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Critical Issues in Microbusiness Finance and the Role of Donors[*)]

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Summary

In the early 1990s, a consensus emerged among the leading experts in the field of small and micro business finance. It is based on three elements: The focus of projects should be on improving the entire financial sector of a given developing country; a commercial approach should be adopted, which implies covering costs and keeping costs as low as possible; and institutions should be created which are both able and willing to provide good financial services to the target group on a lasting basis.

The starting point for this paper, which wholeheartedly endorses these three elements, is the proposition that putting these general principles into practice is much more difficult than some of their proponents seem to believe - and also more difficult than some of them have led donors to believe.

The paper discusses the central issues of small and micro business financing in three areas: credit in general and the cost-effectiveness of lending methodologies in particular (Section II); savings in general and the role of deposit-taking in the growth of a target group-oriented financial institution in particular (Section III); and the process of creating viable target group-oriented financial institutions in developing countries (Section IV). We argue that donor institutions must be willing, and prepared, to play a role here which differs in important respects from their conventional role if they really wish to support sustainable financial sector development.

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I. Introduction

1. The Conceptual Basis of the Paper

Although the international donor community has, over the years, made several serious attempts to make financial services available to the poor segments of the economically active population of developing countries, it is fair to say that something like a consensus has only recently begun to emerge. This "new view", in turn, has its roots in a longer tradition of development-finance policy and thinking about the broad issues it addresses.[1)]

After the Second World War and into the 1970s, development finance was not particularly concerned about poor target groups. This began to change when it become obvious that the channelling of massive amounts of foreign funds to large projects in the developing countries did not lead to the "trickle down effect" which had been expected. In the early 1970s, the concept of *target group orientation* began to emerge. As far as financing was concerned, donors started a wave of small, diverse projects which were meant to make credit available to the poor.

Attempts to set up special target group-oriented, government-owned development banks failed almost everywhere. This led to the evolution of a more radical version of the new policy of target group-oriented financing. It gained particular prominence in the 1980s and consisted in setting up credit programs largely outside of the banking sector as well as outside of the reach of governments. This was the heyday of non-governmental organizations (NGOs) and self-help groups (SHGs) as conduits for donor funds. Their ability to really reach the small and very small borrowers, which is unmatched by other types of institutions, was seen as their main strength. The main drawbacks of these efforts were that such financing schemes proved extremely costly for donors and, at least in some cases, for the borrowers as well; that they inevitably failed to reach many members of their target group; and, most importantly in our view, that these foreign injections of funds did not lead to the creation of institutions which would have been able to play a lasting role in the lives of their "beneficiaries".[2)]

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1) For an overview and a critical assessment, see J.D. Von Pischke, (1991), Part II, and Krahnen/Schmidt (1994), pp. 9-27.

2) For an empirical study of the efficiency of credit-granting NGOs, cf. Schmidt/ Zeitinger (1996).

Around 1990, the "new view" emerged out of the criticism of this development strategy which was *only* target group-oriented.[3)] In addition to a clear gearing of efforts to *poorer target groups* in urban as well as rural environments, the new view consists in a fruitful combination of three main elements:

(1) A focus on *institution building*: Aid efforts should not be directly oriented to the provision of financial services to the target group, but rather to the creation of financial institutions which would be both able and motivated to cater to the relevant target group or groups. Setting up or strengthening such institutions should therefore be the primary objective of aid projects in the field of development finance.

(2) A *commercial approach*: The essential elements of a commercial approach are that the institution tries to keep its costs as low as possible and is able - and also formally permitted - to charge interest rates and fees which are commensurate with its total costs. A commercial approach to small and micro-lending is necessary because only an instititution which, at least over the medium term, is able to cover its costs can hope to remain in existence and to really provide benefits to its clients on a continuing basis and at a predictable level.

(3) A *financial systems orientation*: All activities geared to improving the access of poor target groups to financial services have to look at things in the broad perspective of the entire financial system of the respective country, and this for several reasons. The most important one is that an improvement of the overall financial system is likely to bring the greatest benefit to the target group over the long term.

This paper is firmly based on this new view of small and micro business finance. As a result, we have attempted to incorporate as much as possible of the financial systems perspective, the commercial perspective and the institution-building perspective in the line of reasoning presented here.

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3) The new view is alternatively labelled a "financial sector perspective" (Von Pischke, 1991), a "commercial approach" (Jackelen/Rhyne 1991) and an "institution building approach" (Krahnen/Schmidt 1994). The different labels are not a reflection of substantive differences, but at most a matter of emphasis.

2. The Purpose, Orientation and Structure of the Paper

We fully concur with the three main elements of the new view and strongly recommend that, in their practical work in the field of small and micro business finance, donor agencies and the experts working for them should try to make maximum use of the principles which constitute the new view. However, we realize that it will not be easy to follow this recommendation. In fact, the starting point for this paper is the proposition that putting the general principles into practice turns out to be much more difficult than some of their advocates seem to believe - and also more difficult than some of them have led donors to believe. Given these difficulties, we find it appropriate to strictly limit the focus of this paper to what we consider to be the most important questions in the field of small and micro-business financing. The purpose of this concentration is to provide an orientation for donor institutions which, through their funding decisions, essentially determine the nature of the development projects in the field under discussion here.

The paper contains three main sections, and each one of them deals primarily with one main problem.

Section II discusses the credit business of a target group-oriented financial institution. Here we wish to focus on the choice of a credit technology and to demonstrate that the imperative of keeping costs low and achieving cost-coverage forces such institutions to adopt a special kind of credit technology. This technology is presented and its efficiency is compared with that of the "group lending approach".

The topic of Section III is the provision of deposit facilities to members of the target group. The question on which our discussion centers here is, What role should the deposit business play in the process of building up a financial institution which is clearly target group-oriented, cost-conscious and innovative in its efforts to *lend* to small and micro entrepreneurs?

Section IV covers institution building. It discusses downscaling and upgrading strategies. The main message which we want to convey is that institution-building projects are useful and that they can be successful, but that they tend to take much more time and require much more effort and commitment on the part of the donors than they usually think or seem willing to acknowledge.

II. Credit

1. Credit Technologies for Target Group-Oriented Lending

It has long been doubted that it is feasible at all to extend credit to a target group which is poor and also rarely has adequate financial records or can furnish conventional types of credit security. However, the costs and risks entailed in lending to this target group are not a "given"; instead, they are a function of the *credit technology* which is being employed. One objective of this section is to dispel the general doubts concerning lending to the target group. The second objective is to undertake a comparison of two "competing" credit technologies.

Generally speaking, the term "credit technology" covers the entire range of activities carried out by a credit-granting institution which have to do with selecting borrowers, determining the type of loan to be granted, the loan amount and maturity and the way in which it is to be secured, as well as the monitoring and recovery of loans. More specifically, a given credit technology is a particular configuration of these features. One can distinguish two classes of credit technologies which can be characterized as either "individual-based" or "group-based".

2. The Non-Conventional Individual-Based Credit Technology

As the conventional banking technology is asset- and document-based, its applicability in the case of the target group of small and micro entrepreneurs is obviously quite limited. We shall, therefore, not discuss it any further. The other individual-based credit technology, which we shall call the non-conventional credit technology and which is being applied by certain formal financial intermediaries and NGOs in Asia, Africa, Latin America and Eastern Europe, is different from the first one insofar as it has been adapted to the special situation of borrowers from the small and micro business sector. It retains the advantages of dealing with each individual case separately and is tailored to the situation of the individual borrower, but makes a conscious attempt to acquire more information about the borrower by direct inspection and personal contact rather than by studying documents.

The basic advantage of the individual-based credit technology from the point of view of the borrower are the low transaction costs which he or she incurs. This is the case because the financial institution externalizes neither the risk-induced nor the administrative costs. However, from the point of view of the lender, an individual-based credit technology will only prove to be competitive if it succeeds in minimizing - or at least reducing to a level which does not jeopardize the financial viability of the lending institution - both the risk-induced costs and the administrative costs. How does the non-conventional credit technology attempt to achieve this result?

The default risk is reduced by using non-conventional methods of analyzing the borrowers' debt capacity, and by supplying a product that is tailored to the situation of the target group. The credit analysis is based on an assessment of the "family enterprise" in its totality, and in particular its *ability* to repay even if the borrowed funds have no impact on the earnings potential of the family business. This limits the credit risks and helps to avoid the need to monitor the specific uses to which loans are put, which would not be feasible in any event. Loan sizes as well as maturities and repayment patterns are also determined in such a way that the risk for lenders and borrowers is limited.

Although an attempt is also made ex ante to ascertain the *willingness* of the borrower to repay the loan, the credit technology still has to include unambiguous incentive mechanisms, including penalties, which reduce the moral hazard component of the credit risk after the funds have been disbursed, and are nonetheless appropriate to the economic situation of the borrowers. This means, among other things, that borrowers are (only) asked to pledge assets as collateral which they can easily provide but which would be relatively expensive - or difficult - for them to replace if they were seized. With this type of collateral policy, the primary goal of the credit-granting institution is to make the borrowers take seriously their payment obligations.

The non-conventional technology also provides for the utilization of rigorous credit monitoring and recovery procedures in the case of arrears, which complements the penalty mechanisms mentioned above.

The credit technology would fail to have the desired effect if it were not backed up by control and organizational structures at the credit-granting institution which ensure incentive-compatible implementation. Accordingly, an institution utilizing the individual-based credit technology will make a single loan officer responsible for the entire loan-granting process as well as its relationship with the client after disbursement of the funds such that the officer develops a quasi-personal relationship with "his" or "her" borrowers which gives him or her access to significantly more information about them and their businesses over the course of time. The effectiveness of this system can be enhanced by introducing a performance-based pay scale for the lending staff.

A significant reduction in administrative costs is achieved by offering only a limited range of standardized products and by introducing as many standardized, routine procedures as possible into the process of credit extension. Special computer software packages are employed which have been designed to meet the specific requirements of the credit technology.

3. Group-Based Credit Technologies

The other class of credit technologies are those which involve groups of borrowers - in one form or another - in the process of granting and recovering loans. Two variants are of special importance here. One involves the use of what may be characterized as "groups as loan guarantors"; in the other variant, the group plays more of a social role, and it may be characterized as the "group as social network" approach.

While the utilization of the individual-based credit technology gives rise to specific risk-induced and administrative costs which the lender should strive to minimize, employment of the group-based credit technology seems to imply that the lending institution can avoid incurring precisely these kinds of costs by employing group pressure or, as the case may be, formal group liability, and by shifting a considerable portion of its administrative costs onto its borrowers.

Therefore, it is not too surprising that group loans to members of economically disadvantaged target groups are fairly popular not only among certain new financial institutions and a great many credit-granting NGOs; they are also frequently viewed favorably by the international donor community. Taking their cue from the Grameen Bank, a number of institutions, above all in Latin America, are using some features of this Asian model. Accordingly, given the fact that the Grameen Bank is considered to be the most outstanding positive example of a successful group-lending program, it is advisable to take a closer look at how this bank really goes about its lending activities and how other institutions which apply a group-based credit technology differ from this model.

Most surprisingly, closer inspection reveals that the Grameen Bank does not make use of any kind of formal group liability, nor does it rely very much on "peer pressure" - which is alleged to be the distinguishing characteristic of group lending systems of all types - to influence the borrowers' repayment behavior. In fact, it does not impose any penalties whatsoever on a group if one of its members is either unable or unwilling to pay. The group merely has a moral obligation to act as a social support system for the group members and to try to induce a delinquent borrower to make his payments. Thus, the bank chooses not to exploit the potential of the group as a means of enforcing group liability. Instead, it appears that the institution prefers a more individualistic form of liability, which is, for example, reflected in its policy of requiring that its individual customers secure their loans with tangible assets whenever this is technically feasible.[4)]

Group-based lending approaches have been popular for a number of years in Latin America, and more and more credit-granting institutions have developed approaches which appear to be similar to the one used by the Grameen Bank without, however, being able to achieve a comparable degree of coverage of their target groups. The study on which this paper is based discusses in some detail how the Latin American NGOs form borrower groups, the main features of their credit contracts, the kinds of problems they encounter with their groups in terms of instability, and what they do to mitigate these problems (see Schmidt/Zeitinger 1994).

In our view, there are three major differences between the group-based credit technology used in Latin America and the one which has been developed by the Grameen Bank.

(1) Differences in the process of forming groups: This process can take up to six months in Bangladesh and is carried out with extreme care although group formation would appear to be relatively easy since the target group is defined in extremely narrow terms and most of the members of that target group live in small villages with rigid, traditional social structures and normally have known each other for quite some time. As a consequence, the borrower groups of the Grameen Bank tend to be very stable. In Latin America, on the other hand, the process of group formation usually does not take much longer than a week although there tends to be less social cohesion among the group members to begin with. Consequently, the groups are quite unstable.

(2) Differences in the concept of group liability: The Latin American version of the group-based credit technology adheres much more strictly to the principle of solidary liability (indeed, it requires the use of a formal joint and several liability arrangement) than the "model" that has been developed by the Grameen Bank.

(3) Differences in the cost of loans: The loans granted by Latin American financial NGOs using this group-based credit technology rarely carry an effective interest rate of less than

[4)] See e.g. Sprodofsky (1994). This "revelation" is certainly not intended to detract from the impressive achievements of the Grameen Bank!

50% p.a. in real terms, which is significantly higher than the costs incurred by the Grameen Bank's borrowers.[5)]

In our view, the group-based credit technology as it is used in most cases in Latin America represents a kind of negative, "mirror-image" version of the system used by the Grameen Bank which in effect misses the point of what the institution in Bangladesh has done so successfully in recent years. Why, then, have so many institutions in Latin America chosen to use this approach? We can only surmise that many institutions have adopted it with an eye to the preferences of donors who ultimately fund such projects.

4. Comparing Individual-Based and Group-Based Lending

This section contains elements of a comparison of the group-based and the "non-conventional" individual-based credit technology. The criteria for such a comparison must relate to both the supply side, namely the financial instutitions, as well as the demand side, i.e. the borrowers.

Considered from the point of view of institutions which may use it, a credit technology can be called "efficient" if it makes it possible to reach the target group more effectively and to do so at a lower total cost to the lending institution than would be possible with other credit technologies. This definition focuses on the productivity and the cost-efficiency of the technology.

For the purpose of comparing efficiency, we have compiled and analyzed data from a number of formal and semi-formal financial credit-granting institutions in Asia and Latin America which cater mainly or exclusively to the needs of small borrowers and use one of the two approaches. The institutions included in the comparison are generally considered to be very positive examples of institutions employing the respective technology.

We have derived three hypotheses concerning the relationship between the productivity and cost-efficiency of the two credit technologies and tested them (informally) on the basis of the data (See Schmidt/Zeitinger 1995). The hypotheses are as follows:

[5)] See Schmidt/Zeitinger (1996), where it is reported that a sample of Latin American NGOs which regarded themselves as efficiency-oriented offered standard loan contracts to their clients with an average *inflation-adjusted* interest rate of 88% (on an annualized basis) in 1991.

(1) Group lending has an advantage over individual-based lending in that *at an early stage* of the life of a credit program or a credit institution, group lending is more productive and cost-efficient.

The reason for this hypothesis is that, according to the claims made by advocates of the group-based lending approach, and based on what we know about the way in which groups are in fact being formed in Latin America, the process of setting up groups takes less time and is less costly than the corresponding process of learning and of training a lending staff which is required in the case of an individual-based credit technology. On the basis of the available evidence this hypothesis could not be rejected, so we assume that it is valid.

(2) *In the course of time*, however, the productivity and cost-efficiency of an institution using group lending increases only moderately, while a bank or NGO lending on a strictly individual basis can increase its efficiency rather quickly.

The reason for this hypothesis is that the group lending technology shifts a considerable part of the burden of selecting customers and monitoring their repayment behavior onto the target group and thus "externalizes" bank functions. In so doing, a bank using this technology deprives itself of the opportunity to learn and, by learning from its experience, reduce its administrative costs. In contrast, the notion of learning, of getting to know customers better and developing routine procedures for extending, monitoring and collecting loans is at the core of the individual-based lending technology. By comparing pairs of institutions of similar age, nature and location, and by evaluating the limited data on time series which we were able to gather, we found strong empirical evidence that this hypothesis is correct.

(3) The efficiency of a *relatively old institution* using groups is still higher than that of a bank or NGO of comparable age which employs the individual-based credit technology.

The reason for this hypothesis is that shifting important functions of the financial institution onto the borrower groups is assumed to lead to cost savings on the part of the institution, as this is, after all, a central part of the rationale of the group lending approach. Thus, even a bank which has had substantial experience in the utilization of the individual-based credit technology would presumably not be able to compensate for this cost advantage of the group approach. Although the evidence on this hypothesis is mixed and somewhat inconclusive, there are some indications that it is wrong.

Empirical verification or falsification of these hypotheses on the basis of scant information concerning only a handful of institutions is, of course, difficult. Nevertheless, we consider the results of our preliminary analysis to be highly revealing and practically relevant: If the first hypothesis were indeed correct and the third one indeed wrong, this would imply that, due to increases in efficiency over time caused merely by institutional learning of the kind that can take place with the individual-based technology, an individual-oriented bank would eventually outperform a comparable group-oriented bank or NGO in terms of efficiency. What appears as a specific strength of the group-based technology at first sight, namely the externalization of vital banking functions, turns out to be a weakness in the longer run, as it prevents the financial institution from learning and reducing its operating costs. Given a sufficiently long time horizon, which is called for in development finance projects anyway, the discounted value of the total administrative costs of an individual-based-technology bank would then be lower than those of an otherwise comparable bank employing the group-based lending approach.

The assessment from the perspective of the lending institution has to be supplemented by an assessment from the *perspective of borrowers*. Both groups of institutions which we have compared have the same target group and are equally good in terms of accessibility. However, with respect to the speed with which a loan can be obtained, flexibility regarding the terms of the loan, and most importantly, with regard to transaction costs, the non-conventional individual-based technology is definitely superior to all kinds of group-lending technologies for the small and micro entrepreneurs. Even if a difference in terms of cost-efficiency at the level of the suppliers of credit were not easy to establish, the balance of both kinds of costs would seem to show quite clearly that the individual-based non-conventional credit technology is the better of the two. Thus, donors should reconsider the preference which some of them seem to have for the group lending approach.

III. Savings

1. The Relevance of Saving

Fortunately, saving is no longer "the forgotten half" of development finance (Vogel 1984). In order to avoid any misunderstanding of the main proposition which we wish to advance in this section, we will begin by strongly emphasizing the significance of saving in a macro- and a micro-economic perspective and, at the same time, the significance of deposit-taking both as a service to clients and as a source of funds for financial institutions:

(1) Seen from a macroeconomic perspective, saving is necessary as it is the basis of capital accumulation.

(2) Seen from the perspective of the customers, the provision of deposit facilities is a service which is needed by all groups in society, and thus they must be offered. Poor people and small and micro entrepreneurs also need and demand deposit facilities.

(3) Seen from the perspective of *all* financial institutions of a given country, deposit mobilization is necessary as it provides the funding required for the lending operations of the banking system.

However, it is in the spirit of the new view of small business financing to take a financial systems perspective. This perspective provides the straightforward insight that no single institution should be looked at - or treated - as though it were the entire system. The three arguments in support of the importance of savings apply without qualification to the financial sector of a country or a region as a whole. But we do not think that they apply with equal force to those innovative *urban-based* financial institution which direct most of their lending to the target group of small and micro entrepreneurs. For them - and their credit customers - specialization in lending may be more advisable at least as long as they are still growing rapidly. Thus, *not all target group-oriented financial institutions must at all times provide savings facilities* in order to mobilize the bulk of the funds for their lending business from depositors, in particular from the members of the target group on which the institution focuses its lending operations.

As neither macroeconomic nor demand-side considerations make it imperative that *each individual* institution develops a deposit business, we must look all the more closely at the supply side and ask why target group-oriented financial institutions should be, or should become, "full service banks". The question is worth asking for the simple reason that most donor agencies seem to have developed a strong and almost dogmatic preference for target group-oriented "full service banks" in recent years. They have even come to consider the model of a "full service bank" as an ideal from a development-policy perspective.

2. Two Models of a Target Group-Oriented "Full Service Bank"

There are, in fact, two different models of a "full service bank". One model can be called the "*intra-sectoral full service bank*". Such a bank would try to mobilize the bulk of its deposits from the same target group to which it directs most of its lending. Some observers would regard such a full service bank as the absolute ideal. The relevant question in relation to this model is simply: Is it at all a realistic one for an institution which considers poor people, and in particular small and micro entrepreneurs, as its target group?

The other model would be an "*inter-sectoral full service bank*" which tries to lend to "lower" social strata than those from which it collects the bulk of its deposits. The most interesting question to be asked in relation to this model is this: Is it good for the members of the target group that "their" financial institution tries to mobilize deposits from *other* segments of the local society?

3. Empirical Evidence

It seems advisable to take a short look at the available empirical evidence in order to assess the feasibility and the advisability of the two models of a "full service bank". Unfortunately, there are only a few well-documented case studies of successful savings programs at target group-oriented financial institutions. The relevant literature, fascinated as it is by the sheer ability of small savers to put aside money, rarely contains hard empirical data which would allow one to evaluate the concept of a target group-oriented "full service bank". Such data would tell us about

(1) the size distribution of savings as an indicator of where the deposits come from;

(2) the costs - in terms of both interest costs and administrative costs - of mobilizing savings from different groups of depositors;

(3) the stability of the deposit base; and

(4) the relationship between the volume of deposits and the volume of lending.

We have looked at empirical material on the deposit mobilization efforts of some well-known development finance institutions in Asia and Latin America. Certain Asian institutions, like BKK and the Unit Desa Program in Indonesia, have the reputation of being very successful in this field. But considered in detail, the success of BKK is quite limited as far as *voluntary* savings are concerned. BKK's mobilization of *small savings* is insufficient to fund its lending operations to any appreciable extent. Unit Desa is more successful. But there appear to be several interesting reasons for its success. First of all, its deposits are guaranteed by the big government-owned bank BRI, of which the Unit Desa Program is a part. Secondly, it offers considerably higher interest rates than, say, BRI itself, thus raising the possibility that many deposit customers of BRI may simply have shifted their deposits to another part of the same conglomerate. In macroeconomic terms as well as in terms of improving the supply of deposit facilities, the value of these savings services may therefore be limited. Although we do not have data on administrative costs, the high interest costs alone would support the hypothesis that mobilizing savings is an expensive proposition in even in those parts of Asia where staff costs are relatively low..

The experience of certain target group-oriented financial institutions in Latin America points in the same direction: even when normal market interest rates, and rates which are positive in real terms, are offered, *voluntary* saving by the members of the *target group* contributes only a small volume of deposits. Thus, a rapidly expanding target group-oriented financial institution clearly needs alternative sources of funding. If it seeks to obtain these additional funds on the local market for deposits, it will find it difficult to quickly attract savings capital from members of the *middle class* even if it offers a substantial interest rate premium. This is so because it takes a new independent bank several years to gain the trust of potential savings customers and because competition among financial institutions for their business is intense in cities and for this group of clients.

The Peruvian municipal savings banks are an interesting case here and one which shows how difficult it is to implement the model of an inter-sectoral full service bank. Over the last few years, these institutions' savings deposit volume has been equivalent to more than 100% of their outstanding loans. The savings banks' growth in the early 1990s has been primarily a function of their ability to attract savings deposits, and this has in fact proved to be a rigid constraint to the growth of these intermediaries. Indeed, a considerably higher growth rate would have been needed in view of the credit demand of the target group as well as the economies of scale which could have been exploited with a stronger funding base.[6]

The case of the Peruvian municipal savings banks provides the rare opportunity to say something about the administrative costs of mobilizing savings. In a study prepared in the context of GTZ's support to the Peruvian savings banks, Rochus Mommartz finds that in 1993 the full costs of savings mobilization were in excess of 10% (per year) for the stock of total deposits.[7] A large part of these deposits came from big savers and institutions. The full costs of mobilizing small savings, defined as savings deposits of less than US$ 500, amount to a surprising 40% per year - despite the fact that these banks have, with foreign assistance, gone a long way in introducing cost-saving administrative procedures and that they make ample use of electronic data processing techniques.

4. Implications

The evidence provides additional confirmation of what has, by now, become common knowledge: there is indeed a demand on the part of small savers for appropriate deposit facilities. And this implies, as a kind of "moral imperative", that a target group-oriented institution - as well as the people who run it and the donors who support it - must seek to ensure that there is a supply available to meet this demand.

However, in marked contrast to the situation which prevails in many rural areas, where one specific development finance institution is often the only one that is at all accessible and that could therefore offer formal deposit facilities, in the urban environments in which most of the financial institutions that lend to small and micro entrepreneurs operate, there is in most cases a supply of deposit facilities available "on the market". Therefore, these institutions need not, and should not, be burdened and constrained by the expectation of donors that they themselves should also provide - complicated and costly - deposit services for borrowers from their main target group *at an early stage of their lives as institutions*, and they should not be forced to restrict the scale of their credit operations to that dictated by the volume of funds generated by their mobilization of small savings.

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6 See Lepp (1994, pp. 222-280), and most recently Bredenbecker (1997).

7) See Interdisziplinäre Projekt Consult (1994). The study of Bredenbecker (1997) supports these findings with more recent data from selected Cajas.

A possible objection to this proposition is that there are synergies between the lending and the deposit business of a bank. But if we look back at the discussion presented in Section II above, it can easily be seen that if credit is granted to the target group in such a way that lending costs are kept down, there will not be any appreciable potential for synergies. And even if the synergies existed, they would most likely not be sufficiently important to offset the high costs, and they could not solve the problem posed by the limited quantity of funds mobilized in the form of small savings. Therefore, we come to the conclusion that the model of an "*intra*-sectoral full service bank" for the target group is in fact an illusion and should be abandoned as the "ideal" of donor agencies.

Thus, what remains to be discussed is the model of the "*inter*-sectoral full service bank". What are the implications of gearing savings operations mainly to middle- and upper-class depositors in terms of the quality of the lending operations, which are directed mainly at lower-class borrowers?

The most important consequence of efforts to attract savers from the middle class is that the institutions incur high funding costs as middle-class savers often must be induced to switch banks. Savings from the middle class are also relatively more volatile and force the institution to hold higher liquidity reserves, thus leaving less of their funds for lending. In addition, the mobilization of a sufficient volume of savings from the middle class also tends to induce the institutions to make changes in their credit business and in the general orientation of their business policy as they must have at least some of the attributes of a "normal" full service bank in order to be attractive to these customers. Thus, securing the business of middle-class savings customers cannot be expected to lead to an increase in the quality of a target group-oriented intermediary's credit business with its primary clientele. With respect to the way in which a target group-oriented intermediary defines its basic mission as an institution, one possible consequence of this attempt to accomodate the banking needs of a different social class is a gradual shift away from the target group it was originally designed to serve. A similar case can be made against efforts to attract big savers, including institutions. Thus, the "inter-sectoral full service bank" is also a concept which proves to be difficult to implement on an economically sound basis and one which is questionable from a development-policy standpoint.

This of course raises the question of where the bulk of the funding required for onlending will come from. There is no getting around the fact that some kind of large deposits or other funds must be attracted. The precise extent to which large local deposits should also be sought will be a function of the institution's size and age. We feel that new and clearly target group-oriented institutions should be able to rely primarily on long-term borrowing in the framework of bilateral and/or multilateral Financial Cooperation programs, which makes their funding much more predictable and reliable. In view of the total costs of other sources of funds, it is evident that access to foreign aid funds at normal, i.e. market-oriented, rates is in itself a valuable form of assistance for the institutions which we are considering here. There is no need to provide these funds at concessionary rates. Of course, foreign funding creates a form of dependence. But overall we feel that this dependence has fewer negative consequences for the consistent, long-term target group-orientation of the institutions than a dependence on the savings deposits of other social strata.

IV. Institution Building

1. Assumptions and Evaluation Criteria

A strategy of development finance as institution building is based on three assumptions:

(1) The economic and social situation of the target group can be improved if more and better financial services are offered to them.

(2) Providing more and better financial services requires that there be institutions which can supply these services on a continuing basis and which are motivated to do so.

(3) An institution can provide adequate financial services to the poor only if it is financially viable, or can at least become financially viable over the medium term.

In an institution-building perspective, financial institutions should meet two requirements. They should be target group-oriented and they should be financially sound. These two requirements are not in conflict in the long run, although there may well be conflicts in a short-run perspective.

In accordance with the general thrust of our paper, this section will concentrate on an issue of particular importance and practical relevance from a donor perspective: How can viable financial institutions be created, and what does this require in terms of donor support? The general message of this section is that institution-building projects are so worthwhile - and so difficult - that it seems to be advisable for donors to treat them as projects in their own right and not to consider institution building merely as something which is added on to projects which basically have a different focus.

2. Selecting Partner Institutions

This section discusses whether particular types of institutions are, by their very nature, especially appealing, or especially likely to be unsuitable, as partners for institution-building projects. The ideal institution which donors would want to select or, as the case may be, create as a partner institution would be socially close to the target group; professional like a bank and therefore able to keep its costs relatively low; on good terms with, but not too close to, the respective government; and efficiency-oriented without being profit-oriented.

Traditionally, donors have treated the type of partner organization with which they would be willing to cooperate simply as a given. In an explicit institution-building approach, the selection of a partner institution is regarded as a problem of choosing among various alternatives mainly on the basis of the first two criteria mentioned above, i.e. target group-orientation and professionalism.

A crucial aspect of partner selection is the ownership and governance structure of a potential partner institution. Institution building typically entails the task of finding a suitable owner or creating an ownership position. This task consists of assigning the function of being responsible for the project to some specific person or institution. We will call this person or group of persons or institution "the owner". In doing so we employ a functional or economic concept of ownership.[8)] The owner in this broad sense assumes, in the developing country, general and ultimate responsibility for the success or failure of the project. Ownership in this sense does not necessarily imply legal ownership, but legal ownership may be the basis of functional ownership; and, of course, a private commercial bank or the government of the respective country can be an owner, too. How problematic the implications of private or public ownership will prove to be depends in large part on the governance structure. The governance structure consists of the specific regulations which define the responsibilities and powers of the owners in relation to the project and the local institution which carries it out.[9)]

It is important to point out that the governance structure of the partner institution cannot, and should not, be treated as a given but designed carefully in the context of setting up the project. This is why there are no a priori grounds for considering only certain types of institutions - with certain ownership and governance structures - as eligible and suitable partners and "objects" of institution-building projects. In particular, neither government-owned banks nor private commercial banks nor NGOs should be ruled out as partners, although it will probably be more difficult to shape the governance structure in an appropriate way with these kinds of owners than, for example, in cases where an NGO is the partner institution.

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8) For a detailed study of this concept of ownership, see e.g. Fama/Jensen (1983).

9) The concept of "governance structure" which we use in this paper is influenced by the writings of O.E.Williamson; see e.g. Williamson (1985), pp. 64-84.

3. "Downscaling": How to Make a Financial Institution More Target Group-Oriented

Downscaling as one of the standard strategies in the field of financial institution building[10)] presupposes that there is a formal financial institution which could at least in principle provide financial services, especially credit, to the target group, but has so far not served this segment of the market, and whose owners and/or management would be willing to engage in this new activity.

The financial sector reforms that have been initiated in many countries during the last decade have created an environment which makes the provision of financial services to the entrepreneurs from the small business community, if not an attractive proposition, then at least conceivable from the point of view of commercial banks. So there are now market forces which would in principle induce the existing banks to go "down market" in their efforts to expand their customer bases. As - and where - these forces are still weak, it may be worthwhile to strengthen them through complementary incentives and to induce formal sector institutions to serve the financing needs of the target group on an increasing scale.

There are certainly banks which will, over the medium to long term, adopt, or develop on their own, the credit technology and the organizational structures needed to serve this new type of client. And it is precisely these banks which are most likely to be interested in becoming partners in a downscaling project. This raises the question of whether it is legitimate from a development-policy standpoint to accelerate a process which will take place anyway. Our answer to this question is clearly affirmative: if a development project speeded up this process in a bank with a large branch network by five years, many small entrepreneurs could get access to formal credit five years earlier.

On a practical level, the concerns which even innovation-minded banks may have with regard to the risks and costs of small-business and informal-sector lending are an obstacle to the successful implementation of a downscaling strategy. There is in the meantime a sizeable body of empirical evidence to the effect that loans to micro enterprises can indeed exhibit lower arrears and default rates than loans to large enterprises, provided that a suitable incentive structure is in place and that an appropriate credit technology is employed. Downscaling requires, first of all, that this empirical information be made available to the prospective partner institutions.

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10) On the standard classification of institution-building strategies (and its deficiencies), see Krahnen/Schmidt (1994), pp. 81-86.

The core of the donor activities in a downscaling project relates to the transfer of a lending technology like the one described in Section II above, and to the considerable start-up costs of introducing such a technology and implementing the organizational structures which this technology presupposes. It is precisely these "start-up costs" which may pose an almost insurmountable obstacle to the initiation of small and micro lending activities by institutions that are in principle willing to do so. International donor organizations should be prepared to provide short-term support to enable participating institutions to overcome their reservations. Such assistance, which amounts to a short-term subsidization program, would not only provide incentives for a bank which is generally willing in principle but still reluctant in practice, but it should also ensure that the start-up costs are not passed on in full to the institution's small and micro credit customers, even though in some cases this would be feasible.

The practical experience which the Inter-American Development Bank (IDB) and the European Bank for Reconstruction and Development (EBRD) are currently acquiring with what has in the meantime become an explicit downscaling strategy illustrates the potential of, and the problems posed by, downscaling. The strategy appears to work well now. Nevertheless, in the beginning a great many reservations had to be overcome at the level of the donor institution, the participating banks and the respective governments. As an outcome of a lengthy learning process, the donor institutions are now less concerned than they were initially about the fact that, in the context of the cooperation program, they do indeed interfere with the internal structure of the participating banks to a substantial degree.

4. "Upgrading": How to Build an NGO and Turn It Into a Small Bank

4.1 The Focus of the Discussion in this Section

In this section, we present some stylized facts relating to the process of how an institution which tries to concentrate on providing credit to small and micro-scale businesses is born, grows up and becomes a formal financial institution with the potential to play a lasting role as an element of its country's financial system and as a provider of financial services to persons who have traditionally not had access to formal sector credit. In the longer paper whose findings are summarized here, we illustrate the upgrading strategy with a case study which is based on the experience of GTZ, the German Agency for Technical Cooperation, gained in specific projects in Latin America with the strong support of the Microenterprise Division of the IDB. In that case study, and also in this section of the present paper, we wish to convey three messages:

(1) Creating or supporting an NGO and converting it into a formal institution with a consistent target group orientation is a process which takes a long time to complete. During this timespan the institution has to be able to rely on continuous support *of the relevant kind* from the donor or, as the case may be, donors.

(2) The most crucial aspects of the process are finding the appropriate combination of technical and financial assistance, and ensuring that the different forms of support, and especially the provision of funds for onlending, are forthcoming at the right time and in the right quantities.

(3) The process of building up a financial institution should lead to a situation in which the institution's operating income is sufficient to cover its full costs. There is no way around the fact that, before this stage is reached, there is a need for the donor(s) to subsidize the emerging institution. And even in the final stage, the operating costs, which by then will be passed on completely to the institution's customers, are still likely to be high by conventional standards.

For ease of exposition - and because this proves to be advisable in practice - we assume that the partner organization is, or will be, an NGO. This is, after all, the typical case. In cases where this is not so the substance of our arguments still applies.

4.2 The Creation of a Financial NGO

In the first phase, an NGO is created or, as the case may be, modified. Four elements are needed in order for this to take place. These four elements have to be designed in a very careful manner and, typically, with considerable involvement of the relevant donor or donors. These are the four elements:

(1) *A legal form*: The institution should be a non-profit organization (NPO), preferably constituted under private law. Its formal status should be such that the institution is to a certain degree independent of the people behind it, and is legally in a position to conduct serious lending business and also to receive donations from foreign institutions. These considerations make the legal form of a foundation more advisable than the alternative form, which would be an asssociation.

(2) *A governance structure and by-laws*: At the heart of the governance structure is the definition of the institution's mission. In our case, it consists in providing appropriate

financial services to a specific target group on a financially sound basis. In the by-laws, the mission should be formulated explicitly, and expressed in operational terms to the greatest degree possible.

The governance structure gives a board of trustees supreme authority to determine the institution's business policy and ultimate responsibility for internal control, yet provides for its business operations to be run by a management (preferably a team) which must perform its functions with a high degree of professional competence and whose members should not simultaneously sit on the board of trustees.

(3) *Key individuals*: A foundation's governing body is its board of trustees. It is composed of individuals who are ultimately the project partners. In its composition, the board should above all reflect the interests and objectives which will shape the character of the future financial institution. Ideally, it should include a number of individuals with a successful track record in business, some with experience in banking, and others whose experience lies more in the field of social services.

(4) *Money and commitment*: With this type of donor-induced NGO it is neither necessary nor desirable for the initial capital to be raised by the founders and/or board members themselves, and this for two reasons. Firstly, very few of the people who have the qualifications required for board membership would be capable of providing a sizable contribution to the sum of money which the NGO will need very soon after the start of its operations. And secondly, significant disparities in terms of the individual capital contributions would tend to rob the group of its all-important internal cohesiveness. This has an important implication: in order to guarantee from the outset that all members of the board of trustees enjoy equal status, it is essential that the start-up and original endowment capital be provided by a donor organization (albeit subject to conditions).

4.3 The Growth and Transformation Process

Assuming that a new NGO has been set up, or, as the case may be, that an existing NGO has been chosen as the basis for the project and transformed to the extent that this appeared advisable, the following scenario illustrates the possible economic and technical development of a - largely donor-induced - financial NGO. The scenario, which is described in detail and backed up by specific figures in the main text of the study (Schmidt/Zeitinger 1994, sect. 3.2), shows the sequence of individual steps and the extent of the institution's need for funds for onlending, as well as the optimal timing for such injections. These funding needs should be covered by the donor or donors in addition to the pure technical cooperation component they provide.

The scenario covers a time span of *ten* years. The *first four* years are the time needed for the NGO to reach financial sustainability, and thus a situation in which transformation into a formal financial institution is advisable and possible. The remaining six years can be roughly divided into a phase of rapid efficiency growth and a subsequent phase of slower growth in efficiency. From the tenth year on, further growth is assumed to be possible only by a purely quantitative expansion of operations.

During the first year the institution's lending operations will be on a small scale, with a small portfolio and a small number of employees, each of whom is responsible for only a small number of customers and a limited portfolio. The funds used for lending are essentially the endowment capital. The initial loans are very small, not only because of the particular target group involved, but also because the institution needs to exercise caution while learning to deal with the new borrowers. Despite high interest income of 40% p.a. on the average outstanding portfolio, the institution will not be able to cover its costs during this first year. The technical assistance component during the first year, as well as during the two following years, should include support by several international and local experts and the donation of computer hardware and fixed assets.

In the second year it will already be possible to treble the volume of lending, since both the absolute number of staff members and their efficiency will have increased. The new institution uses a lending technology like the one which we have called the non-conventional technology and described in Section II above. It is the specific advantage of this lending technology that it enables the institution and the people working in it as loan officers to learn from experience, and by so doing to achieve a rapid and substantial increase in productivity.

Now that the institution is more experienced in working with the target group, the average size of the loans will rise slightly. During the second year, the institution must receive additional funds from the donor or donors in order to secure its growth and productivity increase. But this time the funding should take the form not of a grant but of an interest-free loan.

The third year will see another large increase in the number of borrowers, and they can be served more effectively due to the opening of new branches. Average loan sizes and maturities will again rise slightly. A combination of the increased number of employees, the further improvement in their efficiency and the rise in the average loan amount, together with a constant level of interest rates, leads to an earnings situation which, for the first time, enables the institution to cover all its operating and risk-induced costs. In order to ensure that the institution grows at as fast a rate as is technically possible, it needs to receive an additional injection of funds from outside in the form of a "soft" loan (e.g. 6% p.a. in US$).

In its fourth year the NGO achieves a breakthrough in financial terms *en route* to becoming a cost-covering financial institution. In this phase, it is strongly recommended that the financial NGO initiate the transition to a formal-sector financial intermediary and change its legal structure to that of a corporation, as the legal form of a foundation will pose an obstacle to receiving the funds it needs in order to safeguard its future growth prospects. Its funding needs from year 5 on can, and should by all means, be met by loans provided by international development institutions at their normal "commercial" rates. From year 4 on and with a portfolio size of more than US$ 10 million, the combined administrative and risk costs of the institution will drop to below 20% and slowly approach 12% p.a.

As set forth in detail in the numerical example in our study, the original endowment capital of the foundation, together with the donations of PCs and other fixed assets, will form the equity base required for the establishment of a formal financial institution - or part of it. The foundation, the original NGO, becomes the (principal) owner of the bank, in which the donor organization(s) can (and should) now also acquire a formal stake by converting a portion of the soft loan provided in year 2 into equity.

Once a bank has been founded, the focus of the technical assistance component can be gradually changed and shifted to other activities, e.g. the launching of a deposit-taking business. As we have demonstrated in Section III above, the deposit business should be developed gradually and with due consideration being given to its costs. The deposit business should be seen primarily as an activity that is designed to provide a service to the customers of the bank. The consideration that opening up this second line of business will convert the institution into a "complete", and thus a "proper", bank should be of only secondary importance. And during this phase of the institution's development, the role of deposits - in particular in so far as they come from the target group of small and micro businesses - as a source of loanable funds should not be overestimated.

5. Implications

On the basis of practical experience, we think that the entire process of first creating an institution, then bringing it up to a level at which it can cover its costs, and finally converting it into a real formal bank without giving up its target group orientation, which we have attempted to describe, represents a realistic approach.[11] But it requires a long-term vision and a long-term commitment on both sides. Therefore, donors who want to be partners and supporters of this process have to be prepared to play a more lasting and, at the same time, more flexible role and to make their own future behavior more predictable and reliable for their partners from the developing countries than they are used to doing, and also to introduce a greater element of predictability and commitment than they would really like to. After all, the long-term involvement, which seems to be necessary, unfortunately also creates incentives and opportunities for the local partners to abuse the commitment of their foreign partner. The only realistic option which we see for keeping this problem under control is a degree of active participation of the foreign partner in the basic decisions of the local partner which is also not customary and about which donors - and others - may also have certain reservations.

We want to conclude the paper by pointing out four widespread deficiencies in the way that donor institutions consider and handle institution-building projects. These observations are based on our consulting experience gained in cooperation with several major donor organizations. The general thrust of our critical remarks is that donors tend to exhibit a certain reluctance to consider institution building projects as a genuine and legitimate type of project and to take them as seriously as they need to be taken.

(1) Some donors seem to feel that it is difficult to justify pure institution-building projects in the field of finance, and more specifically in conjunction with the provision of credit to a target group which is difficult to deal with. As a consequence, they quite frequently incorporate elements of direct support for the target group into an institution-building project, even if these elements water down the project strategy and lessen its chances of success. Overly rigid requirements stipulated by donors with respect to loan sizes or interest rates are features of this tendency to furnish direct support to the target group which undermines the institution-building effort.[12)]

(2) In practice, some donors burden institution-building projects with multiple and inconsistent objectives. In part, this tendency seems to be grounded in the assumption that creating an institution and transforming it into a viable and professional financial

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11 Real financial institutions which have successfully completed this process are Financiera Calpiá in El Salvador and Banco der los Andes in Bolivia.

12) In contrast to those requirements which are mentioned in the text, performance requirements which put pressure on the partner institutions to bring their costs down to a certain level would be in the spirit of the institution-building approach.

intermediary is not a particularly difficult task, leaving the project management staff or the institution itself with plenty of capacity for doing other things at the same time. The preference on the part of donors for an "integrated promotion" of small and micro-business people as well as a tendency to demand too early that their partner institutions become something like "full service banks" are manifestations of this widespread misconception.

(3) Many donors follow a general policy of very limited intervention. As a matter of principle, there can be no doubt that the optimum is as little intervention as possible. However, in the context of building financial institutions, the real issue is how much non-intervention is feasible if the objective of the project is still to be achieved. In our experience, institution-building projects require a much higher degree of intervention and long-term commitment on the part of the donors than other types of projects.

(4) A certain uneasiness about the responsibility they have in the context of an institution building project is probably the reason why donations and loans play a much bigger role in such projects than equity. Donors should understand that equity is in many cases the appropriate financial instrument for building up an institution. They should not be too concerned that, by providing equity where this is called for, they become owners, and thus "responsible".[13)] In fact, their position is very much like the position of an owner in the first place, and they in any case assume responsibility for the success of the projects which they support.

[13)] See Schmidt/Zeitinger (1996) for a detailed discussion of why donors should take seriously, and live up to, the responsibilities which they incur in their role as *de facto owners* of many of the projects which they support.

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