbursed amount by the end of the cycle. Similar findings are reported from Zanzibar (Allen and Staehle 2006) where PAR is estimated to average 23 percent, but the annual loan loss rate is less than 2 percent.

For bank-linked SHGs, differences have been found between external and internal repayment performance. Isern et al. (forthcoming) found significant differences in repayment performance between internal loans (from the SHG to the member) and external loans (from external sources to the SHG, which then on-lends to the member). The average PAR for loans 30 days overdue was 25 percent among the five institutions studied, and dropped to 11 percent for loans overdue one year. However, PAR 30 days for external loans averaged 9 percent and dropped to 4 percent for loans overdue one year. These findings indicate that most members do eventually repay their loans. Ferguson & Co. (2005) found that SHGs in Tamil Nadu had a better repayment discipline for external loans from banks or MFIs, with 9 percent demonstrating an irregularity in repayment, than for internal loans, with 28 percent showing irregularities. These differences were attributed to the SHGs' desire to maintain their creditworthiness with banks.

In Africa, FSAs also show considerable variation in repayment performance. In Tanzania, loan arrears over 90 days accounted for 5 percent of loans outstanding, whereas in Uganda, 25 percent of loans had been dormant for at least seven months. However, Jazayeri (2005) noted that "loans did tend to be eventually paid off even with a long delay since the annual loan losses were on average below 10% and in well performing FSAs below 3%."¹²

Seibel (2005), using statistics compiled by the microfinance unit within the Ministry of Finance in Mali, reported an on-time repayment rate of 96.3 percent in 2003 for CVECAs in that country. However, repayment on bank loans to CVECAs in Mali was 100 percent, reflecting that “village banks and their members are aware of the source of funds of their respective loans and are much concerned about repaying their bank-refinanced loans on time lest they lose their creditworthiness.” (Seibel 2005) In contrast, loans from the same bank to farmers’ cooperatives had repayment rates of only 72.6 percent. In the Mouhoun region of Burkina Faso, the repayment rate for CVECAs in 2005 was 98.6 percent, according to the Web site of the promoting agency CIDR.¹³

The two credit-led models reviewed in this paper include three ADPs in Indonesia and NEIAP in Sri Lanka. All of the projects exhibited poor collection performance of their donor-financed RLFs. Only 18 percent of the CBFOs supported by the ADPs had repayment rates of at least 90 percent. Similarly, NEIAP had repayment rates at the end of its first phase that were as low as 20 percent, even with project officers pressuring overdue borrowers to repay their loans.

Gemidiriya, also in Sri Lanka, with a savings-led model entirely managed by community members, had loans at risk¹⁴ of only 1 percent in its RLF portfolio as of May 31, 2006. Gemidiriya includes several features, apart from the credit-led versus savings-led dichotomy, that could have contributed to its improved performance over NEIAP. These features include the formation of small groups within the larger group, joint liability of small group members for the loans of other members of their small group, an appraisal system that focuses on the capacity of the borrower to repay the loan, and the availability of a mechanism—completely separate from the savings and loan activities—that enables extremely poor people to obtain a grant to start an income-generating activity. NEIAP has a loan program but no grant program and targets its lending to women whose households do not own irrigated land. Thus, these women tend to be the poorer members of the community. NEIAP also operates in a postconflict environment in which the poor have few assets to cushion them from economic adversity. Thus, when small economic activities financed by loans fail, NEIAP borrowers often have few other sources of income from which the loan can be repaid.

In summary, the record of experience on loan collection performance shows that the ability of CBFOs to limit their annual loan losses to international best practice standards to 5 percent or less of the average outstanding portfolio varies considerably across programs, with credit-led programs having poorer collection performance than savings-led programs. Groups linked to banks tend to have better credit discipline for their bank loans than for loans financed from member savings, although there are indications that many overdue loans financed from savings are eventually repaid, even if it is after the due date.

Profitability

Profitability can be measured by a variety of indicators, including return on assets (ROA), return on equity (ROE), and financial self-sufficiency (FSS). This

last indicator adjusts for subsidies, even if such adjustments have not been made on the organization's books. The April 2006 issue of the *MicroBanking Bulletin* reports that, in 2004, the average ROA of reporting institutions was 1.9 percent, ROE was 6.9 percent, and FSS was 110.4 percent. Among peer groups, rural banks reported the lowest ROA at 1 percent, and NGOs the highest at 2.7 percent.

Ferguson & Co. (2005) found that, of the 52 percent of SHGs studied that had record-keeping systems permitting financial analysis, 90 percent had achieved FSS, including coverage of support organization costs. Isern et al. (forthcoming) found that the five SHG programs studied had ROAs after adjustment for loan losses ranging from 1 percent to 16 percent, with an average of 9 percent. However, adjusting ROA to include the costs of external promotion and support dropped the average ROA to 0 percent, with considerable variability depending on the costs of the support organization. In one case, promotional costs decreased ROA from 16 percent to minus 1 percent, and in another case there was no change at all.

Gemidiriya's VSCOs are highly profitable as a result of low loan losses and low costs. The cost of the external technical support provided by the project has not been factored in, but it is a relatively low cost, with one locally recruited facilitator for every 30 to 35 villages. The project has an exit plan for these facilitators: the recruitment of interested and capable VSCO members as community professionals, who will provide ongoing technical support to existing VSCOs as well as form new ones. The VSCOs will pay directly for their services, enabling the project facilitators to phase out.

Seibel (2005) found that the CVECA network in the Niger delta region of Mali had an ROA of 0.37 percent in 2002 and 1.25 percent in 2003 despite a deterioration of the on-time repayment rate during the period.

Interestingly, CBFOs often charge interest rates on their loans that many development organizations and donors would consider exorbitant. CBFOs usually determine their own interest rates, and they often do so by reviewing the terms of credit charged by moneylenders in the local economy and offering better terms. VS&LAs, for example, provide dramatic returns to savers. In Zimbabwe, where annual inflation has recently been as high as 127 percent, groups charge 20 percent per month interest and have earned a net return after inflation of 15 percent per year, 65 percent higher than savings in commercial banks. In Niger, where groups typically charge 10 percent per month interest on loans, the annualized returns to savings have been 76 percent.¹⁵

In summary, the record of experience on profitability shows that CBFOs are usually profitable if they keep loan losses under control. Credit-led CBFOs, however, often are not able to do this. CBFOs can be highly profitable if they charge interest rates similar to those found in the local economy. When the costs of external support organizations are considered, profitability drops; the effect of this adjustment depends on the cost-effectiveness of the support organization.

Efficiency

How cost-effective is it to support the development of CBFOs compared with other types of financial services providers such as MFIs?

The *MicroBanking Bulletin* uses several indicators to measure an organization's efficiency in reaching its clientele, including "cost per borrower." The April 2006 edition of the *Bulletin* reports an average cost per borrower of \$96, ranging from \$212 for banks to \$136 for credit unions and \$75 for NGOs. This indicator measures the operating costs for credit provision, rather than the costs of developing the organization from the start-up phase until profitability is reached. This information is rarely available, especially because many financial institutions serving the poor receive support from multiple donors over long periods of time.

CARE's experience has been that VS&LA group development costs between \$18 and \$60 per member, depending on the country and on the scale and maturity of the program. On average, group development costs within a mature program in Africa are around \$30 per member (Allen 2005a). In addition, program evaluations indicate that spontaneous replication of groups is occurring in many cases, reducing the overall cost to the support organization. In Niger, for example, a June 2004 evaluation showed that 15.6 percent of new groups were formed without the support of the CARE program (CARE Niger 2004).

Similarly, Isern et al. (forthcoming) report that the costs of SHG promotion for the agencies studied average \$18 per member, but range from \$3 to \$32. These findings are supported by Nair (2005), who cites SHG promotional costs to be \$196 per SHG over five years for Dhan Foundation, a leading promoter of SHGs. With a membership of between 10 and 20 people, this translates into a per-member cost of between \$10 and \$20. The World Bank's AP-RPRP has a per-SHG cost of \$253, based on a budget of \$119 million to support the formation of 469,941 SHGs. This translates into a per-member cost of between \$13 and \$25. Support from RPRP includes livelihood development, empowerment, and social change as well as financial services; thus, the costs attributable to the financial services would be significantly less than the figures stated.

Isern et al. (forthcoming) noted that the lowest-cost organization, a bank, had the highest PAR, and that program focused on literate, less poor women who live close to the bank's branches. This finding illustrates the interconnectedness of performance indicators and demonstrates the importance of qualitative interpretation. The study's authors noted that the "study's results do not consistently find that higher promotional costs lead to higher portfolio quality, deeper outreach, higher SHG ratings or greater profitability after adjusting for loan provisions. The results are more nuanced and clearly depend on the promoting institution."

In summary, the costs of supporting CBFOs appear to be less on a per-member basis than support for other institutional forms. It is difficult to make generalizations, however, because costs are highly dependent on many

variables such as country context, scale and maturity of the program, quality and range of financial services provided, and the extent of support for other activities.

Other Indicators

Sustainability is more than just financial performance, although financial performance is considered by many to be a good predictor of the quality of governance and management. An assessment of sustainability should include an analysis of robustness of the organizational structure, internal systems, quality of service delivery, and capacity of members.

Ferguson & Co.'s 2005 analysis of the sustainability of SHGs in Tamil Nadu included the following indicators for evidence of a robust structure: presence of norms for meetings, attendance rate at meetings, member awareness of norms, clearly defined and understood roles of SHG members and office bearers, and ability to enforce norms. Indicators of internal systems and processes included the ability to maintain records, existence and quality of auditing, regularity of elections, and rotation of office bearers. Indicators of service delivery included extent and regularity of savings, availability of credit, repayment of internal loans, and number of times that the group had taken external loans. Following a combination of quantitative and qualitative analysis, the study's conclusion was that basic self-sufficiency had been achieved in the sample group of SHGs in Tamil Nadu that had been in existence for at least three years; however, much more needed to be done on parameters that affect long-term sustainability, including the ability to form durable credit links with banks, ability to operate independently, adoption of democratic practices, and professional practices such as accounting and auditing.

Long-term survival of the group is a strong indicator of long-term sustainability. A 2006 study in Zanzibar of VS&LAs that were created by CARE but had not received assistance for four years showed that 100 percent of the original groups were still in operation, there was a 256 percent spontaneous increase in the number of groups in operation (that is, formed without assistance from a support organization), and a similar increase in the overall number of participants. A 1998 evaluation in Maradi, Niger, showed that 96 percent of the VS&LA groups created in the district since 1991 were still operating and that spontaneous replication was occurring. A 1999 evaluation in Tahoua, Niger, found that 100 percent of the groups created since 1994 were still functioning. It can be argued that VS&LAs' payout of savings and interest earnings at the end of a period, usually a year, is an important success factor for the sustainability of these groups. This feature enables groups to draw a line under the previous year's transactions and resolve any outstanding disputes or financial anomalies. It allows groups to weed out bad members or those who simply no longer wish to participate, add new members, limit the volume of money that needs to be accounted for by nonliterate or semiliterate members, and provide payouts when most members need the money, such as at the beginning of the agricultural season or when school fees are due.

Dropout rates are a good proxy for client satisfaction. If an organization is able to retain its members, this is a strong signal that the organization is providing its membership with services that they value. Isern et al. (forthcoming) found that, over five years, 15 percent of members in the SHGs studied dropped out while 9 percent joined as new members. The main reasons for dropping out were death, marriage, or migration. In the VS&LA study in Zanzibar, 12 percent of members dropped out over four years.

5. Critical Factors for Success or Failure

Where CBFOs have shown positive results, what appear to be the critical success factors? Where they have failed, what were the key flaws in program design or implementation?

Murray and Rosenberg (2006), who reviewed evaluation and implementation reports for 60 projects with community-managed loan funds from 1990–2005, found that:

Success is strongly linked to the source of funds that groups receive . . . When loans are financed by an early injection of external funds from donors or governments, . . . projects appear to fail so consistently that this model of microfinance support is never a prudent gamble . . . Savings-based groups . . . 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. When [SHG] 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 (p.1)"

The findings from the projects and models reviewed in this paper support the viewpoint that savings-led groups perform better than credit-led groups. As outlined in section 4, the credit-led CBFOs in Indonesia's ADPs and Sri Lanka's NEIAP-I have not performed as well as CBFOs using a savings-led model. Therefore, the first critical factor for the success or failure of a CBFO is as follows:

- *Mobilization and intermediation of member savings*

Why are savings so important? Allen (2005a) notes that *a savings-based model reduces risk for the poor, whereas a loan-based model increases it*. Far too often in the development world, the assumption is made that access to credit will automatically enable poor people to invest in profitable activities, pay back their loans with interest, and improve their economic security. This assumption greatly understates the element of risk. Many poor people are already highly indebted, and additional debt may undermine their economic security rather than enhance it. This is particularly true if financial services providers are focused mainly on credit delivery, without reference to the borrower's capacity to identify and manage profitable livelihood activities.

Some recent experience in Andhra Pradesh, India, buttresses Allen's point of view that external capital can overburden the poor with debt. Over the past several years, banks in India have lent considerable funds to MFIs for on-lending to their poor clients. This has led to stiff competition among the various providers of microfinance services. As a result, many poor women

have received loans from several lenders at the same time, often irrespective of their level of existing debt and repayment capacity. This had led to a situation of overindebtedness, with many poor rural clients unable to repay their loans. Remedies for such situations in the short term include a code of conduct and better screening of clients by microfinance service providers. In the longer term, development of a microfinance credit information bureau would help lenders to identify clients who have existing obligations.

When given the choice, poor people will often choose to make use of savings services rather than take loans. People use those savings both as a buffer against unexpected expenses, such as medical expenses, and to plan for predictable outlays such as holidays, school fees, agricultural inputs, and life-cycle events. VS&LA groups often time the payout of their funds to coincide with a period during which most members need money for one of these purposes. Poor women who save and lend to each other in small groups in the Gemidiriya program in Sri Lanka cite easy availability of loans for emergencies as one of the main benefits of participation.

Savings-led programs have numerous other advantages. They help the poor to develop financial discipline by encouraging small, regular savings. These savings can provide dramatic returns on investment, as has been demonstrated by VS&LA groups. Savers can benefit enormously by saving and prudently lending the savings to others in the group or community. Interestingly, the large returns on savings in the VS&LA model have made group members reluctant to deposit their savings in banks, where returns are considerably less attractive.

Sri Lanka's credit-led NEIAP-I project performed poorly compared with the savings-led Gemidiriya. Gemidiriya requires that members save regularly and encourages groups to lend the savings within the group, thus providing members with financial intermediation experience. Savings serve as collateral for loans to group members, thus ensuring that members properly appraise loans with an eye toward potential borrowers' repayment capacity.

In Indonesia, the ADPs did not promote savings mobilization on a regular and consistent basis. The 10 percent savings that some CBFOs required from their members in order to obtain a loan in many cases were not collected up front, but instead were subtracted from the loan amount. In other cases, people who had no intention of saving on a regular basis could access credit by making one or several large savings deposits; they could then withdraw their savings after they received the loan. As a result, members were not required to have a stake in the organization, they did not have to demonstrate financial discipline before receiving a loan, and savings could not be used as a collateral substitute.

These lessons are evident in India's AP-RPRP, for which both the project and the banks require that new SHGs gain experience with savings and internal lending for six months before they access commercial bank credit.

- *Vision for the development of a sustainable financial organization*

Projects that support CBFOs should view these organizations as long-term providers of financial services to community members rather than simply as mechanisms for the distribution of loan funds. It is surprising how often topics

related to organizational development are ignored in training and technical assistance programs. The focus is often on the development of livelihoods, with financial services as the means rather than the end. That perspective often does not consider the fact that poor people—just like wealthier people who have access to formal financial services—need financial services on a *continuing* basis for a variety of financial services that, among other things, protect their current assets, help them manage risk, and enable them to grow their economic activities in the future as well as during the project period. Thus, the focus shouldn't be livelihoods *or* sustainable organizations, as is so often the case, but livelihoods *through* sustainable organizations.

In Indonesia, many villagers had the impression that the ADP was operating a loan fund rather than creating a sustainable CBFO. Community members did not perceive that they “owned” the CBFO and thus had little commitment to the organization. Few had their own money invested; instead, it was funded solely by donations from the World Bank.

NEIAP-I viewed WRDSs as a means to finance livelihoods of the poorest women. The operations manual for the microfinance component of NEIAP-I was heavily oriented toward the processes of selecting loan recipients, procuring inputs for them, and collecting repayments. In fact, project staff spent considerable time collecting repayments, particularly as the completion of the first phase neared. Repayment performance would have been much worse than it was if the staff hadn't made extraordinary efforts to get the loans repaid. Members of the WRDSs had no money of their own invested in the societies. NEIAP-II is currently restructuring the microfinance component based on lessons learned.

In the VS&LA Field Programme Guide (Allen and Staehle 2006), the focus is squarely on organizational development. Topics include Groups, Leadership, and Elections; Development of Policies and Regulations; Development of Association Constitution; Record-keeping; How to Manage a Meeting; and Action Audit.

- *Clear ownership of external loan funds*

In the ADPs and NEIAP, members were confused about the ownership of the loan funds provided by the World Bank. Local government had a strong presence in the supervision, monitoring, facilitation, and technical assistance of the CBFOs. Most members, as well as some local governments, did not fully understand that the government's role was to support and protect the groups, but not to own the funds. Thus, natural incentives were missing for strong stewardship of the loan funds by the CBFOs. In NEIAP-I, this confusion existed even at the level of the NGO service providers, many of whom were unclear about ownership of the funds.

In contrast, ownership of the loan funds in Gemidiriya and Andhra Pradesh's SHG federations is clear. In Gemidiriya, the village company owns the RLF and delegates the management of it to the VSCO. This agreement is recorded in a Memorandum of Understanding between the two parties, and two members of the company's board of directors sit on the VSCO's decision-making

committee, thus ensuring that the interests of the company are represented. In Andhra Pradesh, the RLF from the World Bank is owned by SHG district-level federations and lent through a clearly defined set of rules, first to a lower tier of federation and then to the SHGs, who lend to members.

- *An organizational structure that facilitates management by members*

Evidence suggests that success is more prevalent among smaller CBFOs or larger ones that are organized with a division of management roles and responsibilities among smaller units. The larger the organization, the more it needs professional management to be successful, because management complexities grow with size, but members cannot realistically be expected to be involved in the day-to-day management of a large organization. In many sparsely populated rural areas, however, people who have skills that are suitable for the management of a financial intermediary do not exist. Those who are well-educated often move to urban areas where their skills are in high demand, they can earn good salaries, and they can provide their children with better education opportunities than those available in the village. CBFOs operating in this context need to find ways to operate successfully without such professional management. Principally, this means keeping it simple, transparent, and small.

Traditional Rotating Savings and Credit Associations (ROSCAs)¹⁶ have existed in many parts of Africa for a long time, so they are a good place to start for lessons. Wright and Mutesasira (2001) found that in Uganda, the composition and size of ROSCAs were considered by members to be the most important factors for their success or failure. Homogeneity in terms of income level and gender, and membership of 6 to 10 people who could be trusted by all members, were key. Larger ROSCAs were considered by members to be prone to management problems and breakup.

FSAs, which have at least 100 members, are organized as one large group, governed by a board of directors, and staffed by paid employees. Jazayeri (2005) found that FSAs experienced difficulty recruiting educated and competent individuals as managers, board members, or internal auditors, and board performance in terms of frequency of meetings, quality of discussions, and quality of oversight varied from excellent to very poor. Most board members did not have a high education level, and insider dealings needed constant oversight from the apex organization. Improvement in allowances paid to board members improved their motivation and participation. Remote FSAs had the worst governance because of poor qualifications of the board and limited interest. According to Jazayeri, “the small institutions were too small to generate financial incentives and too big to rely on the logic of small groups for internal governance” (2005). In addition, the corporate shareholding structure of the FSA model did not provide incentives for better management than did a cooperative structure; as a result, FSAs that were originally established as shareholding companies are now converting into cooperatives. FSAs are increasingly turning to external private management agencies to help with administration and financial record-keeping. It is not yet clear how sustainable this will be in the long run.

Gemidiriya VSCOs have a large number of members, but they are organized completely differently from FSAs. Rather than the unitary structure found in FSAs, they have a three-tier structure that features bottom-up governance and management. The lowest level, the small group, typically has five to seven members who elect their leadership to represent them at the next level, the cluster. Clusters, with a maximum of 40 members, in turn elect their leadership to represent the cluster at the third level. Thus, the governance of the highest level comes directly from the elected representatives of the lower levels. Management occurs at the lowest level that is possible for each given type of financial service. Small groups are formed by villagers who self-select their membership and manage their savings and internal lending activities. Each small group determines its own level of regular savings, which is based on group members' economic status and preferences. Members may save more money than the required minimum determined by their small group, and these savings, which are kept in commercial banks, are managed by the cluster. Clusters are adequately sized to provide a cost-effective way of paying the transaction costs for the group to link with the bank, which secures these savings. The highest level, the VSCC, doesn't manage savings activities at all; it manages the company's RLF for the benefit of small group members. Allocating management responsibilities in this way reduces the management burden at each level and ensures that savings are handled transparently, reducing the possibility of fraud.

Federations of SHGs display a similar structure and dynamic. The SHGs are the lowest level, typically with 10 to 20 members, and manage their own savings and lending activities. SHGs then federate at one or several levels, with the federations performing roles that cannot be effectively performed by the SHGs. Although the models of federation vary according to the support organization, the principle is the same.

VS&LAs usually have a membership of between 15 and 25 people. Allen and Staehle (2006) note that this size "strikes an appropriate balance between creating a useful pool of capital and keeping meetings manageable." Governance is handled through a general assembly and a management committee. The general assembly of all members creates and approves the constitution, and the management committee elected by the general assembly manages according to the rules set in the constitution. This system is inherently transparent because of the small size of the groups and the use of procedures that to a large extent substitute written transaction record-keeping with observation and memorization. All transactions take place at meetings attended by all members of the association. Such mandatory attendance is only practical when membership is small.

- *Appropriate loan policies and processes*

A critical success factor for any organization providing loans is an appropriate process for the selection, appraisal, and repayment of loans. In professionally managed organizations, the owners and managers are completely separate from the borrowers, whereas in CBFOs, they are often one and the same. As a result, the processes for loan management are likely to be quite different.

NEIAP's loan program was designed for the poor members of the community who do not have ownership of irrigated land. Consequently, it provided loans to members based on a needs prioritization, with the poorest and most vulnerable receiving loans first. However, the poorest and most vulnerable might not have a strong capacity to repay the loan, especially if the economic activity financed by the loan is not successful. Livestock loans have been particularly problematic. In NEIAP-I, the project often provided loans in-kind rather than in cash, partly because of supply shortages in the post-conflict area in which the project was operating. Borrowers often complained about the quality of the animals provided; this most certainly had a negative impact on repayment performance.

AP-RPRP uses needs prioritization to allocate the project-provided RLF, but does so in a completely different way than NEIAP. SHGs develop plans for the investment needs of their members, and each SHG appraises the capacity of its members to undertake a selected activity and to repay the loan. After this process has been completed, the SHGs send their requests for project loan funds to the village organization (VO). The VO prioritizes based on the poverty level of the SHGs and sends the short list to the federation of VOs, which makes a similar calculation before awarding loans from the RLF.

Using repayment capacity to determine who gets loans is prudent for the CBFO and the member: the CBFO manages with an eye toward sustainability only if it provides loans to the creditworthy, and members who cannot repay loans are not burdened by over-indebtedness. Often, loans are not appropriate for the poorest members.¹⁷ To ensure the inclusion of the most vulnerable and destitute, the Gemidiriya program includes a one-time grant for the poorest. The village company allocates a small part of its Livelihood Development Fund for Grants to the Poorest, specifically for members like the disabled, widows without any income, single women with small children and no income, and other destitute people. The objective of the one-time grant is to provide necessary support for starting very small income-generating activities, so that grantees are able to earn income, join VSCOs as savers, and later apply for loans for their income-generating activities. This is a safeguard against the exclusion of the most vulnerable, who lack the financial capacity to participate in livelihood activities. The village community, through the village assembly, agrees on the rules for the selection of beneficiaries and the amount of each grant. The implementation experience so far has shown that these grants are enabling the poorest to begin economic activities without the risks associated with a loan. In many cases, grantees are able to join small groups from inception, so they do not need to be mainstreamed later.

It should be noted that Gemidiriya grants are managed completely separately from loans. This is an important success factor that has been learned from the experience of NGOs that provide subsidized social services as well as unsubsidized financial services. Separation is important so that people don't receive mixed messages about the necessity of repaying their loans. In many cases, NGOs have set up separate entities for their financial services, with a different name and location, to ensure that clients understand the difference.

- *Simplified systems, including financial management systems*

Because CBFOs operating in sparsely populated rural areas usually cannot obtain the services of people with experience managing financial services, they must rely on the skills and capacities of people living in the village. In most cases, such CBFOs need appropriately simplified systems. What is appropriate is highly dependent on the context. In parts of Africa, for example, where the literacy of villagers, particularly women, may be quite low, a simplified system would be very different from Sri Lanka, where literacy levels throughout the country are around 95 percent.

The VS&LA model contains several features that decrease its complexity, especially for non-literate people. Foremost among these features is the distribution of the savings and earnings at the end of a cycle, usually a year. (A similar feature is found in some SHGs as well, although the distribution period may be different and the amount partial.) Thus, financial intermediation is limited to the amounts of money that can be easily controlled by members using nontraditional systems, such as memory recall of member transactions. The author of this paper conducted a post-project impact evaluation in 1993 of a CBFO project in Bangladesh that offers interesting perspectives on this point. CBFOs visited during the evaluation included only those that had been independent of external support for at least three years. Forty-one percent of the groups supported by the project were still in existence, and discussions with members from a representative sample of these groups revealed that all successful groups had adapted the permanent model they had learned from the support organization to one that was less permanent. The principal innovations were exactly the ones found in VS&LA: distribution of savings and earnings once the funds involved became too large to manage, withdrawal and addition of members at this point, and then starting the cycle all over again.

Developing simplified financial management systems is not an easy task. It requires an understanding of the most essential elements needed to ensure security and transparency and, in many cases, a willingness to introduce nontraditional elements. The VS&LA model is unique in that, until recently, it had two tracks for record-keeping: a literate track and a nonliterate track. The literate track was a simplified written system, whereas the nonliterate track relied on members' memories of transactions. Allen and Staehle (2006) have now merged the two systems. The new system retains group-level memory recall and eliminates group-level ledgers, but it adds individual-level passbooks. This newly simplified system needs to be tested but early results from Uganda and Bangladesh appear promising.

In Sri Lanka, Gemidiriya hired the most prominent MFI in the country to develop a simplified accounting and loan-tracking system for the VSCOs. Given Sri Lanka's high literacy rate, the starting point was recognition that rural people would be able to manage a fairly robust written system. Nevertheless, this MFI had great difficulty accomplishing the task, being firmly wedded to the notion of an accounting system that met the requirements of a large professional MFI. After a year of effort, and repeated revisions, a system was finally devised that CBFOs were able to implement

successfully. However, Gemidiriya has found that it is important for each VSCO to have two bookkeepers, who are paid staff, because the skills gained by the bookkeepers in managing the financial records make them valuable recruitment targets for other local businesses. If one bookkeeper leaves, the second bookkeeper is able to provide continuity and training for the replacement.

In many cases, CBFOs are able to keep the records, but they are not able to convert the data generated into useful information for decision making. For example, Ferguson & Co. (2005) found that 94 percent of SHGs surveyed in Tamil Nadu kept basic records, but only 40 percent had a good understanding of their financial status. In many cases, the records were incomplete. Records in this type of situation may be worse than no records, because they can give members a sense that their savings are secure when this may not be the case.

In Indonesia's ADPs, the projects invested significant resources in establishing financial systems for the RLFs. Although CBFO leaders were given financial training, many who were interviewed by a study team as part of the 2003 Independent Evaluation Group (formerly the Operations Evaluation Department) credit line review were unable to interpret the financial reports produced for their organizations. Records and reports were sometimes produced by consultants and facilitators because of the limited capacity of the CBFOs to do this work. This meant that financial management knowledge was not transferred to CBFO managers who would need these skills in the future. These findings indicate that the financial management systems were too complex for the skill levels of the villagers and should have been simplified.

▪ *Appropriate and high-quality capacity building*

This has been a critical factor for the success or failure of every project reviewed in this paper. In many cases, project implementation staff and support organizations lacked adequate technical skills to carry out high-quality capacity building in organizational development. Bank task teams often assume that all service providers have the requisite technical skills. The fact that a service provider works in the field of rural development does not mean, however, that it has strong capabilities in savings and loan management. In many cases, failure of CBFOs can be traced to unqualified service providers that have not been properly screened and trained by the project before they are given technical assistance assignments.

In Indonesia, NGOs were hired to provide training and technical assistance in accounting, cash management, and credit operations. As indicated above, in many cases these service providers were unable to transfer skills to the CBFOs; instead, NGO facilitators did much of the work themselves. These practices decrease the chance that the CBFO will survive when the facilitator's contract ends or she or he decides to take up some other line of work.

The remedy for such a situation may be proper screening and capacity building of service providers, rather than simply removing them. In NEIAP-I, the poor performance of the service providers led the task team designing

NEIAP-II to replace NGO service providers with the government's Rural Development Department (RDD). The problem with this strategy was that the RDD also did not have the requisite skills, nor did project staff, most of whom had an engineering background, in line with the project's main emphasis on rehabilitating irrigation infrastructure.

The failure of technical training is often a failure to set up and manage systems of supervision; a failure to have a simple management information system that tracks important performance information; and a lack of understanding on the part of program managers that this matters.

- *Continuity of technical support*

One of the key criticisms of many support organizations is that they do not wean their groups off dependency. Critics say that they do this so that they can continue to access donor funding for their staff. The support organizations argue that they provide services that CBFOs, particularly small ones such as SHGs, cannot provide for themselves. Ferguson & Co. (2005) found that 75 percent of SHGs sampled in Tamil Nadu, India, depended on the NGOs that facilitated their formation for activities such as auditing and credit links. Most also depended on an animator to prepare the records and represent the SHG in federation meetings. SHGs rarely had elections or rotated office holders. The study concluded that overdependence on the animator "led to issues in the functioning and very survival of the SHG."

The VS&LA model is carefully structured to decrease the level of external support as the groups gain experience. External support takes place in three phases: (1) an intensive phase, when the animators work weekly alongside the groups, providing training and hand-holding; (2) a development phase, when animators visit less regularly and observe the group's interactions, but do not do the work themselves; and (3) the maturation phase, when the group works independently and animators visit the group only for a final evaluation and the first share-out of the accumulated assets. Allen (2005a) states that in Africa, 95 percent of groups that became autonomous following these three phases were continuing their operations two years after achieving independence. Such a model avoids overdependence on the animator and defines success principally in terms of the group being independent of further support and staying in business for the long term.

Murray and Rosenberg (2006) argue that technical support is needed on a continuing basis, rather than just during the inception stages. This continuing support "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" (Murray and Rosenberg 2006). Such arrangements are found in the CVECA, VSCO, and SHG models. Allen, on the other hand, argues that federations and domestic support structures need long-term support and investment to become effective, may find sustainability elusive, and may involve group members in roles that have little connection to pressing needs. These factors can reduce the potential of a program to optimize the number of CBFOs it can put in place,

for benefits that may be unclear, especially in remote rural areas where intermediating larger pools of capital may be unnecessary.

In Africa, CIDR's institutional strategy for CVECAs includes the development of second-tier organizations: technical service providers (services communes or SCs) and groups of caisses (unions) that negotiate bank refinancing. The CVECAs sign annual contracts with the SCs, who provide technical support and conflict resolution. A peer review of this model conducted in 2003 by CIDR's development partners¹⁸ found that the process of construction of the external services has been long and difficult but necessary. The contractual nature of the link between the CVECAs and the SCs does not always guarantee the authority of the SCs when problems are detected, although bank refinancing is conditional on the CVECA having this contractual relationship. In addition, the SCs are small and isolated, contributing to a lack of dynamism in some cases, and many need technical assistance themselves. As a result, CIDR has created national-level entities that can ensure the technical quality of the entire network. The national level's role includes developing a common charter of best practices to clarify and harmonize the practices and obligations of the SCs, ensuring that internal controls are in place and resolving crises. Despite the weaknesses of the SCs, the experience has been that they need to be strengthened rather than replaced, because a national-level entity alone cannot achieve economies of scale in a sparsely populated rural area and cannot provide adequate follow-up of individual CVECAs.

In India, the concept of a federated SHG structure is well established; the main arguments center on when and how these federations should be formed, the services they will perform for their member SHGs, and how they will cover their costs. Services such as external audit, SHG grading, and training are well accepted; there is more debate on whether federations should engage in financial intermediation themselves or serve only as a referral mechanism between SHGs and banks.

In Andhra Pradesh, India, where RPRP has been building several layers of SHG federations, continuity of technical support, as well as funding, is proving to be important, as the time needed to achieve sustainability is substantial. It varies according to level of federation, with each successively higher level requiring more time. RPRP estimates that it will take two to three years for a VO—which is the first level of federation of SHGs—to become viable, five to seven years for a subdistrict-level federation, and six to nine years for federation at the district level. The federations earn income from the World Bank-funded RLF that enable them to cover at least some of their costs.

World Bank projects in India and Sri Lanka are developing another mechanism to ensure continuity of technical support: the development of community professionals from among the membership of the groups (Munshi, Hayward, and Verardo 2006). This is a low-cost way to improve services, replicate the model in new villages, and provide employment to young rural people who are well educated but jobless. Federations can earn an income from managing the work of these community professionals, either through direct employment or consultancies.

In summary, CBFOs could manage more aspects of their operations better if the support organization designed and implemented appropriate systems and conducted member training in a way that reduced dependence over time. There are, however, genuine concerns about the ability of CBFOs to function effectively over the long term without external support in certain key areas, such as audit, performance monitoring, and bank linkage. These functions can be provided by support organizations, networks, or federations of CBFOs. Attention must be paid to the type, value added, and pricing of the services to be provided, so that a plan can be developed to cover the costs of developing these arrangements.

6. Links to the Formal Financial Sector

What does experience indicate about the potential of CBFOs to link to institutions in the formal financial sector, and what is the nature of this linkage?

CBFOs linked to banks or other professional financial services organizations such as MFIs can potentially access for their members a more diverse range of financial services than those they are able to provide themselves. Links range from using the bank solely as a secure place to hold member savings to accessing loan funds and insurance.

From a bank's or MFI's point of view, provision of financial services to strong and sustainable CBFOs is a way to reach a clientele who they could not otherwise serve cost-effectively. Costs can be reduced if the bank or MFI makes bulk loans to a CBFO that on-lends the funds to its members, rather than making individual loans to a large number of small borrowers. Costs are further reduced by the CBFO taking responsibility for loan appraisal and repayment of loans to members. In this way, CBFOs can become *basic building blocks of financial intermediation* in areas in which FFIs find it difficult to operate profitably, and these arrangements can contribute to longer-term sustainability.

For some CBFO programs, such as Gemidiriya in Sri Lanka, links to banks for safekeeping of excess savings is viewed as a critical first step that enables the CBFO and bank to get to know one another. Once the CBFO is able to demonstrate that it is a strong entity, the bank may be receptive to providing loans to members who have demonstrated creditworthiness through on-time repayment of their internal CBFO loans. The experience so far has been that banks, particularly state-owned rural development banks, are eager to develop a relationship and even offer to travel to the villages to open the accounts. One important reason for this receptivity is the mandate of state-owned rural development banks to provide services to rural people. They have an institutional incentive to reach out to the poor but often find it difficult to do so, unless the poor have organized themselves through CBFOs. This policy-induced behavior is key in India as well as in Sri Lanka.

In India, SHGs operate in an environment of significant government support and a dense network of bank branches in the country. Thus, the context in India is undoubtedly more favorable for linking CBFOs to banks than in most other countries. The government-owned NABARD has been instrumental in promoting credit links between SHGs and banks, and providing funds for banks to on-lend to SHGs. The Government of India supports lending to the rural poor by requiring banks to lend to priority sectors, including agriculture and microfinance. In fiscal year (FY) 2004–05, SHGs supported by RPRP in Andhra Pradesh sourced 45.5 percent of their credit needs from banks and other FFIs; lending from these institutions amounted to \$346 million,

accounting for more than 40 percent of total commercial bank credit provided to SHGs in the entire country. In FY 2005–06, commercial bank lending to SHGs in Andhra Pradesh increased to \$440 million. In Tamil Nadu, there are around 300,000 SHGs; in FY 2004–05, according to NABARD, 118,996 SHGs borrowed a total of \$171 million from banks and apex microfinance lenders. However, Ferguson & Co. (2005) found that among the SHGs studied in Tamil Nadu that had been in existence for at least three years 70 percent had received only one bank loan, or no bank loan, indicating that sustainable bank links had not yet been established.

In Mali, CIDR has developed a strong link between CVECAs and banks, particularly a government-owned agricultural development bank, the Banque Nationale de Développement Agricole (BNDA). According to Seibel (2005), outreach has significantly increased as a result of bank linkage, including donor-financed credit lines, to CVECAs in the Niger delta region of Mali. In 2003, loans from external sources accounted for 57 percent of loans within CVECAs in this region. Seibel notes that savings in these CVECAs were sluggish, showing slightly negative growth from 2001–03, which raises the question of whether donor-financed credit lines provided through banks may have stifled the development of savings.

In East Africa, FSAs operate a savings or current account at a bank and pay a monthly premium for their borrowers for life insurance. Jazayeri notes that “the absence of linkage for refinancing [credit] was a severely limiting factor and slowed growth significantly in many cases. This also led to credit rationing and demotivated many members” (2005). Recently, FSAs began to change their ownership structure from a company model to a cooperative model so that they could mobilize and intermediate savings, potentially alleviating some of these constraints.

Not all observers see the advantage of project interventions that link CBFOs to banks for either safekeeping of savings or access to loan funds. Allen (2005) cites the low return on bank savings compared with what groups can earn by lending out their savings themselves, and notes that many members of VS&LAs do not want linkage for this reason. High returns to savers, however, translate into high costs for borrowers; thus, if VS&LA members had access to bank loans, the borrowing interest rates would almost certainly be lower.

Allen and Staehle (2006) state unequivocally that “we believe that VS&LAs should not be proactively linked to external capital sources. Once they have completed their period of training and supervision, independent Associations will be able to make their own decisions about the need for additional capital from external sources and the ideal type of relationship.” (p. 1)

The findings of this paper confirm that savings-led models (that is, savings first, followed by modest amounts of external credit) perform better than credit-led models (that is, no emphasis on savings); nevertheless, VS&LAs linked to banks or MFIs in geographic areas where such links are feasible might enable members to source larger as well as cheaper loans than what is available from the group’s internally lent savings.

In summary, CBFOs serve poor people who can amass only very small pools of capital; thus, their resource constraints may limit the usefulness of their lending from internally generated savings. In addition, people may borrow from CBFOs at high interest rates for emergencies, but they may not be able to do so to finance a low-return economic activity. Thus, linking to a bank or MFI may enable members to borrow for investment in livelihood activities that cannot be financed through the CBFO's own funds. Such links may also provide a secure place to keep member savings that are not lent internally by the group, as well as provide access to other financial services such as insurance.

7. Accountability to Members

What precedent is there for building accountability into the community-based approach to delivering financial services or developing appropriate supervisory mechanisms?

Accountability to members can be achieved through appropriately designed *internal* regulations and controls, accompanied by well-tailored capacity building, or through *external* supervision. CBFOs for the most part are too small to be supervised cost-effectively by the institutions that supervise the formal financial sector. Therefore, agencies developing CBFOs have focused on internal processes, including development of federations and networks that can assume some functions related to accountability.

Internal Accountability

Accountability is always important, but it is most important for CBFOs that mobilize and intermediate savings. CBFOs funded exclusively by donor-provided RLFs may end up losing the donor funds if they are poorly managed; however, individual clients with no money of their own invested in the organization will not be worse off financially than they were before the donor intervention. Other negative effects of failed RLFs—such as an increase in social tension within communities and the continuation of a culture of dependency and loan default—should be a concern for donors and governments, because this provides disincentives for other financial intermediaries that may be interested in serving this market.

A system with accountability to its members must be a transparent system and have rules and processes understood by all members, and clear roles and responsibilities for office holders and staff. First and foremost are the processes for savings, so that they are protected against fraud and mismanagement. Although savings have numerous advantages, as illustrated throughout this paper, providing for their safety is not necessarily easy.

Accountability for the security of savings cannot be ensured through record-keeping systems alone. Passbooks provide a record of each member's individual savings, as do group ledgers, but these records often are not summarized or cross-checked against cash physically present in the group or in the bank. Depending on the size of the group and volume of savings, this can be a relatively sophisticated task. Thus, additional methods are often needed to protect members against fraud by office holders or managers. VS&LAs use strong boxes with three locks, one for each member of the management committee. The box cannot be opened without all three officers being present. At the end of every meeting, the cash physically present in the box is tallied for accuracy, and all members witness the process.

In Gemidiriya, to ensure accountability in the collection and banking of savings, savings are managed at the small group and cluster levels, rather than

at the VSCO level. At the VSCO level, with hundreds of members, record-keeping systems and internal controls that are adequate to protect savers against fraud or mismanagement would be difficult to achieve. Within a small group of 5 to 7 members, or a cluster of less than 40 members, this is a much easier task. Small group members control their savings and internal lending activities at regularly scheduled meetings, using transparent procedures. Small groups are represented at the cluster level by their officers, including the treasurers, who oversee the banking of savings that the groups do not retain for internal lending. Thus, there is a direct and transparent link between the bank account shared by the 40 members of the cluster and the individual saver.

The Indonesia ADPs offer lessons on loan accountability. In these projects, loan decisions were made by officers who did not have any direct interest in the success of the RLF. For example, in the Bengkulu ADP, an executive board, including a chairperson, secretary, and treasurer, ran the day-to-day savings and loan operations, but the board did not have loan approval authority. Loan decisions were made by a team of five people selected by the village community. Incentives were decided by a village consultative forum. Thus, the executive body had no accountability for loan quality, which undoubtedly contributed to the poor performance of the loan portfolio.

In NEIAP-I, the executive committee lacked accountability for the performance of the RLF because loan recipients were selected through a process of targeting by the project.

Accountability Through Federations and Networks

This is a work in progress in all the models studied, except the VS&LA model, which does not promote second-tier organizations unless spontaneous demand for federations emerges from the VS&LAs.

In India, the role of federations in ensuring accountability to members differs according to the model of federation used by the promoter agency and also according to the level of development of the federated structures. Nair (2005) reviewed the services provided by four federations considered to be “best cases” of the state of the practice. All four provide audit services and capacity building to their member SHGs and help to resolve conflicts. The federations play an important role in identifying external auditors, managing the process, and ensuring quality. All four federations need to improve their risk management, repayment monitoring, and financial management systems.

The CVECA model includes external audits at all levels: the village caisse, the technical service provider, and the unions that obtain bank finance for their member caisses. As of 2003, these audits were being financed by the BNDA, the state agricultural development bank lending money to the caisses through donor-funded credit lines.

The FSA model calls for the development of an apex organization to mobilize, establish, train, and supervise FSAs. It is essentially a franchise arrangement, with the apex determining FSA policies and procedures, hiring the premises for individual FSAs, and installing necessary infrastructure. Six types of

assistance were foreseen for the apex: (1) correcting mistakes; (2) training in record-keeping, lending policy, organization, and year-end closing of the books; (3) providing external oversight of the managers to ensure professionalism; (4) ensuring external cash control to prevent embezzlement; (5) following up loans; and (6) communicating to shareholders on business performance. Supervision was carried out by the apex twice a month. Jazayeri found that internal auditors were generally “unable to provide needed independence and competence to replace the external supervisors (from the apex) . . . The shareholders also did not trust internal auditors as being solely in charge of supervision” (2005).

8. Factors for Determining the Most Suitable Type of Intermediary

What factors or conditions might determine whether rural communities would be best served by CBFOs, other types of financial intermediaries such as banks, NGO-MFIs, financial cooperatives, or a combination of these?

The characteristics of demand for financial services, as well as the costs of providing those services, influence the types of financial services providers that can operate profitably in a given area.¹⁹ At one end of the spectrum, effective demand for financial services is low, with smallholder households mainly producing crops for consumption and few opportunities for off-farm economic activities. These characteristics produce a need for low-cost organizations that can cover the costs of intermediating small pools of capital for large numbers of customers with small transactions that satisfy their household cash-management needs. At the other end of the spectrum, better and more diverse economic opportunities lead to a higher demand for financial services, which can be serviced profitably by higher-cost organizations intermediating larger pools of capital for a smaller number of customers with larger transactions.

Grant and Coetzee (2005) have developed a “Carrying Capacity Curve,” which shows the cost characteristics of financial services that can be delivered in a particular market environment. The weaker the market, the lower the cost must be for financial services to be delivered profitably. Factors that increase the costs and risks of lending in rural areas include the following:

- Isolation and poor road and communications infrastructure;
- Low productive capacity that reduces the profitability of business investments;
- Small loan sizes and high fixed costs, which are often exacerbated because of the distance;
- Seasonality of cash flow that requires larger cash reserves and lump sum repayments that also increase the risk of bad debt;
- The risk of poor harvests that can affect the entire client base in a region; and
- More barter transactions that can make collection more difficult (Grant and Coetzee 2005, p.1.)

CBFOs, including village-based financial cooperatives, can be appropriate solutions in areas that display the characteristics of relatively low productive capacity, low monetization of the economy, and poor infrastructure. As economic conditions and infrastructure improve, possibilities emerge for outreach to the rural poor by banks and professionally operated MFIs. The paragraphs below outline some of the factors that should be considered

for each type of intermediary and the types of assistance that might be relevant.

Banks

The high operational costs relative to the size of transactions is an important reason that many banks do not downscale their services to include people living in sparsely populated rural areas. However, provision of financial services to low-income people requires fundamental changes in the way a bank does business. Changing this business culture—or adding a separate division—can be difficult, and many banks may not think that it is worth the effort. This is because the transactions will be such a small part of most banks' operations that the small profits that can be earned may not compensate for the significant cost and effort involved in tailoring products and delivery systems for low-income rural people. Thus, use of credit lines to encourage banks to get into this line of business often fails to produce sustainable access to financial services for the poor because the problem is often *incentives* rather than *money*. Consequently, a better approach is to identify banks that have a genuine interest in the development of financial services for the rural poor and provide capacity building assistance to help them become profitable in this business line. The specific solution will vary with the institution; some possibilities include creating a separate unit within the bank or establishing a separate affiliated company, and using technology to drive down costs. Examples of capacity building assistance include technical assistance for the development of appropriate products, service delivery mechanisms, and information systems, as well as grants to help defray some of the costs of putting these products, systems, and technologies in place. If a credit line is included, the bank should assume a portion of the credit risk to create strong incentives for good repayment performance. When selecting a bank, it should be kept in mind that banks with a large rural branch network have the greatest potential for expansion of services.

MFIs

These institutions already have a deep commitment to the provision of financial services to the poor. In many countries today, however, they serve a clientele that is either urban, peri-urban, or located in densely populated rural areas. Reaching people in sparsely populated rural areas is still a challenge, mainly because costs are difficult to cover. MFIs cover a broad spectrum, from those registered as NGOs to those that are licensed as banks or NBFIs. NGO-MFIs are not part of the formal financial sector, so they are unable to fund their growth through investment capital or intermediation of savings, although they often can borrow. This is one of the principal reasons for undertaking a corporate transformation to become an FFI; the other reason is the desire to provide clients with savings products that meet their needs. The provision of donor credit lines to nondeposit-taking institutions to fund growth is only a temporary solution, because the credit line will eventually have to be repaid and replaced by other sources of funding. Thus, a credit line to such organizations should be coupled with technical assistance that improves their ability to obtain funding from commercial sources. Technical assistance could

include systems that increase transparency and accountability and also include ratings by an independent rating agency. Grants that enable MFIs to acquire efficiency-enhancing technology may make the extension of services to villages a more attractive proposition for those MFIs that operate in countries with dispersed populations.

Cooperative Financial Institutions

This is a broad category that ranges from large cooperative banks to credit unions to small village-based cooperative entities, so generalizations are difficult. Historically, one of the biggest problems with cooperatives in developing countries has been governments and donors using these organizations to channel cheap credit to rural populations. Although some cooperatives and their federations have been irretrievably damaged by such actions, others could benefit from technical assistance to develop transparent systems, create internal controls, improve accountability, and train members, managers, and boards of directors. Building the stake that clients have in their organization, as savers, rather than building relationships based on loans, is a key success factor. Donor-funded credit lines to cooperatives have a long history of discouraging member savings and introducing unhealthy borrower domination, so they should be avoided unless there is a clear justification. Cuevas and Fischer (2006) have outlined the issues and options for developing appropriate regulatory and supervisory structures for cooperatives; this is an area in which high-quality technical assistance would be beneficial in many countries.

CBFOs

These organizations, including village-based financial cooperatives, can operate cost-effectively in geographic areas where banks and professionally managed MFIs that are able and willing to reach out to rural communities do not exist, cannot be attracted for the reasons outlined above, or are not interested in serving the poor. CBFOs, like cooperatives, should follow a savings-first approach. This takes time, so quick results in terms of loans disbursed should not be expected. As with cooperatives, external capitalization may damage these organizations, especially if external loan funds are injected before groups have successfully organized and operated using their own savings. The possibility of developing relationships with banks will depend on the presence of banks within reasonable distance of the CBFO and the interest of members in establishing such a relationship. This may start quite modestly with the opening of a bank account, but even that simple step can be empowering for people, especially women, who have never had access to a bank account. Technical assistance for CBFOs should focus on organizational development, especially developing a structure that ensures accountability to members and providing sustainable financial services. Federations and networks of CBFOs can help these small organizations obtain necessary services, such as audit facilities and training, but the costs of creating these structures need to be balanced against the likely economic returns.

9. Developing a Strategy to Provide Financial Services to the Rural Poor

Given the wide variety of organizations that could potentially be supported, what steps could a project design team follow to make a decision on the type(s) of organizations to support and the nature of that support?

Step 1: Demand Analysis

When developing a strategy, first consult with communities to identify the demand for financial services among the population in the areas covered by the project. What financial services are needed by various members of the community, from subsistence farmers to local business people? What are the gaps in coverage, in terms of types of customers served, types of services provided, and geographic reach? If there are no service providers other than informal groups and moneylenders, why not? What are the advantages and disadvantages of these informal providers? From this analysis, determine whether a financial services intervention would be beneficial.

Step 2: Supply Analysis

If a financial services intervention would be beneficial, identify the type(s) of organizations that potentially would be *willing* as well as *able* to develop financial services for the rural poor in the project area.

If sustainable, professionally managed financial services organizations exist in the project area, visit these organizations to determine the extent to which they are serving rural communities, including the poor within those communities, and to identify the constraints that are preventing them from achieving deeper outreach. Could a project intervention alleviate some of these constraints? What types of people would these institutions be willing and able to serve, and in what geographic locations? What would be the components of such assistance?

If professionally managed financial services organizations do not exist in the project area, or are not interested in serving the rural poor, are there professional intermediaries elsewhere that could be attracted to the project area to serve this clientele? What types of incentives or technical assistance would be needed?

What is the history in the project area of village-based entities such as savings and credit associations, cooperatives, and SHGs? Do they serve a clientele that is not attractive to formal intermediaries? Assess their ownership, governance, and management structures, financial products, customer base, and ability to cover costs. If they are not sustainable, assess the reasons for this situation and evaluate the extent to which technical assistance could enhance long-term sustainability. In some cases, ownership, governance, and management issues

may be so severe that it would be better to start up new CBFOs than to support organizations with longstanding insoluble problems.

Step 3: Strategy

Develop the strategy based on the information collected and analyzed in steps 1 and 2, as well as the characteristics of the project area. If the project area includes both secondary towns served by banks and MFIs, as well as sparsely populated rural areas, consider a two-pronged approach: supporting the efforts of professional financial institutions to reach out to rural customers that can be served profitably, as well as supporting the efforts of CBFOs to become sustainable organizations that could potentially be linked to more formal institutions.

If a project opts to develop CBFOs, what project design elements would help foster success?

- Develop a plan at the outset for the sustainability of the CBFOs. Members should not be viewed as “beneficiaries,” but rather as prospective owners of a financial institution. Those who decide to participate should have invested in the institution through member shares and savings.
- Empower members through a participatory process to develop their own set of rules within a defined institutional model and set of recognized best practices. All the models reviewed in this paper have some elements of member design, such as decisions on savings amounts, interest rates, and loan repayment terms. Most poor villagers who become members of these organizations, however, are not skilled in the management of savings and credit activities; thus, a robust model based on local precedent that establishes a framework within which these decisions can be made is essential.
- Have a pilot phase, during which a model suitable for the local context can be developed and fine-tuned with high levels of participation. Based on learning from the pilot, prepare an operations manual outlining the details of the model *before* large-scale implementation.
- Develop an effective monitoring and evaluation system. It is essential to set up and manage a system of support and supervision, starting with a baseline survey and development of a management information system that tracks key performance indicators on organizational sustainability.
- Ensure that appropriate technical assistance is available from qualified service providers. During the project design, conduct a needs assessment of local service providers to determine their capacity to provide effective support and ensure that the project implementation plan allows for training and supervision of these service providers so that they can properly support the development of CBFOs. Use international service providers as appropriate to help with the preparation of detailed training guides, training of local service providers, and development of simplified accounting and financial management systems. Build local capacity, such as developing a cadre of skilled community facilitators and sponsoring workshops in which community members can share their experiences.

- Above all, facilitate mobilization of savings and intermediation by members of these savings at project inception. Repayment of internal loans made from member savings is one measure of capacity and willingness to repay credit, as well as an indicator of financial discipline and trust. Only members with a consistent savings history as well as strong repayment of internal loans should be allowed to access credit from external sources.

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Annex 1. Typology of Microfinance Service Providers

Type	Features	Advantages	Disadvantages
1. Formal Financial Institutions (FFIs)			
1a. Private commercial bank	<ul style="list-style-type: none"> Usually has corporate shareholding structure Regulated and supervised 	<ul style="list-style-type: none"> Able to offer clients a wide variety of financial services, including savings, credit, insurance, and payments 	<ul style="list-style-type: none"> Usually not interested in serving low-income people Even if interested, difficult to reorient staff and systems for service provision to the poor
1b. State-owned bank	<ul style="list-style-type: none"> May be commercial bank, agricultural bank, or development bank Regulated and supervised 	<ul style="list-style-type: none"> May have large branch network, including secondary towns not served by private banks 	<ul style="list-style-type: none"> Often not profitable so must be heavily subsidized to stay in business Usually has greater outreach than commercial banks but often does not serve the poor
1c. Microfinance bank	<ul style="list-style-type: none"> Usually has corporate shareholding structure Principal clientele includes small and microenterprises Often has been transformed from NGO structure Regulated and supervised 	<ul style="list-style-type: none"> Has “double bottom-line”; that is, profitability and services to lower-income clients May be able to offer the full range of services to clients 	<ul style="list-style-type: none"> Clientele often not as diversified as a commercial bank, thus potentially more risky than a bank serving a wide range of customers
1d. Non-bank financial institution	<ul style="list-style-type: none"> Includes many different types of organizations; for example, finance companies, leasing companies, and MFIs that have transformed from NGO structure but 	<ul style="list-style-type: none"> Finance and leasing companies: focused on a small set of specialized products that may not be available from banks 	<ul style="list-style-type: none"> Usually not allowed to offer a full range of services, including savings Not diversified, thus potentially more risky than an entity serving a

Type	Features	Advantages	Disadvantages
	<ul style="list-style-type: none"> have not become full-fledged banks Often regulated and supervised 	<ul style="list-style-type: none"> MFIs: focused on the provision of services to people who cannot get bank access Minimum capital requirement lower than for banks 	<ul style="list-style-type: none"> wide range of customers with a diverse set of products and services
2. Cooperative Financial Institutions (CFIs)			
CFIs range from FFIs (cooperative banks) to semiformal village-based savings and credit organizations (SACCOs)	<ul style="list-style-type: none"> Member owned Usually one person, one vote May be closed bond (for example, all members have same employer or profession) or open bond (open to all) 	<ul style="list-style-type: none"> Member-owned structure can create a strong sense of ownership 	<ul style="list-style-type: none"> Governments have often used cooperatives for their own purposes, leading to low sense of ownership by members May be used by government to channel subsidized services to a clientele favored by government
2a. Multipurpose cooperative with financial services	<ul style="list-style-type: none"> Often set up with government support Main activity may be input supply or marketing Often supervised through government ministry or department that lacks financial supervision skills Sometimes federated 	<ul style="list-style-type: none"> Multiple services under one roof 	<ul style="list-style-type: none"> Tend to have input supply and marketing expertise rather than financial expertise Supervision often weak Systems may not be adequate for accountability and transparency of financial transactions
2b. Financial cooperative, including credit unions	<ul style="list-style-type: none"> Primary focus is on financial services Often supervised through government ministry or department that 	<ul style="list-style-type: none"> Savings-first orientation can create incentives for strong management and internal controls 	<ul style="list-style-type: none"> External finance (for example, credit lines) may lead to borrower domination Supervision often weak

Type	Features	Advantages	Disadvantages
	<ul style="list-style-type: none"> lacks supervision skills or accountability • Sometimes federated 	<ul style="list-style-type: none"> • Federated structure could provide access to services that primary cooperative cannot afford such as technical assistance and external audit 	<ul style="list-style-type: none"> • Board and managers may lack necessary skills, especially financial skills • Systems may not be adequate for accountability and transparency
3. Nongovernmental Organizations–Microfinance Institutions (NGO-MFIs)			
3a. Multipurpose NGO	<ul style="list-style-type: none"> • May be established by local or foreign organization • Usually registered as a nonprofit society, trust, or association • Diversified set of services such as health, education, agriculture 	<ul style="list-style-type: none"> • Multiple services under one roof • Focus on the poor 	<ul style="list-style-type: none"> • Difficult to operate microfinance using a business approach when other services have a social welfare approach
3b. Multipurpose NGO with microfinance services separated from other services	<ul style="list-style-type: none"> • May be established by local or foreign organization • Usually registered as a nonprofit society, trust, or association • May be a separate department or separate legal entity • Principal product is credit 	<ul style="list-style-type: none"> • Enables the NGO to retain both social and financial services but develop microfinance using a sustainable business model • Clients less likely to get mixed messages 	<ul style="list-style-type: none"> • Difficult to acquire expertise in many diverse subject areas • Usually not allowed to offer savings services other than “forced” savings
3c. Microfinance NGO	<ul style="list-style-type: none"> • May be established by local or foreign organization • Usually registered as a nonprofit society, trust, or association • Principal product is credit 	<ul style="list-style-type: none"> • Specialization makes it easier to operate a business aimed at long-term sustainability 	<ul style="list-style-type: none"> • Usually not allowed to offer savings services other than “forced” savings • Difficult to finance growth because it has little access to commercial refinance and no shareholder capital

Type	Features	Advantages	Disadvantages
3d. Microfinance NGO transformed into a bank or NBFII (see 1.)	<ul style="list-style-type: none"> • New entity is often a shareholding company • NGO is usually one of many shareholders in this new entity • Usually regulated and supervised 	<ul style="list-style-type: none"> • Able to increase capital and finance growth by seeking outside investors • Easier to obtain commercial refinance • Often allowed to offer more services, such as savings 	<ul style="list-style-type: none"> • Product mix still more limited than a commercial bank • NGO may be less able to ensure continued focus on poor, as NGO only owns a percent of company • Mixed ownership structure can complicate governance
4. Community-Based Financial Organizations (CBFOs)			
4a. Includes variety of village-based entities with names such as village bank and self-help groups; more complex form than traditional entities (see 5.)	<ul style="list-style-type: none"> • Member based • Village based • May not be registered • Small savings collected and intermediated 	<ul style="list-style-type: none"> • Varies according to the model—see examples below 	<ul style="list-style-type: none"> • Varies according to the model—see examples below
Example 1: CVECAs—West Africa	<ul style="list-style-type: none"> • Same features as above • Links with farmers associations that assist with credit appraisal • Village units clustered into unions that obtain refinance from development bank and manage overall finances • TA provided by independent group financed from margins on bank loans 	<ul style="list-style-type: none"> • Members obtain access to finance for agricultural (as well as other) activities • Network is able to cover costs, especially on-lending from savings (see disadvantages for 1a. and 1b.) • Agricultural bank that in the past failed to funnel funds profitably to rural farmers is now able to do so 	<ul style="list-style-type: none"> • Long-term donor commitment needed because of long time frame and high cost to set up the system • Members' desire to hold down interest rates has made it difficult to cover costs for on-lending from bank credit lines and has discouraged member savings
Example 2: Self-Help Groups (SHG)—India	<ul style="list-style-type: none"> • Similar to ASCA (see 5.), but intends to be permanent 	<ul style="list-style-type: none"> • More flexible than ASCA • Savings sometimes 	<ul style="list-style-type: none"> • Savings cannot be withdrawn unless a member leaves SHG

Type	Features	Advantages	Disadvantages
	<ul style="list-style-type: none"> External funds: SHGs borrow from banks and on-lend to members Sometimes federated 	leverage external funding (banks, MFIs), enabling larger loans	<ul style="list-style-type: none"> May be difficult to achieve bank links without support from the government
Example 3: VS&LA Model—Africa	<ul style="list-style-type: none"> “Upgraded” ASCA model with capacity building for group development, governance, internal rules, cash control Impermanent (payout at end of time period) yet permanent (groups restart after payout) No external funding 	<ul style="list-style-type: none"> Low cost More flexible than basic ASCA High returns to savings Can work without written records Credit available when needed without complex procedures Members can have access to their savings at any time 	<ul style="list-style-type: none"> Amounts saved generally small Loans generally not suitable for large investments; however, members can schedule annual distributions at a time when most members need large lump sums
5. Traditional Village-Based Providers			
5a. Rotating Savings and Credit Association (ROSCA)	<ul style="list-style-type: none"> Unregistered Time-bound Members deposit a fixed amount each period Each period, one member receives all funds Rotates until everyone has received funds No external funding 	<ul style="list-style-type: none"> Works well in remote rural communities Well-known in many countries Simple, easy-to-manage system No written records Enables people to obtain usefully large sums 	<ul style="list-style-type: none"> Amounts saved generally small Inflexible: cannot deposit or withdraw funds as needed, so generally not available for emergencies No lending Savings tied up until member’s turn to collect
5b. Accumulating Savings and Credit Association (ASCA)	<ul style="list-style-type: none"> Unregistered Time-bound Usually a fixed amount deposited each period Funds lent to members with interest No external funding 	<ul style="list-style-type: none"> Same advantages as for ROSCAs More flexibility than ROSCAs for people who want loans Members receive a return on their investment 	<ul style="list-style-type: none"> Amounts saved generally small Loans generally not suitable for large investments, because of small loan size and risk Savings tied up for the cycle

Type	Features	Advantages	Disadvantages
5c. Moneylender	<ul style="list-style-type: none"> • Fast, easy access • High interest rates • No external funding 	<ul style="list-style-type: none"> • Available everywhere • Simple and accessible • Loans usually available when people need them (may be liquidity constraints during certain seasons) 	<ul style="list-style-type: none"> • Interest rates generally too high for investment in business • Poor can end up in debt trap and lose critical livelihood assets, such as land • Usually do not offer other financial services such as savings and payments

Source: Author.

Note: ASCA = accumulating savings and credit association; CBFO = community-based financial organization; CFI = cooperative financial institution; CVECA = caisses villageoises d'épargne et de crédit autogérées; FFI = formal financial institution; MFI = microfinance institution; NBFi = non-bank financial institution; NGO = nongovernmental organization; ROSCA = rotating savings and credit association; SACCO = savings and credit organization; SHG = self-help group; TA = technical assistance; VS&LA = village savings and loan association.

Annex 2. Microfinance in Post-conflict Rural Areas of Sri Lanka

The North-East Irrigated Agriculture Project (NEIAP) illustrates the difficulty of developing sustainable financial services in inaccessible rural areas with extremely poor people and little institutional capacity. In addition, NEIAP operates in a postconflict area where much of the population was internally displaced and living in refugee camps for a decade or more. During this time, the irrigation infrastructure for the cultivation of the staple crop, rice, was severely damaged. In addition, people lost many other assets, including livestock. Today, the economy is characterized by semisubsistence agriculture, and other economic activities related to agriculture.

The Mid-Term Review of NEIAP-I revealed that the irrigation infrastructure improvements were benefiting only the most advantaged people in the community, because the poor have no irrigated land and they farm dry uplands, which are far less productive. Furthermore, the war produced a large number of widows, many of whom have no secure source of income. As a result of these findings, the project initiated a Livelihood Support Activities (LSA) component, which provides Women's Rural Development Societies (WRDSs) with revolving loan funds (RLF). The RLFs, which are owned by the WRDSs, make loans to vulnerable group members for the acquisition of productive economic assets. The LSA component has now been in operation for three years, and the project entered a second phase in 2005 (NEIAP-II).

The Implementation Completion Report from NEIAP-I showed that most WRDS members have benefited from LSA, although some members were unable to repay their loans because their animals died. Repayment rates varied between 20 percent and 100 percent, suggesting that many of the WRDSs will not become sustainable entities that can provide long-term financial services to their members. Some of this variability can be explained by enterprise failure, but not all. Other reasons for the variable and generally poor financial performance of LSA may include the following:

- The LSA component was started in a haphazard way, with no operational manuals or relevant experience among the project staff. Project staff are, for the most part, engineers who can rebuild irrigation but know little about microfinance.
- The nongovernmental organizations (NGOs) hired to implement the component were assumed by the project to have adequate capacity to implement LSA but no assessment was conducted to find out whether this was actually the case. Some of the NGOs had such a poor understanding of the component that they did not realize that the funds provided to WRDS members were loans rather than grants.

- Women were told to join the WRDSs if they wanted to receive funds for income generation. Emphasis was not placed on the development of a sustainable village-level financial intermediary that would provide services over the long term.
- Adequate capacity building in organizational development was not provided to the WRDSs, although efforts were made to introduce some financial record-keeping.
- The WRDSs did not promote savings, believing that participants were too poor to save. Lack of savings meant that participants had no safety net if their economic activities or households faced difficulties.

Under NEIAP-II, the project has undertaken some changes in LSA design, based on these findings. A savings component has been added, and the WRDSs—which can be as large as 100 members—have been reorganized so that they have a bottom-up governance structure. WRDS members now form themselves into small groups of five to seven members, and elect a chairwoman and treasurer. The chairwomen of the small groups form the Executive Committee (EC) of the WRDS and the treasurers form the Credit Committee (CC). This structure avoids the elite capture found in many groups with a large membership and gives voice to the poorest and most vulnerable, as each small group has representation on the EC and CC.

However, no decision has yet been taken on how to manage the RLF. One option is to strengthen the WRDSs' ability to manage the RLF. This would involve initiating a massive capacity building program that would include all the key implementation partners: the NGOs, the government's Rural Development Department, and project staff. A cadre of community professionals would be developed from among the membership of the WRDSs, who could then train new villages. The weakness of this approach is that NEIAP lacks an experienced microfinance professional on its team, and has had difficulty recruiting one, because of the postconflict and isolated environment.

Another option would be to select the best-performing NGOs that have participated in the project and initiate a capacity building program to turn them into professionally managed financial intermediaries. Under this scenario, the project loan funds for new villages would be given as a grant to the NGOs rather than as an RLF to the WRDSs. The expectation would be that the NGOs would be able to access additional funding from banks once they had demonstrated their profitability. The WRDS members would be able to access loans from the NGOs in areas that the NGOs could reach cost-effectively. Because the NGOs are expected to cover their costs and become sustainable, remote villages would not be able to receive LSA support.

The last option would be to attract a bank or MFI to the rural areas covered by the project. Discussions are currently ongoing to develop this option.

Annex 3. Self-Help Group Model

The World Bank supports microfinance in Andhra Pradesh and Tamil Nadu, India, using the Self-Help Group (SHG) model. The aim is to reduce poverty among the rural poor, including the poorest of the poor, poor women, and other vulnerable people, through assistance for productive livelihood activities. The projects seek to empower the poor and improve their livelihoods by developing and strengthening civil society and community-based organizations, and providing technical and financial resources to expand livelihood opportunities and mitigate the risks faced by the rural poor.

SHGs are savings and credit groups consisting of between 10 and 20 members on average that save within the group and lend these savings to members. The World Bank-supported projects strengthen SHGs and SHG federations, and strengthen links between SHGs and financial institutions. The projects increase poor people's access to savings, credit, and insurance services to allow them to better exploit opportunities to increase incomes and reduce vulnerabilities. They also deepen the poverty outreach of SHGs by supporting the formation of SHGs among the poor who are not currently members of SHGs or facilitating the inclusion of the poor in existing SHGs, whichever is the most feasible approach in a particular community. Capacities of new and existing SHGs are improved by building the governance and management skills of SHG members, officers, and staff, and introducing improved systems.

A key focal area is strengthening the links between SHGs and mainstream financial institutions, such as banks and insurance companies. This is done by strengthening the capacity of SHGs to interact with financial institutions (for example, by improving governance and management skills, upgrading accounting systems, and promoting the formation of SHG federations), and arranging periodic forums at multiple levels where representatives of SHGs can interact with representatives of financial institutions.

The projects provide grant funding for livelihood activities to supplement funds available from member savings and bank links. In Andhra Pradesh, revolving loan funds (RLF) are provided to federations of SHGs for on-lending to SHG members. In Tamil Nadu, a small seed fund is provided as a grant to new SHGs to help them leverage larger credits from banks than would otherwise be possible.

The projects facilitate the formation and strengthening of SHG federations that provide value-added services to SHGs. A federated SHG system reduces the costs and improves the quality of financial services delivery to the rural poor by aggregating demand, reducing information asymmetries, and providing services that individual SHGs find difficult to procure themselves.

In Andhra Pradesh, three tiers of SHG federations are developed:

- Village Organizations (VO), which are federations of SHGs within the village;
- Mandal Mahila Samakhayas (MMS), which are federations of VOs at the mandal, or subdistrict, level; and
- Zilla Samakhayas (ZS), which are the highest level of federation at the district level.

These federations help SHGs obtain necessary services and address other social, development, and livelihood needs of SHG members. This can include activities as diverse as helping members access services from the government such as health and education, to procuring technical assistance for livelihood activities, to addressing such longstanding social issues as alcoholism within communities and gender inequities. VOs strengthen SHGs in their village, arrange bank lines of credit to SHGs, and support village development. MMSs provide support to VOs, secure links with government departments, arrange auditing of the SHGs, and intermediate the RLFs. The ZSs arrange various types of insurance for SHG members, including asset, health, and life. The time needed to achieve sustainability varies according to the level of federation. The project estimates that it takes two to three years for a VO to become viable, five to seven years for an MMS, and six to nine years for a ZS. The MMSs, as the owners of the Rural Poverty Reduction Project (RPRP) loan funds, have an important source of revenue that helps to cover their costs.

In Tamil Nadu, where the state is implementing the Tamil Nadu Empowerment and Poverty Reduction Project, the design of the federated structure will be based on emerging best practices in India for second-tier organizations. To help transform SHGs into financially and institutionally sustainable organizations, start-up funds for their federation establishment costs will be provided on a decreasing basis over three years. Periodic independent rating of the SHG federations will be carried out.

Annex 4. Village Savings and Credit Organization Model

The World Bank-supported Community Development and Livelihood Improvement Project, also known as “Gemidiriya,” supports microfinance through Village Savings and Credit Organizations (VSCOs). Microfinance is part of a larger initiative that supports the efforts of rural communities to identify, prioritize, and fund their development needs through a “direct financing of communities” mechanism, using the community-driven development (CDD) approach.

Gemidiriya supports the development of community organizations that are initiated by, and managed by, the poor. A number of legal options are available in Sri Lanka for such organizations, including associations and people’s companies. Although some villages in the pilot area opted for the association legal form, a consensus has gradually emerged that a people’s company has more advantages, including the ability to engage in business activities. The company must include at least 50 people and is governed by a general body and board of directors. The company owns all the grant funds provided by the World Bank and allocates them through a participatory process.

Most of the grant funds are used for village infrastructure improvements, such as construction of community centers and improvement of secondary roads. However, one of the key priority areas for many communities is to improve the livelihoods of community members. Financing the acquisition of the productive assets needed to diversify and expand household income is a key constraint that communities in the project area have identified. Despite the prevalence of formal financial institutions (FFIs) in Sri Lanka, most of the poor do not have access to financing from these organizations. Consequently, communities have decided to use some of the funding provided by the World Bank to finance income generation.

As a result of these concerns, as well as interactions with communities participating in the pilot Village Self-Help Learning Initiative (VSHLI), Gemidiriya incorporated in its design a savings and loan program that is aimed at the provision of financial services to villagers on a sustainable basis. The Gemidiriya microfinance model aims to expand opportunities for income generation by people who currently do not have access to loans from FFIs and improve access to financial services through links with FFIs. The savings and loan model has been designed to ensure transparency, accountability, and good governance, so that these objectives can be met.

A VSCO is set up under the overall supervision and guidance of the company. The VSCO is not a separate legal entity; it is a department of the company that is responsible for managing the savings and loan operations. These operations

have been separated from other company operations because they are different in nature. Experience in other countries has demonstrated that multisector organizations should clearly distinguish profit-making loan operations from other socially oriented operations.

To enhance accountability, the VSCO uses a bottom-up governance and management system. The basic unit in a VSCO is the Savings Group (SG). An SG consists of five to seven members who save together weekly and lend to each other the amounts that they decide to collect as mandatory savings. This unit of five to seven members was selected by communities in the VSHLI pilot as the preferable model, because it enables groups to form within neighborhoods, making it easier for them to meet than would be possible with a larger group. A key feature of the SG is its complete independence in terms of determining the membership of the SG, the amount of compulsory savings that the group wants to collect, and managing that money. SGs usually make short-term loans to their members for emergency and consumption purposes, but they may choose to lend to people outside their group or for other purposes. The SG structure makes it possible for people of different economic levels to participate in savings activities; groups formed of the poorest of the poor may decide to save as little as \$0.10 per week.

Each SG elects a chairperson and a treasurer. These officers serve for two years and have two main duties: to manage the SG activities and to represent the SG within a cluster. Clusters are formed from a maximum of 6 SGs, and thus have a membership of around 40 people. The Cluster Committee (CC) is composed of the chairpersons and treasurers of each SG. The CC is responsible for opening and maintaining a bank account for the voluntary savings of SG members. Voluntary savings can be any amount of money that an SG member would like to save over and above the compulsory savings collected and rotated within the SG. The treasurers of the SGs who participate in the CC are responsible for ensuring that the voluntary savings of the members of the SGs have been deposited in the bank, maintaining the records of voluntary savings, and ensuring that the records agree with the bank balance. A decision was taken to bank savings at the CC level for two reasons: (1) the SG treasurers are able to verify the savings of their members at every meeting, ensuring that no mistakes or improper transactions are made, and (2) the cluster establishes a relationship with a bank that can be nurtured over time, leading to access to other financial services.

Each CC elects a chairperson and a treasurer to manage its affairs. In addition, the chairperson represents the cluster at the Village Savings and Credit Committee (VSCC) level. A VSCC is formed of the chairpersons of the clusters, as well as two representatives of the board of directors of the company. The VSCC manages the loan fund owned by the company. It does not have any role in managing the savings of members. By keeping savings management at the lower CC level, where records and bank balances can be inspected by SG officers on a regular basis, the threat of savings mismanagement is significantly reduced. Also, focusing VSCC operations on the management of the loan fund enables members who are not financial professionals to focus on

this task. The role of the representatives from the company board of directors is to ensure that this body makes decisions that will result in the loan fund maintaining its value over time.

This three-tier governance and management structure has the following advantages:

- Responsibility is allocated to the lowest level at which the relevant tasks can be managed with transparency;
- Officer holders are empowered at all levels to participate in the governance of the organization, which builds a cadre of people with leadership skills; and
- Even the poorest people in the community have a meaningful role in the management and governance of the savings and credit activities.

Annex 5. Village Savings and Loan Association Model

Over the past 15 years, CARE International has developed, extensively tested, and replicated a community finance model, the Village Savings and Loan Association (VS&LA). It provides the rural poor with a secure place to save, the opportunity to borrow in modest amounts, and convenient access to these services. It is transparent in its operations, inexpensive to set up, and can be managed by local people.

Originally developed in Niger in 1991, VS&LA is now operating in 18 African, 2 Asian, and 2 Latin American countries. CARE's experience with VS&LA has matured over the years. Beginning with a basic approach designed for impoverished and uneducated rural women, it has evolved to be a suitable option for literate and nonliterate people. The model includes a complete set of training materials and an Excel-based management information system. Numerous development agencies, including International Fund for Agricultural Development (IFAD), Oxfam, Plan International, World Vision, and Catholic Relief Services, have now adopted the model. Evaluations have shown it to be an effective solution to meet the needs of poor people who live in communities that cannot be reached by banks and MFIs.

VS&LA is a group savings and loan system in which, after training and practice, groups of between 10 and 30 people have the capacity to govern and manage their savings and loan activities. Rules are simple, transparent, and easy for every group member to understand. Group members either (1) contribute a fixed amount on a weekly basis, usually ranging from \$0.04 to \$0.25, or (2) at every meeting, buy between one and five shares that have a fixed purchase price. The amount of the contribution or the share value is set by the group. After several weeks, the group begins making loans to members, with the loan term and interest rate decided by the group. Most of the loans are used for income-generating activities. The groups use their own savings as the source of loan capital and *there is no external long-term dependency either for technical support or loan fund capitalization.*

A group usually begins with a field agent entering a village and holding preliminary meetings to discuss the VS&LA concept. Once new groups have been formed or old groups reinvigorated, the field agent attends the meetings regularly over a three-month period to teach the basic elements: establishment of a management committee, internal rule making, weekly contribution level, loan procedures, interest and penalties, problem solving, and conflict resolution. In nonliterate groups, each meeting begins with a recitation of the rules, with each group member responsible for remembering and reciting one rule. Group members have passbooks, but other written records are not necessary. The methodology for oral record-keeping has been fully developed and is covered

in the training modules. Two members count the cash each week, which is kept in a lockbox with three separate keys held by three different officers. All the locks must be opened at the same time to allow access. Experience has shown that this system vastly reduces the chances of fraud, an important consideration, given that many groups do not live in communities with banks that can safeguard savings.

After the training period, the village agent takes a more passive role, progressively allowing the participants to accept more responsibility for the management of their own affairs. At this point, the village agent's main role is to reinforce the methodology followed by the group so that meetings are conducted according to a well-established set of rules and procedures. Although these may be modified by the group when they become independent, the solid grounding in a methodology that works is the foundation on which the program's success is based.

At the end of the first year, the field agent visits the group to conduct an informal evaluation, discuss any problems, and train members on the annual distribution of assets. The savings and interest collected on loans are distributed to the members; some may be retained to start the next annual cycle of loans at a level that avoids waiting for the slow buildup of a useful sum. The main reasons for distributing the funds are to keep the size of the funds within the management capacity of the group members and to allow the members use of their accumulated funds at a time of year when a large sum of money is needed, such as for agricultural inputs or education expenses. The groups then restart their operations, after allowing members who do not want to continue to participate to leave and others to join.

A variety of studies of the VS&LA program have indicated that members who operate small economic activities tend to keep their businesses in operation throughout the year, have a bigger say in household decisions, enjoy better nutrition, invest more in their children's education, and enjoy a higher social status than nonmembers. There is a significant increase in small household and livestock assets, usually those controlled by women. The loans given out by the groups tend to be used almost exclusively for income-generating activities, such as purchasing inventory for a small store, feeding livestock, and petty trade. The shared-out funds from the savings groups tend to be used primarily for food, clothing, school fees, and life-cycle events.

Unlike most Accumulating Savings and Credit Associations (ASCAs) and many other community-based programs, members can withdraw their savings at any time throughout the cycle, if in need. The loss of accrued interest earnings is a disincentive to do so, especially late in the cycle, but access to savings has become an important principle of VS&LAs.

Although VS&LA programs are mainly implemented in rural areas, where CARE focuses its efforts, they also work well in urban slums, although group sizes tend to be smaller and meetings are held monthly.

Many of the strengths of the VS&LA model lie in what it is not. It is not complicated. It is not expensive. It is not donor driven. It is not dependent on rigid structures or outside investment. Most important, it does not depend on

long-term technical support, which distinguishes it from most other community-based microfinance methodologies. The model is easily replicable, inexpensive to establish, and requires minimal training. It can be implemented in a wide variety of institutional settings, from multisector rural development projects to stand-alone financial services projects. Successful implementation does not need highly trained experts, large budgets, and long time frames to reach sustainability. It is a model that has the potential to be massively scaled up, particularly in Africa, where vast numbers of poor people in countries such as Sudan, Democratic Republic of Congo, and Liberia do not have access to sustainable financial services. At of December 2006 more than 1 million people are members of VS&LAs, mainly in the poorer parts of Africa.

Endnotes

¹ See Kloppinger-Todd (2005), chapter 7, for a typology of countries based on different levels of demand for financial services.

² See also Kloppinger-Todd (2005), chapter 4, on success factors for informal village-based models and community-driven development.

³ See Kloppinger-Todd (2005), chapter 4, for a full discussion of the delivery channels and models for rural financial services.

⁴ The author has conducted site visits to the projects in Sri Lanka and India that are included in this paper.

⁵ The recently initiated Tamil Nadu Empowerment and Poverty Reduction Project (TNEPRP) builds on the experiences of Mahalir Thittam. Findings from Tamil Nadu in this paper come from an institutional assessment of self-help groups (SHGs) and SHG federations supported by Mahalir Thittam that was prepared during the preparation of this new project.

⁶ The term “village bank” does *not* mean that such entities are formal financial intermediaries; the term “bank” is used in the generic sense of an entity that provides financial services.

⁷ Other agencies such as Oxfam, Plan International, and the International Fund for Agricultural Development are also replicating the VS&LA model.

⁸ See annex 1 for the key features, advantages, and disadvantages of ASCAs, as well as another dominant traditional model, the Rotating Savings and Credit Association (ROSCA).

⁹ Networks are groups of organizations that have linked together for a particular purpose, such as experience sharing or technical support. Federations are organizations whose members include other organizations.

¹⁰ The *MicroBanking Bulletin* can be downloaded from www.mixmbb.org.

¹¹ PAR is defined as the outstanding principal balance of all loans past due more than a specified number of days, divided by the outstanding principal balance of all loans. The number of days used for this measurement varies, but in loan portfolios with mostly short-term loans of six months or less, 30-day PAR is often the standard indicator.

¹² This report can be downloaded from the Rural Finance Network Web site, available at <http://ruralfinancenetwork.org/pages.php?p=54&r=7&ID=5&PHPSESSID=4f5f3cd53865beeb5078d6d19f0304e5>.

¹³ The CIDR Web site is available at www.groupecidr.org.

¹⁴ Loans at risk are defined as the number of loans with payments that are late by a specified number of days, divided by the total number of outstanding loans. This indicator is easier to calculate than PAR; hence, it is useful for organizations without sophisticated loan-tracking systems.

¹⁵ The difference in both cases between hypothetical yield and actual yield does not reflect high administrative costs and loan losses; rather, it shows that not all savings are lent out all the time.

¹⁶ See annex 1 for the key features, advantages, and disadvantages of ROSCAs.

¹⁷ See Ritchie (2006) for a discussion of the use of grants for this purpose.

¹⁸ The peer review was conducted by the Comité d'Echanges, de Réflexion et d'Information sur les Systèmes d'Épargne-crédit (CERISE), a network of organizations supporting MFIs of which CIDR is a member.

¹⁹ See Kloeppinger-Todd (2005), chapter 7.