CGAP

THE WORLD BANK

SCALING UP POVERTY REDUCTION

Case Studies in Microfinance

Consultative Group to Assist the Poor
World Bank Financial Sector Network

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Contents

FOREWORD

MARILOU UY AND CARLOS CUEVAS
WORLD BANK FINANCIAL SECTOR NETWORK

The international development community has rallied around the Millennium Development Goals in an unprecedented way. Microfinance supports the MDGs for the simple but powerful reason that many of the MDGs—especially those for improved nutrition, health care, and education—are the priorities of poor people themselves all over the world. Study after study confirms that poor families with access to financial services eat better, keep their children in school longer, receive better medical care, and live in safer housing than those who do not have such access, other factors being equal. Access to financial services hands poor people the tools to solve their own problems and to chart their own paths out of poverty.

The problem, then, is not establishing whether microfinance works. The problem is how to increase its scale exponentially. Today microfinance is only reaching about four percent of the estimated demand for financial services by poor households. Annual rates of increase are also stuck in single digits. We cannot reach the hundreds of millions of poor people who urgently need access to finance by replicating nonprofit microfinance institutions one branch at a time. Rather, to achieve massive scale and fulfill its huge potential, microfinance **must** become fully integrated into developing countries' mainstream financial systems, rather than being isolated in a niche of the development community. After all, poor people are the overwhelming majority in those countries. It is illogical, as well as unjust, that any country's formal financial system would serve a handful of elites while excluding most of its citizens.

The cases prepared for the "Scaling Up Solutions to Poverty Reduction" conference in Shanghai (May 2004) represent some of the most powerful examples of scaling up in the history of the modern microfinance industry. The cases provide notable diversity in terms of both geography and institutional type. They range from Central Asia, South Asia, Latin America, and Africa, and include traditional non-governmental organizations, commercial banks, agricultural banks, and building societies. The commonalities, however, are perhaps even more striking than the differences. All the institutions made a conscious management decision to pursue scale while serving poor clienteles. All demonstrated creativity and a willingness to take calculated risk. And all operate in accordance with commercial business principles, regardless of governance structure or legal status.

ELIZABETH LITTLEFIELD, DIRECTOR AND CEO, CGAP

Last year in CGAP's annual report, I wrote about CGAP's vision of the day when "[t]he term 'microfinance' will no longer be necessary as we remove the walls—real and imaginary —that separate the microfinance community from the much broader world of financial systems, markets, and development." Today we already hear the term microfinance much less often. All over the world, it is being replaced by the phrase "financial systems for the poor."

The difference is more than semantic. "Microfinance" suggests that there is something inherently different about poor people's financial needs, something that is— and should be—segregated from the financial mainstream. "Financial systems for the poor" describes a self-evident truth: that it is neither just nor economically logical that any country's financial system should exclude the majority of its population. In partnership with likeminded financial institutions, donors, service providers, policymakers, and opinion-shapers, CGAP is working to help build democratic, inclusive financial systems all over the entire developing world that serve the majority—the poor.

We are finally beginning to see promising examples of a financial democratization that was hard to imagine even a few years ago. In Kazakhstan, commercial and state savings banks are competing to deliver microfinance products to the poor. In Mongolia, the state agricultural bank restructured, privatized, and moved into microfinance. It now serves half of all the rural households in Mongolia through 350 branches. And it is making money. India's second-largest bank is building a network of thousands of village internet kiosks with low-cost card readers, point of sale devices and automatic teller machines to deliver banking and insurance services to poor families throughout rural India. Similar experiments are underway in Latin America and Central Asia.

Working partnerships are springing up between institutions who would never even have entered dialogues a few years before. In places as different as Haiti, Georgia, and Mexico, partnerships between banks and microfinance institutions enable the microfinance providers to use banks' branch networks to transfer funds and collect payments.

Microfinance institutions are working with insurance carriers to develop and deliver new lines of pro-poor insurance products. Information technology providers and software developers are waking up to the huge market for automation in the microfinance sector—and microfinance practitioners are waking up to the huge efficiency gains they can achieve through technology. Credit bureaux are being established to track—and potentially reward—the financial behaviors of clients who a few years ago were considered beneath notice.

Mainstream socially responsible investors are stepping up their investments in microfinance. Ten new funds will be launched in 2004, and the total amount invested is expected to more than double. Governments, too, are keeping pace with this rapid evolution. More than

50 countries are developing or implementing new microfinance regulatory frameworks to ensure that their poor citizens' financial assets are protected.

CGAP works to increase the capacity of existing microfinance institutions, to encourage new entrants into the sector, and to broker partnerships that graft the collective wisdom of the microfinance industry—how to make uncollateralized loans and get paid back—onto institutional models that can reach the poor on a much more massive scale.

CGAP's flexible approach—strengthening what needs to be strengthened, building what needs to be built—is informed by a sense of urgency. More than a billion people still lack access to basic financial services. Our approach is systemic. In *developing* countries, we believe the entire financial system should serve the poor majority. Our aim is to strengthen a wide range of complementary and competing providers that might serve the poor. In *developed* countries we aim to help improve aid effectiveness, addressing systemic problems that hinder donor effectiveness, especially in supporting the financial and private sectors.

And at a global level, we aim to help build the architecture that will underpin large scale, robust and healthy financial systems for the poor—a supportive legal and policy environment and ready availability of high quality financial information.

The next phase of microfinance will succeed as the best of different worlds are integrated: the mission focus from the development origins of microfinance with the efficiencies of the banking sector and the force multiplier of commercial capital. It is deeply exciting to see so much of CGAP's vision—the dismantling of the walls—starting to be realized. But as with any wall that finally comes down, it's not so much the final blow that does the job as the accumu-lated impact of all the blows that came before it.

Many groups have shared and continue to share CGAP's vision of financial democrati-zation: microfinance practitioners, donors, service providers, governments, and not least, the poor themselves. It is CGAP's honor to serve them all.

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Chapter 1

Struggling Through the "Growth versus Best Practice" Tradeoff: The CrediAmigo Program of the Banco do Nordeste, Brazil

ROBERT PECK CHRISTEN, WITH STEVEN SCHONBERGER AND RICHARD ROSENBERG

Executive Summary

The CrediAmigo microfinance program mounted by Brazil's Banco do Nordeste (BN) shows how an international financial institution like the World Bank can be a useful catalyst in the development of microfinance retail capacity. The World Bank's patient, phased support to BN as it designed, launched, and nurtured CrediAmigo goes against the common perception that multilateral banks always focus on large near-term disbursements to the detriment of longer-term capacity building.

In five years, the CrediAmigo program has provided microcredit to over 300,000 of Brazil's working poor and is financially sustainable. Most of these families live on less than two dollars per day, and work in the cities and towns of the northeast region. Even more importantly, CrediAmigo has demonstrated to the development community throughout Brazil that microcredit can be delivered sustainably, on a large scale, and with great impact on low income families. Prior to the success of CrediAmigo, no microcredit program in Brazil over the past 30 years reached more than a few thousand clients. Today, although there are a large number of well-funded public and private initiatives throughout Brazil, CrediAmigo stands alone in the scale and effectiveness of its achievement.

Progress so far suggests some lessons for multilateral donors in microfinance:

- Freedom from dogmatic presuppositions (for instance, "large state-owned banks can never do good microfinance") allows an opportunistic approach that is more likely to yield results.
- After proper pilot work, a bank with a large pre-existing branch network can roll out microfinance much more rapidly than a new microfinance-only institution. In the case of many public development financial institutions (DFIs), they also have the mandate to do so.

- Outcomes may be better when large amounts of lending follow, rather than precede, the development of proven retail capacity.
- Donors must help DFIs stay focused on best practice finance principles, especially when the short term interests of both donor and DFI lie in disbursing large amounts of credit with little regard for loan recovery.
- Donors MUST counter the ultimate tendency of DFIs to grow too quickly and with too little financial discipline.
- Donors can be effective with a limited technical role—setting benchmarks consistent with international best practice, and putting the client institution in contact with top microfinance practitioners.
- To accomplish this, generalist donor staff working on microfinance activities should get a basic grounding in the elements of sustainable microfinance, preferably through training or, at a minimum, close work with specialists.

Throughout the five years that Banco do Nordeste developed its CrediAmigo program, it has struggled to balance its desire to expand the program quickly and reach a maximum number of clients with the constrictions imposed by maintaining high levels of loan repayment and full cost recovery. This tension has been characterized by repeated episodes of rapid expansion, deterioration in the quality of its loan portfolio, and low staff productivity, followed by periods of consolidation and reversal of these negative operational and financial trends. Overall, until now, CrediAmigo has largely stayed the course and, as a result, is considered to be a world-class microenterprise credit program. This standing, however, is threatened by the Brazilian government's recent interest rate policy, that could deprive CrediAmigo of important financial resources necessary to re-invest in its future growth and stay in keeping with its mission.

Implementation Process

Brazil has long been considered one of the world's great untapped microfinance markets. Because of the country's large population, high rate of poverty, and open economy, it has the largest concentration of microenterprises in Latin America—estimated at more than 9 million, with at least 2 million in the Northeast Region alone.[1] Despite this large potential market and scant outreach by the banking sector, in 1998 no Brazilian microfinance program had more than 5,000 clients. And only two programs, both nongovernmental organizations (NGOs), could even be considered to be on a path to full sustainability.

In 1996 the World Bank decided to explore the development of microfinance as part of its poverty reduction efforts in Brazil's Northeast Region, the poorest in the country. Since the Inter-American Development Bank was planning a US $150-million microfinance apex to finance the few NGO MFIs operating in Brazil, the World Bank task team decided to pursue a complementary approach focused on developing the commercial bank model.

The task team spoke with private and public banks operating in the Northeast Region to gauge their interest and capacity. Private banks viewed microfinance as charity work rather than as a commercial opportunity. Public banks were more interested, given their social mission, but seemed to provide a weak basis for a financially sustainable program. In November 1996, a World Bank team met with senior management at BN's headquarters in Fortaleza to discuss microfinance experience and was impressed with the commitment shown for obtaining and supporting best-practice microfinance operating principles.

At an early stage in the discussions, the World Bank sought technical help from experts on the staff of CGAP. In February 1997, a joint World Bank-CGAP mission visited BN to evaluate it as a potential microfinance platform. The team was well aware that microcredit programs in state banks seldom succeed. But they found that BN was unusually business oriented and seemed relatively free from external political interference. The bank was reorganizing to improve its efficiency through better staff incentives, information systems, client focus, and flexibility—all key elements for successful microfinance. The mission concluded that these factors, along with the strong commitment of BN senior management and BN's already significant outreach in the Northeast Region, outweighed the risk of political interference inherent in a public bank. Based on the mission's assessment, the World Bank agreed to provide minor funding for a pilot microfinance program at BN through an existing loan for technical assistance and training.

The World Bank Trains Its Staff

It is clear in retrospect that the effectiveness of the World Bank's engagement with BN depended on the development of World Bank staff skills and the close involvement of successful microfinance practitioners. Once the Bank decided to support the CrediAmigo pilot, both the task manager and his division chief attended the three-week Microfinance Training Program in Boulder, Colorado (USA). These officers say that the training helped them focus the dialogue with BN on key elements of success, and to bring to the table specific technical advice from successful, experienced practitioners they contacted through their training in Boulder. A number of these practitioners were later recruited by the World Bank task team and BN.

World Bank Technical Involvement is Limited

During the pilot stage, World Bank and CGAP assistance was limited to helping BN find high-quality international expertise and learn from similar experiences in other countries. BN used World Bank funding to send senior managers to study successful MFIs in Bolivia, Chile, Colombia, and Indonesia. Based on these visits, BN was able to consider different technical approaches and develop a short list of consultants. BN chose ACCIÓN International, a group with strong experience in solidarity group lending.

With ACCIÓN's assistance, BN surveyed

informal enterprises and developed pilot loan products. It also prepared training materials and selection criteria for its microfinance loan officers. The bank chose to outsource the microfinance loan-officer function because of the inflexible qualifications and salary levels of its unionized workforce. Throughout this process the World Bank's role was limited to administrative assistance in managing the funds. CGAP's role was limited to helping identify the requirements for program development, organizing study tours, and finding potential technical assistance providers. Ultimately, however, through its periodic presence, CGAP provided a constant reminder to all of the best practice operating principles that would ultimately be the key to Credi-Aamigo's success.

In December 1997, BN initiated Credi-Amigo in five of its branches. The pilot incorporated lessons from the study tours, a market study, and technical assistance. Testing was restricted to a single loan product: 90-day loans to individual clients organized in "solidarity groups" of about five borrowers who cross-guaranteed each others' loans. Payments fell due every 15 days. The interest rates were considerably higher than BN's rates to its conventional borrowers (as high as 6% per month), but far below the rates of informal money-lenders. Prompt repayment was encouraged by offering interest rebates and new loans within 24 hours for groups that consistently repaid on time.

BN's cabinet chief was named general coordinator of the program, with the freedom to recruit top staff from throughout the bank. In view of the high quality of the program's management and design, the World Bank decided to arrange a US $900,000 Japanese grant to support loan officer training, information system development, and further technical assistance, all in preparation for a possible World Bank loan in support of CrediAmigo's later expansion.

Overconfidence Leads to Disaster . . .

The pilot seemed to go well for the first four months. BN's management was excited by the program's potential and the positive response in high quarters of the government. In their understandable enthusiasm, BN's senior managers decided to speed up implementation, expanding CrediAmigo from five branches to 50. They announced publicly that CrediAmigo would have 100,000 clients by the end of its first year of operation. The World Bank, CGAP, and the program's own technical assistance advisors all warned that four months was far too short to test the repayment performance of the new loan product, because defaults typically rose in later loan cycles. But BN management felt committed to the expansion in order to gain a presence in all regions covered by its development mandate. The World Bank then indicated that further support, including the Japanese grant, would be contingent on maintaining good portfolio quality, with 30-day portfolio at risk no more than 5 percent.[2]

As predicted, the expansion resulted in rapid deterioration of portfolio quality and heavy loan losses. Poorly selected and trained loan officers were given quantity-based performance targets, so they rushed to lend without sufficient focus on repayment capacity and follow-up. The rapidly mounting loan losses took BN's managers by surprise.[3] After two months of expansion, the President of BN told all regional managers to slow or stop new lending and concentrate almost exclusively on loan recovery. ACCIÓN worked with BN on loan recovery strategies, and on retraining loan officers and branch managers. Despite these efforts, the episode eventually cost BN more than US $2 million in loan losses. It took another six months before portfolio at risk fell back within the agreed limits.

. . . But Strong BN Commitment Gets CrediAmigo Back on Track

It would have been easy for the World Bank to walk away at this point——there were no deep or longstanding commitments. BN had done precisely what naysayers had predicted at the outset of the project. Few in the informed microfinance community thought the relationship was worth continuing. But the task manager and key members of the CGAP team sensed that BN management was still committed to making CrediAmigo sustainable, so they persevered with what from the World Bank's perspective had become a far riskier proposition.

Indeed, it is not unusual for large banks to underestimate the complexity of consolidating a microfinance program. BN's experience shows that the resulting problems do not have to be fatal, if the focus returns to sustainability. The problems and costs of their premature expansion convinced BN managers at all levels that microfinance portfolio quality was challenging and volatile, and that they needed to manage it much more carefully. Since this initial misstep, CrediAmigo has focused consistently on growth with quality. This commitment has been evident in a variety of ways:

- Growth in the number of branches and loan officers has been carefully controlled.[4]

- As a state-owned bank, BN has maintained a commitment to profitability in the design and management of CrediAmigo. The program was initiated with a 5-percent flat monthly rate, translating to a 6.9-percent effective monthly rate after adjusting for inflation.5 Since then, the interest rate has declined in proportion to the cost of funds in Brazil, but it has remained at levels consistent with achieving profitability.[6]

- Sustainability required a high-productivity model with low costs and an institutional culture that would be difficult in a large public development bank. BN created a "bank within a bank," first by outsourcing loan officers, and then by replacing BN staff branch managers with coordinators drawn from the loan officer pool.

Finally, the World Bank Makes the Big Loan

Because of the World Bank's historical knowledge of the CrediAmigo program, and the high quality of CrediAmigo's information systems, the Bank needed only a single preparation/appraisal mission to prepare a US $50 million loan to support the program’s expansion over the next five years.[7] The mission agreed with BN management on performance targets that kept the loan and its disbursement tied to portfolio quality, efficiency, and sustainability. The World Bank’s involvement with BN had looked very risky two years earlier; but by the time the large loan was prepared, the risk had lessened dramatically because BN now had a proven microfinance business and had demonstrated the management commitment needed to keep that business sound as it expanded. The World Bank’s Board of Directors approved the loan in May 2000.

Subsequently, BN expanded its outreach by increasing the number of outlets. CreditAmigo operates in 165 of 175 branch offices and through a number of additional points of service in poor neighborhoods. It has negotiated additional funding with foreign agencies. And BN leads discussions on microfinance in many forums throughout Brazil. Its most enduring problem remains the high number of clients that take out one or two loans and drop out. This situation is common across microfinance in many countries and in many institutions, and is a core issue that needs to be addressed by the industry as a whole.

In recent months, CrediAamigo has faced its most difficult challenge to date. The newly installed government of Brazil has announced a significant number of initiatives designed to broaden the access of the working class to financial services. Some of these, such as sponsoring the development of point-of-service technology throughout extensive retail and commercial infrastructure have the potential to positively transform the entire financial landscape of the country.

Others, such as the stated, well-meant desire of the government to reduce what it views as excessively high prevailing spreads in the pre-existing community of microcredit operators threaten the very survival of most of the leading NGO microlenders. The government has decided to impose a 2 percent cap on the difference between funds it makes available to MFIs, and the effective rate they can charge per month to end clients with small loans. These MFIs exhibit a significant dependence on government funds in their liability structure and currently require a far greater spread to cover their operating costs.

While CrediAmigo does not utilize funds from the government, and therefore is technically exempt from this cap, BN is a public bank whose president was named by the current government of Brazil. The bank and its microcredit program CrediAmigo have a very high profile in the microfinance community, but it can not be seen to diverge from the government position on interest rate spreads. If BN accepts those same spread caps for its CrediAamigo program, the program may not be able to cover its fully allocated costs out of its operating revenue without an interest subsidy on its sources of funds, much less invest the required resources to take on enduring problems, such as high drop-out rates, or increase market penetration through technological innovation and product re-engineering. BN had already been steadily reducing its initial interest rates to microborrowers before the government decree, though not to the levels that would be consistent with the new cap.

In other countries with relatively more robust microcredit sectors, interest rates have steadily fallen as a result of competition, a situation that has not yet arrived in Brazil due to extremely low levels of market penetration. Longstanding experience in development financial institutions (DFIs) around the world suggests that, in spite of their outreach mission, unprofitable programs end up starved of resources and, ultimately, fail to serve the poor with high quality financial products. In today's modern financial sectors, unprofitable DFIs are ready targets for closure.

Impact Analysis

Within only three years of operation, CrediAmigo was already among the top microfinance institutions (MFIs) in Latin America, in terms of geographical penetration, numbers of clients, and depth of outreach. As of November 30, 2000, the program had over 55,000 active clients in 358 municipalities throughout the Northeast Region of Brazil. Three years later, CrediAmigo has served close to 300,000 clients with loans through its 175 branch offices, and ranks first on the continent in number of active clients.

But most notably, BN has one of the lowest average loan balances of any program in the world, in relation to GNP per capita. The average outstanding loan balance was R$541.47 (US $270), less than 6 percent of Brazil's per-capita GNP.8 By and large, the clients of CrediAamigo have incomes that permit levels of consumption below two dollars a day, while many families are living on less than one dollar per day. Firm statistics are not yet available, although the bank is now commissioning an impact study to be carried out with the support from the World Bank to understand more fully the nature of its clients and their household finances.

CrediAmigo's portfolio quality and staff productivity are at international best-practice levels. Only 3.5 percent of its loans are late, using a 90-day portfolio-at-risk measure. Its annualized loan loss rate has been steadily increasing from its historical level of 2.5 percent, after fully provisioning all loans with any payment 90 days or more overdue, though it is still just within acceptable parameters. Loan officers with nine months or more of experience are each handling more than 300 clients, on average.

About 85 percent of CrediAmigo's 108 branches became operationally sustainable within three years. The program as a whole reached full financial sustainability in mid-2001.[9] By 2002 it had recuperated all of its accumulated operating losses. CrediAmigo's returns on assets peaked at 4.7 percent for 2002, and have steadily fallen ever sincebecause it has lowered its interest rates, while still operating in positive territory. Thus, CrediAmigo is demonstrating that a "down-market" focus can be consistent with sustainability in commercial banking in Brazil.

To maintain program sustainability in the face of the mandate to decrease interest rates, CrediAamigo has undertaken to reduce costs and increase productivity——twin tasks that were desirable under any circumstances as the program has reached greater scale. It reduced operating expenses from 30 percent of total loans to 20 percent over the course of the year 2003. This brings the program within international best-practice efficiency ratios. It did so by increasing loan officer productivity, adjusting the staff incentives package, and controlling expenses in middle management.

The latest round of interest rate decreases (to 2 percent a month) would make the program fall below sustainable levels if commercial costs of funds were applied to the liability structure of CrediAamigo, even if some fees were allowed. At 2 percent a month maximum interest and a 4 percent up-front fee, the effective interest rate for Crediamigo is 38 percent. With an operating cost of 20 percent, loan losses of 5 percent, and a commercial cost of funds at around 16 percent (1990 CD rate), for a total cost of 41 percent, the program requires an interest-rate subsidy to break even. While the immediate level of interest-rate subsidy is not great, it does raise a concern about whether cost cutting measures will unduly impair the operations of the program over the long term.

Driving Factors

Several factors led to the success of Credi-Amigo. The single most important was the commitment of the President of BN to acquiring and implementing best practice microcredit principles, regardless of the fact that this was a significant departure from normal operating practices in the bank.

- Above-market interest rates are offered to clients, in order to cover the relatively high cost of administering very small loans sustainably.
- Compensation of microcredit staff is based on the results they achieve (personal accountability).
- Management information systems give microcredit staff immediate access to accurate transaction history and current repayment status for all clients.
- Credit decisions are decentralized and backed up by ex-post quality controls.
- The bank is committed to very high levels of loan recovery.
- Microcredit lending operations are specifically separated from BN's government-directed lending programs.
- The World Bank considered the fact that BN President Queiroz was intending to stay an additional 5 years critical to the successful launch of the program.

Commitment and Political Economy for Change

In September 1996, BN's president Costa de Queiroz told the World Bank that he was interested in developing a world-class microfinance program. Emerging from a major reform, BN had R$6 billion (US $3 billion) in assets and 176 branches throughout the Northeast Region. To satisfy BN's regional development mandate, Queiroz was looking for ways of reaching the poor that were more effective than the bank's directed lines of credit had been. He was particularly interested in the informal sector.

Dr. Costa de Queiroz was appointed president of BN in March 1995, following a very successful career as a private businessman in the state of Ceara. Dr. Queiroz immediately began a major reform of the bank, with the objective of making it more modern, efficient, and responsive to the development needs of the Northeast Region. Loan assets grew from R$2.6 billion to more than R$6.0 billion; the number of loans grew from 68,000 to more than 404,000.

- BN's market share increased from 35 percent of all loans granted in the Northeast Region to 78 percent.
- Administrative expenses as a percentage of assets were less than half their 1995 level (3.4 percent in 2000 versus 7.9 percent in 1995).
- Staff were reduced from 5,468 to fewer than 4,000.
- Lag time between loan request and approval was reduced from an average of 217 days to a mandated limit of 21 to 60 days depending on loan size.
- BN reorganized its structure and processes to make the client its central focus and reduce barriers to staff interaction across functional areas.
- BN invested heavily in staff training and information systems.

It was into this environment of far-reaching institutional reform that CrediAmigo was placed.

Institutional Innovation

The program was ultimately put under the direct management of Queiroz's chief of staff, which ensured that it would receive the unconditional and full support of the President as it was deployed throughout the branch network and operating divisions of the bank. CrediAmigo has been managed from the start by a small group of fewer than 25 full-time headquarters staff. Line managers were drawn from bank staff in branches. Banco do Nordeste outsourced the contracting of its cadre of loan officers and their immediate supervisors in order to circumvent restrictions imposed by collective bargaining agreements that would have made microcredit unprofitable and unsustainable within the normal staffing patterns of the bank. These outsourced loan officers and coordinators represent 85 percent of total staff of the program.

As the program was developed and important issues arose, CrediAamigo drew on senior managers from all departments in the bank. This guaranteed a higher level response when compared to the traditional bank downscaling approach, which has been to build and staff a separate division within the bank wholly dedicated to microfinance. The added advantage of this approach has been the far deeper levels of integration of the program and its culture into the bank.

President Quieroz always saw in microfinance an opportunity to reinforce broader reforms within the bank. This has been accomplished. BN managers have repeatedly said that the example of CrediAmigo is having a catalytic effect on the rest of the bank. BN is using the experience gained under CrediAmigo in areas such as the use of staff incentives and the development of a low-delinquency loan culture.

Learning and Experimentation

On at least two occasions, Banco do Nordeste has attempted to grow too quickly, which has led to excessive losses and the need to re-establish core operating procedures and principles. In each case, BN has been able to pull back and consolidate its operating procedures and re-establish best practice performance. The first occasion was triggered by the need felt by the bank to establish the presence of the program throughout the Northeast Region, where it operates and has a development mandate. This decision was costly in terms of extraordinary loan losses, but the bank has since recuperated all lost funds through profits generated by the program.

The second occasion was prompted by the desire to grow the program more quickly, in part due to the excess liquidity represented by the additional funding negotiated with development organizations and by the desire of BN to expand its outreach and the impact of the program. This decision also led to a sharp increase in loan losses, although not as severe as in the first occasion.

Both occasions reveal the fundamental conundrum faced by large, public institutions when they confront the undeniable fact that they have not been successful in meeting the full demand for high-quality financial services in their target market. They constantly face the trade-off between just pushing services out and incurring the higher costs that ensue from high loan losses, and trying to stick with best practice methodologies and incurring the higher costs of staff training that are required to keep loan losses low. Thus far, BN has struggled through this dilemna ultimately favoring best practice in its decisions, at the clear expense of program growth. It has not been easy, and BN is constantly looking for ways to grow more quickly and increase its impact. This is, after all, its clearly stated mission.

External Catalysts

Successive Brazilian governments have demonstrated a longstanding interest in promoting microenterprise credit through a series of public-sector initiatives. Access to microcredit has frequently been an important issue in political campaigns. While the government's initiatives can typically be characterized as leaning toward subsidized and targeted development credit, the CrediAmigo program resulted from a fortunate coincidence between the ongoing reform process in BN and the interest and ability of the World Bank staff member to pursue a radically different approach. Certainly, BN felt the mandate from the highest government authorities to engage in microcredit. This continues to the present day, and the current administration has launched a number of new initiatives designed to broaden access to finance, some of which fall into the classic subsidized credit paradigm while others, are quite forward looking.

Lessons Learned

The activities most critical to CrediAmigo's development into a world-class microfinance program included conceptualization, design, piloting, and initial consolidation. The most notable aspect of these activities is that they required limited external funding and occurred before any disbursements from the World Bank loan. Although these processes required significant investment from BN over almost three years, external assistance costs were relatively low.

From 1996 to the loan appraisal in 1999, the World Bank spent about US $150,000 of its own budget, including the costs of participating in the initial seminar, the observation missions (usually two-days), the Microfinance Training Program in Boulder, one identification mission, and the project appraisal mission. CGAP provided about US $50,000 in technical support, including staff time and external consulting. In all, BN received US $1.2 million in external financial assistance (US $300,000 of reprogrammed funds from a prior World Bank loan and US $900,000 from the Japanese), although it spent less than half of that on technical assistance related to program operations.

Other funds were spent on impact evaluation assessments and client training activities. It spent about US $5 million of its own funds for the salaries of the BN personnel who designed the program, training costs, full financing of the loan portfolio, and accumulated losses, including the US $2 million write-off of bad loans.[10]

The BN experience suggests that donors may need to be opportunistic rather than dogmatic in their approach to microfinance. At first the World Bank was reluctant to support a large state-owned development bank, even one that had undertaken significant internal reforms. But the demonstrated strength of the commitment by BN senior management, along with a pressing need to develop substantial microfinance retail capacity in the Northeast Region, and the Inter-American Development Bank's "preemption" of the NGO arena, all combined to persuade the World Bank to take a risk and support CrediAmigo. Although the Bank was advised to withdraw its support, particularly after the ill-advised expansions in 1998, the clear commitment of BN's senior managers to develop a world-class program kept the World Bank engaged.

In comparison with other recipients of donor support, managers of competent banks are particularly skeptical of, and resistant to, technical advice from donors or from consultants selected by donors. Recognizing this, the World Bank team limited its direct role to providing focus rather than technical advice. Nevertheless, it took the unusual step of investing in a three-week training program for two of its key staff. In retrospect, the WB team members felt that this training was critical to the success of the engagement.

Recruiting outside experts is important but cannot substitute for the role of donor staff as the authoritative interlocutors for their institution. Donor staff who lackbasic technical literacy in microfinance will not usually be able to identify good consultants or use them well, and may not have the credibility that is essential for an effective dialogue with the implementing institution.

The most important contribution of World Bank management was its patience in allowing development to proceed at its own pace. The process of developing, piloting, and consolidating the CrediAmigo program, particularly with the need to recover from the early rapid expansion, took three years before a loan was appraised. This required exceptional patience from the World Bank's country management in Brazil, which was under pressure from various sources to move more quickly with the loan. Although there was some consideration of moving more quickly with a smaller loan, management continued to support the task team's assessment of the program's readiness for a major World Bank loan.

As a result of this patient approach, a larger loan was provided with less risk of undermining the program's focus on sustainability. The initial development process allowed BN to develop its expertise and confidence in managing a large microfinance program. Even the early missteps, based completely on BN decisions with consequences financed by BN resources, were an important element in establishing the program's low arrears culture in a public bank environment. BN's success in resolving its early problems and developing a sense of how to manage the trade-off between growth and portfolio quality without the pressure of disbursing a World Bank loan has brought the program to a level where neither BN nor the World Bank see the US $50 million loan as an incentive to "supply-led growth."

In recent years, BN management has negotiated further lines of financing from the Interamerican Development Bank and the "Germans." These funds raise the total financing available for CrediAmigo to close to US $100 million, and seem to have provided some of the impetus for the mid-2003 push to grow the loan portfolio. As with the initial push in 1999, this push led to a deterioration in the quality of the loan portfolio, resulting in a spike in non-recoverable loans, a decrease in loan-officer productivity, and a drop in overall profitability for the year. Profits for 2003 were considerably down from their high in 2002. While BN management has not allowed this degraded portfolio quality to persist, this episode reveals how the constant pressure applied by the donor community to support successful programming, combined with the temptation on the part of government agencies to grow the same, can combine to blow up initiatives that, left on their own, would prosper at a more natural pace.

The CrediAmigo experience suggests that the World Bank and other multilateral donors can play a catalytic role in microfinance development if they:

- Pursue the best available opportunities in a country rather than impose a universal model. (All capacity-building approaches involve substantial risks.)

- Allow programs to develop their capacity to manage growth with portfolio quality before providing significant funding for program expansion, even when this may delay lending targets. (The biggest constraint to the spread of microfinance services is a shortage, not of funding, but rather of competent retail capacity.)
- Encourage donors to take advantage of their technical role to set benchmarks consistent with international best practice and put institutions in contact with top microfinance practitioners, which can be the critical ingredients that keep a DFI on track.
- Ensure that donor staff working with MFIs are grounded in the basic elements of sustainable microfinance, preferably through training or, at least, close work with high-quality specialists.

End Notes

1 For background on Brazil's microenterprises, financial sector, and microfinance industry, see Steven Schonberger, *Microfinance Prospects in Brazil,* Latin America and the Caribbean Region and Economic and Socially Sustainable Development Unit (Washington, D.C.: World Bank, 2000).

2 "Portfolio at risk" is a measure that divides the remaining balance of loans that are late by the remaining balance of the whole loan portfolio.

3 Because microcredit is unsecured, repayment discipline can collapse very rapidly. When micro-borrowers sees many of their peers defaulting on their loans, motivation to repay plummets. The main reason borrowers repay their loans is the expectation of future services. They know that once people stop repaying, the service will not be available very long, and they do not want to be the last one aboard the sinking ship.

4 To increase its geographic outreach cost-effectively, CrediAmigo began establishing "individual branches" consisting of a single loan officer. These branches account for most of the growth in branch numbers since August 1999.

5 In comparison with normal loans, microloans are tiny, yet staff intensive. Thus, administrative costs are high when measured as a percentage of the loan amounts. It takes a very high interest rate to recoup these costs, especially if management is committed to breaking even at an early stage. Experience has shown that clients value the loans so highly that they are willing to pay elevated interest rates; in fact, many of them have been paying much higher rates to informal money-lenders.

6 When BN transfers funds to a CrediAmigo branch, it charges an internal transfer price equal to the prevailing rate on Interbank Certificates of Deposit.

7 In fact, BN could have funded the five-year expansion from its own resources. The World Bank loan was still attractive to the Brazilian government because it brought in needed foreign exchange.

8 At the end of 2000, BancoSol in Bolivia had 61,000 loan clients, after 13 years of operation. Compartamos in Mexico had 64,000 clients, after about 10 years. The median outstanding loan balance for Latin American MFIs was 45 percent of per-capita GNP, according to the April 2001 issue of *MicroBanking Bulletin*. In Bangladesh, Grameen Bank's average outstanding loan is US $140, or about 40 percent of per-capita GDP.

9 "Operational sustainability" is the ability to pay all operating costs *except* the cost of funds from interest income on loans. "Financial sustainability" is the ability to pay all costs, including financial costs, from interest income.

10 One can argue that BN did not need to spend this amount of money, that it could have achieved the same results with a third of the up-front investment. But perhaps these types of "mistakes" are normal for working through very large institutions. The alternative might have been heavy handed (and expensive) technical assistance, which the Brazilians would not have accepted. There is evidence of banks that have spent far less, such as the Banco del Estado in Chile, which made virtually no mistakes after spending a few years looking for the right model, and banks that have spent far more, such as Bank Rakyat Indonesia, which had to turn around the performance of 3,500 branches.

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Chapter 2

Equity Building Society: A Domestic Financial Institution Scales up Microfinance

BY TAMARA COOK, CGAP

Executive Summary

Equity Building Society (Equity) is a homegrown success story that has only recently attracted international attention. Equity's beginning, 20 years ago, was inspired by an entrepreneurial vision of a potential demand for financial services in the underserved, low-income population of Kenya. Despite high hopes for serving this market, the first 10 years were characterized by a difficult environment, fierce competition, and a lack of institutional knowledge of how to operate a profitable financial institution. On the verge of collapse in 1993, Equity brought in outside experts and committed to radical steps to turn the institution around. This commitment led to improved financial performance and increased outreach.

Since 1993, Equity has grown from 12,000 depositors to more than 250,000 depositors (as of December 2003), making Equity Building Society home for more than 13 percent of all bank accounts in Kenya. This growth can be attributed to committed staff and leadership, high-quality customer service, effective marketing, low barriers to access (especially compared to traditional commercial banks), appropriate product design, an acceptable enabling environment, and more recently to external support from donors. Equity also offers a wide range of loan products and other financial services, such as money transfers, banker's checks, and bid bonds.

In the last few years, Equity has gained recognition within Kenya, and throughout Africa and the world, for its dramatic growth and professional operations. Of course, success brings its own challenges. In the coming years, Equity will need to manage the sustainability of this impressive growth by incorporating new staff, supervising the expanding branch network, maintaining the quality of customer care, and strengthening the quality of its loan portfolio.

Implementation Process

Equity Building Society opened its doors in 1984 to bring financial services to ordinary Kenyans, especially to those who had no access to the formal banking sector. The founders hailed from senior positions in government and business, and shaped the institution based on their indepth understanding of the socio-political circumstances, their commitment to the government's rural development policy, and their ability to turn a commercial profit in Kenya. Taking advantage of new rules that enabled Kenyans to open formal, licensed financial institutions, Equity was registered as a building society, which was an affordable option in terms of license fees and capitalization. The building society legislation influenced Equity to offer savings services and mortgage loans. Equity realized, however, that it was servicing a microfinance market for low minimum-balance deposits and loans that were rarely used for housing.

In its early years, Equity faced fierce competition from a multitude of locally-owned financial institutions, which also were set up during this time. Equity resisted the temptation to attract deposits from government and parastatal organizations in contrast to other financial institutions. Instead, Equity mobilized individual customers by one-on-one marketing, entrenching a culture of service excellence from the start. For its first decade of operations, Equity struggled to maintain clients and cover costs, while other small institutions closed and confidence in the sector eroded.

Despite Equity's dedicated efforts in a difficult environment, a report issued by the Central Bank of Kenya in 1993 confirmed that the institution was technically insolvent and had poor board supervision and inadequate management. Non-performing loans were 54 percent of the portfolio, and accumulated losses totaled KSh 33 million against a paid-up capital of KSsh 3 million. At this stage, deposits were being used to meet operating expenses. Its liquidity ratio stood at 5.8 percent, far below the required 20 percent. However, the Central Bank of Kenya did not request closure of Equity, and the Society was given the chance to turn around for the sake of its existing clients who were still committed to the institution.

Realizing the need for a radically new and professional approach to retail banking, the Equity Building Society board recruited two experts, a promising banker (who later became the finance director) and an experienced trainer, to help staff meet the challenges of the new environment, expand its marketing, and on the whole enhance its efforts. With the help of the new management team, Equity focused on staff training and marketing. The original culture of good client service and teamwork was revived, and the number of depositors grew.

The efforts to turn Equity around were also assisted by the new political atmosphere that took hold in the early 1990s. The country was moving away from a one-party political system, and more freedom was evident. Equity succeeded in mobilizing deposits from churches, and the government allowed employees to bank at financial institutions not under government control. Many foreign banks converted from retail to corporate banks, leaving a vacuum in the retail sector. At the same time, banks were closing their rural branches and rationalizing urban branches, attracting a flood of new deposits.

Equity also formalized its commitment to smaller clients in a new mission statement which recognized how financial services contribute to the welfare of clients as well as the national economy. Deposit mobilization increased by 40–60 percent per year, and profits grew. More recently, a special marketing and public relations campaign in August 2003 celebrated Equity's 20th anniversary of "Providing Financial Solutions to Kenyans," which yielded spectacular increases in the number of new savings accounts.

During its first 15 years, Equity relied entirely on its own resources and had neither solicited nor been offered assistance from international partners. This began to change in 1999, when Equity undertook two small projects with EU-MESP and UNDP-MicroStart. Deeper partnerships were developed with Swisscontact and MicroSave-Africa. Both relationships have focused on providing local and regional technical expertise and on jointly developing new products and services. MicroSave-Africa, in particular, brought a focus on services and product design based on client demand. This led Equity to redesign its products, reflecting its change to focusing on clients. The marketing department was restructured, and eventually included a great deal more time on market research.

DFID's Financial Deepening Challenge Fund supported the launch of Equity's mobile banking program. DFID currently provides technical assistance for specific targets, and Equity also receives more general technical assistance from Africap.

The UNDP-MicroStart program also played a role in upgrading and computerizing the management information system, which has had a tremendous impact on Equity's turnover and portfolio growth. In 2003, Africap, a regional microfinance investment fund of international financial institutions, chose Equity for its first African investment of US $1.54 million, accompanied by technical assistance of US $244,000.

A fitting illustration of the turnaround of Equity is the improved ratings by the Central Bank of Kenya. The overall rating (shortly after the 1993 rating) rose to marginal, then to fair, and in 2002 to satisfactory. The Equity board and management were deemed proficient to govern and manage a financial institution. Capital adequacy and asset quality were satisfactory. Management, earnings, and liquidity were rated as strong.

The 2003 report from the Central Bank has just been finalized, and its overall financial condition has been rated as satisfactory again. Capital adequacy, earnings, and liquidity were all rated as strong. However, asset quality dropped to marginal (19.2 percent portfolio at risk) and management was rated as satisfactory. The senior management team has taken this report very seriously and is revamping the credit operations and methodologies to improve credit risk management and administration. The report also noted deficiencies in the management information system and improvements are already underway.

The profile of Equity, as of March 2004, shows an institution that is consistently profitable, operates through 15 branches and 25 mobile units, has 297,000 depositors with deposits of KSh 3.8 billion (US $50 million), and a loan portfolio of KSh 2.1 billion (US

$28 million). It is fully computerized and has 384 staff members, 8 directors, and 2,470 shareholders.

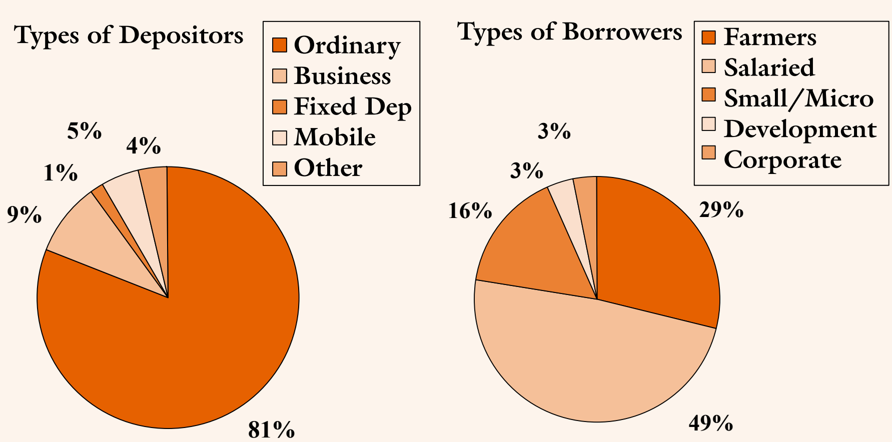
Impact Analysis

Financial services help poor and low-income households increase their incomes and build the assets that allow them to mitigate risk, plan for the future, increase food consumption, and invest in education, health, housing, water, and sanitation. Equity made a deliberate decision to focus on poor and low-income clients to help them improve their lives. Although Equity reaches a wide range of clients, the majority of its clients are small-holder farmers, low-end salaried workers, and micro and small businesses. Figure 1 shows the breakdown of loans according to these categories[1] as well as a summary of deposits by account type.

Although it is not a perfect indicator for poverty level of clients, average account sizes can point to income and accumulated wealth of the type of clients being reached. As of December 2003, 73 percent of Equity's savings account balances were less than US $70, not including the 50,000 new accounts that have not yet received their first deposit.[2] Although most of Equity's savings accounts have very low balances, 63 percent of Equity's total deposit volume is made up of corporate savings accounts and fixed deposits over US $1,000 (see Figure 2). Given the volume of clients with small accounts, Equity staff spend most of their time handling small depositors. However, this does not preclude the relatively large deposits that help provide stability and often longer-term funding to the institution.

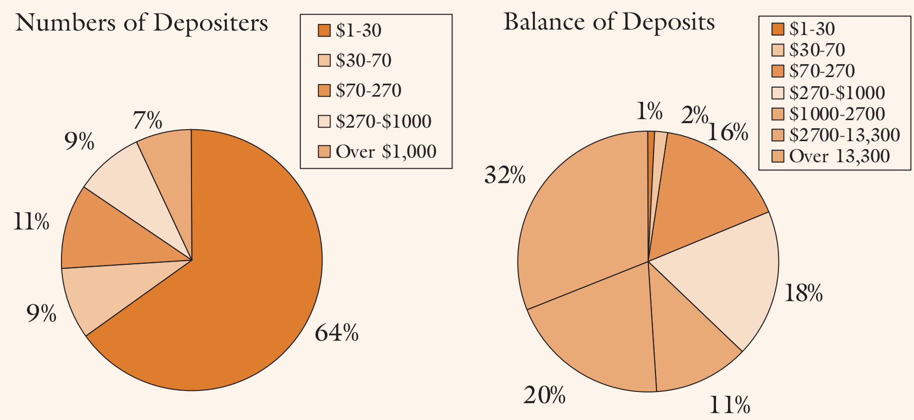
On the credit side, about 80 percent of outstanding loans have outstanding balances of less than US $400, although they only account for about 18 percent of the total outstanding loan balance. (See Figure 3 showing average outstanding balances on Equity's loan categories.) On average,

Figure 1: Distribution of Clients



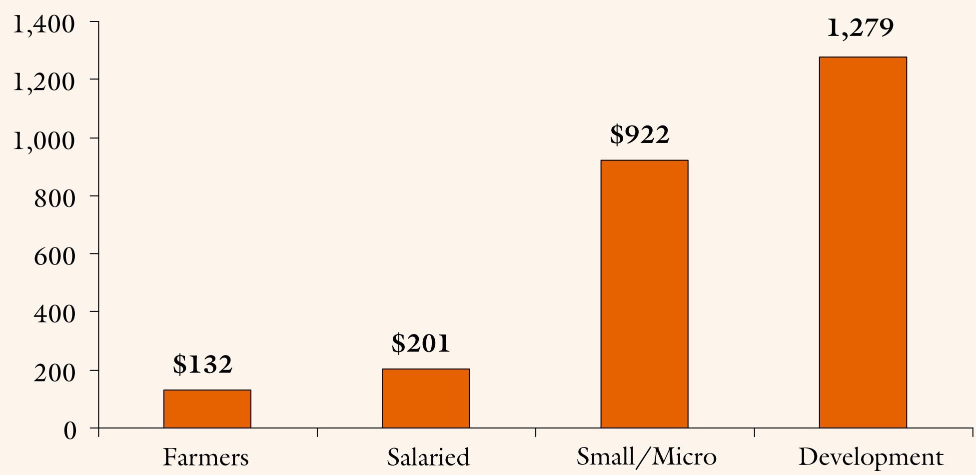
Sources: EBS data, own calculations

Figure 2: Distribution of Deposit Size



Sources: EBS data, own calculations
*Overdrafts and new accounts with 0 balances have been excluded

Figure 3: Average Loan Sizes (US$)



**Corporate loans for medium businesses average $9,500

small-scale farmers take out the smallest loans (US $132), which are usually evaluated on the basis of predicted remittances from the Kenya Tea Development Authority or other farm produce marketing agencies. Farm input loans are also provided for dairy, coffee, and other crops on a smaller-scale.

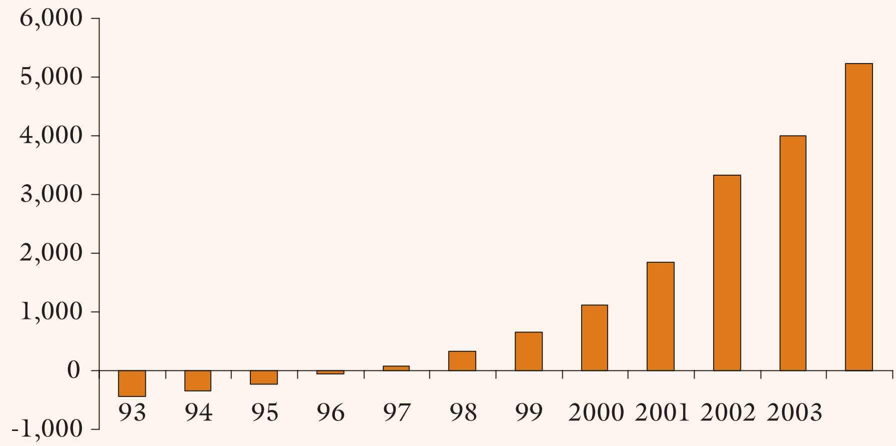
Salary-based loans (including education and medical loans) have slightly higher average outstanding balances (US $201). Loan repayments are deducted automatically from salaries that are directly deposited into clients' savings account at Equity. Equity's Corporate Branch in Nairobi caters to a higher-end market, where business loans average US $9,500. However, in other branches, loans to smaller businesses average US $1,300. Equity's business loans have been based on revenues demonstrated by turnover in savings accounts and secured with collateral such as land and vehicles. A new microcredit product targeting even smaller entrepreneurs is slated for pilot testing in 2004. It will require reorientation of credit methodology (including more flexible security requirements with a strict emphasis on the analysis of regular cash flows) and substantial training for credit officers.

In mid-2003, a qualitative impact assessment[3] was conducted in conjunction with Equity's market research team (using MicroSave-Africa tools), and examined the nature, scope, and depth of client impact at the individual, household and enterprise level. The research team? conducted 23 focus group discussions from eight rural and urban branches. The findings provided insight into how clients use Equity's services to manage risk and meet household and business cash flow demands. Equity's clients report using savings and loans to invest in business activities (inventory, salaries); save for the future (education, medical costs); manage household cash flow needs (rent); invest in assets (land, housing, appliances); and cope with crises or life events (illness, marriages, funerals). In the focus group discussions, clients reported growth in their incomes and assets over the past ten years, and Equity appears to be an important part of that growth.

Equity's commitment to increasing educational opportunities and addressing healthcare needs for Kenyans permeates the institution. Education and medical loans are offered at lower rates if the funds are paid directly to the educational institution or medical provider. Equity encourages saving for education through its "Super Junior" account for children that includes free banker's checks for school fees—a unique service in the Kenyan market. It also offers favorable pricing on issuing banker's cheques required for the payment of school fees each term. The Jijenge savings account, a monthly contractual savings product, helps clients develop the discipline to save regularly for education and medical expenses (among other reasons) and also allows clients to borrow against their savings at a favorable rate.

Equity's impact can also be viewed through the lens of its financial return. By the beginning of 1994, Equity had accumulated losses of KSh 33 million (US $440,000). Given that it held only KSh 31 million in deposits, this represented a serious problem. After the dramatic shift in its operations in 1994, Equity reported its first profitable year, and by 1997 Equity had accumulated a profit of US $80,000, which grew to US $5.2 million by the end of 2003 (see Figure 4). In the 1980s and 1990s, Equity's growth was financed entirely by mobilized savings (domestic) and the personal investment of the founders and shareholders. Survival meant they had to use their resources efficiently, especially to dig themselves out from the crisis in 1993. The recent technical assistance and financial investments in Equity are beginning to reap results, but it is too early to measure the full impact.

Figure 4: Accumulated Profit/Loss (US $ in thousands)



Driving Factors

Equity's success can be attributed to the dedication of its management and staff, as well as to Equity's ability to innovate and maintain extremely high customer service. Equity's success attracted limited external support in 1999, and more substantial support after 2002, but support followed and reinforced the "homegrown" success rather than creating it.

Commitment and Political Economy for Change

Internal and external commitment to change pushed Equity in the right direction. Internally, Equity's management and board governed the institution effectively during a period of generally weak governance in Kenya. The deliberate decision to concentrate on the smaller end of the market shielded the organization from political influence. In addition, Equity's leadership focused operations in one single region (Central region) to provide the best services to the target market. This helped develop institutional capacities without overstretching management, operations, and internal controls. Equity's recent growth is built on the foundation of high quality services and strong institutional capacities.

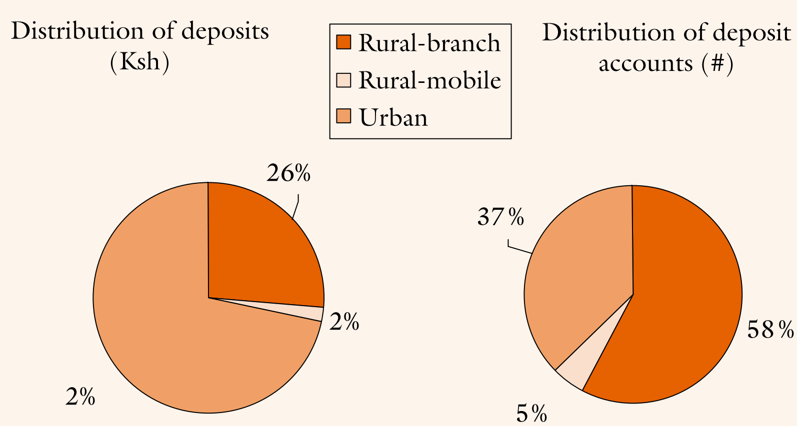
Equity's founding and turn-around benefited from external reforms catalyzed by key decision makers who shared Equity's vision. Equity was established under new rules in 1980s to create locally-owned formal financial institutions with the hope that such institutions would serve the unbanked populations neglected by the commercial banks. In the early 1990s, when Equity was finding its footing again, multi-party democracy and financial and market liberalization helped Equity attract new clients, such as government employees who were (finally) allowed to direct deposit their salaries in non-government controlled financial institutions. Influenced by World Bank/IMF financial sector reform requirements and lobbying by building societies (especially Equity), Parliament revised the Building Societies Act to widen the scope of activities almost in line with the Banking Act. For example, the 1999 revision regularized deposit taking. And last, but not least, regulators who were sympathetic to Equity's mission granted it one last chance to shape up after it was rated "technically insolvent" in 1993 by the Central Bank of Kenya rather than shut it down.

Institutional Innovation

Arguably, Equity's most essential institutional innovation is motivating and sensitizing its staff to embody the company pledge: "…take pride in the noble responsibility of offering financial services and solutions, to empower our customers to face the future with dignity and realize our full potential." Equity has a tradition of recruiting young people at entry points, who are well educated but have little or no experience. The emphasis in Equity is on instilling the corporate culture. In a way, the selection of staff is not so much to bring skills into the institution as to mold inexperienced graduates to its operational norms and customer-service philosophy. This has worked exceptionally well and is reflected in the work ethic and culture emanating from the activities of the entire staff complement. Staff are encouraged to see their work as a "calling," not just a job. This view unifies staff around Equity's vision and has the added benefit of inducing staff to work long hours to achieve this vision when needed.

Equity is committed to bringing financial services to rural clients, which make up 68 percent of Equity's clients but only 28 percent of total deposit volume, given the relatively lower average savings account size of rural clients (see Figure 5). Building on its existing branches in small towns in Central Province, in 2002 Equity launched mobile banking (with support from DFID) to deliver services deeper into rural areas. The mobile units are designed as stand-

Figure 5: Distribution of Deposit Size



alone mini-branches, wholly contained in a fortified sport utility vehicle with satellite connection to the branch, solar power, and a fold-down teller window. The mobile mini-branch drives up near factories, for example, when salaries are disbursed and serves clients directly from the vehicle.

More often, however, the vehicles are used to transport 2–3 staff over rough rural roads to rented offices where Equity opens temporary mobile branches at least one day a week. These minimally- equipped rented locations generally have a counter for staff and an area for clients to wait for service. The mobile branch downloads the information for their clients from the branch onto a laptop (but also brings a hardcopy of the data in case there is a shortage of electricity or they lose the satellite connection with the branch). All transactions by the mobile office are uploaded at the branch before running the close-of-day report. The mobile branches are a cost-effective way to provide better access to rural clients without the significant investment needed to open a full-scale branch. As of December 2003, Equity had 25 mobile units serving 12,161 clients (5 percent of existing clients) with an average deposit size of about US $100, (a significantly lower average than for other savings products). The mobile units earn a profit, in part by charging a small fee to clients, which is less cost than transportation to the nearest branch.

Innovations in information technology can dramatically affect an institution's ability to serve its clients well. For over 16 years, Equity survived despite the growing difficulties of a manual information system, which were amplified at every level of growth. Both customers and staff members felt the strain of the manual system as the volume of Equity's business expanded over the years. Equity launched its computerized management information system in June 2000 (with support from UNDP-MicroStart), completing the installation in a record four months. Equity's efficiency in collecting and reporting data and its service delivery to customers improved greatly thereafter. With the new system, Equity managed to improve its customer turnaround time from 30–40 minutes to about five minutes at the counter.

Although Equity's growth is partly attributed to its marketing and customer-focused efforts, it is clear from its high growth spurt in 2001 that the new computerized system has been a major factor. This, of course, demonstrates the importance of technology to banking in general and to high volume, low-value microfinance in particular. Currently, Equity is investing additional resources in a wide area network to connect all the branches on a real-time basis, in data warehousing to enable better reporting and to prepare for potential credit scoring, and in upgrades to its information system to gain more functionality and reliability.

Learning and Experimentation

Since its inception, Equity has been relentless in its constant focus on clients. Of late, Equity has marketed itself as "the listening, caring financial partner" in an aggressive marketing campaign including radio, newspaper, and television, not to mention the often more important role of informal marketing by key members of society. Far from just a marketing campaign, the slogan represents how Equity runs its business.

Learning and experimentation play key roles in Equity's ability to attract and retain clients. Equity "listens" to its clients through various mechanisms for their suggestions about current products, needs for new services, and perceptions of Equity. Focus group discussions have been an effective method for listening to clients, and have resulted in improved service as well as demonstrated Equity's "caring" to clients in a tangible way. Equity's bright and energetic marketing team received training from MicroSave on designing and conducting these discussions for maximum impact. (MicroSave has also conducted "mystery shopping," after the launch of new products to determine how well staff know and deliver the products, as a valuable feedback loop.) Equity managers have an open-door policy at the branches and head office, and welcome hearing about clients' experiences with Equity—another way of listening to clients.

Equity's approach to learning from clients contributed to the successful launch of the Jijenge savings account, a contractual savings product to help clients "realize their dreams." It was designed to meet the needs of lower-end clients seeking discipline to save for needs, such as school fees, weddings, and household items. Jijenge clients can also access cheaper loans of up to 90 percent of their accumulated savings account for urgent needs. The product was designed using client input, pilot-tested, refined through discussions between head office and branch management, and successfully rolled out with support from the marketing team.

External Catalysts

Since 1999, Equity has selectively accessed external resources that propel it towards its mission. Key medium- to long-term donors and investors formed a steering committee to provide more coordinated support and guidance to Equity. This harmonized approach encourages complementary inputs by donors and investors and lessens the transaction costs for Equity in managing relationships with external supporters. Equity has received technical support and funding from Africap, British Department for International Development, European Union, MicroSave, SwissContact, and UNDP-MicroStart.

Lessons Learned

Equity's 20-plus years of ups and downs offer lessons for institutions, donors, and governments committed to scaling up financial services to the poor in other countries.

Lessons for Financial Institutions

- Understanding poor and low-income clients is essential for identifying "niche" markets, designing appropriate products and services, and developing and maintaining client loyalty.
- Appropriate technology can increase

efficiency (i.e., computerizing information systems) and outreach (mobile banking for better penetration and delivery in rural areas.)

- Investing in staff training and developing meaningful incentives helps staff to internalize and be motivated by the vision of the institution, which in turn leads to tangible results.
- Visionary leadership and top management, while vital to the success of an institution, must be supported by strong and technically competent middle management.

Lessons for Donor Aagencies and Service Providers

- Donors should seek a consortium approach to funding with a medium- to long-term commitment and emphasize results.
- Donors can help institutions manage growth by offering targeted and timely technical assistance that is consistent with the institution's own vision and objectives. Donors should focus on strategic support for optimal impact.
- Domestic financial institutions, even nonbanks, exhibit great potential as a mechanism for massive outreach. Donors should explore relationships with local partners who have demonstrated capacity to grow through visionary leadership, existing infrastructure and client base, and brand recognition in local markets.

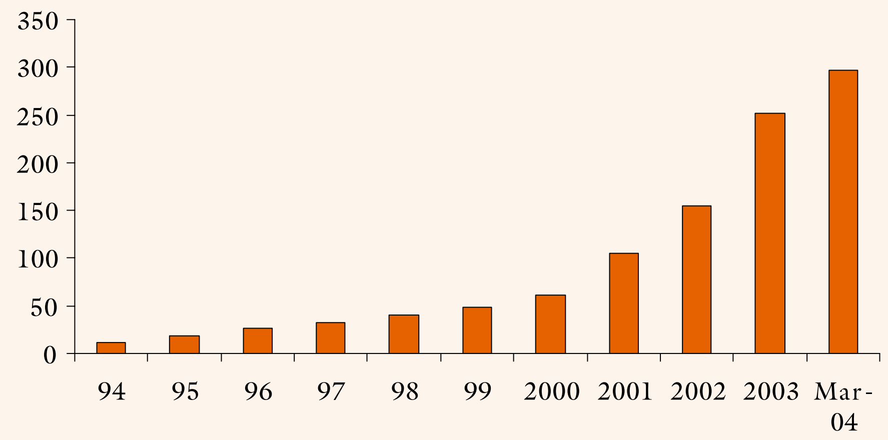
Lessons for Governments and Policy Makers

- Government can create enabling environments for the creation, proper regulation, and expansion of indigenous financial institutions with the potential to reach scale.
- Non-bank financial institutions can play an important role in reaching unbanked clients with appropriate services. In Kenya, building societies were given a mandate to operate like banks. But in other countries in Africa, building societies have been limited in their ability to scale up.

Equity's Future: Managing the Sustainability of Scaling Up

At the end of Equity's first decade of operations, it was a defunct building society. During its second decade, Equity emerged as an organization with great potential. As it enters its third decade, Equity will need to transform into a high-performance institution. The main challenges will be managing growth, transforming the institutional culture of what was a family-like business, and balancing the enormous success in mobilizing deposits by expanding and improving the quality of its lending operations. The continuing growth and expansion will require significant enhancements of Equity's organizational architecture, especially at the governance level (e.g., advancing the executive oversight function of the board of directors). Planned upgrades to the lending methodology will need to be rolled out including a more serious emphasis on recovery and portfolio quality. Internal controls need to be strengthened and an effective asset liability management system developed. One of the essential ingredients in sustaining the institutional growth is building up the adequate internal capacity of appropriate staffing and middle management capacity. Equity has demonstrated that it is capable of managing these challenges and should continue to scale-up its success in the years to come.

Figure 6: Number of Deposit Accounts (in thousands)



End Notes

1 Development loans are for longer-term construction and land development provided to all three categories of clients.

2 Equity reduces its barriers to entry by allowing clients to open accounts without a minimum deposit.

3 UNCDF Impact Assessment report.

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Chapter 3

The Agricultural Bank of Mongolia

BY JAY DYER, J. PETER MORROW, AND ROBIN YOUNG

Executive Summary

The Agricultural Bank of Mongolia (Ag Bank or XAAH) is the main provider of financial services in the rural areas of Mongolia. It has the largest branch network in the country, with 379 locations (93 percent in rural areas), and provides deposit and loan products at each point of service. Although it was in receivership in 1999 and faced possible liquidation, this former state bank has been completely turned around and was privatized through international tender to a major Japanese company in March 2003.

Turnaround efforts have resulted in Ag Bank disbursing 878,000 loans between late 2000 and February 2004, while maintaining an arrears rate consistently below 2 percent and becoming the most profitable bank in Mongolia, with a return on equity of 44.19 percent in 2003. As of February 2004, 128,227 loans were outstanding for a portfolio of almost US $50 million with US $75.5 million in 377,424 deposit accounts. The 15,433 domestic transfers totaled US $260,000 for the month. The average outstanding loan balance is US $382, deposit accounts average US $200, transfers US $17, and half of Mongolia's households do business with Ag Bank. This turnaround identified and mobilized the strengths of an existing institution to rapidly disseminate desperately needed financial services to the rural areas and protect access to the few existing financial services upon which many rural Mongolians rely.

After many years of operating deficits, loan losses, and a failed attempt at privatization, Ag Bank was placed in receivership in 1999, and many in the international community felt that it could never operate sustainably and should be closed. However, the importance of Ag Bank to Mongolia's rural sector can not be overstated. Although one of the smaller financial institutions in the country, it was the only bank with branches throughout Mongolia's vast territory through which to transfer money, make government pension and salary payments, and accept deposits. Closing it would have had a devastating impact on the rural economy.

The World Bank made reforming Ag Bank a condition of its Financial Sector Adjustment Credit Program for Mongolia, and the US Agency for International Development (USAID) agreed to provide funds for an outside management contract. The Government of Mongolia agreed to provide this outside manager with full authority to manage the institution, free from political or other interference.

A contract was signed with Development Alternatives, Inc., (DAI) of Bethesda, Maryland, USA, to manage the bank. In July 2000, a team led by Chief Executive Officer J. Peter Morrow arrived in Mongolia. DAI staff and advisors provided technical support as the team set the agenda for the turnaround and transformed Ag Bank. By agreement among all parties, the mission of the turnaround was to: (1) restore financial soundness to the bank; (2) bring financial services to the country's rural population; and (3) prepare Ag Bank to operate independently and be privatized.

The management team developed a new lending program, converted payment services into deposits, created an extensive marketing program to improve the bank's image and attract clients, implemented strong controls through new policies and procedures, established a more effective management structure, and significantly increased training activities.

In January 2003, the Government of Mongolia received three viable bids for Ag Bank, all from strong and fully qualified private sector buyers. H.S. Securities of Japan was the highest bidder, and at US $6.85 million became the successful purchaser of Ag Bank. The sale closed on March 25, 2003. The new owners have hired DAI to continue managing Ag Bank, a contract that is fully paid for out of the bank's income.

The rural areas of Mongolia have been the bank's main focus, and its successes there have laid the foundation for substantial growth and new services for all Mongolians. Ag Bank's current mission statement is "to be the principal nationwide financial services company in Mongolia by delivering first-class products with the highest level of customer service." Key to the turnaround of the institution was developing and implementing products throughout the country profitably. Ag Bank has shown that financial products can be created and delivered gainfully in even scarcely populated and poor areas if they truly meet the needs of customers. The institution has proven that it can sustain itself and, in fact, contribute significantly to Mongolia's overall economic development. Aside from the large impact of its loan and deposit activity, the opening of 110 new branches and creation of more than 1,000 good paying jobs boosted the economies of many communities. In addition, Ag Bank is now one of the largest taxpayers in Mongolia where before it was a cash drain on the government.

Implementation Process

Following almost a decade of political interference and mismanagement that led to losses and insolvency, a new governance structure combined with an independent and professional management team turned Ag Bank into a profitable and rapidly growing private bank. Following is a timeline of the key events in Ag Bank's history:

- ***1991.*** The bank was founded as the Agricultural Cooperative Bank. The government arranged for agricultural cooperatives, herders, and farmers to capitalize this new bank, which took over 326 rural branches and settlement centers. It had 2,600 employees, held a portfolio of approximately US $2 million mostly in non-performing loans and deposits whose interest rates were set by the Central Bank, and assumed the activities of the former monopoly State Bank.

- ***1992.*** The deterioration of Ag Bank's business and the movement toward a market economy in Mongolia forced a reorganization of the institution. The bank expanded its lending to larger loans because of government interference.

- ***1996.*** The Ag Bank's liquidity and financial position deteriorated to a level where the Central Bank appointed a receiver.

- ***1999.*** Existing shareholders' interests were eliminated, and the Central Bank put together a restructuring plan. The government became the new sole owner through a capital infusion from government restructuring bonds, converting debt to equity, and injections of cash.

- ***1999.*** The World Bank made reforming the Ag Bank a condition of its Financial Sector Adjustment Credit Program for Mongolia, and USAID agreed to provide funds for an outside management contract. The government of Mongolia agreed to provide this outside manager with full authority to manage the institution, free from political or other interference.

- ***2000.*** Development Alternatives, Inc., of Bethesda, Maryland, USA, won an international competition to manage the Ag Bank. After the contract was signed in July 2000, a team led by Chief Executive Officer J. Peter Morrow and Chief Operating Officer Debra Boyer arrived in Mongolia to manage the Ag Bank. A new operating strategy was implemented and profitability achieved in 2001. By agreement among all parties, the mission of the turnaround was to:

    - Restore financial soundness to the bank
    - Bring financial services to the country's rural population
    - Prepare the bank to operate independently and be privatized

- ***2003.*** H.S. Securities was selected in an international bid as the buyer of Ag Bank and retained DAI on a management contract. Growth and profitability continue to increase.

Objectives: Sustainability and Privatization

At the beginning of the management contract, the team knew it would be crucial to (1) develop internal staff capacities, (2) develop proven products for the market, and (3) find a successful resolution to the political influence that dominated Ag Bank for years. The initial project goal was privatization. By stabilizing the institution and creating transparency, a buyer would clearly understand what was being bought. By developing and expanding the product and service offerings in the market, the Ag Bank would have the profitability to sustain itself. As a measure of success, the bank was privatized in March 2003.

H.S. Securities, the buyer of Ag Bank, has stated that it wants to continue to expand based on the bank's target markets. It will be investing millions of dollars more into the bank to continue the outreach and market penetration. Since privatization, Ag Bank has continued to grow rapidly, practically doubling the loan portfolio from US $24.7 to US $49 million during the first year. This was supported by a 110 percent capital increase, from MNT 3.9 billion to MNT 8.2 billion (US $3.32–$6.98 million at actual exchange rates), through reinvesting all earnings plus a fresh capital injection from H.S. Securities of US $2 million. This commitment and financial capacity is the best assurance that access to these financial services throughout the country will continue.

Political Issues

Before the intervention of outside management, Ag Bank had never escaped the close supervision of political authorities, particularly at the local level. Throughout the 1990s, soum (county) and aimag (province) governors continued to appoint the bank's local managers and considered them part of the local municipal management team. Loans were directed or heavily influenced by local political needs. The head office had relatively little control over Ag Bank's offices and their operations.

Thus, a critical part of the restructuring plan was to insulate the bank from this political interference. The agreements between the government of Mongolia, Central Bank, World Bank, and USAID required the government not to interfere in any Ag Bank operations. Other than continuing Central Bank supervision and monitoring, no governmental entity could take any steps to influence Ag Bank.

In effect, normal corporate governance was suspended for the remediation period. An independent Board of Directors (made up of two members from the government of Mongolia, two nominated by USAID, and an unaffiliated professional Chairman) was appointed to monitor the remediation process and ensure the government did not interfere. The Board, a semi-annual meeting between the management team and donors, an annual independent audit, and Central Bank supervision formed the *ad hoc* corporate governance structure for the restructuring period. This arrangement was essential to break the pattern of interference that had contributed significantly to the bank's demise.

Shortly after the project started in July 2000, there was a complete change in government from the Democratic Party back to the former Communist Party. Although initially suspicious of the agreements made for Ag Bank's remediation, the new government eventually supported it fully.

Credit Culture

No bank in Mongolia had previously attempted to develop and implement a fully transparent lending program available to all who qualify. Some donors suggested that Mongolia's loan history was so bad that Ag Bank should be remediated without lending. However, the team felt that it was critical to make loans, otherwise, the bank would not recover financially or restore services to the public. Through the appropriate design of financial products and the right staff motivation, a new credit culture was developed.

Previously, most people in Mongolia had to rely on pawnbrokers and family members for loans. Thus, Ag Bank's new lending products were truly welcome as they gave people access to larger sums of money at a lower cost. In the past, loans that were secured through banks were associated with the government. Hence, institutional pressure to repay on time was often lax, and the culture of timely repayment among potential borrowers was weak or nonexistent.

For successful growth and profitability, this culture had to change, from the level of the branch manager to the customers. The first step in meeting this challenge was to hold the branch managers completely accountable for the decisions they made. Absolute zero tolerance was given to politicians locally or nationally who tried to influence the lending. Because an outside management team was running Ag Bank, it was easier to build and sustain this firewall.

Staff Culture

Some felt Ag Bank had too much of a "state sector" mentality and that the staff would not be able to accept the changes necessary to turn the bank around to a position of growth, efficiency, and profitability. Although the employees were well educated and adept at performing most day–to–day banking tasks, it was clear that a new organizational culture would not develop overnight and would be an ongoing process. The key was to harness the capabilities of the staff right away and then expand on their skills. Management wrote new policies and procedures for all areas of the bank and developed a training program. Given the regional and branch operating structure of Ag Bank, training-of-trainers programs were used. The program focused on training at the aimag level, which served as provincial or regional hubs, and then the aimag staff would train the rural locations that reported into that hub. Thus, a fast and efficient way of disseminating new products and other communication was developed. Because of the "state culture" to follow the rules, people caught on quickly and responded to the changes.

In addition, each aimag center branch manager comes to the head office in Ulaanbaatar once a quarter and is given substantial one-on-one time with the senior management of the bank. Targets for lending and deposit generation are set quarterly. Administrative issues also are handled at this time. Thus, the targets are set mutually by the regional branches and the home office so they are realistic yet meet the bank's overall strategy and objectives.

Achievement of targets is reinforced through the incentive system that has become a critical part of the success of the institution. Every employee receives incentive compensation on a quarterly basis that is a significant percentage of his or her salary.

Fully changing the culture from one focused on tasks to one where priorities are customers and revenues still is evolving, but is clearly much improved.

Brand and Image of the Ag Bank

A major obstacle was changing the public's perception of Ag Bank. Although the institution had many advantages, the bank still suffered from its reputation as a politically driven, untrustworthy, and insolvent organization. The first approach to change the public's perception was to provide valuable products and services to customers as soon as possible. The one-percent withdrawal fee was immediately dropped (which had been a major impediment to mobilizing bank deposits), and rates on time deposits were raised to the top of the market, quickly giving Ag Bank the liquidity it needed.

The management team brought in external marketing expertise and launched a major public relations campaign to announce throughout Mongolia that Ag Bank was serious about business and was open to all. Likewise, the bank rebranded itself by switching its name to an acronym, "XAAH." This translates to khan or king, a name with strong local appeal because of Genghis Khan. Television and radio campaigns soon followed.

Product Strategy

The strategy has been to develop products that meet the needs of a large segment of the market, ensuring diversification in product and geographic area. The idea, from the beginning, was to pilot test products quickly and then to expand delivery rapidly via locations countrywide, while always maintaining a focus on quality lending. This is different from the strategy of a slower national rollout and a focus on quick saturation at each branch. All Ag Bank products were designed to be integrated into the branches by existing staff who are responsible for delivering a wide array of these products. Combined with setting quarterly goals mentioned above, this strategy ensures that appropriate product offerings and combinations are tailored to each market.

Loans

Ag Bank continues to identify market opportunities for new loan products. Starting with working capital loans for micro and small businesses just four months after the management team took over, they have expanded to loans for medium enterprises, pensioners, and herders, plus payroll deduction loans and agricultural loans. Currently, the bank is piloting mortgage loans. Although most of the loans are in local currency, some new loans are available in US dollars. Prudent credit policies ensure that lending decisions are based primarily on a client's cash flow followed by collateral to ensure low default rates. Following are descriptions of key loan products.

Micro and small business loans. This product is the mainstay of the lending program in all markets. The original product, launched in November 2000, was the "small trader loan," which evolved into the "small business loan" as the market for the product was widened to include small service, production, and mixed purpose businesses—essentially any kind of micro or small business. Although initially only for short-term working capital, qualified and experienced borrowers can now access term loans. Current interest rates are 2.2–4.0 percent per month and are decreasing because of competition and efficiency gains in underwriting from growing economies of scale. With micro and small business loans starting at US $80, the average outstanding loan size for this product is US $1,419.

Small and medium-size enterprise (SME) loans. This product was developed for medium-size production companies. Because these loans are larger in size and term, they are inherently more risky. They are being made on a limited basis now while the lending team for SME loans is trained and the products are tested in the market. The collateral on some of these larger and longer-term business loans consists of personal residences or business assets. A significant expansion of this product is expected in 2004. The average outstanding small business loan is US $5,011.

Herder loans. These loans were specifically designed to meet some of the unique needs of nomadic Mongolian herders, while taking their cultural and business differences into consideration. Available on terms of up to one year, they help cover the gap between living and operating expenses in the months when herders are not generating income or wish to purchase herd-related goods. Because herders have substantial cash at certain times of the year, penetration of the herder market with comprehensive training and banking services is a priority. The average outstanding herder loan is US $722.

Agricultural production loans. Introduced in May 2002, these loans have garnered interest primarily from vegetable growers, small private wheat farmers, and hay producers. The average outstanding agricultural production loan is US $604.

Payroll loans. Borrowers can borrow up to seven times their monthly salary for a variety of purposes for a term up to one year. Loan payments are made directly through a deduction from their regular salary. These loans provide significant cross-marketing opportunities for Ag Bank. Employers realize that the bank can handle their entire payroll under a mutually beneficial agreement: employers save on administrative costs and bring employer deposits and fees to the bank. The average outstanding payroll loan is US $218.

Pensioner loans. Pensioners were coming into Ag Bank branches monthly to withdraw their payments, an indication that this market was underserved for loans. There were also enormous transaction costs for paying so many small pensions per month. As part of the pension disbursement reform effort in 2001, a loan product was developed for this market. These small loans, which can be up to six times the value of a monthly pension, are repayable by assignment and automatic deduction from future pension payments. These loans empower pensioners to control their cash flow, enable them to borrow money to help their family members venture into microbusinesses, and are an alternative to the traditional practice of borrowing from pawnshops and the informal sector. The average outstanding pensioner loan is US $69.

Deposits

The deposit strategy since DAI took over management of Ag Bank in 2000 has been threefold: (1) to increase the deposit base to fund the bank's growth; (2) to attract a large and diverse number of customers (business and consumer) to solidify the bank's franchise and strengthen the network; and (3) to lessen the dependence on government sources of funds.

By creating products that meet the needs of the market, dropping withdrawal fees, and providing good customer service, Ag Bank has been able to increase its deposit base 740 percent since July 2000. This growth has in turn propelled the bank's expansion. The dependence on government deposits has dropped from 52 percent of all deposits at the end of December 2000 to 6.7 percent at the end of January 2004.

All deposit products are offered in the local currency, tugrug, or US dollars. Following is a summary of deposit products:

- ***Personal or business current accounts.*** These accounts are designed for those who are making regular financial transactions and who need regular statements.

- ***Savings accounts.*** Depositors may add and withdraw money at any time without fees. The account pays interest.

- ***Time deposits.*** This product pays a higher interest rate than a savings account. Deposits are encouraged to be held for at least three months, and incentives are given to savers to add to their deposits over the term.

- ***Pension direct deposit.*** This program was contractually agreed to with the Social Insurance Fund in early 2001. This meant opening accounts for each pensioner, which provided them with an additional service and raised the deposit base of Ag Bank by opening hundreds of thousands of new accounts.

- ***Payroll direct deposit.*** Similar to the pension direct deposit, this product is marketed to large employers that want to eliminate the administrative expense of paying employees in cash. In addition to increased fee income for the bank, the bank also benefits from the many new individual deposit accounts and cross-selling opportunities.

Money Transfer Products

All transfer products are available to anyone, but Ag Bank customers receive reduced fees. Following is a summary of the bank's transfer products:

- ***Quick Pay*** This franchise, which has been developed throughout Mongolia, has been key to the success of Ag Bank. This product guarantees fast delivery (in three hours or less) of cash transfers between offices in the capital, Ulaanbaatar, and any one of the 77 online locations throughout the country.

- ***Money transfer.*** Money can be transferred from one Ag Bank location to any other Ag Bank location in the country. A transfer is delivered the next day to a regional center and within three days to a rural center.
- ***Western Union.*** Money transferred through Western Union can be received at any Ag Bank in Mongolia, and sent to more than 180 countries worldwide.

Impact Analysis

Ag Bank operates a network with 379 points of service throughout Mongolia, much greater than any of the other 16 banks operating in the country. With 354 of its offices in the countryside, the bank reaches 98 percent of the rural communities in Mongolia.

The results from the new products introduced and other restructuring initiatives have been impressive. Below are some of the remarkable statistics for the period July 2000–February 2004:

- Bank offices grew from 269 to 379 points of service.
- The number of employees increased from 803 to 1,833.
- One of every two Mongolian households uses Ag Bank.
- Almost 900,000 loans were made with arrears consistently under 2 percent. (Portfolio at risk over one day was 1.83 percent as of December 31, 2003.)
- The total portfolio outstanding is US $49 million.
- The average loan size is US $382.
- Ninety percent of all lending is made in rural areas, across different population sectors.
- Deposits grew 740 percent from about US $9 million to US $75.5 million; the 377,424 deposits have average balances of US $200.
- There were 15,433 monthly domestic transfers, totaling US $259,796, and the average transfer was US $16.83.
- Monthly pre-tax profits grew from a loss to a current average of US $300,000, with a return on assets of 2.96 percent, and a return on equity of 44.19 percent in 2003.
- Ag Bank paid US $2.9 million (at current exchange rates) in income taxes in 2001, 2002, and 2003 combined.

The management team developed a new lending program, converted payment services into deposits, inaugurated an extensive marketing program to increase deposits, established strong controls through new policies and procedures, structured management more effectively, and significantly increased training activities. Products include loans, deposits, domestic and international transfer instruments, and government payment services. Clients are micro and small businesses, herders and farmers, consumers, and government organizations.

Ag Bank has designed and offered microenterprise loans, SME loans, crop and herder credits, and pension and salaried-based loans (see Table 1). Individuals who do not qualify for the bank's small business loans often use a consumer loan to get started in a new venture. Ag Bank has created a new class of bank borrowers. By recognizing the informal lending sector as a real competitor, Ag Bank has developed a service that encourages many borrowers to successfully move into the formal financial system. Ag Bank's branches are quickly replacing pawnshops, store owners, and relatives for business and consumer borrowers. As a result, families and businesses are able to borrow more money at better terms and lower costs. As of February 2004, 878,976 loans had been disbursed and 128,227 were outstanding.

Another example of an important change has been the conversion of 200,000 government social security and salary payments into deposit accounts. Experience at Ag Bank shows that one-third of all government payments made through a deposit account stay in the account for an extended period. This conversion brought more deposits to the bank and helped build relationships with new customers who could then take advantage of other financial services and loans.

Money also has moved from under mattresses to the bank, witnessed by the growth of individual deposits from just over US $2 million to US $54 million between December 2000 and February 2004. The average deposit account at Ag Bank is US$168. Most of the new depositors are people who previously did not have accounts in banks.(See Tables 2 and 3 for a breakdown in the distribution and evolution of deposits.)

Ag Bank's aggressive growth of deposits and loans, and the subsequent expansion of

Table 1: Ag Bank Loan Porfolio (as of February 2004)

Loan Product	Date Product Launched	Total Number of Loans Disbursed	Total Value of Loans Disbursed (US $000s)*	Total Number of Loans Outstanding	Total Value of Loans Outstanding (US $000s)*	Average Loan Oustanding (US$)
Micro and Small	Nov 2000	80,835	98,780	13,485	19,135	1,419
Small & Medium	May 2001	3,300	15,555	1,633	8,184	5,011
Pensioners	May 2001	628,431	36,912	72,277	5,003	69
Herders	Aug 2001	31,373	20,753	9,449	6,819	722
Payroll Based	Oct 2001	132,784	34,177	30,539	6,654	218
Crop	May 2002	1,483	746	148	89	604
Mortgage	Apr 2003	770	3,752	696	3,144	4,518
Loan Product		**878,976**	**210,674**	**128,227**	**49,028**	**382**

other banks' operations throughout Mongolia, have had an impact on the intermediation of Mongolia's money supply. In 2000, more than half the country's money supply was in currency held outside of banks; today, less than one-third is held as currency. The long-term benefit of this intermediation for Mongolia's development is considerable as it provides internal resources for increased investment.

Another measure of Ag Bank's impact is the growth of the small businesses that dominate rural Mongolia. Average small business loan sizes have increased steadily over the past three years as increased inventory levels have translated into increased

Table 2: Ag Bank Deposit Porfolio (as of February 2004)

Deposit Category	Outstanding Balance (US $000s)	% of Total Outstanding Blanace	Number of Depositers	% of Total Depositers	Average Accound Balance (US$)
Organizations	**15,849**	**20.99**	**14,354**	**3.8**	**1,104**
Current	12,024	15.92	14,318	3.79	840
Time	2,823	3.74	22	0.01	128,347
Demand	1,001	1.33	14	0.00	71,471
Individuals	**59,667**	**79.01**	**363,070**	**96.20**	**164**
Current	2,044	2.71	266,875	70.71	8
Time	47, 265	62.59	39,971	10.59	1,182
Demand	10,358	13.72	56,224	14.90	184
TOTAL	**75,515**	**100.0**	**377,424**	**100.0**	**200**

Table 3: Ag Bank Deposit Evolution (in US $000s)*

Deposit Category	31 Dec 2003		31 Dec 2002		31 Dec 2001		31 Dec 2000	
Business	9,730	13.2%	9,798	22%	8,117	33%	3,663	28%
Government	4,293	6.7%	8,207	18%	8,570	35%	6,712	52%
Individuals	50,225	80.1%	27,028	60%	7,752	32%	2,520	20%
Total	**64,248**	**100%**	**45,034**	**100%**	**24,439**	**100%**	**12,896**	**100%**

*Note: Most loans and deposits are in the local currency, tugrug, and have been converted here to US dollars at the current exchange rate of 1,174 sales. Today, with loans to micro, small, and medium enterprises, Ag Bank's average outstanding business loan is US $1,807.

From a cost recovery perspective of the original work that began in July 2000, the value of Ag Bank has increased so much over the period that it could have easily paid for the cost of the turnaround by the value that was created—witness the bank's sale price and the ongoing management contract between HS Securities and DAI. The earnings in 2003 were close to the entire cost of the three-year, donor-financed turnaround. Today, Ag Bank is the second most profitable bank in Mongolia, with average monthly net income of US $300,000 (including the cost of the DAI management contract that is paid out of earnings). In 2003, Ag Bank ranked number one of all Mongolian banks in terms of return on assets (2.96 percent) and return on equity (44.19 percent).

Driving Factors

The government of Mongolia's commitment to change Ag Bank, as part of its overall privatization and economic modernization program, was key to success. Its strategy of hiring international consultants and privatizing the bank was the right recipe. The experienced management team, coupled with the commitment of the local staff and strong business strategy, provided the skills to achieve the projected outcomes. Finally, the support and pressure from external forces encouraged political fortitude and kept the project on track.

Commitment and Political Economy for Change

Management's Independence.

A critical part of the turnaround was getting assurances from the government that the new management team could operate free from political influence. The new management team was given the authority over personnel issues, credit policies, and expenditures through a memorandum of understanding. It also was given capital forbearance (that is, normal minimum capital and capital adequacy standards were suspended) for the period of the restructuring agreements.

Central Bank Guidelines

Early on, the turnaround team reached agreement with the Central Bank as to when Ag Bank's financial ratios would comply with prudential standards, and a conservative timetable was put in place. Management met all Central Bank guidelines a full year before the end of remediation and has continued to exceed all requirements.

Privatization

Although the outside management had the authority and responsibility to run Ag Bank, the concern was that problems could arise when they left, when the "firewall" came down. This is why it was so critical that one of the pre-conditions previously discussed—government commitment to privatization of the bank—was held to. The government of Mongolia agreed to turn the institution over to private investors for accountability, and the initial management contract ran until the bank was privatized.

The government of Mongolia carried out its privatization agreement by organizing an international competitive tender, on the advice of KPMG Barents (now BearingPoint), another USAID contractor. Most observers found the process fully transparent and successful.

Local Staff

Taking control of the decision process did not end with ministry and senior management. Previously, local branches functioned as part of the province or county administration. Branch managers were appointed in most cases by the local governors of the ruling parties. Appointment as a branch manager was a source of jobs and loans for people who desperately needed them. Based on the culture, they were more likely to first accommodate the need than to understand the implications from a business perspective. Managers at Ag Bank branches now understand the importance that the institution be strong, which will increase outreach to even more viable clients and, thus, stimulate the overall economy. They also know that the senior management team holds them accountable for their actions, but that if they perform well, they will be compensated fairly and receive proper incentives and bonuses for performance.

The foreign managers also recognized that the national staff needed insulation from local pressures, as they would become the next logical targets. The key to overcoming these obstacles and temptations has been: (1) clear policies that require transparency; (2) personnel who will speak up when they are asked to circumvent policy; and (3) staff's willingness to use the foreign managers as a way not to comply with inappropriate requests. The first encounter with an official who wants his way and cannot get it may be difficult, but when people learn that the new management operates transparently, they usually will not ask for favors or bribes.

Institutional Innovation

An experienced management team using a sound business strategy, upgraded and retailored those products, services, and operations that took advantage of the vast branch network.

Managerial Leadership.

The skill sets and competency of the senior management were critical. The team brought together experiences, knowledge, and management skills gained from working in countries with similar economic situations, as well as indepth knowledge and experience of US banking. In addition, some of the most experienced Mongolians were recruited for the executive team, who provided critical technical and cultural knowledge for the transformation of the bank. The management team set the tone and led the organization to develop a culture based on operating discipline and service innovation.

Management featuring clear lines of authority was the joint effort of expatriate and local professionals. The starting point of Ag Bank's turnaround was precarious. Decisions had to be reached and implemented quickly, and it was critical to deploy individuals with relevant outside experience who were not beholden to domestic political interests. Local departmental managers hired or promoted to the executive level were highly valued for their institutional memories as well as their keen understanding of the domestic market and culture. The project could not have been successful without this synergy between outside and inside management.

Products and Services

Before restructuring a bank and introducing new financial services, it must be confirmed that an underserved market exists with untapped demand sufficient to support the restructured bank. If the prospective market is being adequately served by others, the cost and effort of a turnaround are probably not justified and could crowd out existing financial institutions. In Mongolia, studies were conducted to understand the general market potential before the turnaround contract began. The fact that a strong, informal market offered loan rates of 12–15 percent a month revealed a demand that banks were not serving. Every project needs a golden goose, a competitive advantage. In the case of Ag Bank, a real need for sustainable financial services existed in the rural areas of the country. The bank was able to leverage existing branches and staff to deliver services quickly and efficiently.

Diversification

In addition to offering new products, one important shift in the product and client mix was diversification away from government reliance. At the beginning, more than 50 percent of deposits were from the government. This reliance put Ag Bank's liquidity at potential risk should the government withdraw significant funds. The bank sought and attracted deposits from private businesses and individuals. The result has been a shift from 52 percent government deposits to the current 6.7 percent. The private sector deposits are made up of hundreds of thousands of individual depositors, which created greater diversification.

Operational Efficiency

If faced with challenging financial targets, the first reaction of many new managers is to start cutting costs. A common problem at state-owned banks, however, is that not enough is spent to generate required revenues. There are costs associated with delivering products and offering an acceptable level of customer service that are critical in a competitive market. It was found that small additional expenditures (primarily staff training and minor improvements to the banks themselves, such as roofs and purchases of furniture and computers), combined with prudent lending at the initial 269 Ag Bank points of service, could lead to exponential growth in revenues. With only US $300 profit from each small point of service and the contributions from larger regional centers, it was not long before US $300,000 was earned each month. These numbers were substantial for a bank without capital and with initial assets of only US $10 million. Nonetheless, with client-focused services, prudent lending, and professional management, the results were quite achievable.

To generate profitability, however, the increase in revenues needed to be met by cutting unnecessary expenses. For example, although new staff were hired to improve the services or technical aspects of the bank, other staff had to be cut because they were less competent or were redundant. In the case of Ag Bank, most of these cuts took place while it was under Central Bank receivership. One of the first steps new management took was cutting the right costs.

Learning and Experimentation

The most important change for the new organization was focusing on client service and a healthy bottom line. This meant all staff had to learn new ways of doing business, and the organization had to experiment with products and systems that matched the institution with its market.

Staff Training

One of the clear advantages at Ag Bank was a well-trained and disciplined staff. Although they were not used to thinking strategically, they quickly grasped new products and marketing approaches and implemented them. In the countryside, staff and their families are imbedded in the local communities, and they know who, where, and how to find people to borrow money who would pay it back.

State-owned banks often have negative public images. It is important to capitalize on the existing positive aspects of the brand, but the institution also needs to be seen as "new and improved" from both a customer and an employee perspective. Ag Bank had a particularly unsavory reputation in the eyes of the public, but it was trusted because of its implicit government backing. Through efforts to develop brand identities, better customer service, and overall public confidence, Ag Bank now commands much more favorable opinions. Staff buy-in is critical to the success of an institution. Within the bank, motivating the staff with training, fair and performance-based compensation, and recognition for good work has created better and more efficient working environments.

In the two and half years of the USAID-funded remediation, training was an integral part of reform for staff at all levels. The training program focused on the practical skills and information that employees needed to deliver bank products and perform their jobs. Because of the importance training played in the turnaround of Ag Bank, Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (GTZ) provided assistance to establish a professional training department at the bank and significantly upgrade the skills of trainers.

Product Development

In addition to staff training, product development and rollout was based on a rapid but integral learning and experimentation process. As described above, products were identified by managers at various levels. Once standard policies were drafted and approved, the products were pilot tested, refined, and then rolled out nationally. Training for product rollout went from the national to the regional and branch levels, and decisions on how much to focus on a particular product were decided jointly at the local and national levels. In this way, staff was able to experiment and learn which products were most appropriate in each market.

Management Information Systems

One common reason why a business fails is uncontrolled growth. In a state-owned bank turnaround, it is imperative that revenue growth be balanced by a quality portfolio and by systems and procedures to detect and correct problems. Systems to monitor portfolio performance and to detect fraud are both crucially important. These systems do not have to be complex—at remote branches, they need not always be computerized—but they must be timely and complete. At Ag Bank, the lack of computers and networked communication systems was not a hindrance to timely and accurate reporting. Managers developed simple paper reporting systems through which local, regional, and national data were tracked and used for ongoing analysis and decision making. The data are critical to the learning and experimentation process as they provide the evidence of which innovations work and which require refinement.

External Catalysts

The support and pressure provided by external agents—including donors and private firms—were key to securing initial and ongoing commitment for change and achieving sustaining results at Ag Bank.

Donor Agencies

Although a turnaround is conceptually feasible without international support, the turnaround in Mongolia would not have occurred without participation by the World Bank and USAID. Other bilateral and multilateral entities also made significant contributions. International donors helped ensure the decision-making authority of the turnaround teams and provided critically needed funds for capital improvements and technical assistance. The World Bank was instrumental in reaching consensus with the Mongolian government, while USAID funded the DAI team that led Ag Bank’s turnaround.

Consultants and Managers. As an expatriate on a management team, operating under a clear sense of corporate governance and of protecting Ag Bank's assets, the CEO and his team had clear power and the authority to say “no.” Foreign managers working on the bank’s turnaround did not have the societal imperatives that would create expectations and temptations contrary to the turnaround efforts. Therefore, it was critical that the new senior managers come from outside of Mongolia for the rapid turnaround. Likewise, the external consultants were important for managing a transparent valuation, bid, and selection process.

Private Investors

The private investors that purchased the bank were the final link in ensuring the turnaround efforts created economic value and that the bank would continue to offer services to rural Mongolians in a sustainable manner. Their international links have brought new ideas and resources to the institution.

Lessons Learned

It is challenging to turn around a large state-owned bank. Success rests on a confluence of political and financial circumstances, both internal and external. The driving factors summarized above should be considered as requirements for any successful turnaround effort. The most critical lessons learned are summarized below.

Management must be politically independent and qualified

Management was able to pursue successful turnaround strategies at Ag Bank because of the unique design of the remediation and the support of the bank's stakeholders. As the historically state--owned bank in the countryside, Ag Bank was under very strong pressure to serve the government's political needs. Because the USAID-funded project team was given full authority for the bank, a unique approach for USAID, a new credit and operating culture could develop that has resulted in a very profitable and high quality credit portfolio. The carefully structured independence, buttressed with donor conditions, was essential to rebuilding a sound bank.

The starting balance sheet must be clear

Before beginning an assignment, the turnaround team must understand the true position of the bank's balance sheet and negotiate accordingly with the government. All earnings and fixed assets must be properly evaluated, and any needed capital must be put into the institution to raise the capital base to no less than zero. Capital can be injected as cash or as development bonds, depending on the institution's liquidity position. If bonds, the interest should be paid in cash to provide adequate cash flow. There should be adequate funds to cover initial operating costs and to purchase immediately required fixed assets. A long-term cash flow stream needs to be identified to support the ongoing operations.

Staff requires training, incentives and protection from political pressures

Staff requires ongoing training in skills, policies, products, and systems, especially during a time of significant organizational change. Transparent and performance-based incentive systems help ensure that priorities and behavior are aligned with the institution's best interests. When staff is threatened or pressured by political forces, senior management should provide protection in the form of being used as an "excuse" for not giving in.

Marketing is essential

A key lesson learned by Ag Bank is the importance of marketing- focused research, strong brand promotion, and products responsive to customer demand to provide an income stream to sustain the organization. Ag Bank's managers used a combination of local knowledge from their branch managers, formal market surveys, and experience from working in other developing countries.

Financial intermediaries can profitably service low-income markets

Some doubt whether low-income populations can or will pay for the financial products and services they need. The experience in Mongolia proved different—that where per capita incomes are low, there is a large market for the right kind of deposit and credit products, even if the interest rates and fees are relatively high. Low-income market segments will pay for the right products and good service.

Meeting client's financial services needs has a positive economic impact.

Often, small businesses will borrow lower amounts of money than they need, which can be valuable in building a credit history. However, if the lending products do not adequately meet the needs of the business owners, and match their ability to service certain levels of debt, a large dropout rate will occur. Thus, the products (including the delivery and services attached to them) must grow and develop to reflect accurately the needs of the market. The most expensive part of a borrower relationship is acquisition—bringing the borrower into the institution for the first time. Profitability and sustainability will come from loan renewals and cross-selling other products.

Penny wise may be pound foolish when it comes to operating efficiency.

Although competitive and profitable banks must operate efficiently, the focus should not be exclusively on cutting costs. Rather than closing branches, the focus should be on revenue-generating services that take advantage of the network. Incremental revenue can add up to significant net income. Nonetheless, operating costs should remain under control. State-owned banks can usually meet the needs of their market segment with relatively low-cost operations. The intent is not to compete with international banks going after high-end customers, but to appropriately serve rural and low-income market segments. Money should be spent to make the branches adequate and comfortable, but they do not have to be the best in town. Occasionally, only two people are needed in a location, and hand ledgers and a calculator may be adequate technology.

State-owned banks can be turned around.

With a low operating costs and good returns from lending, Ag Bank was able to generate the profits to reinvest in physical and human infrastructure and make the bank sustainable, while providing the needed services to the underserved market. The process evolved into a "virtuous cycle" driven by the strong demand, as well as unmet need, for the new services. The Ag Bank experience stands in contrast to the commonly held view that state-owned "dinosaur" banks cannot be turned around and successfully privatized. There may be other cases where, despite a poor history and state sector culture, latent but strong franchise value in a branch network or customer flow can be capitalized into profits and sustainability.

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Chapter 4

Microfinance in Bangladesh: Growth, Achievements, and Lessons

BY HASSAN ZAMAN

Executive Summary

It is truly remarkable that the microfinance industry in Bangladesh has been able to provide access to credit to around 13 million poor households. There are hundreds of organizations offering microcredit, although the bulk of the clients borrow from a handful of large organizations—Grameen Bank, BRAC, ASA, and Proshika.

This growth in access took place during several distinct phases over the last three decades. The origins of the current microcredit model can be traced back to action research in the late 1970s, carried out by academics as well as practioners in organizations that were created to deal with the relief and rehabilitation needs of post-independence Bangladesh. The 1980s witnessed a growing number of non-governmental organizations (NGOs) experimenting with different modalities of delivering credit to the poor. The various models converged around the beginning of the 1990s toward a fairly uniform "Grameen-model" of delivering microcredit. This last decade, especially, saw a sharp increase in access to microcredit. And in recent years, the standard Grameen-model has undergone greater refinement in order to cater to different niche markets as well as to different life-cycle circumstances.

Looking at the Bangladesh experience in perspective, one can argue that the current, remarkable scale of access is attributable to specific factors. First is visionary leadership within the pioneering microfinance organizations. The founders and leaders of Grameen Bank and BRAC, in particular, created decentralized structures with appropriate incentives that encouraged high staff performance, which in turn underpinned rational expansion based on existing capacity and client demand. Second, the government of Bangladesh created a conducive macro-environment and implemented a "hands-off" regulatory policy. Third, donors played a constructive role by providing resources at the appropriate time. This included funding the initial expansion phase of several microfinance institutions and then building the institutional capacity and systems needed to ensure sustainability. Fourth, high population density and relative ethnic, social, and cultural homogeneity made "franchising" the microcredit model less difficult, and significantly propelled its expansion. Fifth, the public-private microcredit "wholesaler," PKSF, was far-seeing enough to take

advantage of already-established retail capacity to scale up the microcredit industry, as well as demand professional standards and a focus on sustainability.

The consensus in the literature holds that access to these micro-loans has considerably reduced the vulnerability of poor households in Bangladesh. Poor households are able to smooth their consumption more dependably, thereby limiting the hardships arising from seasonal shortfalls of income. Unanticipated shocks such as natural disasters can be better absorbed by building up assets. Female borrowers are less vulnerable and more empowered within their households and the wider community.

The availability of microcredit has indirectly affected social conditions—for instance, children of borrowers are more likely to go to school, have better sanitation facilities, and better nutrition. These impacts are due to the "increased income effect" of microcredit as well as the "social mobilization effect" of borrower group meetings.

This paper proposes five lessons from Bangladesh that are relevant to microfinance growth and impact in other countries. First, an "enabling environment" for microfinance is critical, especially maintaining a stable macro-environment where both interest rates and inflation are kept at reasonable levels. Government regulations and policies are needed to create an appropriate environment for the growth of the sector, where regulatory policies strike a balance among protecting the interests of depositors, supervising microfinance institutions that collect savings, and not excessively regulating the sector with unnecessary red tape.

A second lesson is that microcredit may be a more effective remedy against poverty and vulnerability if it is complemented by other interventions. These interventions may be especially important for the poorest households, which face the greatest risk of income fluctuations and have the greatest need for a range of financial and non-financial services.

Third, there is a role for donor financial assistance in expanding the capital base of emerging microfinance institutions, as well as developing the technical capacity necessary for organizational sustainability. Hence, subsidies can be justified to support microfinance institutions in their earliest stages, as long as there is a viable route to institutional sustainability.

A fourth lesson is that, while visionary leadership cannot simply be "franchised," the systems and formal rules that govern the successful microfinance industry in Bangladesh can to an extent be replicated. These may vary according to the size of the organization, but by and large, the successful organizations delegated significant decision-making authority away from head-offices, monitored individual staff performance, and linked staff incentives to program targets. Client feedback and program monitoring are also crucial. As organizations grow, the willingness to change products based on client need and demand and to create products tailored to niche markets is crucial for success.

Fifth, one of the lessons unique to the Bangladesh experience was the critical role played by a microfinance wholesaler, in expanding access and developing professional standards. However, apex bodies are not a panacea, and a rigorous analysis of the underlying retail capacity and demand for funds must be carried out before they are established.

Introduction

The fact that the microfinance industry has been able to provide access to credit, currently, to nearly thirteen million poor households in Bangladesh is truly remarkable. There are around twelve hundred microfinance institutions (MFIs) operating in Bangladesh,[1] but the industry is dominated by by four large MFIs—BRAC, Grameen, ASA (Association for Social Advancement), and Proshika—that serve around 11.5 million, or 90 percent of all MFI clients.[2] After the "big four," the next largest NGO, Swarnivar Bangladesh, has 0.7 million clients, and then there are probably only ten NGOs that have more than 100,000 borrowers. The bottom line is that the majority of the MFIs are small (less than 5,000 borrowers), and that the bulk of the access to microcredit is supplied by four MFIs. As such, the experiences of scaling up discussed here draw primarily upon these large MFIs.

The Evolution of the Microfinance Industry in Bangladesh

The growth in the poor's access to credit took place in several distinct phases over the last three decades. The origins of the current microcredit model can be traced back to action-research in the late 1970s, carried out by academics as well as practioners in organizations that were created to deal with the relief and rehabilitation needs of post-independence Bangladesh. The 1980s witnessed a growing number of non-governmental organizations (NGOs) which experimented with different modalities of delivering credit to the poor. The various models converged in the beginning of the 1990s toward a fairly uniform "Grameen-model" of delivering microcredit. It sparked a sharp growth of access to microcredit during this decade. In recent years, the standard Grameen-model has undergone more refinements in order to cater to different niche markets as well as to different life-cycle circumstances.

The 1970s

Experimentation in providing credit to households considered "unbankable" by the formal financial system originated a few years after Bangladesh's war for independence in 1971. The independence movement gave rise to a new generation of young activists who were keen on contributing to the reconstruction of this war-ravaged country. The new government and a myriad of aid agencies that arrived on the scene were unable to cope with the scale of destitution, and non-governmental organizations emerged to meet the challenges. The early years of the NGO movement in Bangladesh focused on relief and rehabilitation with an emphasis on community development. However, by the mid-1970s, two of the NGOs that would subsequently expand in scale, BRAC and Proshika, found that "elite capture" was a serious impediment to their development objectives. As a result, a separate focus on the poor through a "target-group" approach was introduced. Moreover, an ideological debate within both these organizations began to brew, between those who favoured economic tools (credit, savings, etc.) to support poverty reduction and those who believed that social mobilization against existing injustices would suffice and financial services were unnecessary.

Around the same time, a team of researchers at Chittagong University, led by Professor Yunus, began an action-research program that provided loans to poor households in a few villages. Borrowers were mobilized in "peer groups" composed of four to five individuals who were jointly responsible for each others repayment. Several of these small "peer monitoring groups" would be organized together into a larger unit which would meet weekly with the primary purpose of repaying loan installments. The process of trial and error initially combined males and females in the same credit group, but then changed to separate gender groups. It also included "occupational groups," but this was dropped in favor of village-based groups. The demand for loans grew rapidly and Professor Yunus enlisted the support of the Bangladesh Bank and other commercial banks to provide the Grameen Project—as it was then called—with resources. The success of this experiment paved the way for the establishment of the Grameen Bank under a special ordinance in 1983.

The 1980s

In the early 1980s, several NGOs experimented with different ways of delivering credit. One important mode tested was the efficacy of providing loans for group projects compared to offering loans to individuals with peer monitoring. The broad lesson was that the latter was more effective because of the incentives and it lacked the "free-rider" problems seen in lending to a group. Hence, by the late 1980s, the predominant model became providing individual loans to a target group of poor households, with peer monitoring and strong MFI staff follow-up.

The Association for Social Advancement (ASA) is a classic example of this shift. Its initial emphasis was on forming "peoples' organizations," mobilized for social action against oppression. It changed to target groups and then to provision of financial services in the late 1980s. Now ASA is the fourth largest MFI in Bangladesh in number of clients, and its unique low-cost credit delivery mechanism is being replicated in several other countries. ASA keeps paperwork requirements to a minimum, has decentralized most decision making to the field, and overall has a very lean operation.[3]

The 1980s and early 1990s were also important to the development of management capacity within several of the large MFIs, which allowed them to expand their microcredit programs. What is particularly interesting is that the development of the know-how and confidence to implement large programs arose, in some cases, from the experience of scaling up programs not related to microcredit. For instance, in the case of BRAC, its first major experience with a nationwide program came when it implemented an oral rehydration program to combat diarrheal disease. Thirteen million women were trained to use a simple but effective rehydration solution, and BRAC staff were paid based on how many of their trainees used and retained this knowledge.[4]

Early to Mid-1990s

The early 1990s was the period of rapid expansion of the Grameen-style microcredit approach.[5] The growth was fueled largely by "franchising," whereby new branches replicated the procedures and norms that prevailed in existing branches. It was clearly aided by the high population density and relative ethnic, social, and cultural homogeneity in Bangladesh. A notable shift occurred during this expansion phase to placing a greater emphasis on individual borrower accountability for loan repayment and less reliance on peer monitoring. Staff follow-up of loans became more rigorous and professional with the use of computerized management information systems.Donor funds helped in varying degrees to expand the revolving loan funds for MFIs, particularly during expansion phases of the various institutions. Moreover, PKSF emerged during this period as a wholesale financing institution. Following this expansion, a geographical mapping of microfinance suggests that all districts in Bangladesh now have microcredit services, although there are many smaller pockets with little or no coverage (e.g., Chittagong Hill Tracts). A closer look shows that there is somewhat greater coverage of poor households in the central and western districts. The southeast and pockets of the northeast still have room for expansion of coverage.[6]

Mid-1990s Onward

Feedback from the field, academic research, and international experience contributed to an increasing emphasis on providing diversified financial services for different groups of households from the mid-1990s onwards. The benefits of a narrow focus on microcredit during the expansion phase was that it kept costs low, operations transparent, and management oversight relatively straightforward. However, it became clear that the standard Grameen model of providing microcredit with fixed repayment schedules, and standard floors and ceilings on loans sizes, was not sufficient to meet the needs of the extreme poor or the vulnerable non-poor.

Moreover, existing microcredit borrowers also required complementary financial and non-financial services. The standard practice for MFIs until the late 1990s was to collect compulsory weekly savings from their clients, holding the money as a *de facto* lump sum "pension," which was returned when a client left the organization. Access to these deposits was otherwise limited, which curtailed a potentially important source for smoothing consumption.

Recognizing these limitations, an increasing number of MFIs in Bangladesh have offered savings accounts that clients can withdraw from more freely, in addition to the fixed deposit scheme. Moreover, many MFIs have life insurance products, whereby outstanding microcredit debts are written off and other benefits are paid following the death of a borrower. Non-credit services can also take the form of input supply, skills training, and marketing support for micro-enterpreneurs.[7] A complementary package to microcredit can also take the form of providing education for the children of borrowers. Grameen Bank, for instance, has a scholarship program for secondary education for girls, and a student loan program for tertiary education. Similarly many MFIs have community health programs, legal literacy training, and information on how to access local resources.

MFIs began to experiment with new niche markets as the traditional microcredit business became standardized (and horizontal expansion slowed) and required less attention. For instance, several NGOs began providing larger loans to "graduate" microcredit borrowers, and in some cases to households which were not part of the microcredit system but which wanted a micro-enterprise loan. These loans typically range from 20000 *taka* (around US $320) to 200,000 *taka* (US $3,200). Innovative solutions are also emerging to address the problem of access for the small enterprise sector. For instance, BRAC has established a separate financial institution, BRAC Bank, that focuses on lending to the "smaller end" of the small enterprise sector, with loans averaging 400,000 taka.

Moreover, evaluation studies pointed out that extremely poor households were struggling to benefit from the standard microcredit model, even if they joined the programs. There were a number of factors that kept the extreme poor from borrowing or from benefiting from loans if they obtained them. Minimum loan floors for a first loan sometimes exceeded what clients perceived they needed. Fixed weekly loan repayments could be difficult to commit to in light of seasonal income. Other members of peer-monitored groups sometimes do not wish to guarantee loans for extreme poor households. Residing in remote or depressed areas can also complicate access.

Programs have been developed to make these constraints more manageable. ASA's Flexible Loan Program introduced more flexible repayment schedules. Mimimum loan floors for first loans were lowered so that amounts as small as 500 taka ($9) could be borrowed. Grameen's program offers zero interest loans to beggars. The Resource Integration Center's program specializes in offering loans specifically to the elderly poor, an unserved vulnerable group. Various programs also combine food aid with microcredit and training, like BRAC's IGVGD program. ASA has targeted remote areas, offering services through its cost-effective mini-branch system, and Integrated Development Foundations work in the Chittagong Hill Tracts.

Factors That Led to the Scaling Up

Institution Building—Leadership, Staff Incentives, and Learning by Doing

It is unquestionable that the vision and persistence of the leaders of the NGO/MFI movement are key factors behind the success of the microfinance industry in Bangladesh. Leadership skills were instrumental at initial stages in persuading a skeptical public that providing credit to the poor could become a viable and replicable proposition. These skills were equally important during the process of scaling up—skills such as being able to recruit and motivate staff, decentralizing authority away from the center, building management information systems and internal controls, as well as having the humility to learn from mistakes.

Staff recruitment, motivation, and retention are particularly important for large organizations. BRAC, for instance, employs around 28,000 staff in its various programs; Grameen has around 12,000 in its microcredit program; and ASA's microcredit program employs around 8,000 staff. A critical element in this process is an objective performance evaluation system for staff that is linked to career mobility and other incentives for staff to perform well both individually and in teams. Grameen Bank, for example, has introduced a system for rating branch offices on the achievement of specific targets, which not only include standard loan recovery but also factor in social indicators, such as the proportion of children of Grameen clients going to school.

Staff motivation is also enhanced by decentralizing significant responsibility to the lower tiers of the administrative structure. ASA is the best example of a lean credit delivery structure with high levels of decision-making authority given to field offices, from loan sanctioning decisions to staff human resource issues. Moreover, the structure within field offices is relatively horizontal with a branch manager who works with individuals fieldworkers to resolve problems and typically shares living quarters with other field staff.[8]

Effective internal controls are also important in ensuring effective staff performance. The fact that financial transactions are handled openly, in the weekly meetings and in the branch offices, is a major deterrent to any form of discretionary behavior by field workers. Many NGOs, particularly the ones that have successfully expanded in scale, have developed measures that include frequently rotating staff within and between branches, scheduling regular field visits by senior management, developing a strong internal audit team, and contracting annual external audits.

A fundamental part of the scaling up of Bangladesh's NGOs, and more specifically the microfinance movement, has been the ability to learn from experiences and adapt programs accordingly. This learning process takes place both through informal feedback by field staff during regular interactions with management, as well as through a formal monitoring and evaluation process. BRAC's Research and Evaluation Division has around 20 professionals whose key function is to evaluate BRAC's multi-dimensional programs and give timely feedback to program staff and management. This feedback process occurs in longer term research as well as assessments with quick turnaround. The shift to more flexible financial services, that took place in recent years, was largely based on client feedback and analysis of the limitations of a uniform microcredit model.

A Constructive Donor-Client Relationship

External resources played an important part in the experimentation, subsequent growth in outreach, and institutional strengthening of the microfinance industry. At the same time, the large microfinance institutions have been successful in "managing donors."

International NGOs, such as the Ford Foundation, Oxfam, and the Aga Khan Foundation, played an important role in the initial stages of the NGO-MFI industry in Bangladesh. The subsequent expansion and consolidation was funded largely by official bilateral agencies, and later by multilateral agencies, when international NGOs could not match the growing resource requirements of the larger MFIs. The 1990s have seen dependence on donor resources progressively decline for the large MFIs. Grameen Bank, ASA, and BRAC do not receive any grant financing for their microcredit operations. Moreover, out of BRAC's total $160 million expenditure on development programs in 2002, more than 80 percent was financed from its own resources, through the interest income on microcredit as well as surplus from its commercial enterprises. Two facets of these trends are worth highlighting.

First, the decisions to subsidize these operations were not free from controversy. Advocates for funding these loan funds had to argue their case with officials within their own agencies who believed that the capital base for loan operations ought to be enhanced only by savings mobilization or borrowing from commercial sources. In retrospect, these decisions to contribute to MFI loan funds were by and large correct, as almost all of the MFIs that received this support have either attained financial self-sufficiency or are well on their way to doing so. Donors also invested in organizational systems and MFI staff training in order to strengthen the capacity to administer these growing programs.

Second, large NGOs in particular have been reasonably successful in managing donors. BRAC, with its large multi-faceted programs, has a long history of working with donors, and the evolution of this relationship is worth highlighting. Donors, who have their own incentives to commit resources and demonstrate results on the ground, have been eager to provide resources to organizations with proven track records. Hence, the likes of BRAC have had to deal with multiple donors who each wanted to fund specific projects. These uncoordinated donor missions and disparate disbursement and reporting arrangements taxed BRAC's internal capacity and led to its management proposing changes for how donors ought to operate.

In the early 1990s, donors shifted their approach from financing specific BRAC projects to financing BRAC programs. Donors also formed a "consortium" that pooled funds, negotiated jointly with BRAC, and agreed to common reporting requirements. An important part of the consortium funding arrangement and the move toward program funding has been an improvement in the predictability of resource flows. For instance, BRAC secured financing for its Rural Development Program for a five-year period from the donor consortium. Moreover, the establishment of a donor liason office for BRAC also acts as a buffer between BRAC staff and the various visitors, consultants, and evaluators.

A Progressive Government Stance

The appropriate "enabling environment" that existed in Bangladesh greatly aided the early experimentation and later scaling-up of the microfinance industry. The macro-economy of Bangladesh has, by and large, been soundly managed, and the significance of this should not be underestimated. The rate of inflation has been kept to single digits, and economic growth over the past decade has averaged around 5 percent per annum, thereby creating economic opportunities for microcredit-financed investments.

It is also significant that the government of Bangladesh has thus far maintained a balanced approach towards regulating and supervising the activities of the NGO sector. This has been critical in ensuring the operational flexibility that is the cornerstone of service delivery by NGOs. While this long relationship has not been free from tensions on both sides, the government of Bangladesh has thus far been able to place the interests of the poor foremost when dealing with NGO issues. A recent example is the decision to release donor funds earmarked for Proshika, even though it was being investigated for alleged irregularities in the use of its funds.

Ultimately, though, the relationship between the government and the NGOs depends on individual personalities and social ties[9] as there have always been widely varying individual views regarding NGOs within the civil service and the Cabinet. Individuals in key positions within the government have time and again been instrumental in facilitating the growth of the microcredit sector. The early development of the Grameen project, its registration as a bank, and the decision to grant it managerial autonomy are clear examples,[10] as was the establishment of PKSF with a strong autonomous board. However, the prevailing consensus is supportive of NGOs, although accusations of involvement in party politics by a handful of NGOs have strained the overall government-NGO relationship of late.

Looking forward, it is clear that the regulatory framework for microfinance needs to be strengthened, particularly in light of the large amounts of deposits mobilized for the poor. The Central Bank, PKSF, and representatives of MFIs are currently working to produce a set of guidelines and standards to strengthen the regulatory framework.

A Professional Apex Body for Microfinance

The Palli Karma Sahayak Foundation (PKSF) was created in 1990, and is governed by a board composed of both public and private sector representatives. It is a public-private apex body that channels funds for microfinance to MFIs, and has been critical to the expansion and improved professionalism of the microcredit industry in Bangladesh. PKSF's core functions include (i) lending money to MFIs, which meet certain eligibility criteria, to expand their microfinance operations; (ii) building capacity and giving hands-on assistance to strengthen MFIs and move them towards financial sustainability; (iii) advocating microfinance issues and helping develop an appropriate regulatory framework for the industry.

PKSF played an instrumental role in contributing to the sharp increase of access to microcredit that took place in the 1990s by expanding the capital base for MFIs to onlend to the poor. For instance, as of December 2003, PKSF loans constitute around 30 percent of ASA's current revolving loan fund. PKSF is also widely credited for sharpening the focus of many MFIs on financial sustainability and in setting appropriate standards to pave the way to a strengthened regulatory structure for microfinance.

There is a growing experience with setting up apex institutions worldwide, e.g., PPAF in Pakistan, RMDC in Nepal, FONCAP in Argentina, LID in Bosnia-Herzogovina, and MISFA in Afghanistan. One of the fundamental factors behind the success or failure of an apex is the underlying retail capacity in a particular country. The overall strength of the MFIs in Bangladesh has been key to PKSF's success. Overestimating the capacity to absorb funds by the MFIs on the ground can lead an apex body to fail. However, if a realistic assessment of the underlying retail capacity is made, then apexes offer many benefits, such as the ability to screen MFIs on standard criteria and creating a "level playing field."

The Impact of Microfinance in Bangladesh

The evidence of the impact of microcredit can be assessed from two interrelated angles. First, who does credit reach, and second, how does it affect the welfare of different groups of individuals and households?

Land ownership, occupational criteria, and asset valuations are standard targeting tools used by microcredit providers in Bangladesh in order to direct resources to the rural poor. These indicators have been shown to be relatively accurate correlates of poverty by program administrators who do not have the time, resources, or expertise to carry out more sophisticated calculations of poverty for each household in their targeted area.

In practice, the land criterion is the one that is more closely adhered to in the field. Several studies show that between 15–30 percent of members of microcredit programs are from "non-target" households as measured in terms of land.[11] However, they typically are marginal farmers and can still be considered part of the vulnerable non-poor, prone to transient bouts of poverty.[12] On the other hand, there is also evidence that a large proportion of extremely poor households join microcredit programs.[13] For instance in Khandker's sample, 65 percent of BRAC households had no agricultural land, compared to 55 percent for Grameen members, and 58 percent for a comparable government-run microcredit program.

Not only do the poorest join BRAC's credit program, but their borrowing pattern is similar to better-off members.[14] In other words, the presence of wealthier households does not appear to affect the credit supply to poor households; however, there is evidence to suggest that poorer households use a larger share of their loans for consumption purposes, compared to better-off households.[15] Noting that the poorest join BRAC's credit program and that they also actively borrow after they join, it must also be mentioned that there is evidence which suggests that households who join microcredit programs a few years after the village group has been established tend to be less poor, compared to the members who join at the start of the program.[16] This feature of better-off households joining over time has also been noted as a general rule of thumb in many targeted anti-poverty programs worldwide.[17] The bottom line is that the literature on targeting suggests that microfinance programs are reasonably successful at reaching the poor, and that those households who fall above the stipulated landholding criterion tend to be marginally above the poverty line and are susceptible to transient poverty in certain years.

The literature broadly supports the hypothesis that access to microcredit contributes to poverty reduction in Bangladesh, although the evidence is not entirely clear-cut.[18] For instance, data collected by the World Bank in 1992 have been used to show widely varying results depending on the methodology chosen to assess impact. Khandker estimates that for every 100 taka lent to a woman, household consumption increases by 18 taka; interestingly, the figure is 11 taka if the same amount was lent to a man.[19] Moderate poverty falls by around 15 percent, and ultra-poverty by 25 percent, for households who have been BRAC members for up to three years (controlling for other factors), according to the author. Similar results are found for Grameen Bank and Bangladesh Rural Development Board (BRDB) members.

On the other hand, using the same data and a different way of correcting for selectivity bias, Morduch finds that microcredit does not have a significant impact on consumption levels and therefore on income poverty.[20] Consumption data from 1,072 households in one district of Bangladesh is used to show that the largest effect on poverty occurs when a moderate-poor BRAC client borrows more than 10,000 taka ($200) in cumulative loans.[21] In other words, there may be a threshold level of credit above which a household gains most in terms of increases in income. The

Bangladesh Institute of Development Studies (BIDS) carried out an extensive study of the impact of PKSF PO's microcredit program using longitudinal data of 3,000 households between 1997–2000. One of the key findings was that "microcredit has a positive and significant effect on poverty status of the program households...."[22] The study also finds that members of microcredit programsare less vulnerable when faced with crises. Moreover, improvements in other social indicators (child immunization, use of sanitary latrines, prevalence of contraception) are also more noticeable for microcredit program members compared to non-members.

The literature also suggests that moderately poor microcredit borrowers benefit more than extremely poor borrowers, in terms of reduction in income (consumption) poverty. The basic premise is that the poorest have a number of constraints (fewer income sources, worse health and education, etc.) which prevent them from investing the loan in a high-return activity. This could be due to the higher risk associated with a high-return activity or because of a long gestation period for the returns to accrue.[23] This is borne out by detailed case-study evidence[24] and by comparing participants of credit programs who cater to different socio-economic groups.[25]

There is strong evidence that microcredit contributes to reducing household vulnerability. Morduch shows that consumption *variability* is 47 percent lower for eligible[26] Grameen households, 54 percent lower for eligible BRAC households, and 51 percent lower for eligible BRDB households, compared to a control group.[27] This consumption smoothing is driven by income smoothing as evidenced by the significantly lower labor supply variability experienced by microcredit members compared to the control group.[28] The importance of this result cannot be over-emphasized, given the fact that seasonal deficits play a key part in the poverty process in Bangladesh.[29] Essentially, Morduch's results indicate that program participants do not benefit in terms of greater consumption levels, but they participate because they benefit from risk reduction.

Asset creation is important to reduce household vulnerability to various livelihood risks. The findings of an impact assessment of ASA borrowers, conducted in 2003, suggests that the average value of physical assets increased by 127 percent in rural areas, and grew by about 150 percent in urban areas over a five-year period. Moreover, the average increase in cash savings rose by 133 percent and 111 percent in rural and urban areas, respectively, over this same five-year period. Similar evidence is found in studies of BRAC, Grameen, and PKSF's partner organizations.

Another pathway by which microfinance appears to reduce vulnerability is through the emergency assistance provided by many microfinance organizations during acute natural disasters, such as the recent floods in Bangladesh. The fact that these organizations turn into de facto relief agencies is crucial to sustaining these households in the immediate aftermath of a natural disaster. Moreover, post-disaster rehabilitation assistance, in terms of both financial and other services, is also highly valued by microcredit clients.

The pathways by which microcredit reduces vulnerability, that have been discussed here, relate to income and consumption smoothing and asset building. However, the impact of credit on women's empowerment, or reducing female vulnerability, has also received considerable attention. Empowerment of women in Bangladesh can be viewed against the backdrop of patriarchy, defined by Cain et al as a "set of social relations with a material base that enables men to dominate women."[30] Hence, it can be thought of as an improvement in intra-household gender relations.[31] Moreover, given the institution of *purdah* (loosely translated as "veil"), a pervasive social construct which restricts the female sphere within a typical Bangladeshi household, empowerment can also be viewed in terms of a woman's interactions outside the homestead and the acquisition of skills, knowledge, and confidence that such interactions can bring.[32]

The work by Amin et al in 36 villages in Bangladesh showed that membership in microcredit programs positively affected a woman's decision-making role, her marital stability, her control over resources, and her mobility, but had less impact on her attitude regarding marriage and education of daughters.[33] Naved finds that the women participants in credit programs, in her sample, felt their status had improved due to the fact that they were seen as income earners for the family because of their access to credit.[34]

Hashemi et al developed an "empowerment index" based on eight empowerment indicators. Their analysis establishes that contributing to her household's income is a significant factor contributing to a woman's own empowerment. However, Hashemi et al also show that credit programs can empower women independently of whether they contribute to family income or not, after controlling for other factors.[35]

Those who are skeptical about the empowering effect of microcredit have focused on the issue of women's control over loans. Goetz et al used a sample of 253 female borrowers from four rural credit providers in Bangladesh. Their investigation of loan histories led the authors to conclude that "about 63 percent of the cases fall into the three categories of partial, very limited, or no control, indicating a fairly significant pattern of loss of direct control over credit." The authors disaggregated their data in terms of loan activity and concluded that investing in traditional women's work increased their chances of being able to control the loan.[36] Montgomery et al also have reservations about the empowering effect of microcredit. Their argument is based largely on secondary sources and a small field survey focusing on the issue of control over loans.[37] While the authors admit that their sample is small, they on balance support Goetz et al that microcredit reinforces existing gender patterns and inequalities by promoting traditional income generation activities,[38] which they believe do little to alter the social status quo.

On the whole, the evidence presented by those who argue that microcredit improves the status of females within a household appears more convincing that that argued by the skeptics' camp. There are two main reasons for this contention. First, the underlying thread of the argument, that access to an important household resource (credit) enhances a female's status within the household, is both intuitively appealing and resonates with the theoretical literature on bargaining models of the household.[39] Second, the focus on female control over loans, as a key component of the skeptics' argument, fails to recognize that credit enters the overall household income pool and that household members jointly participate in the loan investment.

Lessons Learned

The importance of an enabling environment for microfinance cannot be underestimated.

A critical part is maintaining a stable macroeconomic environment with both interest rates and inflation kept at reasonable levels. The lack of macro-stability has seriously constrained the growth of microfinance in several countries, e.g., Malawi. Government regulations and policies are also crucial in creating the appropriate environment for the growth of the sector. These policies need to strike a balance between protecting the interests of depositors, in microfinance institutions that collect savings, and not regulating the sector excessively (i.e., strangling it with unnecessary red tape).

Microcredit may be a more effective remedy against poverty and vulnerability if it is complemented with other interventions.

These interventions may be particularly appropriate for the poorest households, which face the greatest risk of income fluctuations and have the greatest need for a range of financial and non-financial services. Moreover, while the provision of microcredit can enhance a woman's status in the eyes of other household members, social mobilization and legal education interventions in conjunction with credit are likely to have a more significant effect than credit alone. However, this does not imply that microfinance institutions ought to provide these services. In many cases, organizations may prefer to specialize in providing microfinance and facilitate linkages to providers of other non-credit interventions.

There is a role for donor financial assistance in expanding the capital base in emerging microfinance institutions, as well as in developing technical capacity that leads to organizational sustainability.

Hence, subsidies can be justified to support "infant" microfinance institutions, as long as there is a viable route to institutional sustainability. The duration of these subsidies would vary according to local conditions and level of poverty of the clients.

The systems and formal rules that govern the successful microfinance industry in Bangladesh can, to an extent, be replicated. These vary according to the size of the organization, but by and large, these organizations delegate significant decision-making authority away from head offices, are able to monitor individual staff performance, and have linked staff incentives with program targets. Client feedback and program monitoring are also crucial. As organizations grow, the willingness to change products based on this feedback and to tailor or create products for niche markets is critical for success.

The creation of a microfinance wholesaler, like PKSF in Bangladesh, has the potential to play an important role in expanding access and developing professional standards.

However, apex bodies are not a panacea, and a rigorous analysis of the underlying retail capacity and demand for funds needs to be carried out before they are established.

End Notes

1 Credit and Development Forum, "CDF Microfinance Statistics," (Dhaka: CDF, 2002).

2 The latest figures indicate that BRAC has 3.5 million borrowers, Grameen Bank has 3.1 million clients, Proshika 2.9 million, and ASA 2.1 million clients.

3 S.H Choudhury, "Financing the Poor: ASA Experience," *The Daily Star* (Dhaka), March 13, 2003.

4 In addition to this innovative staff incentive system, a detailed evaluation of the oral rehydration experience also points to a number of other success factors: systematic recruitment and training of staff, an effective feedback loop, the willingness of senior management to learn from the lessons from the field, and support from the government, donors, and professional experts. See M. Chowdhury and R. Cash, *A Simple Solution: Teaching Millions to Treat Diarrhoea at Home* (Dhaka: UPL, 1996).

5 S. Ahmed, "Microcredit and Poverty: New Realities and Strategic Issues," in *Attacking Poverty with Microcredit*, (Dhaka: UPL, 2003).

6 PKSF, "Maps on Microcredit: Coverage in Bangladesh," (Dhaka: PKSF, 2003).

7 For instance, to support sericulture, BRAC trains the entrepreneur in silkworm farming, supplies the silkworm eggs, plants the mulberry trees, arranges for extension services by a BRAC specialist, purchases the cocoons from the farmers at their homesteads, and supplies cocoons to a BRAC-run silk-reeling center.

8 P. Jain, and M. Moore, "What Makes Microcredit Programmes Effective? Fashionable Fallacies and Workable Realities," IDS Working Paper 177, University of Sussex, 2003.

9 N. Hossain, "Elites and Poverty in Bangladesh," DPhil thesis, University of Sussex, 2003.

10 M. Yunus, *Banker to the Poor* (Dhaka: UPL, 1998).

11 It is interesting to compare this figure with Copestake's (1992) evaluation of India's Integrated Rural Development Project, where the proportion of non-poor households ranged upto 36 percent. See S. Mustafa, et al, "Beacon of Hope: An Impact Assessment Study of BRAC's RDP," Research and Evaluation Division, BRAC, Dhaka, 1996; R. Montgomery et al, "Credit for the Poor in Bangladesh: The BRAC Rural Development Programme and the Government Thana Resource Development and Employment Programme," in *Finance against Poverty*, ed. D. Hulme and P. Mosely, vol. 2 (London: Routledge, 1996); H. Zaman, "Assessing the Poverty and Vulnerability Impact of Microcredit in Bangladesh: A Case Study of BRAC," Policy Reseach Working Paper Series 2145, World Bank, 1999; and S. Khandker, *Fighting Poverty with Microcredit*, (Oxford: Oxford University Press, 1998).

12 Zaman, "Assessing the Poverty and Vulnerability Impact," 1999.

13 Khandker, *Fighting Poverty with Microcredit*; and Zaman, "Assessing the Poverty and Vulnerability Impact."

14 Zaman, "Assessing the Poverty and Vulnerability Impact"; and S. Halder and A.M. Husain, "Indentification of the Poorest and the Impact of Credit on Them: The Case of BRAC," mimeo, BRAC Research and Evaluation Division, Dhaka, 1999.

15 Halder and Husain,"Indentification of the Poorest."

16 I. Matin, "Mis-targeting by the Grameen Bank: A Possible Explanation," *IDS Bulletin* 29, no. 4 (1998).

17 Lipton, M. "Successes in Anti-poverty." Issues in Development Discussion Paper, No. 8, International Labour Office, Geneva, 1996.

18 The methodological problems associated with assessing the impact of microcredit are complex. The literature typically uses "control groups," usually "eligible non-members," or "recently joined members" in order to address the problem of the counter-factual. There have been attempts to account for selectivity bias with varying degrees of success.

19 Khandker, *Fighting Poverty with Microcredit*.

20 J. Morduch, "Does Microfinance Really Help the Poor: New Evidence from Flagship Programs in Bangladesh," Department of Economics and HIID, Harvard University, and Hoover Institution, Stanford University, 1998.

21 Zaman, "Assessing the Poverty and Vulnerability Impact."

22 BIDS, "Monitoring and Evlauation of Microfinance Institutions," Bangladesh Institute of Development Studies, Dhaka, 2001.

23 G. Wood and I. Sharif, eds., *Who Needs Credit? Poverty and Finance in Bangladesh* (London: Zed Books, 1997).

24 F. Farashuddin and N. Amin, *Poverty Alleviation and Empowerment: An Impact Assessment Study of BRAC's RDP—Ten Qualitative Case Studies,* mimeo, BRAC Research and Evaluation Division, 1998.

25 R. Montgomery, D. Bhattacharya, and D. Hulme, "Credit for the Poor in Bangladesh: The BRAC Rural Development Programme and the Government Thana Resource Development and Employment Programme," in *Finance against Poverty*, vol. 2, ed. D. Hulme and P. Mosely (London: Routledge, 1996). Montgomery et al compare the performance of BRAC borrowers with the borrowers from a government-run microcredit scheme, the Thana Resource Development and Employment Programme (TRDEP). The initial endowment conditions of TRDEP's borrowers are higher than BRAC's (average pre-loan landholding is 46 and 30 decimals* for TRDEP and BRAC members, respectively, and the percentage of income derived from daily labour is 5 percent and 32 percent, respectively), while the credit-delivery mechanism and average loan size are, broadly speaking, very similar. The typical TRDEP borrower's increase in assets and income during the course of the most recent loan is higher than for BRAC clients, giving rise to the author's contention that better-off borrowers benefit more than poorer borrowers. (*Note: A decimal is 1/100 of an acre.)

26 Morduch only includes households who fulfill the targeting criteria of the three organizations and labels them "eligible households."

27 These results are statistically significant at the 95 percent level.

28 Morduch's estimates of labor supply variability is 39, which is 46 percent lower for microcredit members compared to a control group.

29 H. Rahman, "Mora Kartik: Seasonal Deficits and the Vulnerability of the Rural Poor," in *Rethinking Rural Poverty: Bangladesh as a Case Study,* ed. H. Rahman and M. Hossain (Dhaka: UPL, 1995).

30 M. Cain, S.R. Khanum, and S. Nahar, "Class, Patriarchy and Women's Work in Bangladesh," *Population and Development Review* 5, no. 3 (1979): 405-38.

31 R. Naved, "Empowerment of Women: Listening to the Voices of Women," Special Issue on Women, Development, and Change, *Bangladesh Development Studies* 22 (2 & 3): 155-79; N. Kabeer, *Reversed Realities: Gender Hierarchies in Development Thought* (Dhaka: UPL, 1994); S. Hashemi, S. Schuler, and I. Riley, "Rural Credit Programs and Women's Empowerment in Bangladesh," *World Development* 24, no. 4 (1996):635-53.

32 S. Amin and A. Pebley, "Gender Inequality within Households: The Impact of a Women's Development Programme in 36 Bangladeshi Villages," Special Issue on Women, Development, and Change, *Bangladesh Development Studies* 22 (2 & 3): 121-54; S.C. White, *Arguing with the Crocodile: Gender and Class in Bangladesh* (London: Zed Books, 1992); and S. Mahmud, "From Women's Status to Empowerment: The Shift in the Population Policy Debate," Bangladesh Development Studies 22, no. 4 (1994): 77-99.

33 Amin and Pebley, "Gender Inequality within Households."

34 Naved, "Empowerment of Women." Naved uses Participatory Rural Appraisal (PRA) techniques to identify the effect of participation in Save The Children's savings and credit program in Manikanj.

35 Hashemi et al, "Rural Credit Programs and Women's Empowerment."

36 A. Goetz, and R. Sen Gupta, "Who Takes the Credit? Gender, Power, and Control over Loan Use in Rural Credit Programmes in Bangladesh." *World Development* 24, no. 1 (1996): 49.

37 Montgomery et al, "Credit for the Poor in Bangladesh."

38 Goetz, "Who Takes the Credit?"

39 S. Lundberg and R. Pollak, "Separate Spheres Bargaining and the Marriage Market," *Journal of Political Economy* 101, no. 6 (1993): 988-1010.

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Chapter 5

Madagascar : Credit with Education Program in the TIAVO Savings and Loan Associations Network

BY HERMINIA MARTINEZ

Executive Summary

The network of Savings and Loan Associations (SLA), known as the TIAVO network, began as a pilot program in rural microfinance in 1996, serving Fianarantsoa, the poorest province in Madagascar. The TIAVO network has impressively expanded its services to the poor, especially to the very poor, by integrating the SLA and Credit with Education programs. It achieved these gains despite political turmoil in Madagascar in 2002 and other severe constraints. Fianarantsoa—like all of Madagascar—faces inherent disadvantages in providing financial services for the poor: it has a low per-capita income, the population is dispersed, and communications are inadequate, in part because of the country's rugged topography.

The expansion of the TIAVO network is part of a nation-wide program supported by the government of Madagascar with donor financing. It aims to assist local groups to develop self-sustaining financial institutions, in four of Madagascar's six provinces (initially), to address the virtual lack of financial services for the poorest of the population. Proponents of the program recognized at the outset that the microfinance institutions created or expanded under this microfinance program might not reach the very poor without specific efforts. Consequently, they tested and implemented special programs for socially excluded groups—typically women and the poor living in isolated areas.

The Credit with Education (CWE) program was introduced in the TIAVO network in 1999, using Freedom from Hunger's methodology and financed through MicroStart (United Nations Development Programme). Under CWE, poor women are encouraged to form groups, or credit associations (CAs), that join the SLA and thus gain access to credit from the TIAVO network. The TIAVO SLAs are member-owned microfinance institutions that serve low-income members. Members must have savings and provide physical guarantees in order to get access to credit—requirements that individual women could not meet, but now can through CWE and the CAs.

CWE program loans are small and are guaranteed by the CA members; repayments are weekly or biweekly. Loan recipients are selected by local women's committees. The CWE

program integrates training with the credit program. Promoters (field agents) visit the CAs in their communities every week. During these visits, they also provide training on family health, child nutrition, and business practices; and disburse loans and collect repayments.

From 2000–03, loans outstanding in the TIAVO network increased more than sevenfold, to around US $850,200, and membership more than tripled to 14,000. In the three and one-half years since the CWE program started, 129 CAs were established, with close to 2000 women members. CA members received a total of 11,000 loans by the end of 2003. Initially an independent program within the TIAVO network, CWE is now being integrated into the network operations.

The experience of the program offers one more example of how successfully microfinance institutions can target programs to the very poor, and more evidence that these programs do increase the depth of outreach to the very poor.

Implementation Process

Background and Rationale

In Madagascar, providing services to the poor, particularly financial services, is difficult and costly. The country is one of the poorest in Africa (per capita income was US $240 in 2002[1]), it is very large (582 thousand square kilometers), and the population is dispersed. The country has inadequate transportation links associated with its rugged topography. The TIAVO network in Fianarantsoa, the poorest province in Madagascar (83 percent of its population is poor), was chosen for the case study because both the network and a targeted program for the very poor have made impressive progress over the past four years, despite the odds against. In addition, the program targeted at the poor integrated two other initiatives, from which there are lessons to be learned.

Objectives and Features

The TIAVO network is one of four networks supported under the 15-year Microfinance Program which is financed by the government and donors, including the World Bank through its Adaptable Program Credit. The program aims to encourage the development of sustainable microfinance institutions, primarily savings and loan associations (SLAs), by providing technical support to local groups in the four provinces where most of the population lives.[2] The program also will begin putting a legal framework for microfinance into place. Microfinance networks supported by the government program expanded from 9,500 members in 1999, to close to 100,000 members at the end of 2003.

The Microfinance Program includes a specific initiative—the Credit with Education program—to provide services to the very poor (the socially excluded) in each of the networks. The architects of the program recognized that large segments of the population, who were not already clients of the participating institutions, would initially be missed. The special initiative actively sought out this target population and enlisted knowledgeable network field staff (or agents from a private agency contracted on a fee basis) to educate them about the advantage of the services offered. Performance of the program for the socially excluded is measured by how efficiently and how many beneficiaries are served.

A specialized institution within the Microfinance Program provides support to the SLA network on technical aspects, including the program for the socially excluded groups, which will decline over time. Contracts with the specialized institutions providing technical assistance[3] include performance benchmarks that are monitored. The participating SLA networks are required to comply with prudential norms set by the Madagascar Banking Commission and to meet performance targets associated with the technical support they receive.

The TIAVO savings and loan associations are member-owned microfinance institutions serving low-income clients. The SLAs encourage member savings, which is a prerequisite to credit. Under the Credit with Education program (CWE), poor women are helped by promotersof the program, or field agents, to organize into credit associations (CAs). The women choose the members of their CA, and the CA becomes a member of an SLA. Women are eligible for loans from the network without meeting savings or physical guarantee requirements. The loans are small and guaranteed by the CA members, and repayments are weekly or biweekly. Loan recipients are selected by local women's committees based on their personal knowledge of applicants.

The program integrates training with the credit program. The promoters visit the CA groups in their communities every week and give training on family health, child nutrition, and business practices. Instruction is also offered on financial matters, such as managing the family budget, saving, making deposits, and requesting loans. The promoters disburse loans and collect repayments during their weekly visit to each CA. CWE managers approve the loans, which are made by the TIAVO network with funds obtained for this purpose from UNDP and World Bank, and are disbursed through the local SLA. Since 2002, some SLAs have been dealing directly with the groups, approving the loans that they disburse.

Features of the savings and loan transactions in the TIAVO SLAs and CAs are summarized in Table 1.

Political and Regional Context

Madagascar today is a democracy with a generally liberal economic system. The country has undergone a process of political and economic liberalization since the late 1980s, which has entailed periods of civil unrest. Regionalism is strong, although until the late 1990s when reforms began, the government was highly centralized. Fianarantsoa, located in central Madagascar, has traditionally carried considerable political weight. The population in the province is dispersed and lives in two distinct regions—the highlands (cattle grazing and subsistence farming) and the coastal plain (historically coffee exports, but increasingly subsistence agriculture). Communications between the two regions are weak, which makes reaching the poor difficult. In the 1970s and 1980s, Fianarantsoa benefited from a large number of government-funded programs, including credit programs. The latter contributed to a tradition of non-repayment of loans in Fianarantsoa, a problem the TIAVO network has had to address.

The Microfinance Program was developed by the government, in the second half of the 1990s, to bring about economic growth and poverty reduction through ambitious policy reform program. An element of the reforms was government divestiture from ownership of two banks. The state banks were bankrupt and had abandoned their mandate of financing small and poorer clients through their large branch network. The Microfinance Program was intended to partially address the vacuum created by the privatization of the state banks. The program is aligned with the objectives of the government's Interim Poverty Reduction Strategy of December 2000 and the Poverty Reduction Strategy of July 2003.

Initial commitment to the Microfinance Program by the government and other stakeholders was strong. The TIAVO network leadership was interested in the program because it could increase its membership and influence in the region. A number of non-governmental organizations, including Freedom from Hunger, had discussed credit programs with local leaders in Fianarantsoa, where the main bank, the Agricultural Bank of Madagascar, was reducing its branches in

Table 1: Features of Savings and Credit Transactions

Feature	TIAVO SLA	TIAVO MEMBER CA
Members	Persons/groups in the municipality of the SLA	Low-income women in the municipality of the SLA; members of a credit group
Membership fees	Contribution to SLA capital: US$1.7; fee: US$0.8	Fee: US $0.50–US $0.80
Credit eligibility	SLA member; savings deposit in SLA, 10-30% of credit; physical guarantees, 100-150% of credit	Member of a credit group
Loan size	Varies: Average loan for low-income members, US$50; rural, US$473; urban, US$1,097	Loan maximum: US$23 (first loan); US$152 (last loan)
Interest Rate	Equivalent of 3% per month for amounts due	Equivalent of 4.5% per month for amounts due
Maturity of loans	Depends on type of loan	Initial loans 4 months; subsequent loans 5 months
Repayment Arrangements	Depends on client	Weekly or semi-monthly, incorporating member training

Sources: Assouline. 2003, TIAVO 2003 Annual Report.

preparation for privatization. The government saw support for the microfinance program, and the programs for the most disadvantaged, as an action that could help alleviate the pervasive lack of financial services for the poor, which had been aggravated by the state bank failures.

The TIAVO network is the principal institution in the microfinance program. The CWE component of the network was funded for the first three years by the UNDP as part of its MicroStart program using the methodology of Freedom From Hunger. Initially, implementation of CWE was assigned to the Agency for the Execution of the Microfinance Project (AGEPMF), which was specifically created in 1999 and charged with the coordination and follow-up of the 15-year Microfinance Program.[4] The CWE program was later moved to TIAVO to pre-empt a similar (and redundant) pilot program that TIAVO intended to initiate.

Preliminary Results and Comparison with Original Objectives

The TIAVO network began in 1996 as a pilot rural microfinance program, then in 2000 significantly expanded and strengthened its systems. Over the past three years, its operations have increased substantially, with membership more than tripling to 14,000. Loans outstanding increased more than seven-fold during the three-year period, to US $850,200 by the end of 2003, partly reflecting pent-up demand after the political difficulties in 2002 (see Table 2). Arrears, which were a serious problem in the network, have been declining for the past three years, from 16 percent (arrears of more than thee months) in 2001 to a more acceptable 3 percent in 2001.

The network surpassed its self-financing objectives, covering about 77 percent of all costs (except depreciation). The government finances TIAVO operations on a declining basis under the Microfinance Program. At the end of 2003, 36 of the 130

Table 2: Evolution of TIAVO Network

Indicators	1999	2000	2001	2002	2003
No. of Members	4452	4820	6223	8408	14000
No. of SLAs	29	24	23	27	36
Total Number of Active Loans	1078	1898	897	1302	2834
Loans Outstanding (US $000)	112.0	157.2	133.8	257.3	850.2
CWE/Total Loans Outstanding (%)	14.1	13.4	31.6	18.6	9.1
Arrears (more than 30 days) *	N.A.	12	16	6	3
Operational Self-Sufficiency **	N.A.	50	54	64	77

Sources: AGEPMF database.
* Figure at end of September of each year.
** Operational Self-sufficiency covers all costs except depreciation.

savings-based SLAs in the country were members of the TIAVO network.

The CWE program, started in 1999, was initially a separate activity within the TIAVO network with its own accounts and independent management. The CWE program was gradually integrated into the TIAVO network as the latter was expanded, beginning in 2000 with the transfer of CWE accounts from the TIAVO head office to the individual SLAs.[5] (The transfer should be completed in 2005.) Over the past three years, CWE activities have been consolidated, including transferring CA supervision to TIAVO, and incorporating CWE operations into the regular TIAVO accounting system. CWE increased its efficiency by raising the ceiling for loans in urban areas and introducing incentive payments for promoters. (The incentives are linked to the quality of the portfolio and number of members served.) TIAVO also tightened control of CWE operations to make it more reliable and began rotating the promoters.

The CWE program exceeded the originally planned objectives in terms of members and loans approved (see Table 3). The costs of the program (US $450,000) were higher than estimated at the start of the Microfinance Program. These higher costs can be attributed to the fact that the program is larger (more members, more loans, more promoters) than anticipated, and because it was set up as a stand-alone program rather than integrated into the network, which would have reduced costs.

Impact Analysis

The impact of the program on beneficiaries, the network, and the region cannot yet be quantified because base line data was not gathered as planned, and the results of an impact study are not yet available. The average loan to the members of the CAs is US $37, while the averge loan size of

Table 3: Actual and Projected Development of Credit Associations in TIAVO Network

Indicators	1999	2000	2001	2002	2003	Projected
No. of Members	634	1189	1610	1746	1922	960
No. of Savings Groups	26	61	105	105	129	160
Avg. Size of Group					15	6
No. of Promoters					6	4
No. of Active Loans	581	1015	1409	1443	1657	960
Loans Outstanding (US $ 000)	16	21	42	48	78	

Sources: Background documents for World bank Appraisal of Microfinance Project, 1999. ABEPM and TIAVO databases members of the TIAVO SLAs is US $222 (see Table 4). It seems the program is reaching the poor, even those who live in remote areas. About half of the CAs are on the coast, a region which is particularly isolated and where there are few financial intermediaries. Figures for another network in the Microfinance Program, which is located in a more urban area, show that close to 50 percent of the members of the groups in the socially excluded program (the CWE program of TIAVO) are among the very poor (the poorest one third among the poor).[6]

The impact on the development of the TIAVO network itself will also be significant. At the end of 2003, loans outstanding under CWE program accounted for some 9 percent of total loans outstanding in the network, and 40 percent of all TIAVO SLAs had CWE programs. The importance of the CWE program in the individual SLAs varies considerably: CWE program loans outstanding range from 2–65 percent of total loans outstanding in the SLAs where the program operates.

It is expected that the CWE program will increase the impact of the TIAVO network, particularly along the coast. Analysis shows that the focus on lower income clients has had an impact on the operations of the network.[7] Visits by CA members to the SLAs has increased the familiarity of the women with the activities of a savings and loan association, and has helped the SLA leadership understand issues and needs of this clientele. As a response to the program, the TIAVO network is planning to develop new credit products geared to the CA members. To have access to credit, the CA women will need to join the SLA as individuals, pointing to the interest that SLAs have in this potential market.

Cost and Efficiency in the Use of Resources

The US $450,000-grant from MicroStart covered the operating costs of the program—salaries of promoters and related expenses such as transportation, equipment, specialized training, and administration expenses. Equipment and administration costs were high in part because the program was set up as an independent activity and did not benefit from the TIAVO systems. Costs were also affected by the turnover of promoters at the beginning of the program. This partly reflects

Table 4: Comparison of TIAVO and CA Indicators 12/31/03

Indicator	TIAVO	CAs
No. of Members	1385*	1922
No. of SLAs/CAs	36	129
Loans Outstanding (US$ ‘000)	850	78
Average Loan Size (US$)	222	37
Deposits/Member (US$)	429	0.1

Sources: TIAVO 2003 Annual Report, AGEPMF Database. Assouline, 2003. *Including 129 CAs.

the very difficult environment in Fianarantsoa (extreme poverty, poor transportation) which makes the task of promoters unusually difficult. (The TIAVO network also suffered from the new system of personnel rotation).

The costs of operating the program were in line with what had been anticipated. By 2002, income from operations covered some 70 percent of direct operating costs of the CWE program (excluding indirect costs such as the TIAVO supervision and general TIAVO expenses). Efficiency indicators, such as the number of beneficiaries served by each promoter, are consistent with those estimated at the beginning of the Microfinance Program. An analysis by IRAM has estimated that in order to cover costs, the number of CAs served by each promoter will have to increase from an average of 15 (in 2003) to an average of 20.[8] Efficiency of promoters should increase as administrative functions are transferred to the network. However, as measures to increase CWE efficiency are introduced, it is critical that the training aspects of the program not be sacrificed. In fact, there is a concern over an excessive preoccupation with ensuring quick profitability of this type of program. The push toward early profitability could lead to shifting the program towards higher income beneficiaries who can absorb larger loans at the same cost to the CA or SLA.

Driving Factors

Commitment and Political Economy for Change

Madagascar's political liberalization of the early 1990s saw the government lift restrictions on a number of activities, including the creation of cooperatives. Successive governments have recognized the need to improve the conditions of the poor, particularly in the rural areas, and supported programs, including microfinance, designed to assist them. Programs to address poverty directly were emphasized in the late 1990s when macroeconomic reforms were advanced. The government prepared an interim poverty reduction strategy in 2000, followed by a full strategy in 2003, which focuses on governance, inclusive growth, and service delivery for human and material security.

Microfinance initiatives supported by the government, international (official and private), and bilateral organizations began in the early 1990s, in response to the chronic shortage of financial services in rural areas. The design of the Microfinance Program involved extensive consultations with stakeholders, and particularly among organizations in this field working in Madagascar. The Microfinance Program, of which the TIAVO network is part, focused on providing technical support to local groups, and its costs were small compared to other government programs which involve large transfers. Even though the government obtained financing for the technical assistance being provided to the four networks, it has not, on the whole, been involved in their operations.

Institutional Innovation

The CWE program in the TIAVO network confirms the view that microfinance institutions can provide financial services and training for the very poor. The program also confirms the importance of including a strong training component in programs aiming at increasing availability of financial services to the very poor.

Learning and Experimentation

Testing new approaches was the objective of the CWE program for the socially excluded by the Microfinance Program. In addition, the integration of the CWE program into the SLA network came about gradually, and involved testing different approaches in four SLAs and replicating the successful ones. Increasing the role of the SLAs in CWE collections and loan approval (after the fourth loan to a CA member), and including CA members in the SLA credit committees were both tests. The expanded SLA functions has contributed to the sense of ownership of the program among CA and SLA members. It has helped improve collections under the CWE program, as CA members do not want to to be in arrears with the SLA. CA member participation in the SLA committees (an ad hoc arrangement not provided for under the SLA regulations) did not prove particularly useful because the CA members were not able to represent their groups effectively. However, other forms of CA participation in the SLAs will be tested. Promoter performance improved when incentive payments were introduced. Also, it is expected that individual SLAs will play a more active role in the CWE program as their compensation is increased from 2–10 percent of the credit. Program remuneration favored the TIAVO head office initially, and now will fall from 13–5 percent of the credit.

Lessons Learned

Programs targeted to the very poor can benefit both microfinance institutions and clients.

The experience in Fianarantsoa points to the benefits of introducing programs for the very poor in microfinance institutions. The approach is beneficial both to the institution and to the client: it generates new clients, especially women, for the microfinance institutions, it helps microfinance institutions understand the problems of the lower end of the market, and thus develop appropriate products for this market, and it educates the very poor in the use of a financial institution. Direct involvement of the SLAs in the CWE program, which requires the members of the CAs to visit the SLAs, has contributed to the sense of appropriation of the program by the SLAs and the CAs; and has improved loan recovery in the CWE program, as women want to establish a good record with the SLAs. Creating a program parallel to the microfinance institution increases inefficiencies through increased costs, and may also lead to competition among programs, which in this case is not desirable as the programs in support of the poor are subsidized.

Microfinance institutions require financial and technical support to establish programs for the very poor.

It cannot be expected that microfinance institutions will be able to finance targeted programs from their own resources. The criteria for assessing the program should be efficiency in service delivery and not short-term sustainability, although sustainability should be a medium-term objective. Excessive emphasis on profitability may have the effect of changing the type of client served.

Programs that reach the poor need time to yield results.

Microfinance programs in general take time to yield results because they entail changes in behavior. This is particularly true of programs aimed at the very poor; such programs should have strong training components such as that included in the TIAVO program. The time it takes for programs to yield results should be taken into account when the programs are designed.

Staff incentives work.

The experience with the CWE program confirms what is generally known of other microfinance programs: incentives, particularly for staff, matter. Performance of promoters in the CWE program improved after incentive payments were introduced (it was also true of the TIAVO staff). Similarly, it is expected that the SLAs will play a more active role in the program as they are better remunerated for the work involved.

Monitoring impact on poverty is difficult.

It is critical to have good base line indicators to measure progress and to be able to design improvements in programs. However, the time it takes to design and, more importantly, put in place, monitoring tools should not be underestimated. For instance, despite considerable work at the time the Microfinance Program was designed, the base year data to measure the impact of the program was not gathered in time. A qualified agency could provide support in the introduction of an appropriate impact assessment methodology in programs that require it.

Government has a role in supervising the performance of microfinance institutions.

The government has a role to play in supervising the performance of microfinance institutions, as it safeguards the financial system and depositors in a manner akin to the role it performs in supervising the banking sector. However, governments can be tempted to interfere with the operations of microfinance institutions, which is not useful, when it obtains financing for them. The program in Madagascar has generally had little government interference over the years, which has contributed to its progress, even in the midst of a very difficult political period.

End Notes

1 Gross National Income per capita, World Bank Atlas Methodology.

2 The process of integration of the CWE program in the TIAVO network is summarized in Nathalie Assouline, "Processus d'intégration de l'Activité Crédit avec Education au Sein du Réseau TIAVO," prepared for AGEPMF, IRAM, August 2003.

3 The specialist institution providing technical support to the TIAVO network is Institut de Recherche et D'Application de Méthodes de Développement (IRAM).

4 AGEPMF continues to monitor the performance contracts with the specialized agencies providing technical support to the networks.

5 The process of integration of the CWE program in the TIAVO network is summarized in Assouline, "Processus d'intégration."

6 Anton Simanowitz, "Appraising the Poverty Outreach of Microfinance: A Review of the CGAP Poverty Assessment Tool," Imp-Act Occasional Paper 1, (Brighton, U.K.: Imp-Act, Institute of Development Studies, University of Sussex, 2003).

7 Assouline, "Processus d'intégration."

8 Assouline, "Processus d'intégration."

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Chapter 6

Managing Scaling Up Challenges of a Program for the Poorest: Case Study of BRAC’s IGVGD Program

BY IMRAN MATIN

Executive Summary

BRAC approaches microfinance as a key instrument to build ladders of opportunity for the poorest people, who tend to be left out. BRAC’s main point of departure from conventional thinking is that, although the poorest do need subsidy-based programs to supply their immediate food needs, microfinance can play a fundamental role in constructing a long-term, sustainable foundation for improving food security and livelihoods. However, this is unlikely to happen automatically. BRAC’s experiences suggest that creating a strategic linkage between grant-based and market-based microfinance programs requires careful planning, and solid and committed management. Scaling up this approach to reach significant numbers of the poorest requires constant learning and innovation, and ongoing negotiation with partners based on practical field experience. In particular, it requires an appetite for tackling the larger challenge of developing markets that can open up new opportunities for the very poor.

Most important of all, it requires vision and commitment to include the poorest. BRAC’s experiences suggest that carefully designed strategic linkages, which include grants with a central role for microfinance, can work for the poorest. There certainly will be many different models and approaches for including the poorest, which will vary according to country contexts. However, the starting point has to be reversing the trend of apathy—which either excludes the poorest or treats them as “relief cases” to be dealt with by “others.” BRAC believes that the poorest are, can, and must be central to the vision and commitment of microfinance institutions. Only then will the search for possibilities and opportunities to include the poorest begin and develop.

Implementation Process

BRAC’s Microfinance Canvas

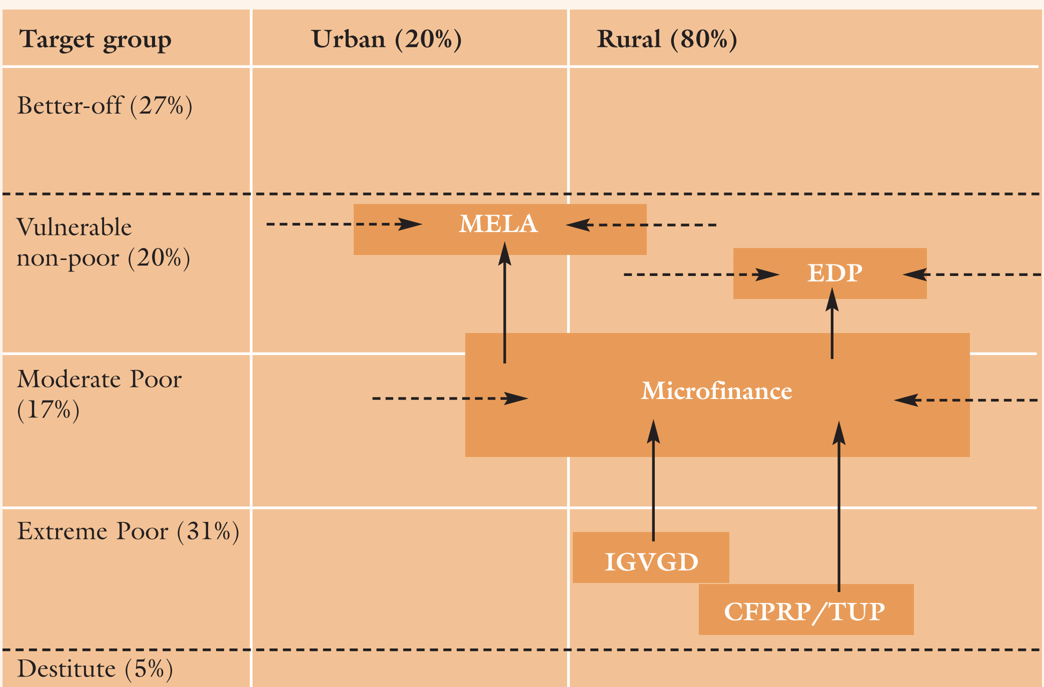
BRAC was originally set up as a relief and rehabilitation committee in 1971 to address the immediate needs of the refugees returning home after the nine-month war for independence.

Today it is today one of the largest micr ofinance NGOs in the world, providing financial services to over 3.5 million poor women throughout Bangladesh. The distinctive feature of BRAC's microfinance is a perspective on the poor as a diverse group with diverse livelihoods, needs, and potential, which change over time in response to life events, new opportunities, and external shocks. This diversity and dynamism of poor peoples' lives is the canvas on which BRAC conceptualizes and designs its repertoire of development programs, where microfinance is a core element. If one maps the various categories of poverty, described in the Bangladesh literature that profiles poverty, onto BRAC's different microfinance programs, one gets a picture like Figure 1.

There are two principles of BRAC's concept of microfinance worth highlighting. One is the belief that microfinance can work for a diverse group of the poor, and two is the importance of creating deliberate linkages to support continuous progression in the livelihoods of the poor, including the poorest.

BRAC's microfinance programs are thus about building ladders of opportunity for the extreme poor—those who tend to be left out of conventional microfinance programs. The idea is to design subsidies in ways that strengthen the initiatives for the extreme poor, so that they, too, over a time can build

Figure 1: BRAC's Microfinance Canvas



Sources: Background documents for World bank Appraisal of Microfinance Project, 1999. ABEPM and TIAVO databases the capacities to benefit from microfinance and other mainstream development programs. The Income Generation for Vulnerable Group Development (IGVGD) and the new BRAC program for the ultra poor, "Challenging the Frontiers of Poverty Reduction/Targeting the Ultra Poor" (CFPR/TUP), are examples of this approach.

It is also about combining microfinance strategically with other interventions to create new livelihoods for people facing sudden vulnerabilities. Recently BRAC began pilot testing a microfinance program that offered training in new skills, for retrenched workers from the ready-made garments factories and state-owned enterprises, and counseling.

Finally, BRAC's microfinance vision supports growth by using the knowledge embodied in its institutional networks to provide financial services to new market segments. The Microenterprise Lending Program (MELA) and the Enterprise Development Program (EDP) both serve growth segments of the market with financial services. (See Table 1 for key information on BRAC's microfinance programs.)

The main idea behind BRAC's microfinance programs for the poorest combines basic social service interventions (such as food aid),which are based on grants, with promotional ones (uch as training, savings, and credit). IGVGD, which hs been in operation since 1985, is a good example of such an approach. Even more interesting, it is a partnership between a donor (World Food Program), the government of Bangladesh, and an NGO (BRAC). This paper highlights the main challenges that IGVDG faced in scaling up, what it learned from the dealing with those challenges, and the steps taken to address them. One of the primary outcomes gained from the IGVGD experience has been the design of a new BRAC program for the poorest, "Challenging the Frontiers of Poverty Reduction—Targeting the Ultra Poor" (CFPR/TUP), which is also discussed in brief.

IGVGD Program and Ladders of Opportunity for the Poorest

In 1985 BRAC approached the World Food Program (WFP), which was providing time-limited food assistance to the extreme poor through its Vulnerable Group Feeding (VGF) initiative, to pilot a new program and model. The results were impressive. A BRAC study found that the income of women who participated in the pilot increased significantly, and that their additional income was more than the wheat donations from the VGF program. Around 80 percent of the women had also entered BRAC's Rural Development Program and gained access to its microcredit and social development services. A separate assessment of the VGF, by contrast, found that many of its participants were no better off when they left the VGF than when they joined.

Impact Analysis

Targeting the Poorest

Reviews of the IGVGD have been favorable and a study commissioned by the WFP found evidence that the program reached

Table 1: BRAC's Microfinace Programs			
Program	**Target Group**	**Term and Conditions**	**Product Details**
MELA	Larger loans provided to BRAC and non-BRAC microentrepreneurs to scale up their enterprises	• Must have good entrepreneurial skills • Must not have any outstanding loans from BRAC or other microfinance institutions • Must open a bank account to receive loan	• Loan size range US $400–$4,000 • 15 % flat interest rate • 12-, 18-, and 24-month loan products repayable in monthly installments
Microfinance	• Less than 50 decimals* of land owned, live in slums, and earn a living by manual labor • Households headed by women and vulnerable poor households (targeted specifically through IGVGD)	• Must be a member of BRAC VO • Must save • Must not have a loan with other NGOs	• Loan size range US $50–$350 • 15 % flat interest rate • Loans repayable in weekly installments over a year
IGVGD	• Households headed by women, who own no more than 10 decimals of land. • Women divorced, separ-ated, or have a disabled husband.	• To be eligible for loans: • Must be a VO member • Must save	• Initial loan size about US $50 • Other conditions similar to Microfinance
CFPR/TUP	• No more than 10 decimals of land • No adult earning member • No productive assets • School-age children working Adult women in manual labor	• Must not be members of any government or NGO development program • Must have at least one adult woman who is physically able	• Distribution of income earning assets • Subsistence allowance for a specified period • Employment and enterprise development training and technical support • Essential health care support

* A decimal is 1/100 of an acre.

the very poor, that the economic position of IGVGD recipient households improved, and that access to NGO microfinance services was greatly enhanced. Hashemi's comparison[1] of the 1994 WFP baseline survey with key poverty indicators for rural Bangladesh (see Figure 2) found that IGVGD attracted members who had significantly higher levels of absolute landlessness, were functionally landlessness (owned less than a half acre of land), owned two sarees or less, and lacked winter clothing, than the extremely poor identified by Rahman and Hossain.[2] While 8 percent of rural households and around 10 percent of extremely poor households overall were headed by widowed, divorced, or abandoned women, approximately 44 percent of households entering the IGVGD program in 1994 were from this social category. This indicates that the program reached a substantial number of the population for whom poverty is likely to be persistent.

Impacts and Graduation

In terms of economic indicators, the 1994 WFP survey found that, on average, incomes of IGVGD clients rose significantly, material assets (ownership of homestead plots, land, beds, and blankets) increased, and the percentage of households engaged in begging dropped dramatically (see Table 2).

A cross-sectional study that compared IGVGD participants at the various stages of the program cycle found significant positive impacts over a range of social and economic dimensions as the participants progress through the IGVGD cycle.[3] [Inst. Tb 2-3]

Another performance indicator, which examined how successful the IGVGD program is at "graduating" very poor households to regular microfinance programs, provided evidence of improvement. At the beginning of the program, only 15 percent of the IGVGD participants were MFI clients. By the program end in 1996, this had increased to 28 percent, and by 2000 had reached 66 percent. Although access to microfinance increased across Bangladesh during the late 1990s, a 440 percent increase in MFI membership for such a cohort

Figure 2: Targeting Performance in IGVGD

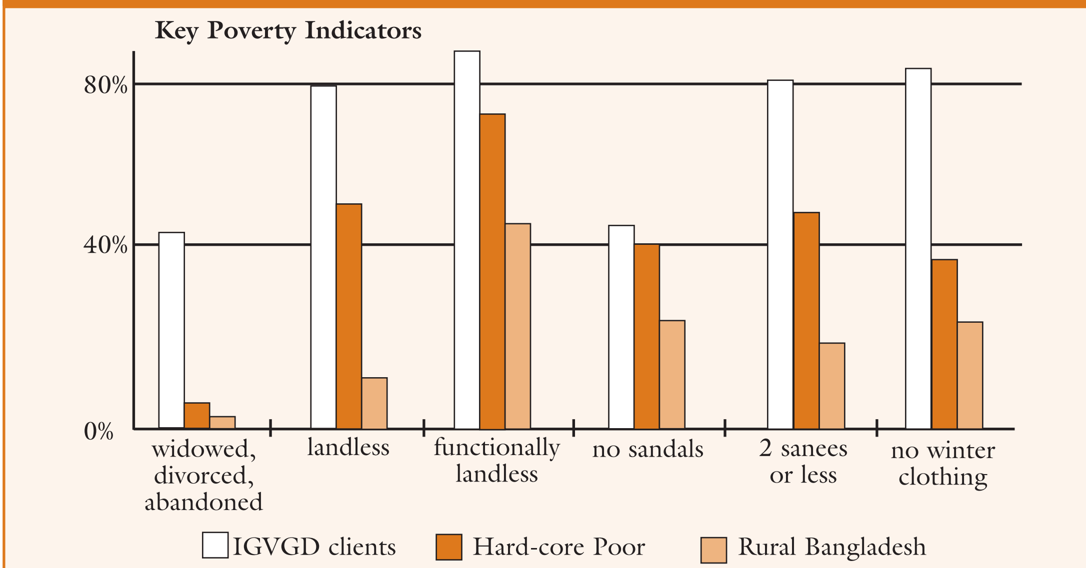


Table 2: IGVGD Economic Impacts

Variables	Time		
	1994 (pre-program)	1996 (end of program)	1999 (3 years after program)
Monthly income (Taka)	75	717	415
Percentage of households earning more than TK300 per month	7	64	31
Percentage of households with homstead land	73	87	na
Percentageof funtionally landless households	94	72	na
Percentage of households with beds	58	60	64
Percentage of households with blankets	14	na	na
Percentage of households begging	18	2	0

Source: Adapted from Hashemi et al. (2001, p. 9)

Table 3: IGVGD Social Impacts

	Food Aid + Savings	Food Aid + Savings + Training	First Loan
% Attending most VO[1] meetings	2	19	83
% Attending Gram Shobha meetings[2]	2	17	40
% Reporting positive difference due to meeting participation	38	55	83
% Reporting that they wanted to start an IGA after training	42	53	82
% Reporting greater levels of confidence	62	78	91
% Reporting that they aspired to be a VO leader	6	16	25
% Reporting that life now is better	24	32	54

[1] The Village Organization (VO) is the gateway of BRAC's development programs. About 30 BRAC members from a village form a VO.
[2] The Gram Shobhas are monthly meetings on specific issues, where both the women members and their spouses attend. These provide a fairly regular forum in which VO members are exposed to and discuss various social and economic problems, and potential solutions.

of very low-income, very low-asset people represents massive improvement in the numbers of the poor gaining access to financial services.

Cost Effectiveness

There are no comprehensive cost-effectiveness or cost-benefit analyses of the IGVGD available, but Hashemi estimates that the amount of subsidy per household was US $135 per cycle for the year 2000, which he argues was a reasonable cost for the improvements that have been recorded.[4] This evidence, plus other reviews, has certainly convinced aid agencies that IGVGD can successfully reduce poverty for sections of the population that few other programs can reach. Over the last few years, donors and MFIs have been keen to build on the IGVGD experience and expand programs for "those left behind."

Driving Factors

The IGVGD program is a partnership between a donor (World Food Program), the government of Bangladesh (specifically the Ministry of Women's and Children's Affairs, Directorate of Relief and Rehabilitation, and local government representatives), and a development organization (BRAC). The main role of the various important actors in the IGVGD program is shown in Table 4.

Commitment and Political Economy for Change

BRAC's commitment to bring the most vulnerable into its development program in ways that are cost effective and sustainable in the long run has been the main driver for the IGVGD program. Concerns over food security, safety nets, and improved nutrition for

Table 4 Major Actors and Their Role in the IGVGD Program

Partners	Main role
Ministry of Women and Children Affairs	- IGVGD household selection - Arrange funds for training - Extend administrative support Monitoring programme progress
Directorate of Relief and Rahabilitation	- Allocating and distributing food aid - Extending administrative support
World Food Programme	- Provide food aid - Arrange funds for training - Monitoring the programme progress - Reseach and Evaluation - Coordinate with GoB and BRAC
PKSF and other banking institutions	- Provide credit funds to IGVGD programme
BRAC	- Development and implementation of the programme which includes: - Arrange income generating activities (IGA) and social awarness training - Provide credit and other sector support - Savings managment - Follow, supervision and monitoring - Mobilize donor funds for training - Research and Evaluation

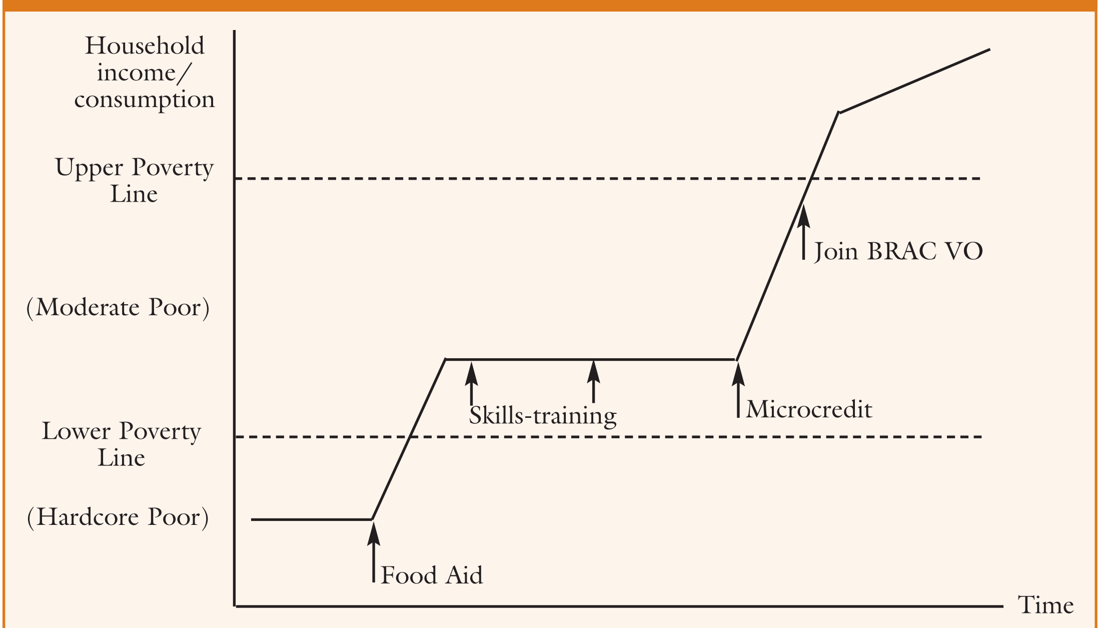
the most vulnerable women attracted the government of Bangladesh to the Vulnerable Group Feeding (VGF) program. Although these needs are central to the lives of the extreme poor, BRAC felt that without a more strategic approach, that linked these vulnerable women to development activities, the food aid-based program on its own would not be able to create sustainable, positive change in the lives of these women. The IGVGD approach, therefore, grew out of BRAC's determination to leverage the existing commitment of the government of Bangladesh towards the most vulnerable women of rural Bangladesh.

Institutional Innovation

In 1987, the government of Bangladesh and WFP transformed the VGF program into the Vulnerable Group Development, or VGD, program. They also reached an agreement with BRAC to expand the pilot scheme into the IGVGD program. Because the architects of this expansion did not grow complacent, the IGVGD continued to evolve.[5] For example, in 1989, field staff pointed out that even though they were members of IGVGD, many women could only buy and raise a single chicken at a time because of lack of capital. Why not provide loans to program recipients as soon as they completed their training? This led to the addition of a third element to the IGVGD––microcredit––with the aim of speeding up client adoption of more productive livelihoods and graduation to BRAC's programs for the moderate poor. This three-pronged approach (food grant, skills training, and microcredit) has been the basis of IGVGD throughout the 1990s.

[Insert Figure 3]

Figure 3: The Idea Behind the Strategic Linkage Approach



Learning and Experimentation

Challenges Faced in Scaling Up IGVGD. During the scaling-up phase, the program expanded into areas with poor infrastructure and weak communications. The new focal ministry did not have offices in all the *thanas* where BRAC had expanded its IGVGD program.[6] Accordingly, per the agreement with the government of Bangladesh, in *thanas* where the new focal ministry did not have presence, the previous ministry responsible for the program would continue to fill in the gap. This was a complex and challenging arrangement because it required coordination between the old and new VGD focal ministries—a far from easy task.

Scaling up the IGVGD program, which was based on BRAC's existing area office infrastructure, also posed challenges for BRAC's microfinance program. The main component of the IGVGD program was ultimately to incorporate the VGD beneficiaries into BRAC's mainstream development programs that operated through Village Organizations (VOs)—the gateway of BRAC's development programs. However, once BRAC agreed to implement the IGVGD program in a thana, all of the existing VGD beneficiaries in the thana had to be covered.

It was not easy to provide the development package to VGD beneficiaries who lived in areas where BRAC had not extended its microfinance infrastructure. Setting up new VOs was not always feasible either, if there were too few VGD beneficiaries in the areas. These areas generally had weak infrastructure and poor communication with the town in the thana where the AOs were typically located. This made organizing training, providing credit, and managing savings for VGD women difficult at best. Follow up and monitoring was also less than optimal, which led to repayment irregularities and eventual dropout of VGD members.

The current VGD cycle had been reduced to 18 months, from the 2-year cycle in 1996. The logic behind shortening the time frame was that more VGD beneficiaries could be helped with the resources at hand. The reduced cycle hampered the effectiveness of the overall objective, which was further affected by administrative delays in the beginning of the program.

The life of the program lost 3–4 months to finalizing the VGD beneficiaries and getting the contract between the government of Bangladesh and BRAC signed. Almost another two months passed before the government circular to the local officials was issued—without which BRAC could not start its work on the development package. This in effect meant that BRAC had only a year to implement the activities of the development package, which was exacerbated by the difficulties of the poor coverage, mentioned above. BRAC was also acutely aware that the period when VGD beneficiaries could benefit the most from a loan was when they had the food security offered by the VGD card. Their experience suggested that the VGD beneficiaries, who took out a loan early and completed the loan cycle while they had food assistance, would be much more likely to stay in the microfinance program, compared to those who got loans late in the cycle and had to repay the loan after VGD support ended.

A lack of understanding about the main purpose of the IGVGD program between the various partners was a major challenge. The IGVGD program has a strong developmental focus in contrast to the earlier VGF program, which principally focused on relief. What this fundamental change in focus meant in terms of program design and approach was not adequately discussed with the most important partners—the local government officials. This gap led to major difficulties for BRAC as the implementer of the developmental component of the program.

One area which best captures this challenge is the issue of returning savings. Savings is not only a financial product, it is an important part of the process for VGD members who are moving from living hand-to-mouth to planning for the future. For development staff, too, the act of saving regularly by the VGD members is important. On one hand, it challenges the image of the members as beneficiaries and relief recipients. On the other hand, it provides a space for engagement. This is why savings constitutes such an important place in development programs. Abed aptly captured the whole idea behind savings as a developmental concept when he said: "In Bangla, we have a very apt word for planning, *porikolpona*, meaning "arranging imagination." Regular savings, however meager, is a very powerful mechanism that gets the poor to arrange their imaginations for tomorrow and beyond. It also is important for building relationship between the savings institution and the people it serves."[7]

However, the other partners of IGVGD did not (and do not) readily understand the larger role of savings in development. This lack of conceptual congruence over savings becomes most evident when the food aid ends and there is pressure from other partners in IGVGD to return the savings to the VGD members. Returning their savings, for BRAC, signals the end of the relationship with the VGD members. This is inconsistent with the central logic of the IGVGD program—that of creating strategic linkages between a relief and a development program to include the poorest.

Another area of contest among the partners is targeting. The development focus of IGVGD targets the poorest women who are physically and mentally able to benefit from the income generating training and who can manage an income-generating project with microcredit. This condition excludes certain categories of the extreme poor for whom the IGVGD approach is not the most appropriate.[8] Yet, because the VGD food aid is one of the scarce resources that the local government representatives can allocate among the poorest, they face a lot of pressure to include different categories of the poorest, including the old and the disabled. This compromises the idea behind the IGVGD program.

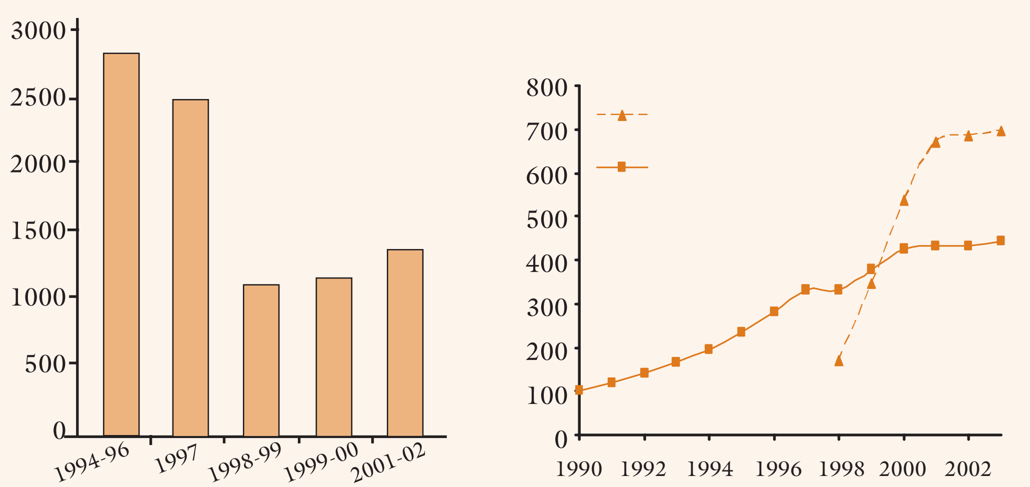
Managing the Challenges

The main challenge to scaling up the IGVGD program was providing effective coverage to areas that were outside the operating area of an Area Office—the lowest unit of BRAC management. Branch Offices were set up to provide better follow up and monitoring to members residing in areas beyond the operating area of an Area Office. The expansion of the Branch Office network is shown in Figure 4 below.

The density of VGD card holders in a thana is an important operational variable for the IGVGD program. If the density is too low, organizing the VGD women becomes difficult, and the whole purpose of the program suffers. Figure 4 also shows the average number of VGD cards per thana for the VGD cycles in which BRAC's IGVGD program was in operation. The average density of VGD cardholders decreased sharply during the time that the IGVGD program was scaling up. From the 1999 cycle, density gradually increased, related to a deliberate BRAC policy to focus on thanas with good VGD-card density.

Several steps were also taken to streamline the internal management system of the IGVGD program. First, in management meetings at all levels, separate sessions on the IGVGD program were held as a matter of routine. This had not been done systematically before. Second, the monitoring function was separated from management; it had been combined earlier. Separate monitors for IGVGD were hired, who regularly monitor the program on specific issues. Third, a more intensive follow-up system was put in place by deploying staff at the regional (roughly district) rather than the divisional level. (Table 5 summarizes some of the steps that BRAC took in response to the challenges faced in scaling up the IGVGD program.) [Insert Figure 4]

Figure 4: IGVGD Over Time



As the biggest implementing partner of a flagship program for the poorest, BRAC also had an important voice and role. BRAC repeatedly highlighted the importance of the government of Bangladesh and its local representatives to this program, especially the need to have a common understanding of the objectives and program activities. To support this, BRAC initiated regular workshops in the thanas for local government representatives. Coordination with local government representatives was the weakest in thanas where the focal ministry did not have any offices or presence. Repeatedly emphasizing this as an important constraint for the program gradually led the focal ministry to take more initiative, such as promoting attendance at the BRAC workshops, expanding their infrastructure in the thanas, and strengthening their monitoring of the program. [Insert Table 5]

External Catalysts

The IGVGD idea and the subsequent program has largely been driven by BRAC, especially during the scaling up phase of the program. However, during the initial piloting of the idea, WFP played a pivotal role.

Table 5 Key Challenges, Consequences, and Steps Taken

Challenges	Consequences	Steps Taken
Inadequate Area Office coverage	• Poor follow up • Training program hampered • Credit disbursement hampered	• Branch offices set up to cover areas far from the Area Office • Separate sessions dedicated to IGVGD issues in all BRAC management meetings • IGVGD monitors deployed • Workshops held in the thanas to coordinate and get better support from local government • Infrastructure of focal Ministry increased in thanas
Time for Implementing Development Package Limited by Procedural Matters	• Credit not be given to all during the food aid cycle • Adequate time not available to provide technical support and supervision for sustainable graduation	• From the 2003 cycle, the VGD cycle increased to 24 months.
Lack of Common Understanding	• Pressure for savings return • Poor motivation • Drop out	• Workshops in thanas with local government officials • Closer dialogues among the partners • Field level exposure

As a matter of fact, when WFP decided to transform its Vulnerable Group Feeding program into the Vulnerable Group Development program, the government was running the program and was expected to implement this new approach. In practice, however, the change of the program name from "Feeding" to "Development" was in name only. Skeptics called it a "poverty containment program" rather than a "poverty alleviating" one.

In 1985, the founder of BRAC, F.H. Abed, had a meeting with the deputy executive director of WFP who told him that that the government of Bangladesh was running the VGD program just like VGF, and that if it continued as such, it would be difficult to maintain support for the program. In terms of outreach, VGD was the largest safety net program in Bangladesh, and its withdrawal or contraction would be disastrous for the extremely poor. The matter was extensively discussed within BRAC to assess the pros and cons of BRAC participating in the program as a development partner along with the government.

BRAC asked WFP to allocate 700 VGD ration cards especially to test the VGD idea in one sub-district of Manikgonj where BRAC had significant presence. However, there was a hiccup during this pilot phase, which turned out to be a blessing in disguise. An influential national daily ran a story on the pilot, accusing BRAC of "taking 25 taka every month" and "making the VGD women work" for the "free card." Yet the VGD guidelines, under which BRAC was operating, clearly mentioned "savings" and "training" as the development components of the program. The government of Bangladesh, also without consulting the VGD guidelines, carried out an investigation into the matter and found BRAC "guilty." In response, the WFP conducted its own investigation and found that BRAC was very effectively following the guidelines. This brought the matter out into the open, and the relevant government ministry started discussing the VGD approach more closely with BRAC. It was a turning point for BRAC as a major, credible actor in developing the IGVGD idea.

Lessons Learned

The Complexity of Including the Poorest: Poultry Sector Development and IGVGD

The story of scaling up IGVGD is closely linked to BRAC's entry and its poultry program. BRAC wanted to find appropriate products for the VGD women, that had large-scale potential; were relatively easy to market with existing skills; were home based, and could generate quick cash flow. BRAC also had to be able to provide or facilitate provision of the required support services. Poultry seemed to satisfy all of these conditions.

The human and physical infrastructure needed to support the development and scaling up of a poultry sector had to be created incrementally. This process needs elaboration to show that developing programs useful to the extreme poor is a complex undertaking that requires coordinated action at various levels.

BRAC observed that the various linkages that made the poultry sector viable was absent, especially for the poor living in rural areas. Poultry raising was not considered a business for the poor. BRAC realized that the crucial challenge for success would be controlling poultry mortality. Poultry extension services were non-existent, and there were many bottlenecks in the supply chain for poultry vaccination. The other big challenge was to improve the quality of the breed to increase yield. A local bird lays only 60 eggs a year. The government had a HYV (high yield variety) poultry setup, but because of the severe supply and support bottlenecks, effective demand was low. The government was very supportive when BRAC began to work on relieving these bottlenecks, because demand would increase all over Bangladesh.

BRAC used its local presence and grassroots knowledge to create a cadre of poultry workers from the VGD women. They were trained in basic poultry diseases and provided medicine and vaccination services for a modest charge. BRAC facilitated the networking of these poultry workers with the government's local poultry and livestock infrastructure. Today BRAC has more than 40,000 such poultry workers working throughout rural Bangladesh.

BRAC started by buying day-old chick from government-run poultry farms, but there were several problems. The largest unit was in Dhaka and transporting large numbers of day-old chicks to rural areas was both expensive and hard on the chicks. The quality of the day-old chicks was not satisfactory, and supply could not be delivered on time or in the right quantity. In 1996, BRAC modernized its small poultry farm. Today, BRAC has six such poultry farms which supply over 1 million day-old chicks every month.

Ensuring quality feed was another challenge that that had to be addressed. Hybrid maize, the main ingredient of poultry feed, was not produced in Bangladesh, so BRAC imported five tons of hybrid maize seeds. To attract farmers to cultivate hybrid maize, a guaranteed floor price was set. In 1999, BRAC set up a poultry feed mill to guarantee a supply of high quality and timely feed for the expanding poultry sector. Recognizing that importing enough hybrid seed would be expensive and would translate into higher feed prices, BRAC entered into a joint venture with an Australian seed company. Today, BRAC's Maize Seed Production Program produces 400 tons of hybrid maize seeds, which in turn produces an annual maize crop of 100,000 tons.

Taking the Challenge Further: BRAC's New Program for the Ultra Poor

BRAC's IGVGD experiences demonstrated the possibility that opportunities could be created from safety nets for those who are left behind by conventional microfinance. This made BRAC experiment even more boldly with the concept of strategic linkages.

BRAC noticed that for a great majority of the poorest, the IGVGD increased their ability to benefit from regular microfinance programs, but for a significant minority, this did not happen. It was more worrisome that those who failed to make it were among the poorest and most vulnerable. There were several reasons for this.

BRAC was at times dissatisfied with the targeting that local government representatives carried out, which was sometimes based on political and other motives. More importantly, the women often failed to get the full benefits of the VGD food aid. Often, one VGD card was unofficially shared between two or more women. Sometimes, women had to "buy" the VGD cards by bribing the government official. The destitute women would borrow the money for the card from wheat dealers, who would repay themselves by charging the women more than market rates for wheat bought with the VGD card. BRAC wanted a program where it had more control over the processes, and which was specifically designed to build a solid foundation from which the extreme poor could move forward.

In January 2002, BRAC started a new experimental program with these challenges in mind, called "Challenging the Frontiers of Poverty Reduction: Targeting the Ultra Poor,"or TUP, for short. The program was designed to address the various interlocking constraints affecting rural women who live in severe poverty. The strategy is to help the ultra poor build a solid physical and sociopolitical asset base. The first two years of the program were the pilot phase, during which 5,000 ultra-poor households were selected each year. In 2004, the program will be scaled up, and 10,000 more ultra poor will participate. In the remaining two years (2005 and 2006) of this experimental program, 25,000 ultra-poor women will be targeted.

Program components for the ultra poor are selected by using a careful targeting methodology, that combines participatory approaches with a simple survey-based tool. The program also includes a special investment program that grants assets and a stipend, an enterprise specific skills development training program, a program of essential healthcare, and a social development program. The program aims to cover 70,000 ultra poor from 2002–2006.

The whole idea behind TUP is to enable the ultra poor develop new and better options for sustainable livelihoods. This requires a combination of approaches, some promotional, such as asset grants and skills training; and some protective, such as stipends and healthcare services. It also requires addressing constraints at various levels, household and the wider environments of institutions, structures, and policies.

The results from the pilot phase suggest that the targeting of the TUP has been successful. Comparison with the general IGVGD membership profile suggests that TUP is targeting people more poor than VGD members. [Insert Table 6]

The changes that are taking place in the lives of the ultra poor targeted by the program also show promising results. The program, according to a recently conducted mid-term review, has produced noticeable gains in social and human capital. A consolidated view of the profiles indicates a majority have escaped their ultra-poor status and acquired a poor but improved standard

Table 6 Key Differences between VGD and TUP Members

Variables	TUP	VGD
Average owning land	2.13	4.72
% of households owning no cultivable land	93	87
% of households not owning the land they live on	54	43
% of households reporting outstanding loan from any source	2.13	36
% of households reporting they eat at least two meals a day	2.13	61
% of households reporting deterioring economic conditions over the last year	44	35

of living. About 40 percent are moving toward the standards of households targeted by microfinance institutions. Although predictions are premature, about 75 percent have some prospect for sustaining these improvements into the future.

At $291 per member, financial allocation for a 18-month cycle of the TUP program is more expensive than IGVGD, which has a financial allocation of $225. However, the two programs target different groups of the extreme poor. TUP focuses on those who fail to benefit from the VGD card or do not get or it. The TUP approach is different and requires a more comprehensive, and more expensive, set of instruments for the types of ultra poor the program targets. The main question is the extent to which the benefits provided by the program are sustainable.

It may be too early to assess sustainability, but the mid-term review found that the mean increased net income for TUP members is actually significantly higher than that of IGVGD members (CFPR Donor Consortium, 2004). This very early result suggest that the TUP model may actually be quite cost effective.

In the long run, the most important variable will be the proportion of the ultra poor who manage to build sustainable livelihoods. Joining mainstream microfinance programs, especially being able to participate over a long time, can be an important marker. This has been widely used to assess graduation in IGVGD. Although this will certainly be an important indicator for monitoring graduation, it may not be the only one, and the challenge will be to find more appropriate ones for the ultra poor targeted by the TUP program.

Bringing in the Poorest

BRAC's conviction, underlying its microfinance programs for the poorest, has been simple yet unconventional—that the poorest can and should be included. The strategy for BRAC was not to force the existing model of microfinance, as it was clear that the model itself was part of the problem. BRAC knew from experiences that the interlocking constraints and deprivations, within which extreme poverty exists, are too complex to tackled by microfinance alone as a strategic intervention.

The IGVGD program used the period of security provided by the food aid to develop the skills and confidence of the poorest, and finally provide them with credit to build on. The TUP program was based on the experience of IGVGD—that there are people too poor to benefit from IGVGD, who still should not be ignored as an eventual target group for microfinance.

The idea of building inclusive markets and systems, especially focusing on those who tend to be left out, has been central to the microfinance movement. Yet, ironically, mainstream microfinance models have not only bypassed the poorest, but mainstream microfinance discourse did not consider them to be an area of concern or relevance for microfinance.

BRAC's experiences suggest that carefully designed strategic linkages that combine grants with a central role for microfinance can work for the poorest. There will surely be many different models and approaches for including the poorest, which will vary according to country contexts. However, the starting point will have to be reversing the trend of apathy, that either excludes the poorest or treats them as "relief cases" to be dealt by "others." The poorest are, can, and must be central to the vision and commitment of microfinance institutions. Only then will the search for possibilities and opportunities to include the poorest begin and develop.

End Notes

1 S. Hashemi, *Including the Poorest: Linking Microfinance and Safety Net Programs*. CGAP Focus Note No. 20, (Washington, D.C.: CGAP, 2001).

2 H. Rahman and M. Hossain, eds., *Rethinking Rural Poverty: Bangladesh as a Case Study*, (Dhaka: UPL, 1995).

3 P. Webb, et al, "Expectations of Success and Constraints among IGVGD Women," report prepared for World Food Program, Bangladesh, 2001.

4 Hashemi, *Including the Poorest,* p. 11.

5 Imran Matin and D. Hulme. "Programs for the Poorest: Learning from the IGVGD Program in Bangladesh," *World Development* 31, no. 3 (2003): 647-65.

6 In 1998, the focal ministry for the VGD program was changed from Ministry of Relief and Rehabilitation to the Ministry of Women's and Children's Affairs.

7 F.H. Abed, "Programs for the Extreme Poor: BRAC Experiences So Far," paper presented at the international conference, "Staying Poor: Chronic Poverty and Development Policy," Chronic Poverty Research Centre, IDPM, University of Manchester, UK, April 7-9, 2003.

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Chapter 7

Bank Rakyat Indonesia (BRI): Twenty Years of Large-Scale Microfinance

BY KLAUS MAURER

Executive Summary

Established 20 years ago, the Unit system of Bank Rakyat Indonesia (BRI) today is the largest and one of the most successful microfinance institutions in the world. The 3,855 Units—small outlets mostly in rural areas with around six staff members each—are scattered all over Indonesia and provide services to almost 30 million small savers (the average account is US $108) and 3.1 million small borrowers (average loan outstanding is US $540). The BRI Units have followed a profitable, sustainable approach to microfinance on a large scale, based on locally-mobilized savings without subsidies and funds from government or donors. The commercially-based provision of credit and savings services has had a powerful positive impact on the lives of millions of poor and low-income households.

Several factors have driven the reform and implementation of the BRI Unit system. Effective leadership, strong commitment, and political support were crucial at the initial reform stage but also throughout the development process. The institutional design of the BRI Unit as the nucleus of the entire system combined standardization and flexibility in a unique way. The BRI experience drew extensively on the lessons and experimentation of other initiatives and from BRI's own trials and pilots.

External factors gave the impetus for the initial reform. Later on, stable macroeconomic conditions and a series of financial sector reforms provided a conducive environment in which the new Unit system could develop and prosper. When the Indonesian banking system collapsed in 1998, BRI's Unit system remained profitable, loan repayment rate stayed high, and the deposit volume more than doubled. The BRI Units emerged from the crisis stronger and even more robust than before.

Implementation Process

Origins of the BRI Units

Bank Rakyat Indonesia (BRI) is a state-owned commercial bank that has historically concentrated on providing banking services to the agricultural sector and rural areas of Indonesia. BRI established 3,600 village units in the early 1970s as conduits for channeling subsidized credit to farmers under the BIMAS program. When the government decided to terminate the BIMAS program, and with it the massive subsidies to unit operations, BRI was faced with a difficult choice: either introduce drastic measures to make the village units viable, or close them down. With the encouragement of the Ministry of Finance, BRI decided to convert the units into a rural banking network that would meet a wide range of financial needs of rural households in a sustainable manner.

The timing and conditions for a "big-bang reform" of the BRI Unit system were favorable as the collapse of BIMAS coincided with important events: the collapse of oil prices and the sharp decline in oil revenues which put heavy strains on the government budget, a new cabinet and key personnel changes in the government (finance minister), and the launching of fundamental economic reforms. A major financial sector deregulation package was announced in June 1983 allowing banks to set their own interest rates; this created opportunities and the enabling environment for a viable rural banking operation.[1]

Establishment of the New Unit System (1984–86)

Viability guided the transformation of the Units from conduits for BIMAS (which was not profitable) to full-service rural banking units. A massive restructuring took place. One of the first steps taken was reorganizing the Units into profit centers and the creating separate balance sheets and profit and loss statements for each Unit. Almost one third of the Units was identified as having low potential and were downsized to village service posts. Many Units were physically relocated from out-of-town field sites to central locations close to the markets.

New products were introduced. A pair of products, KUPEDES (for credit) and SIMPEDES (for savings), have become the backbone and trademark of the new Unit system. KUPEDES is a single loan product for general rural credit. It is non-targeted and is available to any creditworthy customer for any kind of productive enterprise. KUPEDES interest rates were set at 1.5 percent flat per month (an annual effective rate of 33 percent). KUPEDES borrowers must provide sufficient collateral to cover the value of the loan, usually in the form of land titles, but also can pledge buildings, motorcycles or other property. KUPEDES also has a timely repayment incentive, equivalent to a refund of 25 percent of the interest paid on the loan.

SIMPEDES is a simple passbook savings product that was introduced after pilot-testing and experimentation. Savings have been an integral part of the Unit banking philosophy and strategy from the outset. Because more people in rural areas tend to be savers than borrowers at any one time, providing better savings services was seen to be more effective in achieving an equitable distribution of banking services than providing cheap credit. In addition to SIMPEDES, the main product, the BRI Units offer demand and time deposits, as well as another savings product called TABANAS, which is mainly targeted at school children and students.

KUPEDES and SIMPEDES had a successful start, and after three years it became clear that the BRI Unit system could be financially viable. In 1984, only 14 percent of the Units were profitable. Two years later, this had increased to 72 percent. The BRI Unit system as a whole achieved profitability in 1986, the third year of operations.

Expansion and Scaling Up (1987–97)

The initial phase of transformation and establishment of the new BRI Unit system was followed by a decade of rapid expansion and scaling up. The expansion was fueled by continued deregulation and reforms of the financial sector and by macroeconomic growth and stability. Every year, the BRI Unit system added an average of 100,000 borrowers and 1.5 million depositors.

In the sixth year of operation in 1989, the BRI Unit system achieved self-sufficiency in funding when the volume of deposits was equal to the loan amount outstanding. Since then, deposits continued to outstrip loans both in terms of number of accounts and volume. In terms of volume, the deposit-to-loan ratio has been about 2:1, with the result that only half of the funds mobilized by the Units were recycled as KUPEDES loans, and the other half were transferred to the branch system. For the Units, the fund transfer was attractive because they were paid an interest rate—the so-called transfer price—which was normally set slightly above the interest rate paid on time deposits. The branches easily absorbed the Units' excess liquidity and channeled the funds into large corporate loans that were rapidly expanded during the 1990s.

In 1997, the Unit Banking System recorded more than 18 million savers and 2.6 million borrowers (see Table 1). This dimension of outreach clearly established the BRI Unit system as the major institution in rural finance in Indonesia.

Financial and Economic Crisis (1998–99)

In late 1997, Indonesia was hit by a severe financial and economic crisis. Within a few months, the country's currency—the *rupiah*—experienced a dramatic 80 percent plunge in its value against the US dollar, followed by sharp increases in inflation (77 percent in 1998) and interest rates. The ensuing political crisis mounted in May 1998 with the downfall of President Suharto. The banking system was on the brink of collapse, forcing the government to step in and provide a blanket guarantee cover for all bank deposits. Many private banks were closed down, major state banks merged, and non-performing assets transferred to the newly-created Indonesian Bank Restructuring Agency (IBRA).

The BRI Units weathered the crisis period remarkably well. On the one hand, the BRI Unit system experienced an enormous influx of deposits because it benefited from its status as a state-owned bank and safe haven for depositors. In 1998 alone, more than three million new deposit accounts were opened, and the volume of deposits in Rupiah doubled. On the other hand, the

Table 1: Deposits and Loans in BRI Units 1984-2003

	DEPOSITS			LOANS OUTSTANDING		
Year End	Number (in thousands)	Amount (Rupiah billion)	Amount (US$ million)	Number (in thousands)	Amount (Rupiah billion)	Amount (US$ million)
1984	0.003	42	39	641	111	103
1985	0.04	85	76	1,035	229	204
1986	419	176	107	1,232	334	204
1987	4,184	288	174	1,315	430	260
1988	4,184	288	174	1,386	542	313
1989	6,262	959	533	1,644	847	471
1990	7,263	1,695	892	1,893	1,382	727
1991	8,588	2,541	1,276	1,838	1,456	731
1992	9,953	3,399	1,644	1,832	1,649	798
1993	11,431	4,325	2,058	1,896	1,957	931
1994	13,067	5,232	2,379	2,054	2,458	1,118
1995	14,483	6,016	2,631	2,264	3,191	1,395
1996	16,147	7,092	3,026	2,488	4,076	1,739
1997	18,143	8,837	2,424	2,616	4,685	1,285
1998	21,699	16,146	2,044	2,458	4,697	595
1999	24,236	17,061	2,419	2,474	5,957	845
2000	25,823	19,115	1,986	2,716	7,827	813
2001	27,045	21,991	2,105	2,790	9,873	945
2002	28,262	23,480	2,627	3,056	12,011	1,344
2003	29,869	27,429	3,240	3,100	14,183	1,675

number of KUPEDES loans stagnated during the two years of crisis, and the portfolio level declined in real terms.

Most surprisingly, however, loan repayment suffered only marginally. Contrary to the massive defaults of large and corporate customers in the Indonesian banking sector, the KUPEDES borrowers maintained a strong repayment discipline and continued to honor their obligations despite the economic hardships they faced. Microenterprises primarily employed family labor and their own capital, and were able to adjust more flexibly to the external shock. Furthermore, the impact of the crisis on the poor was generally more severe in urban areas than in the countryside.[2] A key factor was also the long-term banking relationship that had developed between the Units and their customers.[3] Amid a general credit crunch in the banking sector, KUPEDES loans were continuously available to existing customers during the crisis years, although Unit managers did not seek out new clients during that period. Borrowers were particularly anxious to continue having access to BRI's credit facilities because such credit availability represented a form of insurance for dealing with external shocks. Hence, they strived to keep their borrowing history good and placed a high priority on repaying their loans to BRI.

The impact of the crisis on the viability of BRI Unit operations was thus only marginal. The BRI Units were able to maintain their profitability, albeit at slightly lower levels. The BRI Units came out of the crisis stable and robust, contrary to the rest of BRI. Due to heavy loan losses in the corporate business unit, BRI almost collapsed and was recapitalized by the government.

Post-crisis Period (2000–Present)

In the four years since the crisis, the BRI Unit system continued to expand in scale. At the end of 2003, the Units recorded 30 million deposits and a volume of US $3.1 billion. The number of borrowers increased to 3.1 million, with a total loan amount outstanding of close to US $1.7 billion. With less than five percent of the portfolio at risk, the quality of loans remained excellent.

The crisis had brought a considerable rise in poverty. In 1998, over 24 percent of Indonesia's population, or almost 50 million people, had fallen below the poverty line, from around 15 percent before the crisis. The Poverty Alleviation Committee, established in 2001, has launched a ten-year program of poverty alleviation until 2010 and has set an intermediate target to reduce poverty to 14 percent of the population, or 26.8 million people, by the end of 2004. The Committee has realized the important role of the banking sector and has obtained the commitment of major banks, including BRI, to expand their lending to micro and small enterprises.

In an attempt to provide access to commercial credit for the enterprising poor in Indonesia on a massive scale, in January 2000 BRI introduced a small-scale KUPEDES product with simplified administrative procedures and flexible collateral requirements for loans under Rp 1 million (US $120). Although BRI has developed a significant portfolio of small-scale loans, it has not expanded to full capacity in the small-scale credit market, and there remains considerable scope for financing a significant portion of micro-entrepreneurs below the poverty line. But there are also limits to the provision of very small loans in a financially sustainable way. Despite the simplified administrative requirements, the break-even point for small-scale lending is Rp 1.2 million (US $143) when accounting for the full cost of lending.[4]

The latest development has been the privatization of BRI. The sale of 41 percent of BRI shares to the public through an IPO was completed in November 2003. The IPO was successful and drew strong interest from investors—its shares oversubscribed by 16 times. The IPO was the largest equity deal since the financial crisis. Total proceeds from the IPO amounted to Rp 4.1 trillion (US $486 million), of which around Rp 2.5 trillion (US $297 million) is to be transferred to the state budget and the remaining is to increase BRI's capital.[5] What impact this partial privatization will have on the microbanking business and the Unit system is yet to be seen. However, with the BRI IPO, microfinance has made a successful entry into private equity markets, and this will send a powerful message to policy makers and bankers in Asia and the developing world.

Impact Analysis

Looking back on 20 years of implementation, the BRI Unit system has had a strong impact on rural microfinance in Indonesia and beyond. The immediate impact was felt by millions of microenterprises and poor households who benefited as savers and/or borrowers from the financial services offered by the BRI Units. Moreover, the BRI experience was a powerful demonstration to policy makers and other financial institutions in Indonesia and in many other countries. Its impact can be measured in terms of efficiency, effectiveness, and poverty outreach.

Efficiency in the Use of Resources

Efficiency and productivity have been key operating principles in the BRI Unit system. The Unit system functions as an independent profit center within BRI, and each small BRI Unit is a profit center within the system. This has formed the basis for transparency, accountability, and efficiency in the use of resources. BRI has set clear benchmarks for staff productivity: one credit officer for every 400 borrowers, one teller for every 200 daily cash transactions, and one bookkeeper for 150 daily transactions. Nowadays, a credit officer is responsible for more than 500 borrowers and a teller handles an average of 6,000 deposit accounts. The computerization of the BRI Units in the course of the 1990s has significantly contributed to the gains in staff productivity. As a result, cost efficiency of the Unit system has increased considerably over the years. In 2000, administrative costs as a percentage of the average loan portfolio came down to about 8 percent, which is very efficient by microfinance standards.

Effectiveness

Judging from the BRI Units' success in building and maintaining a large, stable, and growing customer base, it is clear that BRI has been highly effective in meeting the rural population's demand for savings and credit services at a reasonable cost. Beyond these direct effects, the performance of the BRI Units had a significant impact on financial sector policy in Indonesia. The design of the 1988 decree (so-called PAKTO) for setting up private rural banks was strongly influenced by the initial success of BRI's commercial approach to rural microfinance. The BRI Unit system has emerged as the leading institution in rural areas and has set the benchmark for rural microfinance in

Indonesia. Moreover, BRI has gained international recognition as the most prominent showcase of large-scale microfinance and has become a learning ground for policy makers and practitioners from many countries. The BRI experience served as a model for institutional design in Cambodia, for savings product development in Thailand, and as input for microfinance legislation in Tanzania, to name a few examples.

Poverty Outreach

Over the past 20 years, the BRI Units have provided financial services to millions of microenterprises and rural households, most low-income in the general population and many among the poorer of the rural population. BRI's KUPEDES lending program does not specifically target the very poor below the poverty line but rather the *working poor* who have viable economic activities and sufficient repayment capacity. Poverty data for BRI Unit borrowers are not available, but proxy indicators (such as the number of small KUPEDES loans) provide an indication of depth of outreach.

Presently, the average outstanding loans are US $540, which is about half of the per capita income in Indonesia. In 2001, 60 percent of KUPEDES loans were below US $300.[6] However, KUPEDES lending has not reached much of the population below the poverty line or the very poor, but rather those near the poverty line. A recent impact evaluation found that regular BRI Unit borrowers are relatively better off than other respondents, including BRI savers only and non-customers, whether measured in terms of income or wealth.[7] It remains to be seen whether the small-scale KUPEDES product introduced in 2000 can address these issues and successfully expand lending to poorer segments of the population.

Much of the debate on poverty outreach of the BRI Unit system (and of other microfinance institutions) has focused on *loans* and on the poor as potential *borrowers*. One may argue, however, that poor people are more likely to be found among the BRI Units' 30 million *savers* (average deposit US $108) than among the three million borrowers.

Savings are a cushion against emergencies for poor households. They help reduce their vulnerability and provide them with a tool for managing uncertainty and risks. For many poor people, credit may not be appropriate as it may not lower but rather increase their risk. Findings of the recent impact evaluation seem to confirm this hypothesis for rural Indonesia. When potential borrowers with viable enterprises were asked why they didn't borrow from formal financial institutions, two thirds said they did not want to be indebted.[8] It would be worthwhile to study the characteristics of BRI Units' small savers in more detail, as well as the importance of savings services for the poor, and the impact of savings services in terms of poverty reduction.

Driving Factors

Commitment and Political Economy for Change

Effective leadership, strong commitment, and political support were crucial factors not only at the initial reform stage but also throughout the development process of the BRI Unit system. In 1983, several events converged, to create the political economy and climate for change. The government launched overall economic and financial reforms, which prepared the groundwork for a radical reform of the BRI Units. The blueprint for the new BRI Unit system was perfectly in line with the financial sector reforms announced in June 1983, thus winning the support of the architects of the reform in the Ministry of Finance and the Central Bank.

Commitment and leadership within BRI have been essential. BRI's president director from 1983 to 1992 took personal initiative and responsibility for the development of the Unit banking system. Jointly with the other members of the Board, he protected the Units from interference and led the development of what they called BRI's new institutional culture and Indonesia's new rural banking. system.[9] The change in culture was associated with the shift from subsidized farm credit to commercial microbanking. Starting from the top management, it triggered a major transformation of the entire institution by changing the mindset of its 14,000 employees.

Despite being part of a government-owned bank, the BRI Units were able to maintain their operational autonomy and to stay free from interventions, such as credit targeting, interest rate restrictions, provision of cheap funds, or from interference in lending decisions. However, as the designated bank for the rural and agricultural sectors, BRI continued to implement subsidized credit programs for priority sectors and specific target groups. These programs were shifted to the BRI branches at the district level, strictly separate from Unit operations. This way, BRI was able to accommodate specific requests and special programs from the government and from donors, without disturbing the development of the Unit system.

Institutional Innovation

The BRI Unit—as the nucleus of the entire system—is itself an institutional innovation. Much of its success may be attributed to the organizational set-up of the single BRI Unit as a highly decentralized and semi-autonomous financial entity. The BRI Unit is commonly found in a central location of the sub-district town, often near the market place. It typically rents a one-room office, in order to keep overhead costs low. A Unit covers about 16–18 villages at the sub-district, and nowadays serves an average of 10,000 savers and a little over 1,000 borrowers. The individual Unit was purposely kept small, by limiting the number of staff and focusing its operations. The four staff—a manager, a loan officer, a teller, and a desk officer—have clear job descriptions and division of responsibilities. Personnel responsibilities and performance-based standards are harmonized across the Unit system. As volume of operations increase, up to 11 additional staff are posted to a Unit. If the business of a Unit expands beyond the maximum staff limit, the Unit is split to keep the operation small and focused.

The accounting system allowed each Unit's performance to be evaluated as profit center. Unit managers and staff are accountable, which has instilled a high degree of responsibility among them. A standardized management information system (MIS), centered on a few key performance indicators, provided timely information to managers and supervisors at all levels. On this foundation the staff incentive system was built.

Overall, the Unit as the institutional nucleus combines standardization and flexibility; it can be easily replicated and easily adapted to the scale of operations in a particular area, providing an ideal institutional solution for expansion and scaling up.

Learning and Experimentation

The BRI experience is based on extensive learning and experimentation. Learning from others dominated the period *before* implementation while learning by doing (including pilot testing) were the main features *during* implementation.

BRI did not invent all the features that characterize the Unit system. It pointedly studied the experiences of others before setting up its own system, such as, Bank Dagang Bali, a private bank founded in 1969; the *Badan Kredit Kecamatan* (BKK), a community-based institution in Central Java; and informal moneylenders, specifically that they collected valuable insider information on prospective borrowers from input suppliers and buyers. BRI had experimented with the Kredit Mini and Kredit Midi products for several years and learned how to analyze the viability of informal microenterprises. The design of the KUPEDES product, the analysis of borrowers' repayment capacity, and the system of monitoring and collection were all built on this early experience.

Pilot testing became standard for BRI. Until 1983, BRI had virtually no experience with rural savings mobilization. Following an initial demand study, a first version of SIMPEDES was introduced as a pilot project in November 1984, and quickly showed evidence of massive demand for a liquid, convenient, and safe deposit facility. After some modifications and refinements, the facility was expanded to all Units by September 1986.

The BRI Units also learned from mistakes. For example, continuous access to credit is an important incentive for borrowers to repay their loans. When tight monetary policy caused a liquidity shortage in BRI and the management imposed a halt in lending in 1991–92, loan repayment deteriorated because borrowers perceived the availability of future loans to be at stake. During the recent financial and economic crisis (AUTHOR: which crisis, or when?), the KUPEDES lending window remained open to credit-worthy borrowers.

External Catalysts

External factors played an important role for the initial reform. The oil price collapse in 1983 and the decline in oil revenues forced the government to impose austerity on budgetary expenses and subsidies. Economic pressures made politicians adopt a commercial approach to rural microfinance. During the scaling-up period, stable macroeconomic conditions and a series of financial sector reforms provided a conducive environment in which the new Unit system could develop and prosper. A decade later, the BRI Unit system was stable and robust enough to weather the severe economic crisis.

External assistance was crucial, especially in the early years. Technical assistance was provided by the Harvard Advisory Group, partially funded by the World Bank and USAID. Together with local bankers, the experts developed the initial design and principles of the new BRI Unit system. Financial resources were only required in the very beginning. With the know-how and the systems in place, the BRI Units were soon able to generate their own resources locally. A World Bank loan of US $97 million for KUPEDES onlending was disbursed in 1990, at a time when, strictly speaking, the BRI Unit system no longer needed outside funds.

Lessons Learned

Many lessons can be learned from the BRI experience. Some of its key principles have been replicated and adopted by the international microfinance industry as best practices. Some of the features are unique to the specific context of rural Indonesia and/or to BRI as an institution, but others can be generalized and applied in other countries. The BRI experience has become a learning ground for policy makers and microfinance practitioners from all over the world. BRI has established an International Visitors Program (IVP) to facilitate international exchange and learning, and every year, about 20 international delegations visit and study the BRI Unit system.

Reforming a state-owned bank and utilizing existing infrastructure is possible within a short period of time.

For scaling up poverty reduction, the major lesson to be learned is perhaps that reforming a state-owned bank, and utilizing the existing infrastructure and human resources to implement a sustainable approach of large-scale microfinance, is possible within a short period of time. Commercially-based provision of credit and savings services has had a powerful positive impact on the lives of millions of poor and low-income households, based on locally-mobilized savings without subsidies and funds from government or donors. This required a change of culture: treating the poor no longer as *beneficiaries* but as *customers* who can save, who are able and willing to pay market prices for good services, and who honor their obligations and repay their loans despite economic hardships.

Expand microbanking services to ensure sustainability.

Some challenges remain and actions should be taken to ensure the sustainability of present achievements. First, lending should be further expanded. Even though the BRI Units have done a remarkable job in extending savings and credit services throughout

Indonesia, there is considerable scope for expanding these microbanking services, especially to poorer segments of the rural population. Most Indonesians still do not make use of formal banking services, so the challenge for BRI is to address the needs of this "unbanked majority."[10] However, an expansion of borrower outreach can only be achieved with additional staff, especially loan officers who serve more than 500 borrowers on average. Management must ensure that the increase in staff—and thus cost—is balanced by an increase in income from lending to additional borrowers, in order to maintain the profitability and sustainability of Unit operations.

Re-invest profits to ensure sustainability. BRI should not use the Units' profits to cross-subsidize the non-profitable parts of BRI as has been done. Profits should rather be re-invested in the Unit infrastructure in order to improve the services to those who enabled the profits, Unit borrowers and savers.

Microfinance providers need competition. BRI Units need competition, which they have not had, and they hold a quasi-monopolistic position in the rural areas of Indonesia with market shares of 74 percent (deposits) and 39 percent (loans). Policy makers should create a conducive policy environment, and donors should provide support to other microfinance operators (for example, private rural banks) to encourage healthy competition. Competition is the driving force behind innovations, expanding outreach, and improving services to the poor. All these efforts are necessary to maximize the impact of large-scale microfinance on the reduction of poverty and on the achievement of the Millennium Development Goals.

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Chapter 8

Integrating the Poor into the Mainstream Financial System: The BANSEFI and SAGARPA Programs in Mexico

BY LISA TABER, WITH CARLOS CUEVAS
AND INPUTS FROM JUAN NAVARRETE AND GABRIELA ZAPATA

Executive Summary

With the passage of the Popular Savings and Credit Act in 2001 and the subsequent launching of a US $150 million program to strengthen savings and credit institutions and expand their outreach in marginal rural areas, the Mexican government embarked on a pioneering effort to alleviate poverty and increase income-generating potential by massively scaling-up access to safe and efficient financial services for the poor.

The Savings and Credit Sector Strengthening Program, BANSEFI

The Savings and Credit Sector Strengthening Program, implemented by the National Savings and Financial Services Bank (BANSEFI), is building the capacity of more than 400 "popular savings and credit institutions" (or EACPs by their Spanish acronym) to meet new legal and regulatory standards and offer safer, more efficient financial services. The EACPs target almost 3 million users who are generally among the poor and lower-income groups. These clients typically have no access to the commercial banking sector, which currently reaches only about 25 percent of the adult population in Mexico's urban areas and has a much smaller presence in the rural sector.

BANSEFI wants to ensure that the clients of every savings and credit institution gain access to safe and efficient financial services via its outreach expansion programs. Hence, BANSEFI is developing an information system to link EACPs (those that elect to participate) to its network federations and confederations, the banking supervisor, and BANSEFI itself. This shared technological platform will offer retail financial service advanced software and services—such as treasury management, funds compensation, and portfolio risk analysis—at lower costs available to a network of financial institutions than to individual institutions.

With this technological platform (currently in its pilot stage), BANSEFI also spearheaded the development of a voluntary internet-based network of savings and credit institutions called “L@Red de la Gente,” or “the People’s Network.” L@Red links BANSEFI’s 551 branches to more than 180 offices of 19 participating institutions, and creates an expansive network of more than 730 branches. As of 2005, clients of any participating branch or institution will be able to make transactions on their accounts, for most of the products offered, from any other network participant.[1]

More importantly, these individual institutions and branches have been incorporated as nodes in the network of the national payments system. As a result, emigrants and public institutions can send cash transfers securely and cost-effectively to recipients in some of Mexico’s poorest and most remote locations. Federal programs providing payments to targeted groups for health, education, and agricultural production are already tapping the potential of L@Red, which will expand to include approximately 2,000 branches when the Savings and Credit Sector Strengthening program is completed in 2008. by to. As of December 31, 2003, L@Red de la Gente had distributed payments from these programs to more than 1.5 beneficiaries, and this number is expected to grow to 3.3 million by the end of 2004.

Among these programs, *Oportunidades* (a program that provides cash subsidies for health and education expenses to the poorest of Mexican families) is worth noting. This is one of the most successful anti-poverty programs in Mexico. Approximately 750,000 savings accounts have been opened as a new way to transfer government subsidies through L@Red de la Gente. This has not only made Oportunidades more transparent, but has had the effect of coaxed the poorest Mexican families into using financial products. As these poor families earn interest on their new accounts, they learn how savings can open access to other types of financial services. This is the major permanent impact of the program. As of December 2003, for example, 78 percent of the 633,974 people who received transfers through L@Red from Oportunidades had savings accounts with positive balances in branches of L@Red. This suggests that this strategy is introducing savings services into the welfare dynamics of poor families, which can be the basis of future asset accumulation.

In addition to the transfers from government programs, the network also channeled more than US $53.6 million in remittance payments, sent from abroad to friends and family members. It is worth noting that L@Red de la Gente offers accounts that link different savings and investment products (standard savings accounts, housing-savings accounts, etc.). This feature is particularly useful for remittances, since emigrants can chose the proportions of the money sent to be cashed or invested in different financial products.

Reaching the Rural Marginal Areas, SAGARPA

As part of the same government strategy, the Secretariat of Agriculture, Livestock, Rural Development, Fisheries, and Nutrition (SAGARPA) is now working in 13 states to set up new savings and credit institutions, build the capacity of existing EACPs. SAGARPA aims to bridge the gaps in knowledge, understanding, and interaction between these financial service providers and the communities of poor and mostly indigenous people living in the areas they serve.

A survey of Mexico's marginal rural areas in 2000 showed that just 2.5 percent of households had access to credit from a financial institution, and less than 6 percent used formal financial savings instruments. Poor households in marginalized rural areas stand to gain the most from increased access to financial institutions and services—where they can safely build up liquid savings—because currently they rely on informal savings mechanisms and physical assets, like small livestock, that have low yields and high loss rates. They generally pay high transaction costs and commissions to receive remittance payments, and are typically charged about 120 percent[2] per year in interest if they borrow money.

To combat these trends, SAGARPA began to implement the Rural Microfinance Technical Assistance Project (or PATMIR in Spanish) in 2001 to expand the network of EACPs into Mexico's poor and isolated rural communities. PATMIR provides EACPs with technical assistance and limited start-up funding to develop the outreach capacity of their existing institutions, including opening new branches or savings and credit institutions. In each case, technical assistance providers also ensure that participating institutions comply with the new law requiring minimum performance standards.

As of January 2004, PATMIR had strengthened and increased the outreach capacity of 41 EACPs in Chiapas, Huasteca, Guerrero, and Veracruz, improving the financial institutions upon which nearly 24,000 people rely. In addition, more than 10,000 clients gained access to financial services at new branches or institutions.Clients have more secure savings and can cash checks at savings-driven institutions that follow sound and prudent financial practices. These institutions also offer other services, such as credit funded by member savings and access to the payments system to receive remittances and government transfers (via L@Red de la Gente).

The program has now expanded to three more regions of the country and is expected to sustainably integrate more than 80,000 people from Mexico's poorest, most marginalized groups into the financial system before its completion in 2007. To achieve this goal, PATMIR works extensively with individuals and groups in these rural communities to educate them about the benefits of formal savings, how to use savings and other financial services to their advantage, and the rights and responsibilities of membership in a cooperative financial institution. Rather than quickly adding names to a membership roster, the program focuses on cultivating *conciencia, confianza y compromiso*—awareness, trust, and commitment—between the new members (who are typically from indigenous groups and include everyone (women, youth, and the aged, as well) and their financial institutions, so that each understands its investment in the other.

In addition, PATMIR helps the EACPs to incorporate new ways of attracting and responding to marginalized clients. They can hire multi-lingual staff to promote their services and introduce personal digital assistants and mobile banking to make savings more convenient and attractive.

In 2003, more than 4.2 million families received transfers through one federal safety net program alone, and US$13.2 billion in remittances flowed into the country from Mexicans living and working abroad. Most of these funds went to the marginal areas where PATMIR is working. By incorporating poor and marginalized households into the financial system and providing them with safe savings facilities, families an develop the capacity to better manage the funds received and capitalize on these funds to generate more on their own.

Main Lessons

Bringing the poor into the financial system, especially those at the margins of society in geographically isolated regions, teaching them to better manage the cash resources they have, and giving them access to new sources of finance at lower costs is the root objective of the massive and ambitious programs undertaken since 2001 by BANSEFI and SAGARPA. While it is premature to assess the programs' overall impact, results to date indicate that they are likely to have far-reaching effects on the scope and direction of sustainable financial services in the future to alleviate poverty and stimulate equity-enhancing growth. The main lessons the BANSEFI and SAGARPA programs have revealed so far include the following:

- Government intervention can effectively increase access to financial services for low income households and businesses through getting the regulatory framework right, building the institutional capacity of financial institutions, and subsidizing the deployment of modern technology to increase the efficiency of service providers.

- Packaging the development of adequate regulations and supervision, institutional capacity-building, and technological infrastructure is more likely to yield sustainable results and cost less over time than traditional interventions which focus on increasing credit flows.

- Outreach expansion efforts among the poor in marginalized rural areas have much better long-term prospects if they focus on building the stake that these clients have in their savings and credit institutions, as savers, rather than building financial relationships based on the expectation of getting a loan.

Implementation Process

Context

In 2000, Mexico was in the midst of a remarkable economic comeback and profound political transformation. After ten years of gains in poverty reduction were undone by the severe macroeconomic and financial crisis of 1994–95, the financial system had stabilized, credit to the private sector was growing, and the economy was expanding at a rate of nearly 7 percent per annum. President Vicente Fox's electoral victory in July ended 71 years of domination by a single political party. It brought energy and hope into the policy-making and legislative processes with the widespread expectation of more open, participatory, and transparent government.

Yet about 58 million Mexican people—50 percent of the total population—still lived in poverty in 2000. While the commercial banking sector had recovered from the collapse of 1994–95, about three-quarters of all adults in metropolitan areas—and 85 percent of individual entrepreneurs—had no access to these financial outlets. Bank density ratios were low, with a country-wide average of one branch per 12,000 people. In the southern states of Oaxaca, Chiapas, and Guerrero, bank branch densities ranged from one for every 25,000 to 30,000 people. In rural areas, where about half the population live in extreme poverty, participation in the formal financial system was predictably low. A survey of rural areas in the Oaxaca and Huasteca regions in 2000 showed that just 2.5 percent of households had access to credit from a financial institution, and less than 6 percent used formal financial savings instruments.

About 3 million people countrywide, or approximately 7 percent of the economically active population, relied on loosely or completely unregulated financial institutions to safeguard their savings or provide loans, including a variety of savings and credit associations, cooperatives, credit unions and NGOs. While some of these *instituciones de ahorro y crédito popular*, or popular savings and credit institutions,[3] had built a tradition of solid financial intermediation over more than 50 years, the lack of effective regulation and supervision of the sector as a whole put millions of people at risk of losing hard-wrought savings and investments in poorly or unscrupulously managed institutions. These risks became more apparent with the failure of numerous institutions due to fraudulent activities in 1998–2000. The vast majority of these institutions were small, community-based organizations, moreover, with no links to the national payment system, limited product offerings, and low levels of technology and efficiency.

Despite these weaknesses, in the late 1990s policy-makers began to perceive that popular savings and credit institutions could potentially play a key role in alleviating poverty and stimulating inclusive economic growth. In 1999, the Secretariat of Finance and Public Credit (SHCP), the National Banking and Securities Commission (CNBV), the Central Bank of Mexico (BANXICO), and the National Savings Bank (PAHNAL) initiated a process of consultation with legislators, sector institutions, and the World Bank on the development of a new legal and regulatory framework for popular savings and credit institutions.

Both the outgoing and incoming administrations employed a two-pronged development strategy to combat poverty: efficient and well-targeted public spending combined with sound macroeconomic management. Clearly the lack of access to safe, efficient financial services was affecting the ability of poorer Mexicans to get out of poverty through their own savings, the help of emigrant family members, or productive investment in their own enterprises. The access problem was particularly acute in rural parts of the country, where the government had recently put forward major initiatives—such as dissolving the state grain purchasing institution—to curtail market distortions and encourage the pursuit of new business opportunities in the NAFTA environment.

Agricultural growth picked up after 1998 and aggregate poverty trends declined, but productivity gains were still low and one of every two Mexicans living in rural areas was extremely poor. Maintaining a stable macroeconomic environment, funding social safety net programs, and investing in critical infrastructure were key elements of the Fox administration's poverty alleviation strategy. In addition, the new government focused on enhancing competitiveness, particularly of small-scale enterprises, by better integrating markets and targeting capitalization programs, especially at poorer groups in the rural sector.

Overhauling the Legal, Regulatory, and Institutional Framework

The potential to provide millions of people with efficient and competitive financial services through savings and loans, credit unions, cooperatives and savings associations, which were operating about 1800 offices—including in some of the most remote corners of the country—became a top public policy priority for Fox's administration in 2000. The Consejo Mexicano de Ahorro y Crédito Popular (COMACREP), a council representing at least 80 percent of the sector, was formed to participate in the dialogue with government officials, thus giving about 1.5 million clients or members from communities throughout Mexico a voice in the future of their organizations. After more than 16 months of analysis and negotiations, the Popular Savings and Credit Act was passed in April 2001.

The law, which became effective on June 4, 2001, provides for the gradual incorporation of all non-bank savings and credit institutions into a new legal and regulatory framework over a four-year period, and forms the basis of what is perhaps the most ambitious effort to massively scale-up access to financial services for poor and marginalized people in the world. Under the new law, two types of popular savings and credit institutions (referred to in Spanish as Entidades de Ahorro y Crédito Popular, or EACPs), will be authorized by the CNBV to collect deposits from the public and conduct a range of intermediation activities. The scope of intermediation activities and prudential standards to which institutions are held depends on the size, geographic coverage, and demonstrated operational capacity of each entity, as distinguished by four distinct categories of operations.

The CNBV is also in charge of licensing federations (voluntary groupings of retail EACPs) and confederations (voluntary groups of federations), which play pivotal roles in the new regulatory system. To be licensed by the CNBV, an institution must first receive a favorable rating from the Supervision Committee of its federation, which evaluates candidates and subsequently supervises its licensed members—in an "auxiliary" capacity—according to standards established by the banking authority.[4] The decisions of the supervision committees with respect to the entrance or continued operation of a member EACP can be overruled by the CNBV, however, which maintains ultimate responsibility for the prudential oversight of the individual retail institutions.

A complementary law, enacted on June 1, 2001 transformed PAHNAL into the National Savings and Financial Services Bank (Banco del Ahorro Nacional y Servicios Financieros), or BANSEFI. PAHNAL had a 50-year history and network of 590 branches focused exclusively on capturing deposits, mainly among small-scale clients, investing their funds primarily in government debt securities, and proving nodes in the payment system often used to distribute payments by the federal government. Under the new institutional framework, BANSEFI retained PAHNAL's role of promoting savings habits, and gained an important new set of mandates as a bank for the popular savings and credit institutions and the coordinator of an ambitious one-time program of public support to the sector.

The Scope of the Initiative

The US$150 million program, which BANSEFI initiated in 2002 in coordination with other public sector agencies, including the CNBV and the Secretariat of Agriculture, Livestock, Rural Development, Fisheries and Food (SAGARPA), encompasses the following :

- Consolidating and strengthening approximately 400 popular savings and credit institutions to bring them into line with new regulatory standards and improve their efficiency and outreach capacity
- Strengthening EACP federations and confederations
- Developing an information technology system linking EACPs, federations, confederations, regulators, and BANSEFI, which will help the retail outlets reduce operating costs, improve the efficiency of their administrative processes, and facilitate regulatory compliance through automated reporting
- Developing the capacity of BANSEFI to provide second-tier central banking services to the sector, such as back-office functions, accounting, reporting and financial management, and liquidity brokerage
- Strengthening the CNBV's capacity to adequately supervise hundreds of small, dispersed financial intermediaries, the majority of which are engaged in microfinance activities, through the auxiliary supervision structure

- Evaluating the social and economic impact of the program and the sector on an on-going basis, to gauge its success and allow for adjustments as needed to meet poverty-alleviation objectives

Most importantly, the program will incorporate millions of new clients into the formal financial intermediation system. Retaining recipients of government transfer payments as new account holders in a process called *bancarization* is already rapidly integrating previously unserved segments of the population into the economy through their access to financial services.

BANSEFI and SAGARPA are also coordinating efforts through an innovative partner project (implemented by SAGARPA) to expand the outreach of popular savings and credit institutions particularly among women and indigenous groups, in marginal rural areas of Chiapas, Hidalgo, San Luis Potosí, Veracruz, Oaxaca, Guerrero, Morelos, Michoacán, the State of Mexico, Puebla, and Tlaxcala.

The Rural Microfinance Technical Assistance Project, or PATMIR, provides training in basic principles of household finance and participation in financial institutions for groups and individuals in marginal rural communities. It also assists savings and credit institutions in increasing their outreach to these clients by tailoring products, promotional materials, and outreach methods to the needs of community members. In marginal areas where no intermediaries exist, PATMIR provides professional technical assistance and limited start-up funding to develop new savings and credit institutions, or for existing institutions to open new branches. In each case, technical assistance providers also assist participating institutions in complying with the new legal and regulatory standards.

Implementing BANSEFI and Progress to Date

The government faced formidable challenges in developing and implementing the program to transform the savings and credit sector, as approximately 90 percent of the existing institutions lacked the experience and capacity needed to meet the standards of sound regulation and supervision. The great majority of institutions, moreover, are very small, with single branches located in dispersed communities throughout the country.

A census of institutions was initiated in September of 2001 to determine more precisely the number and size of entities operating in the sector, their locations, and affiliations with other such organizations, if any. A more in-depth evaluation of a subset of those institutions provided more information on the financial health and technological capacity of popular savings and credit institutions, as well as their operational, management and governance capacity. This information was used to help gauge the extent—and cost—of the program of technical assistance needed to strengthen the intermediaries.

Technical assistance and training are being provided to Supervision Committees and EACPs countrywide, so they can evaluate every savings and credit institution which opts to participate, and strengthen or restructuring those institutions which do not yet meet the operational or solvency standards of the new legal and regulatory framework.

To meet these objectives, BANSEFI has recruited international organizations specialized in providing technical assistance to savings and credit institutions and their sector organizations through a competitive bidding process that began in 2001. Action plans have now been formalized for 381 institutions, of a total of 400 that are expected to participate in the program. Those remaining have either chosen to stop mobilizing deposits or will be merged, acquired, or dissolved.

In addition to their individual action plans, popular savings and credit institutions have the opportunity to attend training sessions organized by BANSEFI. So far, courses on risk management, credit analysis, accounting, and governance have been attended by 2,900 people from about 400 institutions. Training for federations and confederations has emphasized the preparation of supervision committee members. As of November 30, 2003, seven auxiliary supervision committees had received intensive training in the law and applications of the norms and guidelines developed for evaluating and classifying institutions, and have been certified by the CNBV.

The CNBV now has 27 people to provide oversight for the sector through a specialized unit, the General Directorate for the Supervision of Popular Savings and Credit Institutions (or DGSEACP, by its Spanish acronym). Each of these staff have benefited from on-site training with expert consultants and participated in seminars and study tours to improve their capacity to effectively supervise the savings and credit sector through the auxiliary mechanism. The CNBV has also developed a number of tools, including the Supervision Guidelines for the federations' supervision committees, the Integrated Supervision Manual for internal use, and a specialized financial analysis system.

BANSEFI has undertaken initiatives to disseminate the requirements of the new law, and accompanying supervision and regulatory framework. Seven workshops have been conducted jointly with the CNBV, each in a different region of the country, to explain the changes, encourage institutions to participate in the sector consolidation and strengthening program.

Key to BANSEFI's role, however, are the actions it has taken with respect to developing a technological platform which sector institutions can use to access back-office or liquidity services, to file mandated reports to their supervision committee and to the CNBV, and also to network with other institutions. The technology platform is expected to reduce the transaction costs and expand the range of services provided by the sector, in addition to facilitating the accreditation of the entities by the CNBV.

The organizational basis of the commercially-oriented network has already been formed with the establishment of "L@Red de la Gente" ("The People's Network"), a voluntary internet-based alliance of popular savings and credit institutions and BANSEFI. L@Red has already linked BANSEFI's 554 branches with more than 180 offices of 19 participating institutions to provide a geographically expansive network of more than 730 branches of coverage.

Implementing SAGARPA and Progress to Date

As of January 2004, PATMIR had so far strengthened and increased the outreach capacity of 41 savings and credit institutions and their branches in Chiapas, Huasteca, Guerrero, and Veracruz, providing more than 10,000 clients with access to financial services from new branches or institutions, and improving the financial institutions upon which nearly 24,000 people rely.

The program now has operations in three more regions of the country and is expected to sustainably integrate more than 80,000 people from Mexico's poorest, most marginalized groups into the financial system before it finishes in 2007. To achieve this goal, PATMIR works extensively with individuals and groups in these rural communities to educate them about the benefits of formal savings, how to use savings and other financial services to their advantage, and the rights and responsibilities of membership in a cooperative financial institution. Rather than quickly adding names to a membership roster, the program focuses on cultivating *conciencia, confianza y compromiso*—awareness, trust, and commitment—between new members (who are typically from indigenous groups and include everyone—women, youth, and the aged, as well) and their financial institutions, so that each understands its investment in the other.

In addition, PATMIR helps the EACPs incorporate new ways of attracting and responding to marginalized clients—by hiring multi-lingual staff to promote their services and introducing personal digital assistants and mobile banking to make savings more convenient and attractive, for instance. In 2003, more than 4.2 million families received transfers through one federal safety net program alone, and US $13.2 billion in remittances flowed into the country from Mexicans living and working abroad. Much of these funds went to the marginal areas where PATMIR is working. By incorporating poor and marginalized households into the financial system and providing them with safe savings facilities, families are developing the capacity to better manage and capitalize on funds they generate and receive from multiple sources.

Impact Analysis

The cost of the popular savings and credit sector strengthening program, including the Rural Microfinance Technical Assistance Project administered by SAGARPA and the comprehensive sector strengthening program underway through BANSEFI, totals about US $150 million. The objective of this program is to develop a vibrant and viable savings and credit sector with dramatically increased financial services outreach, especially to poor and marginalized rural populations. It is premature to assess the program's overall impact, given that it is still being implemented and ex-ante cost-benefit analyses of this type of institution-building initiative are problematic. The degree to which program results translate into poverty reduction will be carefully monitored, however, using panel data from 6,000 households that will be surveyed annually over the five-year period beginning in 2004.

Implementation progress and indicators of impact, to date, indicate that the program is likely to achieve its objective of increasing the number of people served by participating financial institutions from 2 million to 5.5 million by 2008, and show substantial progress in poverty alleviation. The benefits to members and clients of EACPs are reaped directly through lower costs of credit and payment services, positive yields and increased security on savings deposits, and greater access to an array of government programs, including social insurance.

Benefits for Institutions

When financial institutions become more efficient and financially sound, clients can benefit from the lower costs and risks associated with their products and greater access to services. In addition to the advantages of adequate supervision and regulation, the economic benefits for the institutions participating in the program are clear. Efficiency gains will accrue to the EACPs from staff training, upgrading internal controls, and building credit appraisal and risk management capacity, and through the services provided by BANSEFI and network organizations. One such benefit provided to EACPs by BANSEFI relates to liquidity management. BANSEFI consolidates the liquidity of EACPs and invests it on their behalf in the commercial banking system, thus securing a higher interest rate than what the entities could obtain individually. By late December 2003, a total of 93 EACPs had already invested 626.2 million Mexican pesos—or US$55.8 million—in BANSEFI.

The technological platform for EACPs currently being piloted by BANSEFI will contribute significantly to their operational efficiency and income-generating potential. Rather than each individual institution acquiring the technology components needed to manipulate, transfer, and store the information needed to operate and communicate with other sector institutions, EACPs can subscribe to these services selectively and share the cost with other participants. The creation of this common technology platform will allow for shared operating, technological, and marketing processes, and a common trademark.

In addition to compatible or shared hardware and software, the alliance BANSEFI has created with sector institutions through L@Red de la Gente (which currently includes more than 730 participating branch locations) is expected to include more 3,000 points of service by 2008. L@Red aims at breaking a key barrier to developing a viable system of financial services for the poor: gaining sufficient scale and scope to cost-effectively process large numbers of small-volume transactions. Another important result of this technological interlinking is the ability to organize participating institutions as conduits for governmental support programs, which will make it possible for institutions to increase their revenues through fees for the distribution of financial services, and more importantly, by retaining users and increasing their market penetration.

Benefits for Clients

Providing access to sound, efficient financial services clearly contributes to income generation and poverty alleviation at the household level. This is particularly true for the poorer rural households, which are expected to gain from access to adequate deposit instruments and an improved ability to take advantage of productive investment opportunities.

Economic analysis[5] has shown that transforming informal, non-earning financial assets, and monetizing even a fraction of the savings held in physical form by rural households, would have substantial economic benefits in terms of safety and return. Informal means of savings that dominate the households' portfolios are, in principle, inferior to financial instruments in terms of safety and returns. For example, *tandas*, or rotating savings clubs, report a 6 percent rate of noncompliance (group members who cease to contribute once they have taken a turn); and the most common forms of livestock holding, pigs and chickens, have mortality rates above 40 percent. Since holding livestock as savings is more prevalent in poorer areas and among indigenous people than elsewhere, the transformation of these assets into financial savings would benefit the poorest segments of the population by increasing returns and providing greater liquidity.

By providing poor and remotely located households with access to the national payments system through the L@Red de la Gente, moreover, they can more securely and cost-effectively receive remittance payments from family members working elsewhere in Mexico or abroad, as well as the benefits of social safety net and development programs. As of December 31, 2003, L@Red de la Gente had distributed payments from federal health, nutrition, education, and agricultural production programs to more than 1.5 million beneficiaries, and the number is expected to grow to 3.3 million by the end of 2004. By receiving transfer payments through L@Red, poor beneficiaries are introduced to financial institutions and encouraged to participate as members or clients.

About 750,000 new savings accounts have been opened at L@Red institutions through one such program, *Oportunidades*, which provides targeted cash subsidies for health and education. This transfer mechanism has helped to introduce some of the poorest families in Mexico to the financial system. As these clients earn interest on their new accounts, they learn how savings can open access to other types of financial services. This is the major permanent impact of the program. As of December 2003, for example, about 80 percent of those beneficiaries of Oportunidades who had savings accounts in branches of L@Red were maintaining a positive account balance. This suggests that this strategy is introducing savings services into the welfare dynamics of poor families, which can be the basis of future asset accumulation.

In addition to the transfer of government programs, L@Red had also channeled more than US $53.6 million in remittance payments to recipients as of December 31, 2003. L@Red de la Gente offers accounts that link different savings and investment products—such as standard savings accounts and housing investment funds, for instance—so that emigrants can chose how to allocate remittances among different types of accounts.

SAGARPA is working to ensure that the most marginalized people living in largely indigenous rural communities benefit from access to L@Red, as well as the other financial services that savings and credit institutions provide. Through the PATMIR project, more than 41 savings and credit institutions and branches have received specialized technical assistance to strengthen and increase their outreach capacity among marginalized clients, so far improving or generating access to financial services for more than 34,000 poor people.

DRIVING FACTORS

Commitment and Political Economy for Change

The determination to reform and transform the popular savings and credit sector, as a means of alleviating poverty and integrating millions of poor and lower-middle class Mexicans into the formal financial system, was in part the result of a historical evolution in Mexican politics. The election of President Fox in July of 2000 was the culmination of many years of work to create a political system characterized by greater participation, openness, and accountability on the part of Mexicans from diverse social and economic groups and political affiliations. These same forces have arguably helped foster the political will needed to embark on an ambitious and comprehensive program to integrate into the formal financial system those institutions that serve people on the margins of society.

The degree of economic stability Mexico regained over the last decade has also played an important part in providing the resources needed to reform the EACP sector. The results of increased economic integration with the United States through NAFTA, sound domestic macroeconomic management, and high oil prices since 1999 have all contributed fundamentally to the prosperity and stability that have clearly facilitated the EACP reform.

Institutional Innovation

Prior to directing its attention to the popular savings and credit sector, the government had previously attempted to provide access to financial services primarily through first and second-tier development banks and trusts. This approach generally relied on directed credit at subsidized interest rates, subsidized credit guarantees, and debt forgiveness and restructuring. These interventions were unsuccessful in providing sustained access to financial services for their target populations and required large fiscal outlays, estimated to cost approximately US$28.5 billion over the 1983–92 period.

The government began introducing reforms in rural credit policies in the early 1990s, reducing interest rate subsidies, making transfers to development banks more transparent, and experimenting with alternatives to promote sustainable, commercial intermediation. A project was launched in 1995 to provide subsidies for commercial banks to establish services in small cities and rural towns where there was no banking presence. Banks were reluctant to participate and retreated from the program and rural areas altogether with the exchange rate crisis and rapid economic decline of 1995–96.

In addition to these policy failures,the lack of an adequate legal and regulatory framework for savings and credit institutions compleft low-income depositors exposed to the risk of losing their savings and constrained the growth of the sector. Numerous savings and credit institutions were thus supporting the development of an appropriate legal framework for their activities. At the same time, the need for institutional change was reinforced by the detection of fraudulent activities committed by managers of some popular savings and credit institutions in the late 1990s. Not only did thousands of low-income depositors lose their savings in these cases, but some municipal governments that managed their funds through savings and credit institutions lost millions of dollars in scarce public resources. As a result, both the government and the sector initiated a dialogue that led to the design and approval of the new law which governs the sector's activities.

At the same time, international development agencies were putting increasing focus on the potential of popular savings and credit institutions as a means for sustainable increasing broad-based access to financial services. A substantial number of these types of institutions had been offering financial services in Mexico for decades—without any regulation or supervision. Low levels of efficiency and a lack of widespread confidence on the part of depositors, however, severely limited their outreach capacity.

While it became clear that savings and credit institutions represented great promise in achieving the outreach and sustainability goals that so many public sector institutions and interventions had not, there were many difficult questions to answer with regard to regulatory framework and the nature and scope of public investment needed to shore up the sector.

It was clear that the sector, which was and is dominated by small institutions—only three of which have more than 50 branches—would likely take many years to consolidate and organize on its own. BANSEFI was thus created to accelerate and enhance the process, through the benefits of networking, based on successful experiences in other countries. BANSEFI is not an ordinary development bank, as its mission and methods exclude lending. To avoid shifting risk to the public sector, BANSEFI has concentrated on providing fee-based services without exposing itself to the credit risk of the EACPs or their clients. The value that BANSEFI provides to the EACP network institutions is likely to be transferred to them in the future when it puts itself up for sale to these clients. While designed from the experiences of successful savings and credit sector institutions worldwide, an institutional transformation of the nature and scope being undertaken by BANSEFI is undoubtedly a first in the annals of development banking.

At the same time, PATMIR was launched in order to make sure that sound, efficient savings and credit services are delivered to the poor in rural areas, which does not normally happen through a "trickle down effect." Large intermediaries have seldom shown any interest in the marginal rural sector; they tend to focus on an urban and semi-urban market. PATMIR therefore provides technical assistance and small in-kind grants of support to institutions interested in developing tentacles to rural communities and also creates intermediaries adept at responding to the needs of the people in these communities. SAGARPA's innovative program is to trying to demonstrate that the provision of financial services—based on a cooperative savings-driven model—can be profitable in marginal rural areas.

Learning and Experimentation

The implementation of this ambitious new regulatory and development framework for the savings and credit sector has been a challenging process for many of the institutions involved. Some institutions have resisted the changes, preferring to remain outside of the new legal and regulatory system. Some of them have tried to influence legislators in order to boycott the transition of cooperatives into either of the two types of savings and credit institutions considered in the Popular Savings and Credit Act.[6] The inclusiveness that characterized the design of the new law[7] and its general acceptance has prevented this resistance from garnering much support from legislators or other sector institutions, however. BANSEFI has also organized an ongoing campaign to inform and facilitate participation in the new system through greater understanding of how and what it will require.

BANSEFI has not only emphasized the relevance and practical aspects of implementing the new law in its communications and outreach, but has had to focus on explaining its own role in the sector as well. Indeed, its traditional mandate of promoting popular savings together with its new role of coordinating public support for the sector seem contradictory to some institutions. A few see BANSEFI more as a competitor rather than as an agent coordinating support. As a result, BANSEFI has had to reiterate its intention to be sold to the sector and shift its focus to providing second-tier central banking services to popular savings and credit institutions.[8]

In some cases, such as with the transfer of government programs through L@ Red de la Gente, branches of the sector have been given priority when a branch of BANSEFI is located in the same community. Communicating its mission has not been easy, nor have the effects of BANSEFI's efforts to demonstrate its role as a partner to popular savings and credit institutions been immediate. The perceptions of the bank as a "competitor" are diminishing, and participation in the services and networks it supports are increasing.

SAGARPA's efforts to expand the outreach of financial institutions in marginal rural areas have met the difficult challenge of educating people about the use and benefits of financial services. New promotional tools and methods have been developed to explain how financial products work and what improvements they offer over traditional savings instruments are. Technical assistance providers work with institutions to develop products tailored to the particular needs of different marginalized communities in order to attract greater participation. Some of these products include savings plans and accounts tailored to specific groups, including savings plans for children, and accounts set aside for school fees and Christmas expenses. Group savings plans have been created, called "*tandahorro,*" which are based on traditional rotating savings clubs; and specialized credit products, such as credimujer for women and *crediapuros* for emergencies, have been designed to introduce new users to the formal financial system. Many of these services are provided directly at the community level by "*promotores*" or, in the case of a savings and credit institutions in Chiapas, via mobile banking services which operate on market days on a weekly or fortnightly basis.

External Catalysts

The government's program of support for the EACP sector, and for financial education and the expansion of savings groups in marginal rural areas, was developed and is being implemented with the energetic and proactive participation of numerous development agencies and professional savings and credit institutions networks from many countries.

USAID has sponsored US $2 million in technical assistance work to upgrade the capacity of one of Mexico's primary savings and credit networks since 1999. The US Agency for International Development has also been active in helping forge alliances between financial institutions in the United States and the savings and credit sector in Mexico to help lower the costs to Mexican emigrants sending funds back to their families.

Through its Multi-lateral Investment Fund, the Inter-American Development Bank (IDB) has provided US $3 million in technical cooperation for components of BANSEFI's information system that is being upgraded. IDB has also provided support to the CNBV for training in auxiliary supervision. The German government has also supported the sector with US $ 1.2 million for federation restructuring.

The World Bank has been a major sponsor of the government's initiative, having provided a loan of US $64.6 million in 2002 to consolidate and strengthen savings and credit institutions, build supervision capacity, pilot the technology platform for the sector, and expand access to financial services in rural marginal areas. The World Bank is also preparing a new loan, worth approximately US $70 million, to help the government finance the national roll out of the technology platform.

Lessons Learned

Bringing the poor into the financial system, especially those at the margins of society in geographically isolated regions, teaching them to better manage the cash resources they have, and providing access to new sources of finance at lower costs is the root objective of the massive and ambitious programs undertaken since 2001 by BANSEFI and SAGARPA. While it is premature to assess the overall impact of the two programs, results to date indicate that they are likely to have far-reaching effects on the scope and direction of sustainable financial services in the future to alleviate poverty and stimulate equity-enhancing growth. The main lessons the BANSEFI and SAGARPA programs have revealed so far include the following:

Government intervention can effectively increase access to financial services for low income households and businesses by getting the regulatory framework right, building the institutional capacity of financial institutions, and subsidizing the deployment of modern technology to increase the efficiency of service providers.

Packaging the development of adequate regulations and supervision, institution capacity building, and technological infrastructure is more likely to yield sustainable results and cost less over time than traditional interventions which focus on increasing credit flows.

Outreach expansion efforts among the poor in marginalized rural areas have much better long-term prospects if they focus on building the stake that these clients have in their savings and credit institutions as savers, rather than building financial relationships based on the expectation of getting a loan.

End Notes

1 L@Red de la Gente represents, for many financial intermediaries, an additional incentive to accelerate their formalization process, since complying with established performance standards is a requisite to join this strategic alliance.

2 World Bank, *Mexico Rural Finance: Savings Mobilization Potential and Deposit Instruments in Marginal Areas,* Report No. 21286-ME, Washington D.C., World Bank, 2001.

3 "Popular savings and credit institutions" or "savings and credit institutions" are used throughout this paper to denote a variety of non-bank financial intermediaries that serve middle- and low-income segments of the population, such as Sociedades de Ahorro y Préstamo (SAPs), Cooperativas de Ahorro y Préstamo (CAPs), Uniones de Crédito (UC), Cajas Solidarias (CS) or non-governmental organizations (NGOs). Over 90 percent of these intermediaries are CAPs.

4 It is not obligatory for candidates to join a Federation. Nonetheless, they must obtain an opinion from a federation and submit to that federation's auxiliary supervision. Any institution that does not wish to join a federation may submit its application directly to the CNBV. The CNBV will then determine which federation will issue the opinion and, if applicable, exercise auxiliary supervision over the institution, provided that the authorization is granted. Unaffiliated institutions must apply to a confederation to participate in its depositor protection fund, whereupon they would enter into an auxiliary supervision agreement with that body's member federations.

5 World Bank, *Mexico Rural Finance*, Report No. 21286-ME.

6 They have sought immunity from the new law under the umbrella of the so-called *Ley General de Sociedades Cooperativas.*

7 Most notably, through organizations (like COMACREP) created to represent the sector in the dialogue that was initiated to design the new law.

8 The term *Caja de Cajas* is commonly used to denote this role.

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Chapter 9

The Kazakhstan Small Business Program: Commercial Banks Entering Micro and Small Business Finance

BY EVA TERBERGER AND ANJA LEPP

EXECUTIVE SUMMARY

The Kazakhstan Small Business Programme (KSBP) is the second program to try to "downscale" commercial banks as a means of delivering micro and small enterprise (MSE) loans in transition countries. Since its beginning in April 1998, KSBP has worked with seven private commercial banks (including the biggest and strongest local banks), and has greatly outperformed expectations. It serves as a model for expanding the outreach of commercial banks to poorer clients.

The Kazakhstan Small Business Programme, supported by EBRD, was established at the request of the Kazakh government to succeed a failed credit line for small and medium enterprise loans. KSBP's principal objectives are "to provide finance to MSEs which currently have insufficient access to the formal sector finance; and to build up the credit capabilities of Kazakhstan's financial sector so that local banks are able to provide MSEs with access to finance on a permanent basis." KSBP received a sovereign, guaranteed EBRD credit line of US $77.6 million as a refinancing facility. Furthermore, considerable funding was also provided by the government of Kazakhstan, EBRD, USAID, and the EU for a technical assistance package to support institution building in partner banks.

According to its objectives, KSBP was not designed to fight poverty directly, but to promote financial market development that would have long-term, but indirect, impact on poverty reduction by creating sustainable access to formal loan financing for micro and small entrepreneurs. These small businesses are a major and growing source of employment both in developing and transition countries. Measured against its objectives, KSBP can show impressive achievements.

- ***Outreach.*** By February 2004, KSBP was established in all urban centers in Kazakhstan. Partner banks opened MSE departments in 135 branches, with an additional 50 loan outlets in 39 different cities, some of them as small as 20,000 inhabitants. The outstanding MSE portfolio has grown to over US $162 million, with more than 35,000 loans. The MSE departments employ 535 loan officers, who disburse over 4,000 micro and small loans every month. The program is still showing high growth rates.

- ***Target group.*** At least 90 percent of KSBP clients had never had access to formal bank loans, and 85 percent of the outstanding loans are micro-loans. Over 50 percent of the newly disbursed loans are "express micro loans," a newly developed product for very small customers needing uncollateralized working capital loans that are disbursed almost instantly.
- ***Sustainability.*** Although the program has been moving far down in the market to serve the smallest traders, and at the same time growing very fast, arrears have stayed extremely low. (Arrears > 30 days stood at 0.25% of portfolio volume in February 2004.) Loan-officer efficiency has continuously increased. A newly developed profit-center accounting method, currently being tested, is yielding strong evidence that the MSE business has not only passed the profitability threshold, but is just as, or even more, profitable than the average alternative business in the Kazakh banking sector. The partner banks are responding accordingly. They are using considerable amounts of their own funds to expand the business—over 40 percent of the portfolio is now being financed with the banks' own funds—and are continually training new loan officers and opening MSE departments and outlets in new locations. MSE lending, so it seems, has become a sustainable business which private commercial banks will stick with, even when the program staff have gone and KSBP itself has been wound up.
- ***Spill over.*** KSBP has positively affected the institutional set up of the partner banks and their competitors as well. For example, the program's training and recruitment methods are copied, its incentive-based pay schemes are adapted for use in other departments, and MSE loan officers are frequently promoted within the banks to senior positions or are hired by competitors.

The KSBP owes its success to sound, professional institution building. As a first step, a limited number of smoothly-functioning, independent MSE departments were established within each partner bank. Further expansion—into other regions, into poorer market segments, and into the organizational structure of the partner banks—was not attempted until the program could rely on a solid base of successful MSE lending, and human resource capacity had been strengthened by the first generation of local consultants trained by the program.

KSBP also had a favorable environment in which to thrive. Kazakhstan's macroeconomic situation was stable, and the government showed a strong political commitment to developing the SME sector. It supported KSBP from the beginning, while at the same time resisting the temptation to directly intervene in the program. Furthermore, the

Kazakh financial market had been liberalized, and was well regulated and supervised. Strong competitive pressure on banks, as the sector consolidated, made even the big private Kazakh banks interested in participating in KSBP and developing the new MSE business.

To replicate KSBP's downscaling success in other countries, sound institution building needs to be paired with favorable political and economic conditions. If these occur together, downscaling for-profit commercial banks should be tried first, before any other alternative for microfinance, in case the financial services market just needs a jump start in order to become a powerful instrument in the fight against poverty.

Implementation Process

Background and Project Design

The history of the Kazakhstan Small Business Program, teaches an important lesson: Never underestimate the significance of program design and institution building.

Quite unusually for a project as innovative as KSBP, the initial impetus to create the program did not come from the EBRD, but rather in response to an urgent request from the Kazakh government. It needed a replacement for an underperforming program (or more precisely, a failure), consisting of an SME credit line provided by EBRD and guaranteed by the Kazakh government. This SME line, which had been approved in 1993, offered partner banks a financing facility of up to US $122.6 million via an apex structure, but less than one third had been disbursed by 1997. Furthermore, portfolio quality was rather poor, and one partner bank had completely failed, forcing the government to honor its guarantee for a lost portfolio of US $9.5 million.

Confronted with this failure, but nonetheless still convinced that the highest political priority should be the development of the SME sector, the Kazakh government requested that the unused funds (US $77.5 million)—and the sovereign guarantee—be transferred to a new program modeled on the Russian Small Business Fund. This request was approved by the EBRD board in 1997, and KSBP became operational in late spring of 1998.

Its history as the successor of a failed program had a positive effect on the KSBP in two respects. First of all, there could be no doubt about the strong commitment of the Kazakh government to support the SME sector and the new program. Secondly, the lack of success of the SME line had given clear hints as to what went wrong. It was unlikely that lack of demand was the main cause of failure. Even though there had been no reliable numbers on the size of the SME sector in the mid-1990s, there could be no doubt that the sector was growing and that it had hardly any access to the formal banking sector. Almost certainly the failure of the first program had been caused by a deficiency on the supply side. Partner banks lacked the interest and/or know-how to issue and monitor SME loans. There was no mechanism in the old program to overcome this deficiency—a structural fault in design which the new program had to avoid. The mission of KSBP was not only to provide funds to onlend, but equally, or even more importantly, it was to transfer know-how and to create incentives to build the capacity of the partner banks to go after MSE business. Accordingly, the Kazakh government and several donor organizations[1] financed a technical cooperation package to support institution building.

The Start-Up Phase, 1998-99

KSBP went into operation in May 1998. Five partner banks which met the eligibility criteria were selected beforehand (namely, a full banking license, approval by the National Bank of Kazakhstan, an IAS audit, a program-compatible strategy, bank management committed to MSE business, a strategically interesting geographic location, and financial stability as defined by bank regulation standards). Four of these banks, Almaty Merchant Bank (AMB), Center Credit Bank (CCB), Kazkommertsbank (KKB, the biggest Kazakh bank and one of the strongest in Eastern Europe and Central Asia), and Tsesna Bank (TB) were privately owned. The fifth bank, Halyk Savings Bank (HSB) initially was state-owned, but was privatized in 2001. Two more private banks joined the program later: Bank Turan Alem (BTA) in November 1998, and Temir Bank (TB) in September 1999.

Responsibility for implementing the first steps lay in the hands of eight experienced foreign experts.[2] They hired new, local staff to be loan officers, and trained them in microfinance (assessment of client's payment capacity, close monitoring, graduation principle, etc.). The experts became acting heads of the new MSE loan departments, which opened their doors in eight branches of the five banks, in the two main Kazakh cities, Almaty and Astana. They offered micro and small business loans in *tenge* (local currency) and in US dollars as their basic products.

KSBP concentrated on the organizational structure of these new departments, introducing IT-based management information systems (MIS), preparing MSE lending guidelines, and implementing an incentive-based pay scheme for loan officers which took into account all aspects of their performance, from disbursement level to portfolio quality.

The aim of the first phase was to build up specialized loan departments as stable and independent entities within each partner bank. Once this was achieved, the KSBP extended its activities in two dimensions:

- Horizontally, by building MSE departments in the new banks joining the program and in more large cities. By the end of 1999, KSBP had reached six more cities—Aktubinsk, Karaganda, Shymkent, Atyrau, Ust-Kamenogorsk, and Pavlodar.
- Vertically, within the banks by training staff who worked in lending operations other than the MSE department; and outside the banks through efforts to influence the regulatory environment. Such activities included discussions with local authorities to streamline collateral registration procedures and

raise the level of understanding of the KSBP's undertakings, as well as interaction with government agencies to remove legal and administrative obstacles to MSE development in general, and MSE finance in particular.

Furthermore, KSBP improved its own organizational capacity by requiring regular internal audits of the program's portfolio in all partner banks and all regions where the program was being implemented.

The institution building efforts began to show results. The loan portfolio grew steadily, and arrears stayed low. Only a few months after its launch, KSBP passed its first test successfully. In April 1999, in the aftermath of the Russian financial crisis, the Kazakh government stopped supporting the local currency, and the value of the tenge dropped from KZT 85 to KZT 120 to the dollar. Yet this did not undermine the quality of the MSE portfolio, and the portfolio at risk (PAR > 30 days) remained under 4 percent.

By the end of 1999, the first generation of local consultants had joined the project team, taking over training and setting up lending operations in new locations. The KSBP was now ready to tackle the second phase of implementation.

The Expansion Phase, 2000–02

Being able to rely on a core of smoothly functioning MSE departments and having tapped local sources to create new consulting capacity, KSBP now moved to expand its operations without danger of destabilization. Expansion took place in several dimensions.

Regional expansion

From 2000 on, KSBP attempted to capture the urban MSE loan market throughout Kazakhstan. MSE departments were set up in banks in all major cities, and some small cities (of 20,000 inhabitants) were covered by subbranches. By December 2002, 23 more cities had been included in the program. The number of lending outlets had risen to 117, and the number of MSE loan officers to 283.

Product expansion and moving down market

The two basic products of the MSE departments were targeted to the needs of established micro and small businesses, but were not really suitable for market traders and other potential clients who needed small working capital loans that could be disbursed quickly. To be able to offer reliable services to this customer group, KSBP developed a new product, the "express micro loan." In contrast to micro and small loans, express loans can be secured with moveable assets as (unregistered) collateral. Disbursement is extremely fast (within 24 hours), and all client contact is handled by special MSE outlets located at the markets.

Expansion within the partner banks

As the MSE business became increasingly important in every partner bank, the banks' managements realized that it was necessary to firmly integrate these departments into the banks' organizational structure. MSE management positions were created for experienced MSE staff; and a head office department, responsible for coordinating and monitoring the MSE business, was established, step by step, in all partner banks.

Expansion of training and monitoring.

As training new loan officers became routine, and standardly contracted to local consultants, KSBP concentrated on further developing its training program. Seminars for experienced loan officers and back-office personnel, as well as advanced training courses for local consultants, were introduced. Furthermore, first steps were taken to develop performance benchmarks which would allow banks to monitor the efficiency of their MSE operations.

By the end of 2002, another milestone had been reached: MSE lending was no longer a new business, but was firmly established in the market and within program bank. Banks were training loan officers and opening new outlets on their own initiative; they even began using their own funds to expand the business. The skills acquired by the MSE personnel were highly appreciated. The partner banks—and their competitors—were now eager to hire and promote KSBP-trained staff to fill senior positions in lending departments, in risk management, and even in the management of the bank itself. They reduced the number of foreign experts working for the KSBP, and those who stayed on concentrated on the remaining program task—assuring the sustainability the MSE business and preparing to hand over more and more responsibility.

Institutionalization, Preparing for the Hand-Over, and New Challenges, 2003–04

To date, KSBP's lending operations have spread to every city in Kazakhstan with a population over 100,000. The lower end of the market has been penetrated to a degree which hardly seemed possible for commercial banks. In February 2004, express loans accounted for 50 percent of all loans disbursed. Partner banks finance around 40 percent of the MSE business with their own resources. MSE products are marketed regularly. MSE managers in the banks are taking increasing responsibility for planning and implementing new lending operations, as well as for budget control and human resource development. Full responsibility for all basic training activities will be handed over to the partner banks in the near future.

Accordingly, KSBP can now concentrate on product development, advanced training (management, personnel development, conflict resolution, etc.), and audits. It also will streamline the partner banks' institutional procedures to prepare them to gradually assume more and more responsibility. Handing over audit functions to the partner banks is currently being discussed, and the banks have started to adapt their internal structures accordingly. Furthermore, KSBP is actively developing new reporting and monitoring instruments and further standardizing the express loans.

Last but not least, as urban MSE lending via commercial banks no longer poses a "real" challenge in Kazakhstan, KSBP is looking for new challenges. The first pilot projects to test the new "agricultural loan" product have already been set in motion.

Impact Analysis

The Impact of Downscaling in Financial Market Development

Establishing MSE lending in (private) commercial banks, so-called "downscaling" in microfinance, offers clients (especially micro and small entrepreneurs) not served by the formal financial sector, sustainable access to loan financing. Impact assessments which concentrate solely on whether loans actually reach the targeted group of the poor, and whether their incomes and living conditions improve, would be misleading for a downscaling project because its effect on poverty reduction is indirect. The success or failure of a downscaling program does not hinge on direct poverty reduction. Rather, success is determined by whether the program can build and maintain sustainable institutional structures, after donors' support and monitoring are gone. Private commercial banks can only be expected to continue lending to micro and small businesses if it stays profitable.

KSBP's Outreach and Client Structure

The dynamics of KSBP have been remarkable from the beginning. During the first eight months of its existence (1998), 14 MSE departments were set up in five different cities, 842 loans totaling almost US $7.7 million were disbursed, and the outstanding portfolio consisted of 764 loans with a total volume of US $5.8 million. In 1999, the number of branches doubled, the outstanding loan portfolio grew almost 100 percent in volume and almost 120 percent in number of loans. Since then, the number of branches has grown steadily but at a slower pace, picking up new momentum when smaller outlets were added and when the express loan was introduced.

The number of outstanding loans more or less doubled every year of the program's existence, rising to roughly 35,000 MSE loans outstanding in February 2004. Portfolio volume grew at a rate of 170 percent in 2000. It slowed the following two years, to approximately 85 percent in 2001 and 23 percent in 2002, only to explode again in 2003, with a growth rate of more than 100 percent. As of February 2004, the outstanding portfolio came to US $162 million.

Growth of KSBP's portfolio was not bought at the price of moving up-market and abandoning the original target group of micro and small business. On the contrary, average loan amounts (which may serve as an indicator for target group orientation) declined considerably during the first two years of the program. After the introduction of the express loan, the average loan amounts stayed relatively stable at about US $5,000 per disbursed loan, US $1,800 for outstanding micro loans, and US $20,000 for outstanding small business loans. The median client had an outstanding loan of around US $2,000.

Data on KSBP loans confirm that banks have overcome their former reluctance to cater to micro and small business clients. In February 2004, over 65 percent of all loan clients (more than 50 percent of the outstanding portfolio), were individuals with an unregistered business. Women hold 61 percent of all loans (42 percent of the outstanding portfolio), and 65 percent of micro-loans (59 percent of the outstanding micro portfolio). Working capital loans account for almost 80 percent of all KSBP loans, and 82 percent of micro-loans (65 percent and 75 percent, respectively, of the portfolios outstanding).

KSBP's market penetration is remarkably advanced: it is represented in all Kazakh cities with over 100,000 inhabitants, in 64 percent of the smaller cities with populations of 50,000–100,000, and in 25 percent of cities even smaller.

KSBP's performance and outreach to its target group has surpassed expectations, and it still shows extremely high growth rates. There were 535 loan officers in the MSE departments in February 2004—newly created jobs in the banking sector. The loans they issued have supported or created around more 200,000 jobs for their clients' businesses in less than 6 years. Tables 1-4

Is Lending to MSEs Sustainable?

Straightforward data about the profitability of MSE departments is difficult to obtain because their cost and revenue structure is embedded in the financial accounting system of the whole bank. Only now is a special reporting system for MSE departments as profit centers being developed. Looking at the main costs associated with the new MSE departments (i.e., loan defaults, administrative costs, and cost of funds, as well as the revenues generated by MSE lending and preliminary profit calculations) allows some preliminary conclusions about their profitability to be drawn.

Credit Risk and Loan Loss Provisions.

Like other best practice microfinance projects, KSBP has been extremely successful in controlling credit risk. Even in 1999, in the aftermath of the Russian financial crisis, portfolio at risk (PAR > 30 days of arrears) never exceeded 4 percent of portfolio volume. During the last 3 years, which were characterized by financial stability and a booming economy, PAR always stayed well under 1 percent. Considering that

Table 1: Portfolio Development

Month	Outstanding Portfolio							
	Number				Volume (US$ million)			
	Mirco	Small	Total	Annual growth	Mirco	Small	Total	Annual growth
Jun 1998	50	4	54		0,424	0,123	0,547	
Dec 2002	16,433	978	17, 411	78%	41,778	31,609	73,386	46%
Dec 2003	27,724	4,880	32,604	87%	51,507	97,486	148,993	103%
Feb 2004	29,814	5,424	35,238		54,907	107,791	162,698	

Table 2: Distribution of Loans by Loan Amount (February 2004)				
Loan Amount in US$	**Number**	**Percent**	**Volume**	**Percent**
< 1000	6,904	19.59	3,039,038	1.87
1001-2000	9,959	28.26	10,191,287	6.26
2001-5000	9,543	27.08	21,941,387	13.49
5001-10000	4,346	12.33	24,495,695	15.06
10001-20000	2,384	6.77	27,404,825	16.84
20001-30000	933	2.65	18,686,632	11.49
30001-50000	652	1.85	20,831,178	12.80
50001-70000	199	0.56	9,370,367	5.76
70001-100000	194	0.55	13,232,331	8.13
> 100000	124	0.35	13,505,302	8.30
Total	**35,238**	**100.00**	**162,698,041**	**100.00**

Table 3: Loan and Customer Characteristics - February 2004								
	Micro		**Small**		**Total**			
	Number	**Volume**	**Number**	**Volume**	**Number**	**%**	**Volume**	**%**
Working capital	24,469	41,167,524	3,443	64,714,780	27,912	79.21%	105,882,304	65.08%
Fixed assets	3,746	10,838,584	1,760	37,905,268	5,506	15.63%	48,743,852	29.96%
Others	1,599	2,900,928	221	5,170,955	1,820	5.16%	8,071,883	4.96%
Total	29,814	54,907,036	5,424	107,791,003	35,238	100.00%	162,698,039	100.00%
Male	10,282	21,869,2342,	407	43,779,604	12,689	36.01%	65,648,838	40.35%
Female	19,424	32,588,6102,	202	36,048,176	21,626	61.37%	68,636,786	42.19%
Not applicable	108	449,194	815	27,963,222	923	2.62%	28,412,416	17.46%
Total	29,814	54,907,038	5,424	107,791,002	35,238	100.00%	162,698,040	100.00%
Trade	25,633	45,021,792	3,709	66,138,744	29,342	83.27%	111,160,536	68.32%
Production	789	1,985,455	502	12,716,110	1,291	3.66%	14,701,565	9.04%
Service	3,362	7,826,454	1,170	27,877,748	4,532	12.86%	35,704,202	21.95%
Agriculture	16	31,512	13	169,918	29	0.08%	201,429	0.12%
Others	14	41,824	30	888,484	44	0.12%	930,308	0.57%
Total	29,814	54,907,036	5,424	107,791,003	35,238	100.00%	162,698,040	100.00%

Table 4 Relative Market Share of KSBP Loans					
	Aggregate Loan Portfolio of All Banks (US$ million)	Small Business Loan Portfolio of All Banks (US$ million)	KSBP MSE Loan Portfolio (US$ million)	KSBP Loan Portfolio : Aggregate Portfolio	KSBP Loan Portfolio : SME Portfolio of All Banks
Dec 2000	1,899	510	28	1.46%	5.42%
Dec 2001	3,327	828	50	1.51%	6.05%
Dec 2002	4,370	952	73	1.68%	7.71%
Dec 2003	6,385	1,343	149	2.33%	11.09%

Table 5: Portfolio at Risk and Loan Officer Efficiency

Month	No. of Loan Officers	Loan Officer Effciency (each value per loan officer in corresponding month			
		No. of Loan Granted	Volumes of Loans Granted	No. of Loans Outstanding	Volume of Loans Outstanding
Jun 1998	**31**	1.29	11,520	1.74	17,640
Dec 2002	**283**	7.28	37,797	61.52	259,315
Dec 2003	**527**	7.80	40,842	61.87	282,719
Feb 2004	**535**	7.77	42,299	65.87	304,108

Month	No. of Loan Officers	Capital at Risk				
		Number		Volume		
		Arrears >1 day (%)	Arrears >30 days (%)	Arrears >1 day (%)	Arrears >30 days (%)	Arrears >30 day (US$ million)
Jun 1998	**31**	0.00%	0.00%	0.00%	0.00%	0.000
Dec 2002	**283**	0.46%	0.28%	0.89%	0.64%	0.469
Dec 2003	**527**	0.32%	0.22%	0.32%	0.26%	0.395
Feb 2004	**535**	0.57%	0.25%	0.62%	0.25%	0.410

almost 20 percent of all bank loans in Kazakhstan were doubtful at the end of 2002 (according to the National Bank of Kazakhstan), the low loan default and write-off rates for MSE loans are remarkable.

[Insert Table 5]

Administrative Costs

Lending to MSEs is staff intensive and personnel costs account for most of the administrative costs. MSE lending requires thorough credit analysis and close monitoring of the portfolio to keep arrears low. Furthermore, MSE loans are small and have higher administrative costs per dollar lent. Therefore, loan officer efficiency is strategically important in managing profitability of the MSE business. In KSBP, loan officer efficiency has increased continually over time; further efficiency improvements and cost reductions can be expected once all the loan officers hired by the participating banks have become fully experienced lenders.

Cost of Funds

Funding costs vary considerably among KSBP partner banks. While the former state-owned savings bank has access to relatively cheap savings as a source of loanable funds (incurring 5.5% p.a. interest expenses in 2003), other banks had to pay between 9 percent and 13.5 percent for their funds, depending on the currency (tenge or US$) and depending on which bank acquired the funds. Drawing on the funding line provided by the EBRD, the interest costs were just under 8.5 percent.

Gross Margin, Net Margin, and Profitability

The average gross interest rate earned on the MSE portfolio is just over 20 percent, giving banks a margin ranging from 7.5–14.5 percent, depending on cost of funds. Deducting 1 percent for loan loss provisions and 2.8 percent for administrative costs, a net margin of 3.7–10 percent goes to bank profits or other overhead expenses. Furthermore, the pilot profit-center accounting method clearly shows that older branches usually achieve a much better performance than new ones, due to greater efficiency and experience. Compared to the average return on assets (RoA) and return on equity (RoE) in the Kazakh commercial banking system (reported by National Bank of Kazakhstan for 2002, as 1.8 percent and 12.8 percent, respectively), there can be no doubt that MSE lending is already a profitable business which can compete with other businesses of the banks.

Spill-Over Effects of the KSBP

KSBP has undoubtedly had a positive effect on the whole organizational structure of its partner banks, as well as on their competitors and on the financial system in general. Credit assessment and monitoring techniques, administrative processes (credit guidelines, auditing procedures), as well as incentive-based pay schemes, were originally introduced into the banks by KSBP and have been adopted in other departments of the banks. KSBP's methods of human resource development and standard recruitment procedures, introduced for MSE staff, are now used by some partner banks throughout their institutions.

Training courses have become an integral part of human resource management in all partner banks. A considerable number of loan officers trained by KSBP have been promoted within their banks or hired by competitors. KSBP has successfully been able to disseminate knowledge and build capacity, thereby helping develop the financial services market.

KSBP has decisively increased provision of loan finance to thousands of micro and small entrepreneurs in Kazakhstan who previously had little or no access to financial services. What is more important, however, is that MSE finance has been well established as a sustainable and profitable business for Kazakh commercial banks, which will continue without KSBP's support.

Driving Factors

Commitment to Political and Economic Change

Without doubt, the political and macroeconomic situation in Kazakhstan has to be a critcal factor in KSBP's development and success. Kazakhstan is one of the most advanced countries in Central Asia in terms of transition and economic development, mainly because as early as 1993–94 the government firmly committed to pursuing a policy of liberalization, privatization, and structural reform. In the mid-1990s, the reforms began to show measurable effects. As a result, Kazakhstan has had positive growth rates (except in the aftermath of the Russian financial crisis), it has almost balanced its national budget, and it has successfully brought down its inflation rate to under 10 percent.

Reform of the financial sector had already reached an advanced stage when KSBP was launched in 1998. Interest rate ceilings had been abandoned, a two-tier banking system had been established in 1993, and the government was pushing forward with privatization. The last state-owned commercial bank, Halyk Savings Bank, was privatized in 2001, leaving one development bank owned by the government. Just as important, the government refrained from any directed lending. Thanks to this policy environment, the Kazakh government not only was committed to supporting the KSBP, but made a contractual commitment to abstain from interfering in the program.

It was significant, too, that a very efficient banking supervisory authority had been established at the National Bank of Kazakhstan. A legal framework in accordance with international supervisory standards was enacted as early as 1995, and the NBK put pressure on the banks to fulfill its requirements. Many of the more than 200 banks which sprang up in the early 1990s due to lax licensing were closed down. In 1997 the number of banks was reduced to 101, and by 2003, just 34 banks were left.

The consolidation of the Kazakh banking sector is continuing, and competition has been rather fierce in recent years (and remains so). Fighting for market shares, banks were eager to improve their competitive position by acquiring knowledge and attracting new business. This was an ideal field in which to downscale banks, and it enabled KSBP to win the strongest Kazakh commercial banks as committed partners.

Institutional Innovation

The most important institutional innovation was the downscaling approach itself. Numerous institutional design features were newly introduced into the Kazakh financial sector, such as MSE loan technology based on the assessment of cash flow; performance-based pay schemes; and recruitment and training methods, to name just a few.

Because KSBP had no experience in downscaling, some new institutional components had to be newly developed. The most fundamental was a method for smoothly integrating MSE departments into the banks' organizational structures. KSBP also implemented a profit-center accounting system, specifically to monitor the MSE departments. Last but not least, it ventured into pilot testing and launching new products (like the express micro loan and the forthcoming agricultural loan) as MSE lending moved further down market.

Another institutional innovation deserves mention. KSBP used the competition between partner banks to spur outreach, and at the same time to impel exemplary coordination, cooperation, and mutual learning via the structure provided by its program. The Kazakh experience needs to be analyzed more thoroughly to identify optimal levels of competition and coordination. But regardless, when prime conditions for downscaling are present, the KSBP model deserves to seriously considered for replication.

Lessons Learned

Intelligent project design is the key to the success of any downscaling project.

Institution building in downscaling projects should be undertaken in several steps or phases, which can of course overlap in certain cases. In the initial phase, institution building should concentrate on selecting partner banks, training, and creating a small number of MSE departments within partner banks. These departments will be the base from which to expand. The second phase should focus on promoting regional expansion by opening new branches, moving down-market by offering smaller loans, and firmly integrating the MSE departments into the organizational structures of the banks. The third phase should prepare the hand-over of responsibility step by step.

Downscaling private commercial banks to serve MSE loan clients can be successful if the conditions are favorable.

- The macro-economy is fairly stable and the government shows a strong commitment to SME development.
- The financial market is sufficiently liberalized (most importantly, there are no interest rate ceilings) and prudently regulated, and financial institutions are privatized.
- The banking sector is characterized by fairly strong competition, forcing commercial banks to look for new business.
- The market for MSE loans is not swamped by non-profit institutions offering the same product on more attractive terms and conditions than for-profit players can afford.

Ideally, a profit center accounting method should be deployed right from the start.

Monitor profitability, with profit center accounting is a must if MSE lending is to become a sustainable business for the partner banks.

Downscaling should be tried first.

If conditions are favorable, downscaling should be tried first—before other institution building projects are tested—because downscaling private commercial banks is the touchstone for microfinance as a "win-win" solution. If subsidized institution building in for-profit partner banks is the only support necessary to kick-start a commercial microfinance business, the financial services market can work towardpoverty reduction. Donors do not need to support non-profit institutions to provide micro-loans. Instead, donors can channel their scarce resources into those projects that fight poverty, where the market—left to its own devices—would fail.

End Notes

1 Specifically, EBRD, USAID, and TACIS.

2 The project was, and still is, managed by Internationale Project Consult (IPC) GmbH, Frankfurt, Germany. Today the program is run by 30 local experts and three foreign experts.

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Chapter 10

The Case of K-Rep□Nairobi, Kenya

BY JOHN NYERERE
WITH INPUT FROM KIMANTHI MUTUA, WILLIAM F. STEELE, ALEKE DONDO, AND JOHN KASHANGAKI

Executive Summary

K-Rep was started in 1984 as a USAID project applying an integrated methodology to intermediate funds for non-governmental organizations (NGOs) that were addressing poverty alleviation in Kenya through microfinance and enterprise assistance. K-Rep has undergone two major transformations, the most recent and most significant during 1997-2001, when a commercial bank (K-Rep Bank, Ltd.), a development agency (K-Rep Development Agency), and a consulting firm (K-Rep Advisory Services [Africa], Ltd.) merged to fulfill the mission of the K-Rep Group: to empower low-income people, promote their participation in the development process, and enhance their quality of life.

K-Rep's first transition in the late 1980s was characterized by changing its institutional status from a project to an NGO, and by changing its leadership from international managers to indigenous microfinance specialists—thereby establishing a Kenyan NGO. K-Rep's second transition, from an NGO to a commercial microfinance bank, was in the late 1990s, where the main goal continued to be the pursuit of self-sustainability as a basis for long-term scaling up of outreach to the poor. To this end, K-Rep sought sustainable funding sources from the financial markets and financial independence from donors. K-Rep also wanted to influence financial sector policy to be more favourable toward microfinance for low-income people, and to change perceptions of the public, clients, and players in the formal financial economy through its acceptance, legitimacy, and recognition as a licensed financial institution.

K-Rep's need to find external investors for funding and expertise posed a risk to preserving its core mission. The K-Rep Board of Directors developed guidelines for selecting investment partners with the right combination of desirable characteristics: strong financial and commercial discipline; sufficient resources for additional future investments; sufficient clout to influence Kenyan authorities and to protect K-Rep from political interference; and willingness to divest some of their equity holdings when K-Rep went public. K-Rep's

leadership also had to lobby and educate the regulators of the industry on the benefits of an NGO transforming into a regulated microfinance commercial bank.

Despite intensive preparations and training, the actual changeover to a commercial bank presented a cultural shock for personnel and, as a result, operating systems. Management had to bring in new staff to cope with regulatory requirements, introduce special training to resolve a culture clash between new and old staff, and restore morale and commitment by creating an employee stock ownership program.

After the expected initial teething problems, transformation yielded very positive results. In just four years, the combined outreach of K-Rep institutions rose to over 90,000 borrowers and savers (including the autonomous financial service associations—FSAs—created and managed by K-Rep Development Agency), from slightly over 15,000 before transformation. Most of these clients are poor, and new products have further deepened outreach to provide active poor with opportunities to improve their incomes by maintaining and growing their businesses. Although non-poor clients were added in the search for deposit mobilization as a base for scaling up, the ability to reach the poorest of the poor was also enhanced. Out of 45,000 active borrowers and 62,000 active savers of K-Rep Bank in December 2003, approximately 6,000 are considered very poor; and over 70 percent of the 48,000 FSA shareholders are considered poor.

K-Rep's leadership has remained focused on the poor while pursuing sustainability by building stakeholders' confidence that large-scale microfinance business can focus on the poor and still be profitable. Not to be ignored is the for-profit consulting arm of K-Rep, KAS, which has indirectly contributed to scaling up and transferring knowledge by providing advice and technical assistance in over 15 countries across Africa.

Besides the need for a conducive regulatory environment to successfully scale up and transform, an important lesson from the evolution of K-Rep is that leaders have to be ready to continually respond to challenges, to be innovative, and to modify institutional structures in order to successfully adapt to changing environments. In an industry that is still considered new, emerging, and informal, continuous learning and experimentation is essential to respond to needs of clients and stakeholders in microfinance. Perhaps the most significant challenge in institutional transformation and scaling up is developing the human capacity and commitment.

K-Rep's success has provided a platform for legitimizing microfinance and improving awareness among the public about the immense growth opportunities in the industry in Kenya. As a result of K-Rep's demonstrated success and its lobbying efforts, a bill institutionalising a microfinance category among financial institutions, licensed by the Central Bank, is awaiting parliamentary discussion.

Background

The issue of transformationfrom an NGO, here a donor-funded project, to a licensed and regulated commercial bank is critical in the microfinance field. There is immense unmet demand from the poor for access to appropriate financial services, and transformation holds promise for institutions to increase their outreach by tapping into commercial sources of funding. K-Rep is the only microfinance bank in Kenya and in Africa that has gone through this process, and its success can guide other African microfinance institutions (MFIs) and regulators.

World Education, Inc., a private American- voluntary organization launched the Kenya Rural Enterprise Programme (K-Rep) in 1984 as a five-year project funded by the United States Agency for International Development (USAID). Its mission was to wholesale services by providing grants, training, and technical assistance to address the financial, management and technical needs of NGOs involved in micro and small enterprise development. An evaluation in 1986 by USAID concluded that the project had limited development impact, was not cost-effective, and should be terminated at the end of the five years. The report prompted K-Rep founders to question the future sustainability of the project. It also raised issues of reliance on a single donor, and sub-grantees, for results.

This crisis—deciding to terminate or continue dependent on one donor—planted the seed for creating a sustainable institution that would focus on long-term intervention strategies to alleviate poverty through the delivery of micro credit and other financial services. In 1987, the project was incorporated as WEREP Ltd., a company limited by guarantee with no share capital, thus assuming the status of an NGO. By 1987, K-Rep started seeking other donors to broaden its funding base and changed its strategy from being solely a service provider to other NGOs to also developing its own loan portfolio, assuming direct lending responsibilities in 1989.

Development of a Modified Credit Methodology: Juhudi and Chikola

After exchange visits with other MFIs in Bangladesh and Latin America, K-Rep introduced a group-based lending approach among its partner NGOs and launched its own lending program in September 1990. The program, known as *Juhudi*, was modelled after the Grameen Bank group-based lending method and modified to the Kenyan environment. Juhudi is based on the co-guarantees of peer groups of five to seven members (called *watanos*) within larger groups of five to six watanos (known as a *kiwas*). These groups receive an initial two months of training on group dynamics and methodology that emphasizes the importance of savings, before receiving loans.[1]

In 1991, in response to demands and in an effort to upscale outreach, K-Rep targeted the pre-existing indigenous rotating savings and credit schemes primarily located in rural areas and created a new product known as Chikola. Lending to Chikolas was initially a highly cost-effective method of increasing outreach since only one check was issued to each group, which was then responsible for allocation to individual members. In 1994–95, however, repayment rates fell to 90 percent due to a lack of group cohesiveness among the larger Chikolas. As a result, K-Rep changed many features of the scheme and began disbursing loans to individual members within the group, and moving Chikolas toward smaller groups and weekly repayment in line with the Juhudi lending approach.

Transformation to NGO

In 1993, K-Rep received its NGO certificate of registration, in compliance with the NGO Co-ordination Act of 1990, as Kenya Rural Enterprise Program (K-Rep), Ltd. In 1996 and 2000, it became K-Rep Holdings, Ltd., and K-Rep Group, Ltd, respectively, solidifying its move from a project to an institution and self-sufficiency.

Then followed a period of rapid expansion with larger loans, which unfortunately resulted in increased delinquency and increased desertion rates because many clients were uncomfortable co-guaranteeing large loans. Neither were credit officers able to effectively manage their portfolios and provide the necessary client follow-up in this period of rapid growth. In 1994, to turn these problems around, all wholesale lending to NGOs was stopped, due to their increasing arrears to K-Rep. K-Rep began to focus on direct lending activities to low-income communities and merged the administration of the Juhudi and Chikola lending methodologies. K-Rep's institutional strategic plan began to address long-term issues of financial sustainability, growth, continued dependence on donors, and appropriateness of the NGO institutional form.

K-Rep reorganized its operations into two divisions: the financial services division oversaw the Juhudi and Chikola group credit methodologies, and the non-financial services division handled research and evaluation of K-Rep's programs and the NGOs it supported. The research helped develop new products, understand the needs of their customers, improve methodologies, and develop new information for the sector. Although the financial services division was designated as the profit center and provided credit services, the non-financial services division gradually engaged in activities that were not only strategic but also profitable, and helped build outreach capacity through consulting services. K-Rep's transformation from a project to an NGO with two divisions yielded dividends in the breadth and depth of outreach, shown in Table 1.

In 1997, K-Rep decided to cut back on lending for three reasons: 1) the loan delinquency was increasing and K-Rep feared that continued rapid growth would hide the deteriorating quality of the loan portfolio; 2) it had become difficult to raise funds for lending; and 3) K-Rep needed to consolidate its lending activities in preparation for its transformation to a commercial microfinance bank. It wrote off some old NGO loans, and implemented a "Back to Basics" program.

Table 1 Outreach and Performance, 1991-98				
Year	No. of Active Loan Clients	Outstanding Loan Portfolio (US$)	Average Loan Size (US$)	Total Assets (US$ million)
1991	1,253	580,607	463	0.9
1992	2,852	982,991	344	1.2
1993	4,331	1,087,100	251	2.1
1994	5,149	3,514,797	682	5.0
1995	11,137	4,601,441	413	5.0
1996	12,885	4,534,323	351	5.0
1997	10,958	3,622,043	330	5.8
1998	13,150	3,816,639	290	6.3

Under "Back to Basics," K-Rep retrained all of its credit officers in its original philosophy and the fundamentals of microfinance, and re-emphasized the institution's commitment to the microenterprise sector. Service delivery changes were also introduced to help clients gradually learn the habit of weekly deposits, and collateral requirements were revised.[2] The loan portfolio was reduced to US $3.6 million in 1997, then increased gradually to just under US $4 million in 1998. By late 1998, total member savings had risen to over US $1.37 million, and delinquency rates were drastically reduced, with arrears over one day past due down from 20.9 percent in 1997 to 9.7 percent. The number of active borrowers rose from 11,000 in 1995, to 13,150 in 1998, while 4,149 members held savings but had no loans. It became clear that increasing savings was both desirable as a service to clients and necessary to help finance further scaling up and long-term self-sufficiency of K-Rep itself.

The Process of Transforming to a Licensed Institution

K-Rep's vision of transformation to a licensed institution emerged in 1994 from a staff concept paper on possible transformation, and a feasibility study funded by the Ford Foundation in 1995. The decision to transform was based on mitigating the following challenges:

- K-Rep's NGO structure prevented it from attracting funds from investors and inhibited potential benefits of private ownership. Accessing additional sources of capital, particularly from client savings (by mobilizing deposits[3]), would permit sustained scaling up of credit to the target population.

- Cross-subsidizing the non-financial services from lending operations was impeding the growth its lending activities. In addition, the energy and focus required to oversee adequately the micro-lending program was overshadowing the potential for new product development and expansion of the non-financial activities of the NGO.

- K-Rep expected that transformation to a regulated financial institution would enable it to right the inequity of client savings being onlent to wealthier clients of formal banks. K-Rep client savings were deposited in these banks, but neither K-Rep nor the clients could access loans from the same banks.
- Transformation would help ensure institutional permanence of K-Rep's microcredit program through improved governance and increased profitability.

Initially, some board members had reservations about K-Rep's transformation to a commercial bank. They especially feared losing control of K-Rep's mission to new investors with different views, ideas, and missions. This challenge of attracting investment partners who shared K-Rep's twin goals of providing financial services to low-income communities on a commercial basis while also pursuing social development objectives was daunting. Once initial reservations were overcome, a nine-member advisory team[4] was formed to prepare a business plan, present it to potential investors and the Central Bank of Kenya, educate Central Bank officials about microfinance as a commercial proposition, and negotiate the licensing requirements for the proposed K-Rep Bank.

K-Rep's New Organizational Structure

The transformation of K-Rep into a commercial bank required creating three legal entities under the umbrella of K-Rep Group Ltd.,5 which is a holding company with the largest equity holding in K-Rep Bank. K-Rep Bank, Ltd., is a private, for-profit company, owned jointly by others, pursuing microfinance. K-Rep Advisory Services (Africa), Ltd., or KAS, is a private, for-profit consulting firm, owned 100 percent by the K-Rep Group. K-Rep, the NGO, was not created anew, but was reincarnated as the K-Rep Development Agency, with substantial changes in its internal operations.

K-Rep Group transferred the financial assets, liabilities, and activities of the financial services division to K-Rep Bank. The assets, liabilities, and activities of the non-financial services division remained with KDA, which was then divided into microfinance research and innovations; and microfinance capacity building. In 2001, the microfinance capacity-building division was spun off to K-Rep Advisory Services, which was incorporated to provide fee-based microfinance consulting services.

The new structure was intended to protect K-Rep's original vision of providing both financial and non-financial services to the poor. Each institution provides different services within the microfinance and micro enterprise sector. The institutions within the K-Rep Group are separate legal identities. Each has its own board of directors and own mission, vision, core values, and organizational culture.

K-Rep Group, Ltd.

K-Rep Group, as the holding company, has the largest equity participation in K-Rep

Bank (28.8 percent), and wholly owns both subsidiaries, KDA and KAS. The board of directors of K-Rep Group are the same members who oversaw K-Rep's transformation from an NGO to commercial bank, with the addition of the managing director of KAS. This board continues to be the mission bearer for the K-Rep Group and ensures that, although the entities are pursuing different strategies in the African microfinance industry, they remain united in their mission.

K-Rep Development Agency.

As the research and development arm, KDA focuses on product research and innovation, and dissemination of results to the broader microfinance industry. KDA's strategy is to identify, test, and develop new microfinance products to help the poor organize their financial lives, as well as to facilitate partnerships with institutions that can deliver these products and services to poor clients. Some of these innovations include financial service associations (autonomous user-owned, -managed, and self-financed savings and credit schemes), healthcare financing and insurance for the poor, microloans for smallholder dairy farms, low-cost housing finance, and rural savings mobilization (rural communities pool savings to access higher returns, for example, through treasury bills). While K-Rep Bank benefits from the research findings, KDA shares its findings with all interested parties, and helps implement new product lines within other development organizations. Donors continue to support KDA with the understanding that its services are valuable resources for microenterprise development in Africa.

K-Rep Advisory Services (Africa), Ltd.

Incorporated in January 2001, KAS is an independent profit center with its own board of directors and capital structure. As the advisory and consulting arm of the K-Rep Group, it provides a wide range of services that include institution capacity building and training, project management, business, and financial and strategic planning for MFIs. It also manages a public relations program, which hosts visitors from all over the world and introduces them to K-Rep Group activities and other leading MFIs in Kenya. All KAS services are fee-based. KAS continues the management and technical support to NGOs that K-Rep was initially formed to provide.

K-Rep Bank, Ltd.

K-Rep Bank, Ltd., began operations as a fully-fledged commercial bank in December 1999, and to date is the only commercial bank catering to low-income communities that is licensed and regulated by the Central Bank. It is also the first microfinance NGO to transform itself into a regulated banking institution in Kenya and, indeed, in Africa.

Issues and Challenges of Transformation

K-Rep's transformation took four years, requiring difficult decisions of institutional transformation and persistence in mobilizing the right investment partners who could assist in overcoming the Central Bank's concerns with the proposal. Other issues arose, including the danger of mission drift, the appropriate institutional form for K-Rep Bank, the Central Bank's misperception of microfinance, concern over meeting regulatory requirements, and the search for investment partners were other transformation issues.

Despite extensive staff training and systems development and simulation, numerous problems were encountered in data migration and staff morale. The new requirements exacerbated a culture conflict between "old" and "new" staff. The tension between different shareholders was not always creative, which affected the governance of K-Rep Bank. The commitment of management and staff to resolving these challenges of transformation was severely tested over a transition period that stretched throughout the first year of K-Rep Bank's operations.

Internal Issues

The overriding concern of K-Rep's board regarding transformation was "mission drift"—the risk that commercial banking considerations would drive K-Rep Bank up market to serve higher-income clients at the expense of scaling up their mission of serving low-income and poor people. The second was the need for partners that shared the original vision and objectives. A third concern was the K-Rep's preparations to comply with rigors of supervision and prudential guidelines of a regulatory authority.

The biggest issue was grappling with the institutional options for K-Rep Bank. Though the final decision was a commercial bank, management came to this after considering a finance company (non-banking financial institution), a co-operative society, and a building society. Staff, board members, and external stakeholders, such as customers, government, the Central Bank, and other players in the microfinance sector, were canvassed regarding transformation. Internal operations were assessed to determine if systems were capable of operating as a commercial financial institution and were supported by adequate staff capacity and strong leadership. The finance company format initially appeared to offer the best fit, with a lower capital and liquidity requirement than a bank. However, this option was closed by the Central Bank as it pursued a universal banking policy. The co-operative society presented a good option for including clients in the ownership structure, but had a weak regulatory framework. Hence the final preferred option was a commercial bank.

External Issues

Sceptics and doubters were many, the most critical being the Central Bank, as the regulators of Kenya's financial industry. They doubted the viability of microfinance, given its unconventional lending practices and the fact that hitherto it was a donor-funded activity. Whether an NGO could own a bank was also as an issue, given that NGOs have no real owners. The Central Bank worried that no one would be responsible if things went wrong. The situation was exacerbated by the fact that five indigenous banks had recently been placed under Central Bank management due to lack of liquidity, and in 1998 the National Bank of Kenya (the fourth largest) nearly collapsed. The Central Bank therefore decided not to license any new banks, and K-Rep's application was placed on hold. The reluctance of the Central Bank was finally overcome only through lengthy lobbying, donor support to help the Central Bank to understand how microfinance was regulated in other countries, investment by international financial institutions in K-Rep Bank, and the requirement that K-Rep meet a minimum capital investment[6] of KSh 500 million.

Whereas K-Rep had sufficient loans, cash, and other assets to meet the required minimum paid-up capital of US $6.3 million, it needed at least three other investors to comply with a 25 percent ownership limit per single investor. K-Rep restricted its subscription to US $1.82 million in equity and invested US $2.06 million in income notes,[7] while US $4.48 million was offered to other investors. A search for local investors was not successful, as the few that were identified sought returns of over 20 percent. Donor agencies helped search for foreign investors, which finally bore fruit. After many months of lobbying and networking by the Advisory Team, six investors were found that satisfied the desired combination of financial expertise and commitment to K-Rep Bank's social mission.

The Challenge of Regulation

K-Rep Bank came from an NGO background with no stringent external regulator. The first inspection by the Central Bank six months after commencement rated K-Rep Bank as strong, largely due to its capital base, but also cautioned K-Rep Bank about its data migration difficulties, high operating costs, slow growth of deposits, and low earnings. Most surprising, the Central Bank took issue with non-compliance with the regulatory requirement limiting each shareholder to a maximum of 25 percent of total shares, even though K-Rep Group had negotiated its 28.8 percent shareholding with the licensing department of the Central Bank. The Central Bank also questioned K-Rep's field offices because they were not licensed as bank branches and did not meet the minimum requirements in security and infrastructure.

Furthermore, the inspectors advised K-Rep Bank to book large loans and attract large deposits to increase earning and reduce costs, in contradiction to K-Rep Bank's fundamental objectives. Clearly, more work needed to be done to help the Central Bank fully understand microfinance. K-Rep Bank's management formally applied for a waiver of the 25 percent ownership limit; it redefined field offices as "marketing offices" rather than formal branches, and secured approval; lobbied for a Microfinance Regulation Bill (approved by the Cabinet of Ministers in 2004); and lobbied for a microfinance unit within the supervision department of the Central Bank (set up in early 2004).

Data Migration and Harmonizing Operations

Staff members were overwhelmed by new products (such as deposits) and procedures—new savings products doubled transaction volumes. The accuracy and timeliness of data were adversely affected by the centralization of the system. Initially, K-Rep Bank was licensed to operate only one branch, so the head office bank branch took over the accounting and record-keeping that previously had been spread over 17 field offices. The distance between many field offices and the head office slowed data transferof the transactions.

Urgent problems like these diverted management's attention away from business development. Management hired consultants to address the problem, train staff, and restructure data migration at extra cost which had not been anticipated. While the problems were solved within six months, the higher costs of operation and reduced profitability below the projections in the business plan and past performance concerned the Central Bank and K-Rep Bank's board of directors.

The Challenge of Governance

The new regulatory environment was more stringent in matters of governance. Board members represented diverse shareholder interests, and the individual members changed frequently, had limited understanding of microfinance, and mistook the transformation difficulties to mean that microfinance was not profitable. They supported the Central Bank's recommendations for alternative (non-microfinance) products to improve profitability. Some board members became involved in details of management rather than formulating policy, assisting management, and directing the institution. The resulting tensions led to mistrust between management and the board, and diverted energy from productive activities; and confidence dropped.

Some changes in the individuals representing investors on the board were made. The board sought individuals who understood microfinance, and brought in a hybrid of professionals that represented broad interests but common objectives. It also addressed tensions at the board level by ensuring that other directors were trained and exposed to the dynamics of microfinance.

The Challenges in Human Resources

Difficult decisions were made as to which board members and staff members would move to the new K-Rep Bank or continue with the NGO (K-Rep Development Agency) after transformation. On one hand, staff who did not move to K-Rep Bank felt insecure and were not convinced that NGO would survive. On the other hand, some of those who moved to the bank were not convinced of its viability and were further unsettled by the difficulties encountered with data migration and new procedures. At the board level, only two directors moved to the K-Rep Bank board, and the rest felt left out of an institution that they helped establish.

During the first three months of bank operations, productivity actually decreased. K-Rep Bank hired traditional bankers to run certain functions (front and back office operations, clearing functions, regulatory compliance, and treasury management), at higher salaries for specific skills and experience not available among existing staff. The commercial bankers were less sympathetic to microfinance clients and focused more on conventional banking practice and adherence to strict procedural rules and regulations. In contrast, the NGO staff was more sympathetic to their poor clients and embraced microfinance best practices. The resulting culture conflicts and personality clashes slowed operations and polarized the new bank. The tension, however, presented an excellent opportunity to create a new culture that embraced the best of both values.

K-Rep Bank brought the staff together to discuss the issues that affected them. The professional bankers went to the field to learn about microfinance, while former NGO staff members worked in the banking hall as tellers and clerks to give them a feel of traditional banking. Training activities were carried out across cadres rather than across disciplines. Any staff (old and new) who could not adjust to the new environment had to be let go or was transferred back to the NGO (KDA). It took time for the two groups to work harmoniously.

To overcome feelings of being left out, staff and board members who did not move to K-Rep Bank were allowed to buy equity shares through the Employee Stock Ownership Program (ESOP). The new organization structure (K-Rep Group, KDA, and KAS) offered new opportunities for board members who did not move to the K-Rep Bank Board. This, coupled with a bi-annual get-together of all staff and board members of the group, has helped K-Rep remain united with one development vision, which is pursued through different objectives and corporate entities.

The Challenge of Mission Drift

To demonstrate its commitment to serving the poor, K-Rep Bank located its head quarters in one of the largest slums in Nairobi, Kawangware. Nonetheless, K-Rep Bank encountered potential mission drift, as regulators and some board members urged the bank to move into more profitable lending activities (especially after the Central Bank's first inspection). Some of the new staff from the banking sector tried hard to instill conventional lending practices that would exclude poor clients. It would have been difficult to overcome these challenges if the board composition and top management did not include key proponents of microfinance.

The characteristics of K-Rep Bank's product did not change after transformation, even though new loan and savings products were introduced. The bank continues to target poor and low-income people, as did the NGO. The average loan size is one indicator of the bank's orientation toward the poor, which has generally remained at less than US $500 both before and after transformation (with the exception of 1994 and 2001). The average size of first loans is lower at US $263; the higher average loan size is due to larger repeat loans. The average customer deposit size is US $247.

Impact of Transformation on Scaling UP, Services, and Clients

The primary objective of scaling up, to increase outreach, was quickly achieved. K-Rep's initial 1,253 loan clients grew steadily in 1991 to 11,137 in 1995, but then growth slowed considerably, reaching only 13,636 by 1999, the year of transformation (see Table 2).

Teething problems limited growth in the first two years after transformation. But from 2001 to 2003, loan clients doubled from 22,659 to 45,379. The loan portfolio increased from more than US $4 million in 2000 to US$ 20 million in 2003. Although some of this increase came from non-poor clients, a survey of the income status of clients indicates that the number of poor clients in 2003 is triple the total number of clients before transformation. Furthermore, the ability to take savings has brought in new clients, many of them poor. The number of customers demanding savings deposits has greatly outstripped those demanding loan products, reaching 62,643 in 2003.

K-Rep Group's outreach has also been enhanced by KDA's support of developing and spreading the FSA model. By late 2003, 67 FSAs had been established (half in arid areas), with some 48,000 shareholders, most of whom use the FSA to save and withdraw when needed. They have an outstanding loan portfolio of US $0.5 million. Other projects supported by KDA, for example, in HIV/AIDS, agriculture, healthcare, and low-cost housing, reach an additional 9,000 poor people, largely in rural areas.

Impact on Products and Services

Transformation led to a number of new banking products. New loan products consisted of individual loans, wholesale loans, bank overdrafts, consumer loans, health loans and others. This has permitted K-Rep Bank to accommodate more group-based clients, as well as new small and medium enterprise (SME) clients and others who were targeted as a source of new deposits. The deposit instruments include passbook

Table 2 Client Outreach Before and After Transformation 1991-2003

	Year	No. of Loans	No. of Savings Accounts	Loan Portfolio (US $ 000)	Avg. Loan Size (US $)	Deposits	Avg. Deposit Size	Total Assests
As an Ngo	1991	1,253	0	581	463	0	0	0.9
	1999	13,636	0	3,228	237	0	0	6.3
As a Bank	2000	17,139	19,863	4,178	275	3,512	177	12.64
	2001	22,659	28,584	9,458	417	5,377	188	15.42
	2002	38,739	46,969	14,535	375	10,779	230	22.00
	2003	45,379	62,643	20,389	449	15,481	247	28.58

savings (attractive to the poor) and time deposits (to mobilize savings from SMEs and others).

Loan Products

K-Rep Bank continued traditional group-based lending to individual members for a maximum of 24 months, at an interest rate higher than standard commercial bank loans, with options for repayment frequency and a graduated loan size. Prior to transformation, K-Rep offered only the group-based loans (the Juhudi and Chikola products had been merged). The group loan product did not change after transformation, although the proportion of the group-based loans was deliberately reduced to diversify risks. Proportionately it has decreased from 81 percent to 49 percent of the total portfolio; volume grew from US $3.7 million in 2000 to US $10.1 million in 2003.

As a commercial bank, K-Rep has been able to expand its credit products to cater to both conventional clients and its core clients who have outgrown the group based method. Individual loans are issued to clients within the group structure, but are not co-guaranteed by group members as with group-based loans. K-Rep Bank also offers individual loans to clients who have grown their businesses, have substantial savings, and have a minimum of three years successful repayment experience with K-Rep Bank. Previously, such clients would have had to seek loans from commercial financial institutions, with little chance of success.

K-Rep Bank also began traditional collateral-based individual lending with new clients. In 2000, loans and advances increased by 76 percent. K-Rep Bank also developed a credit product, known as *Kati-Kati*, for individual entrepreneurs with high-potential businesses and credit needs that exceed US $1,250. Overdraft facilities are available for current account holders—a standard banking product positioned competitively with other commercial banks and aimed at attracting small business accounts as a source of funds. After transformation, the outstanding loan portfolio grew by nearly 200 percent in 2001, from US $4.2 million to US $9.03 million, then increased again by over 120 percent in just six months, to US $10.9 million in June 2002, despite a poorly performing economy. The primary focus remains on the poor: 80 percent of the loan portfolio continues to represent loans advanced to micro-enterprises through the group-based loan products.

Savings Products

One key objective of transformation was the mobilization of deposits. In 1996, clients and non-clients within the target population were surveyed to determine the level of interest in opening savings accounts. The majority of the respondents (91.7 percent of entrepreneurs and 86.4 percent of non-entrepreneurs) expressed their willingness to open a savings account. Their interests, in order of importance, were access to credit, low minimum balance, proximity, good customer relations, fast service, and competitive interest rates. Prior to its transformation, K-Rep could only use compulsory savings as security for its loans. After its transformation, K-Rep Bank offers five main kinds of savings products: group savings,[8] standard savings accounts (voluntary), *Msingi* children's accounts,[9] current/checking accounts; and term/fixed deposit accounts.

During 2000, the first year after transformation, K-Rep Bank mobilized deposits totalling US $3.5 million, largely from group savings held in other banks. By the end of 2003, deposits had grown substantially to US $15.5 million from a wide spectrum of clients. Despite this growth, K-Rep Bank has a funding gap, which it covers with lines of credit. The majority (96 percent) of K-Rep Bank's depositors are micro-savers, whose savings balances average less than US $650. The total amount of savings for this group accounts for 38 percent of the deposits. Depositors with large balances of over US $13,000 contributed 39 percent of the deposits as of the end of 2003.

Other Services

Together with KAS, K-Rep Bank is developing additional structured financing services. One such initiative helps clients to start a community telephone business. KAS works in partnership with a community phone distribution company in structuring the finance, training and marketing of the product, and K-Rep Bank provides loans of a minimum of US $1000 to a maximum of US $1400, repayable in six months. This particular initiative began in earnest in October 2003. As at March 2004, 421 units have been sold, with K-Rep Bank clients forming the vast majority of owners.

Interest Rates

In the 1990s, K-Rep Bank was able to offer its group-based loans at an average interest rate of 33 percent per annum—comparable to commercial bank lending rates—despite the relatively high operational costs of microfinance, due to its grant-based source of funds. Despite the higher cost of commercial sources of funds after transformation, it was able to reduce the interest rate on the same loans to 31 percent in 2001 and to 30 percent in 2002 (although this was higher than commercial bank rates, which averaged around 14.5 percent in 2004). Before 2001, K-Rep did not offer wholesale or term loans because it did not

Table 3 Average Deposit Sizes for K-Rep Bank Clients (as of December 2003)

US$	No of Clients	% of Total	Amount (US$ 000)	% of Total
< $650	60,267	96%	5,861	38%
$650-$1,300	1,605	3%	1,480	10%
$1,300-$6,500	634	1%	1,601	10%
$6,500-$13,00	58	0%	508	3%
> $13,000	79	0%	6,054	39%
Total	**62,643**	**100%**	**15,504**	**100%**

fall under its mandate as an NGO. As a commercial bank, it has been able to offer these products, with the average interest rate falling from 25 percent in 2000 to 14 percent in 2003 (from slightly above to comparable commercial bank rates).10 Thus, the cost of finance to customers has been declining (at least in nominal terms) as access to credit has been expanding.

Impact on Clients

K-Rep Bank has been able to maintain its focus on providing financial services to poor clients, especially women, who would not normally be able to access commercialsources of finance. Although non-poor clients were added in the search for deposit mobilization as a base for scaling up, the overwhelming majority still use the group-based products designed for low-income clients. In 2002, 11,000 first-time borrowers participated in Juhudi and Chikola groups. Approximately 5,000 (over 12 percent) customers surveyed in 2003 were categorized as very poor. Women, who are largely in trading and small-scale manufacturing, account for 52 precent of K-Rep Bank clients. With KDA, over 70 precent of the 48,000 FSA shareholders are considered poor, 49 percent of them women. Clients have testified not only to the impact of K-Rep Bank's financial services on their businesses and their lives, but also to the positive results of transformation.

Implementation and Success Factors

K-Rep's experience in searching for a model of sustainability while retaining a consistent focus on the poor provides some lessons regarding the factors leading to successful scaling up and implementation of institutional change. Transformation that seeks an appropriate business model has been undertaken with the objectives of extending outreach, in both breadth and depth, and achieving institutional permanence. Each major transformation stage presented important challenges of implementation. This section analyzes lessons from how these challenges were met and key success factors for institutional change, including: institutional commitment, political economy for change, innovation and adaptation, a learning culture, and external catalysts.

Commitment and Political Economy for Change

Transformation posed risks to K-Rep's poverty focus by forcing it to deal with external investors and the Central Bank, both with different objectives than K-Rep, and to hire staff members who came from a purely commercial banking culture. A key success factor was management's readiness to recognize problems and treat them as challenges to be overcome, and determination of its leadership to maintain the institution's original commitment to serving the poor. This is reflected in the "Back to Basics" program of staff training and the continued predominance of women among K-Rep Bank's current loan clients (over 60 percent).

External factors helped create a political economy for change. The government's growing focus on developing a strategy for poverty reduction helped to raise the receptiveness of officials to the role that MFIs could play. International partners played a catalytic role, through donor-supported activities such as sponsored trips to successful MFIs in South America and Asia and through the willingness of international financial institutions and investors to provide capital and help educate and persuade the Central Bank. Public and private institutions worked together to hold seminars to try to develop guidelines that would enable other MFIs to join the financial sector with less stringent hurdles than those that K-Rep had to overcome.

Commitment to poverty focus is further demonstrated by the decision to appoint a seasoned leader from within (rather than an outside banking professional) to undertake the launch and management of K-Rep Bank, in order to ensure consistency and commitment to the mission. K-Rep Group has also demonstrated the commitment of its leadership to poverty focus through collaborative efforts of its different subsidiaries to develop and introduce new financial products for the poor, piloting financial service associations in low-income communities, and working with other organizations outside as well as inside Kenya to share K-Rep's experience in poverty alleviation.

Success with the Central Bank

The regulatory environment was a significant barrier to transformation efforts. The board chairman and the managing director identified and targeted the governor of the Central Bank as a person critical to the success of transformation. They built a solid working relationship, confidence, and trust with the governor and simultaneously educated Central Bank officers on microfinance.

Management continued these efforts after transformation to a bank to help regulators better understand the mechanics of microfinance. They successfully responded to issues raised by Central Bank regulators without requesting special exemptions, thus instilling the credibility of microfinance. The result has been not only the establishment of a microfinance unit in Central Bank, but also the development of legislation that will make it easier for future NGO MFIs to transform and for CBK to regulate the industry more appropriately. Besides contributing to preparation of the new bill, other MFIs are also developing an institutional framework for self-regulation through which they can ensure that non-genuine players do not bring the industry into disrepute.

Institutional Innovation

K-Rep's innovativeness has positioned it as a market leader and created an environment that has helped other MFIs and encouraged other stakeholders to support the industry. From the beginning, K-Rep established a tradition of experimenting with credit methodologies, such as Juhudi and Chikola, to adapt international best practices to the Kenyan context.

K-Rep's second transformation was far more complex in externalising different functions into separate but inter-related organizations. The holding company organizational design not only provided legal ownership, it was crafted to create distinct structures (KDA, KAS, and K-Rep bank) with sufficient synergies to depend on each other in pursuit of common objectives. The structure of three separate institutions was an innovative approach to resolving the potentially divergent objectives (profit vs. social) by allowing each to specialize within the overall K-Rep Group mission of serving the poor.

Governance of the new organizational structure was complicated by having to bring in external investors to meet regulatory requirements. An important success factor was the establishment of guidelines by board and management for selection of suitable partners. Further efforts were needed to ensure that the individuals representing these partners on the board had the right skills and understanding of microfinance to help the new institution fulfill its dual mission of financial sustainability and outreach to the poor.

Institutional change such as K-Rep went through can be devastating to staff morale. Management's humility and readiness to take corrective action were critical with respect to new staff. First, they recognized the need to recruit seasoned bankers in order to quickly meet Central Bank requirements. Second, they recognized the conflict of cultures and brought staff face to face to discuss it. Third, they recognized the need for special training to educate new staff in microfinance methodologies and mission, and to train "old" staff in traditional banking techniques. Fourth, they included K-Rep pioneers and existing staff in the shareholding of the new venture through an employee stock ownership program which helped reinforce their commitment. The result was a blended workforce that enables K-Rep Bank to straddle the middle way of serving low-income communities in a profitable, commercialized way.

Conclusions and lessons

K-Rep has been modelled as a "learning organization." It learned very quickly that its initial integrated model of packaging nonfinancial services with finance might not attain the objectives of outreach and sustainability, and shifted to a minimalist model focusing on developing financial products appropriate for its target population of the poor. It then experimented with new products, such as the Juhudi credit scheme (an adaptation of Grameen Bank methodology), which had greater impact on low-income customers by tapping on their group strengths and focusing on unity, commitment and trust by members.

The results of a study in K-Rep's initial phase as a service wholesaler indicated that the objectives of the MFIs it assisted were not in concert with its objectives of outreach (both in breadth and depth) and sustainability. It then embarked on direct financial service provision to the poor to improve on outreach, efficiency, and effectiveness.

Observing that donor interest and funding were waning, K-Rep embarked on further transformation. It had learned from experience that microfinance was not only viable, but also sustainable if the right models were implemented. It sought to combine the drive for profit as a commercial bank with its mission to serve the poor is its latest venture in learning and experimentation.

Learning was institutionalised by the creation of a research and development department, which could test products and adapt them to customer requirements. Several products adapted from various geographical locations have been incorporated into the K-Rep portfolio of products, e.g., Kati-Kati, Juhudi, Chikola, and FSA. This department laid the foundation for the eventual emergence of KDA, whose mandate largely continues to be experimentation, leaving K-Rep Bank to focus on making profits while the other subsidiaries undertake the risks of experimentation and pass on the benefits. This model has facilitated outreach in terms of learning: the advisory and consulting services provided by KAS have enabled the K-Rep Group to extend their experience to over 15 countries in Africa.

A key lesson is the need for an institution to continually remain dynamic and relevant to the environment in which it operates. K-Rep was initially one entity, but when the time was right, the Board made the somewhat painful decision to spin off the financial services division into what is now K-Rep Bank. A second decision was made to spin off the microfinance capacity-building division into what is now K-Rep Advisory Services. K-Rep's leadership was bold enough and dynamic enough to let go of projects that are now incubated in the K-Rep Development Agency. KDA has a number of projects that it is piloting, with its biggest and most promising being the financial services associations. KAS is incubating a community phone project. K-Rep's structure is designed in such a way that when the board feels that the time is right, financial services associations or the community phone project, for example, could be institutionalised and hived off to become K-Rep entities in their own right.

Implications for Replication in Other Settings

The leadership of institutions seeking to scale up and transform need first to understand and foresee the implications that scaling-up may have, particularly with respect to the structures needed to maintain their core mission and objectives. In Kenya, the Co-operative Bank is scaling up its microfinance activities successfully as a result of better awareness and a regulatory climate more conducive to microfinance, as championed by K-Rep and its partners. K-Rep benefitted from establishing a research and development department that would keep it informed of trends in the industry and experiment. The importance of testing new methodologies locally and adapting them to suit the circumstances requires the creation of an organization capable of learning both internally and externally.

Government support is critical in establishing a regulatory climate that will allow sustainable microfinance institutions to service poor clients. Donors should be understanding, flexible and accommodative of the unique situations institutions operate in, providing opportunities that seek to empower the leadership and linkages to international networks to expose managers to best practices and nurture leadership capabilities. Donors also could in the initial stages support institutions by assuming the risks in investments for social reasons, so as to build confidence with other partners. Finally, leaders must continuously transform institutions and develop their human resource capacities in response to client demands and to the changing environment.

Table 4 Select K-Rep Bank Performance Indicators

Overall Financial Performance	K-Rep Bank (2003)	K-Rep Bank (2002)	Average for African MFIs	Average for all MFIs
Adjusted Return to Assets (AROA)	2.3%	2.5%	3.7%	0.1%
Adjusted Return to Equity (AROE)	6.9%	6.1%	14.1%	2.3%
Operational Self Suffciency (OSS)	132.0%	133%	148%	115%
Financial Self Suffciency (FSS)	126.0%	127%	133%	104%
Productivity				
Borrowers Per Staff Members	172	199	138	121
Risk And Liqudity				
Portfolio At Risk >30 Days	6.7%	2.3%	2.1%	2.8%

End Notes

1 Savings are collected and loans are disbursed at weekly meetings with two members of each watanos eligible for loans in the first month, two more in the second month, and the rest in the following month. This loan disbursement pattern may vary depending on other factors. Each member pays a membership fee and buys a passbook for $3.70 combined. Each borrower pays 1.5 percent of the loan amount to cover the application fee (1 percent) and insurance (0.5 percent). All member savings are compiled in a group savings account at a formal (commercial) bank with a credit officer and two members as co-signatories. Client savings serve as an additional guarantee against loan default, but are withdrawn only as a last resort.

2 In the past, K-Rep required collateral security in the form of savings equivalent to 10 percent of each *Chikola* loan and 20 percent of each *Juhudi* loan. In January 1998, K-Rep changed this loan guarantee amount for new clients to 5 percent of the loan amount, incrementally increasing to 20 percent for loans of US$ 862 and higher.

3 In Kenya, only financial institutions licensed by the Central Bank of Kenya (CBK) can mobilize deposits from the public. The “forced savings” that K-Rep held for its clients as a guarantee for loans was not considered deposit taking from the public as understood by the CBK; it was considered part of the credit methodology and not for onlending.

4 The chairman of the board, managing director, and another board member were included as three members on the advisory team.

5 By law, K-Rep the NGO was not permitted to own all or part of a commercial bank.

6 The minimum capital requirement at that time was US $2.5 million, but there was a proposal to increase this to US $6.3 million over the next two years.

7 A convertible debt redeemable after five years.

8 Each individual in a group has their own account with all the group member accounts electronically linked to each other to cover group guarantees.

End Notes continued

9 This account encourages parents and guardians to start a savings account for their children under 18 years of age. A minimum balance of US $6 is required to open the account and the account earns interest at a minimum balance of US $60.

10 Both inflation and treasury bill rates fluctuated during the early 2000s, but on an overall declining trend, with 90-day treasury bills falling from 13% in 1999 to 1.6% in 2003.