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New Directions in Poverty Finance

Village Banking Revisited

Craig Churchill, Madeline Hirschland, and Judith Painter

The Small Enterprise Education and Promotion Network

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The Small Enterprise Education and Promotion Network
October 2002

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ISBN 0-9722582-0-5

New Directions in Poverty Finance: Village Banking Revisited
Printed in the United States of America

Graphic layout and printing: Copy General

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Acknowledgments

This book is the product of many voices and much experience. First, it was born of the insights and hard work of the participants in the "New Directions in Village Banking Consultative Forum" who joined us from institutions across the globe: ASA, Association of Evangelicals of Liberia, CARD Bank, Catholic Relief Services Cambodia, Compartamos, FINCA, Foundation for Economic Development, Freedom from Hunger, Ghana Cooperative Susu Collectors Association, Katalysis, KMBI, Moldova Microfinance Alliance, ODEF, Pact Nepal, PRIDE Africa, PRISMA, Pro Mujer, Small Enterprise Foundation, Uganda Microfinance Union, Nyesigiso, and World Relief. Their contributions are acknowledged on the title page. Here, we simply wish to thank them for their efforts.

For challenging us to question assumptions and consider new ways of working, we particularly appreciate the forum's resource people, Shafiqual Choudhury, Robert Christen, Monique Cohen, Syed Hashemi, Michael McCord, Marguerite Robinson, Hans Dieter Seibel, Charles Waterfield, and Sylvia Wisniwski. We are especially grateful to Carlos Danel of Compartamos who inspired us with his keynote address and graciously followed up on site with two of our authors.

Many members of the Poverty Lending Working Group contributed to the writing: we thank Kathleen Stack for Chapter 2, Beth Porter for Chapter 3, Gretel Figueroa for Chapters 4 and 9, and Kim Wilson for Chapters 5 and 6.

We greatly appreciate those who gave generously of their time to provide us with well-considered feedback: Jaime Aristotle Alip, Sharon D'Onofrio, John de Wit, Christopher Dunford, Elaine Edgcomb, Michael McCord, Barbara MkNelly, Beth Porter, Robert Richards, Richard Rosenberg, Stuart Rutherford, Kathleen Stack, Tracy Talentino, and Sylvia Wisniwski. Their insights and suggestions greatly improved this book.

An exceptional manager, Dana de Kanter has provided critical inputs to enable the Poverty Lending Working Group to organize a top-quality forum and book. As Executive Director of The SEEP Network, she gives all that is needed when it is needed, enabling SEEP members to realize their visions for improving the quality of their work.

The New Directions in Village Banking Consultative Forum would not have taken place and this book would not have been written without the vision and support of our donors, USAID's Office of Microenterprise Development, USAID's Office of Private and Voluntary Cooperation, the Citigroup Foundation, the International Fund for Agricultural Development, the McKnight Foundation, the Soros Foundation, the Latter Day Saints, and the International Labour Organization. Their support will prove instrumental in developing more, responsive financial services for the extreme poor. Kate McKee of USAID's Office of Microenterprise Development recognized the importance of this endeavor and provided crucial support just when it was needed. To all these supporters—many thanks.

Finally, we gratefully acknowledge those who have lit our way: Jeffrey Ashe, Shafiqual Choudhury, John Hatch, Stuart Rutherford, and Mohammed Yunus. These pioneers have inspired our work: we hope that it does them justice.

The Poverty Lending Working Group
The Small Enterprise Education and Promotion Network

ADEMO
AGAPE
AIG
AIDS
AIMS
AKRSP
ASA

BRAC
BT

CASH[illegible]
CD
CEO
CGAP
CLAP
CPS
CRECO
CBS
CUES

DBF
DFID

ESOM

FINC
FOC
FSA

GB
GDB
GTZ

[illegible]

[illegible]

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Glossary of Abbreviations and Acronyms

ADEMCOL	Asociación para el Desarrollo Microempresarial Colombiano
AGAPE	Asociación General para Asesorar Pequeñas Empresas
AIG	American International Group, Inc.
AIDS	acquired immunodeficiency syndrome
AIMS	Assessing the Impact of Microenterprise Services
AKRSP	Aga Khan Rural Support Programme
ASA	Association for Social Advancement
BRAC	(formerly Bangladesh Rural Advancement Committee)
BT	BURO Tangail
CASHPOR	Credit and Savings for the Hardcore Poor
CD	certificate of deposit
CEO	chief executive officer
CGAP	Consultative Group to Assist the Poorest
CLAP	CARD Loan Acceleration Program
CPS	Client Profiling System
CRECER	Credito con Educacion Rural
CRS	Catholic Relief Services
CUES	Credit Union Empowerment and Strengthening
DBF	death benefit fund
DFID	Department for International Development (British)
ESOP	employee stock ownership program
FINCA	Foundation for International Community Assistance
FOCCAS	Foundation for Credit and Community Assistance
FSA	financial services association
GB	Grameen Bank
GDP	gross domestic product
GTZ	German Technical Co-operation
HIID	Harvard Institute for International Development
HIV	human immunodeficiency virus
IFPRI	International Food Policy Research Institute
ILO	International Labour Organization
ILO—SEED	International Labour Organization—Small EnterprisE Development
ILO—STEP	International Labour Organization—Strategies and Tools against social Exclusion and Poverty
KMBI	Kabilikat para sa Maunlad na Buhay, Incorporated
MBP	Microenterprise Best Practices (Project)
MFI	microfinance institution
MIS	management information system

NABARD	National Bank for Agriculture and Rural Development
NGO	nongovernmental organization
NHHP	Nsambya Hospital Healthcare Plan
PDA	personal digital assistant
PWR	participatory wealth ranking
R&D	research and development
ROSCAs	rotating savings and credit associations
SCWE	Savings and Credit with Education
SEEP	Small Enterprise Education and Promotion (Network)
SEF	Small Enterprise Foundation
TCP	Tshomisano Credit Programme
TPC	Thaneakea Phum Cambodia
UMU	Uganda Microfinance Union
UNIFEM	United Nations Development Fund for Women
US	United States
US$	United States dollars
USAID	U.S. Agency for International Development
VBI	village-banking institution
WEP	Women's Empowerment Project
WOCCU	World Council of Credit Unions

Preface

Village banking was designed in the mid-1980s to provide asset-building loans to poor women in the Bolivian Andes. Over the next decade, this prescriptive lending methodology was adapted to a range of environments, from farming villages in Mali to refugee camps in the West Bank. Despite the resulting changes, village banking retained its social mission—**to catalyze improved living standards for the poor**—and most of its defining features. By the late 1990s, however, managers of village-banking institutions (VBIs) were pursuing goals to reach more and poorer clients with more responsive services, which tested the model, tugged at its mission, and challenged the methodology.

To tackle these challenges, practitioners convened the "New Directions in Village Banking Consultative Forum" in December 2000. The forum charted new means by which village banking could better serve more clients while staying true to its commitment to the poor. By tracing the evolution of village banking, this preface explains the challenges that gave rise to the **new directions** documented in this book.

New Directions in Poverty Finance: Village Banking Revisited illustrates that village banking has become less distinct from other approaches that use financial services to improve the lives of the poor. As a result, while this book uses village-banking institutions as its entry point, the concepts, tools and techniques are widely applicable to any microfinance institution that uses a group-based methodology to reach very poor clientele.

The Original Model

Village banking was built on the features of informal rotating savings and credit associations (ROSCAs) and peer lending pioneered by Grameen Bank (GB) in Bangladesh. The model's operations were fairly straightforward. A VBI's field agents helped self-selected groups of 30 women elect leaders and develop bylaws, and trained them to manage their own financial transactions. Then during required weekly meetings, the group or village bank disbursed loans, collected loan and savings payments, recorded transactions, and decided how to

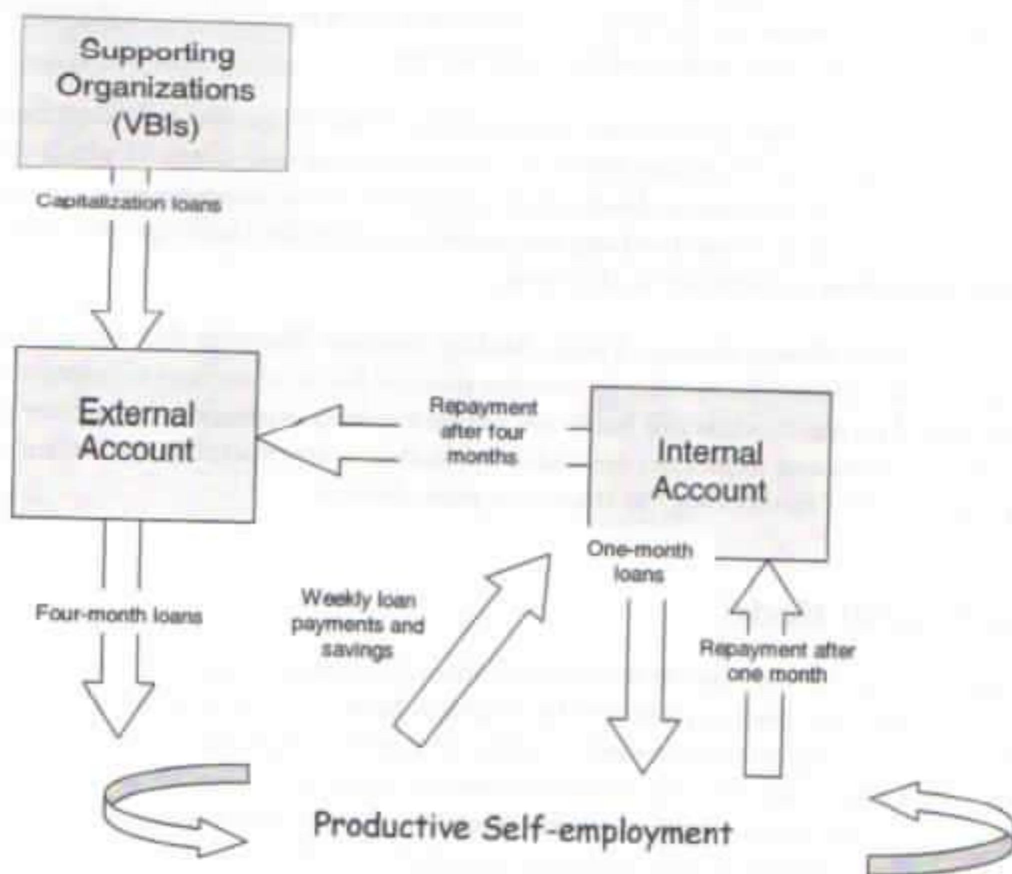
invest their savings. In three years, banks were expected to accumulate sufficient savings to capitalize their portfolios and become autonomous.

Village banks began by borrowing money from the VBI and on-lending the funds to its members under the following standardized loan conditions:

- Four-month terms with 16 equal repayments at mandatory weekly meetings;
- $50 initial loan with subsequent loans equaling the last loan plus accumulated savings;
- Mandatory savings (20 percent of the loan amount) per loan cycle paid in equal weekly installments; and
- Full repayment by the entire group a prerequisite for additional loan funds.

A key feature of the village-banking model was the **internal account** (see Figure P-1). Managed by the village bank, it consisted of mandatory savings, the earnings of the bank, and weekly loan payments (due to the VBI only at the end of the loan cycle). The bank could manage the internal account as it pleased, investing in group enterprises or lending to members or non-members on whatever terms the bank and borrower agreed. Loans from the internal account tended to be much more flexible than loans from the VBI. According to the original model, after three years the internal account would have grown equal to the size of the bank's loan from the VBI. The bank then graduated, becoming independent of the VBI and extending loans to its members from its internal account.

Figure P-1
The External and Internal Accounts of the Original Village Bank Model



Source: Hatch and Hatch (1989)

The village-banking methodology was designed to accomplish the following five objectives:

1. To improve the livelihood of the very poor;
2. To manage the risk of uncollateralized lending;
3. To minimize the operating costs of providing very small loans;
4. To enable minimally educated women to manage their own village banks; and
5. To create an ongoing source of credit for low-income women.

Uniform loan terms for all members enabled the bank to manage its own operations and reduce VBI operating costs. Common loan amounts and repayment schedules simplified bookkeeping. The VBI reduced its operating costs by devolving responsibility for managing the bank's transactions to the clients. At the same time, mandatory illiquid savings assured that the bank would accumulate the capital it needed to fund its members' loans. Together, uniform terms and mandatory savings paved the way for self-management and graduation.

Although the original village-banking model, summarized in Table P-1, shared many features with other microfinance methodologies, three features distinguished village banking:

1. A preference for reaching the very poor, reinforced by delivering services through groups close to members' homes;
2. Credit for all members at all times linked to mandatory savings controlled by the group (the internal account); and
3. Self-management by the group during frequent, regular meetings leading to autonomous local financial intermediation in three years.

The First Decade

As village banking spread, it evolved. By 1994, village-banking institutions were serving 90,000 low-income women, many in rural areas. Practitioners had adapted the model to a range of new environments across Latin America, Asia, the Middle East and sub-Saharan Africa. Adaptations to the model were recognized at the November 1994 International Conference of Village Bank Practitioners sponsored by SEEP. At that time, 68 practitioners of village banking convened in Guatemala to exchange experiences and hammer out standards. The conference highlighted the following ways that practitioners had adapted the model to meet client and institutional needs.

- **Graduation.** Graduation turned out to be in no one's interest. The banks preferred to have ongoing access to external credit rather than to rely solely on their savings. For the VBI, graduation meant losing mature banks that generated the greatest revenues. By 1994, instead of graduating village banks, most VBIs expected to continue providing them with loans.
- **Interest Rates.** Initially, VBIs set interest rates to cover only the village bank's operating costs. After VBIs decided to provide ongoing credit and support, they had to set interest rates to also cover their operational expenses and the cost of funds.
- **Control over Members Savings.** The internal account was arguably the most flexible and empowering feature of the village-banking model. It caused three problems, however: (1) village banks had trouble managing those loans; (2) it was time consuming for the VBI to help village banks with their management challenges; and (3) internal

Table P-1

The Original Village-banking Model

Element	Original Model	Reason
Group		
Size	30 to 50 members.	Fit Bolivian context. Maintain a low cost per client for VBI.
Gender	Women only.	Target limited resources to those most in need. Decrease credit risk.
Functions	Venue for collecting loan and savings payments, disbursing loans, and bookkeeping. Guarantee each other's loans. Provide mutual support and credit discipline from peer pressure.	Manage risk of uncollateralized loans to clients who have no experience managing credit. Provide a non-threatening and convenient means for accessing a loan. Prepare group for self-management. Minimize costs to the VBI.
Relation to VBI	Graduation: VBI provides training and loan for 3 years until village bank is self-capitalized and autonomous.	Empower members. Free up limited VBI resources to enable the VBI to reach new clients.
Loan		
Use	Working capital. Not for agriculture or consumption.	Provide income during the "lean season."
Amount	$50 initially. Increases linked to savings: 20 percent increase per cycle to reach a maximum of $300 after 3 years.	Enable rural women to learn to manage credit with small loans and then manage larger amounts to leverage greater increases in income and assets.
Interest/fees	Set to cover village bank's expenses.	Costs of technical support and capital seen as time-limited investments in the village bank rather than as recurring costs.
Term	16 weeks.	Allow loan size to increase quickly. Match cash flow of small income-generating activities.
Repayment schedule	Equal weekly installments of principal and interest.	For borrower: Provide discipline to repay. For VBI: Manage risk of uncollateralized loans.
Guarantee	Group guarantee (joint liability).	Secure uncollateralized loans.
Savings		
Use	Loans to members and non-members. Investment in group enterprises.	Empower members by enabling them to invest their own savings as they see fit.
Amount	20 percent of loan size, due in weekly installments.	Provide members with discipline to accumulate assets. Capitalize bank within 3 years.
Interest	Loan rate set by group. Interest accrues to group. No individual returns.	Empower and capitalize village bank.
Liquidity	Mandatory; no access.	For members: Instill savings discipline and accumulate bank's assets. For VBI: Serve as security against defaults.
Control	By village bank.	Empower members. Assure eventual self-management.

loans, which did not generate revenue for the VBI, competed with revenue-producing external loans. By 1994, many VBIs required village banks to deposit their savings in a formal bank, limited how much savings the banks could lend out, or eliminated the internal account altogether.

- **Savings Terms.** Initially, VBIs required clients to save 20 percent of their loan amount each cycle. Clients received no interest or dividends and could only withdraw their savings by leaving the bank. By 1994, a few VBIs had reduced the amount of required savings, introduced voluntary savings, allowed clients to withdraw funds at the end of the loan cycle, and paid dividends.
- **Loan Features.** The original loan features—small amounts for short terms repaid in frequent installments—were intended to reinforce repayment discipline, test members' creditworthiness, and enable them to learn to manage a loan. By 1994, many VBIs had delinked the loan size from savings amounts, removed the loan size ceiling, and lengthened the loan terms.
- **Village Bank Meetings.** The original village banks had 30 to 50 members and met weekly. To fit the environments in which they worked, some VBIs altered the size of groups and made the meetings less frequent.

By clarifying what features all the adaptations held in common, the conference defined a village-banking model (see Table P-2), which is less standardized than the original but still a coherent methodology that retained most of its defining characteristics. Its social mission was unchanged.

Table P-2

Village Banking 1994: Major Changes to the Original Model

Element	Original Model	Major Adaptations by 1994
Group		
Size	30 to 50 members.	10 to 90 members.
Gender	Women only.	Some VBIs include men.
Relation to VBI	Graduation after 3 years.	VBI provides ongoing loans and technical support.
Loan		
Use	Working capital only.	Some places also include agriculture and animal husbandry.
Amount	$50 initially. Increases linked to savings: 20 percent increase per cycle to maximum of $300.	$20 to $200 initially. Maximum of $300 to $1,500. Often delinked from savings.
Interest/fees	Set to cover village bank's expenses.	Set to cover VBI's expenses.
Term	16 weeks.	12 to 36 weeks.
Repayment schedule	Equal weekly installments of principal and interest.	Weekly, biweekly, or monthly installments. Sometimes include only interest with balloon payment of principal.
Savings		
Use	Loans to individuals. Investment in group enterprises.	VBI may require savings to be deposited in a formal bank rather than lent out. Also VBI may offer emergency/consumption loans.
Amount	20 percent of loan size, due weekly.	Minimum amount. Some voluntary savings.
Interest	Accrues to group.	Some individual dividends.
Liquidity	Mandatory; no access.	Some VBIs provide access.
Control	By village bank.	By VBI or VBI and village bank.

Achievements and Challenges by 2000

By the year 2000, village-banking practitioners could boast major achievements in outreach and sustainability. In the six years since the international conference in Guatemala, village banking had grown to reach six times as many clients as in 1994. Leading VBIs reached 10,000 to 20,000 clients; Compartamos in Mexico was serving 50,000. A handful of institutions had also proved that village banking could cover its full costs. These accomplishments were achieved while reaching poorer and more remote clients than most microfinance institutions (MFIs). Yet, village-banking practitioners were not satisfied. They wanted to reach more clients, reach poorer clients, provide higher-quality services, and examine alternative institutional structures.

More Clients

Although the number of village-banking members had grown significantly, practitioners were disappointed in the scale of most VBIs. On average, each institution served only 2,400 clients. Most VBIs seemed to be plodding along. Practitioners wanted to understand why they were reaching fewer clients and how to overcome barriers to growth without compromising their social objectives.

Poorer Clients

According to numerous studies, MFIs were reaching clients who were better off than practitioners had assumed. The bulk of microfinance clients turned out to be only moderately poor or not poor at all, though vulnerable to risks that might push them into poverty. While VBIs seemed to reach deeper than most MFIs, village-banking practitioners wanted to understand how to serve more extremely poor clients.[1]

Higher-quality Services

Uniform loans and mandatory savings met only a small fraction of clients' financial services needs. Village bankers wanted to provide responsive services while maintaining cost-effective deep outreach, which might include the following:

- Providing flexible loan products and terms that better fit income streams and needs of clients;
- Providing voluntary savings, emergency loans, or insurance services to help manage risk; and
- Reaching out to low-income markets besides microentrepreneurs.

More client-driven services would likely broaden the outreach and retention of village-banking institutions and increase the value of services to clients. Innovations, however, would also challenge a VBI's cost recovery, risk management, and delivery systems. Village-banking practitioners wanted to know what services were feasible and how they could be implemented.

[1] Poverty classifications are the subject of significant debate. While this document often uses the terms "extreme poor" and "very poor," they mean different things in different countries, or even for different programs. Perhaps the most common definition is the bottom 50 percent of those persons below the poverty line. This book does not enter into that discussion, but the resource list at the end of Chapter 4 provides suggested readings on the topic.

Institutional Structure

Just as the lending methodology drives growth, outreach to the extreme poor, and the ability to offer a broader range of services, so does the institutional structure. Since a number of alternative institutional models were emerging, practitioners wondered how these alternatives would affect their potential to grow, reach the extreme poor, and offer services valued by this market.

To address these four issues, the Small Enterprise Education and Promotion (SEEP) Network's Poverty Lending Working Group convened the New Directions in Village Banking Consultative Forum in December 2000. Village banking pioneers and microfinance experts from around the globe met to examine current practices, reconsider their objectives, and chart a map for achieving them. This book is the result of their efforts.

VBIs are not alone in their efforts to scale up while offering more responsive services. Any MFI intent on serving the very poor must carefully navigate between controlling costs and customizing services, serving social objectives, and achieving significant scale. In support of this quest, New Directions in Poverty Finance provides practical insights and guidance on how to reach large volumes of the extreme poor with high-quality financial services.

Introduction

At the December 2000 New Directions in Village Banking Consultative Forum and during the year that followed, participants hammered out a set of new directions by which village banking might grow dramatically and provide higher quality services while serving the extreme poor. Although forum participants reaffirmed village banking's social mission, they advocated fundamental changes in the structure, operations, culture, and services of village-banking institutions (VBIs). In the process, they questioned village banking's defining features: self-management; mandatory savings; group guarantees; small, short, and standardized loans; weekly meetings; and the promotional role of outside institutions.

New Directions brings into question every defining feature of village banking.

New Directions in Poverty Finance: Village Banking Revisited documents the conclusions, omissions, and debates that the forum raised. This introduction presents how forum participants redefined village banking as a set of principles rather than as a lending methodology. It describes how the pursuit of the principles creates tradeoffs and introduces strategies for balancing them. Finally, it presents a chapter-by-chapter overview of this book. Because this retooled village banking looks more and more like other poverty-oriented approaches, these **New Directions** will benefit all microfinance institutions that aim to serve the very poor.

What Is Village Banking?

If the features that had defined village banking are no longer vital, then what is village banking? While group-based services remain the starting point, village banking today is too diverse to constitute a single model. Therefore, forum participants defined village banking as providing financial services to improve clients' lives while applying the following five principles:

1. **Deep Outreach.** Village banking reaches the extreme poor, in particular women and the rural poor. At present, microfinance serves primarily the moderate poor and vulnerable non-poor. While not necessarily excluding these groups, village banking aims deeper.

2. **Large Scale.** Village banking serves many people. To achieve larger scale, institutions must think big, such as reaching 100,000 clients. Lacking this vision, m village-banking institutions have not taken the hard decisions to simplify services, professionalize operations, and focus on achieving large scale.

3. **Sustainability.** Village banking provides ongoing services by covering its full costs including adjustments for subsidies and inflation. Covering the costs of administerin small transactions requires rigorous cost control, highly efficient operations, extraordinary productivity, and client and staff retention.

4. **Client Focus.** Village banking provides services that maximize client value at a minimum cost. Instead of prescribing a uniform set of services, VBIs aim to efficient meet clients' needs—this is a major shift in orientation. It requires listening to clients regularly engaging in market research, and delivering voluntary, demand-driven services. Client focus also involves the provision of outstanding customer service by friendly and responsive staff.

5. **Culture of Innovation.** Rather than replicating a fixed methodology, a culture of innovation requires institutions to first consider their objectives and then find the bes ways to pursue them. By instilling a culture of innovation, a VBI can ensure that the entire organization is totally geared toward continuous improvement.

This shift from methodology to principles, summarized in Table I-1, recognizes that management decisions drive success. Because VBIs' starting point has been a fixed methodology, listening to clients and innovating has not come easily. Yet, focusing on clien and innovation will be essential for VBIs that aim to offer more responsive services while scaling up. Just as village banking itself was an innovation that enabled institutions to exten financial services to the poor, VBIs must continue to innovate if they are to better serve mo people.

The new village-banking principles unite village banking with any other microfinance strategy that seeks to maximize impact for the very poor.

These principles raise an obvious question: What makes village-banking institutions different from other microfinance institutions (MFIs) that aspire to provide valued services the very poor on a large and sustainable basis? The answer: Nothing. What is striking about these principles is that they unite village banking with other poverty-focused microfinance strategies.

In fact, many of the lessons and innovations highlighted in this book are drawn from poverty-focused institutions that do not use a village-banking methodology, such as Grameen Bank (GB) and Association for Social Advancement (ASA) in Bangladesh; CARD Bank and Kabilikat para sa Maunlad na Buhay, Incorporated (KMBI) in the Philippines; Small Enterprise Foundation (SEF) in South Africa; and the Uganda Microfinance Union (UMU). Consequently, in this book the term **village-banking institution** refers to any organization that uses microfinance to improve the lives of the very poor, not just to organizations that use the village-banking lending methodology described in the Preface.

Balancing the Tradeoffs

In theory, these principles are admirable; in practice, they pose some significant tradeoffs, as described in the following examples.

Table I-1

Village Banking: Similar Principles, New Directions

Village-banking Principles 2000	How the Principle Is Reflected in Village Banking in 1994	How the Principle Is Reflected in *New Directions*
Deep Outreach	Offered small initial loan size. Required frequent, regular repayment. Provided short loan term. Served clients in groups rather than individually in an office. Delivered services close to homes. Required group guarantee, no collateral.	Restructure incentives and develop an institutional culture to reach extreme poor. Consider active targeting. Consider services and features that may better suit the extreme poor.
Large Scale	Provided simple, standard terms. Served groups rather than individuals.	Adopt a relentless drive toward larger scale. Slash desertion rates. Simplify operations where possible. Choose institutional option based on regulatory environment and institutional maturity/mission.
Sustainability	Required ongoing loans and support from VBI. Set interest rates to cover all costs. Required group to manage many functions.	Enhance client and staff retention. Simplify operations and standardize systems. Consider that institutional choice should maximize benefits from regulatory environment.
Client Focus*	Provided some increased access to savings. Adapted initial loan terms to new environments and needs of more mature clients.	Engage in ongoing market research. Make existing loan services more responsive. Consider adding services to help clients manage risk. Consider not requiring mature clients to attend meetings. Consider impact monitoring.
Culture of Innovation*	Adapted to new environments. Experimented with new institutional forms.	Find the most promising ways to achieve principles rather than applying a set methodology. Develop and adapt services, reengineer operations, and pursue promising new institutional options. Nurture a culture that strives for continuous improvement.

*Unlike the others, these principles were not explicitly embraced as principles during village banking's first 15 years.

Deep Outreach versus Sustainability

Serving the extreme poor or those in remote areas is costly. Reaching the poor implies delivering services near their homes, which requires more staff time and greater internal controls. Furthermore, the extreme poor may need to be actively recruited, exclusively targeted, or offered different or more flexible products. These strategies increase operating

costs. The extreme poor or persons in remote areas may not be able to afford products pr
to cover the associated risks and transaction costs.

Client Focus versus Deep Outreach

Managing a range of customized services can also drive up costs, making it difficult to vi
serve the very poor. In particular, customized services will require field staff with a higher level of skills.

Large Scale versus Client Focus

Scaling up requires a simple retail model and a single-minded focus that might prevent VBIs from providing a menu of flexible services: adding or customizing products can slow growth by diffusing the focus of managers and complicating operations. The severity of th tradeoff may be determined partly by the competitiveness of the market. In monopolistic environments where services are scarce, replicating simple retail outlets may be the key to exponential growth. In competitive environments without vast unserved markets, an MFI may be more compelled to provide a range of customized services.

Sustainability and Large Scale versus Deep Outreach

For many microfinance experts, the most effective way to achieve larger scale and sustainability is to create a regulated financial institution. The resulting ownership and governance structures, and compliance with regulatory requirements, however, may be incompatible with deep outreach. For example, a commercial mission and owners might make it difficult to serve the extreme poor, typically the least profitable clients because of their small credit and savings capacity.

Client Focus versus Large Scale and Sustainability

Some VBIs find that services besides savings and credit are essential to their task. These social mission activities—such as providing training, delivering health services, empowering women, and assessing impact—can detract from an institution's progress toward large scale and sustainability.

Since most of these tradeoffs in one way or another hinder deep outreach, it is not surprising that MFIs in general do not serve the very poor. In fact, these tradeoffs frame the importance of village banking: The main challenge for VBIs is to balance the commitment to improving the lives of the poor with the pursuit of larger scale, client focus, and sustainability. Innovation is essential to meeting this challenge. Based on the experiences of poverty-focused institutions, this book presents several strategies for balancing tradeoffs, including pursuing partnerships and linkages, reengineering operations, managing human resources, harnessing commitment, integrating market research, and developing and delivering the right products.

Pursuing Partnership and Linkages

Village-banking institutions cannot provide all services that clients need or demand. To overcome this challenge, some VBIs are partnering with other institutions that have specialized expertise, enabling each partner to do what it does best. For example:

- To offer **voluntary savings services,** some VBIs partner with formal financial institutions. The VBI markets the product while the partner employs a mobile agent to collect the deposits (see Chapter 7).
- Some VBIs provide access to critical **health services** by linking with local health care facilities (see Chapter 9).
- Other VBIs provide **insurance** by serving as a sales and marketing agent for an insurance company (see Chapter 8).

VBIs have even developed partnerships that reduce operating costs and accelerate growth. Chapter 2 describes VBIs that have set aside direct service delivery in favor of **grafting** their group-based services onto existing partner institutions, such as credit union networks or rural banks. Clients benefit from the range of complementary financial services offered by the partner institution, and the partner benefits by expanding its market.

Reengineering Operations

In pursuit of large scale, sustainability, or deeper outreach, some institutions reanalyze their entire operations to see how they might accomplish the following:

- Simplify branch operations to be low-cost, standardized, and decentralized;
- Reorganize staffing and supervision to achieve profitability; and
- Revamp their services to reach poorer clients, respond better to client demand, and reduce client desertion.

They also examine the back office infrastructure to support growth. As illustrated in Chapter 2, reengineering requires a commitment to challenge assumptions and embrace improvement.

Managing Human Resources

Effective management of human resources is probably the single most important means for an institution to achieve its goals. Because staff are the motor of the organization, particularly in a service industry such as microfinance, recruiting the right personnel is critical. Staff training is not just a means to convey nuts and bolts information about job responsibilities; it must also communicate the institution's goals and mission, and indoctrinate employees into the institution's culture. Finally, VBIs must use financial as well as non-financial incentives to retain staff and to motivate them to maximize productivity. Chapter 3 highlights how a VBI can carefully consider each of these human resource functions to achieve its full potential.

Harnessing Commitment

The institutional culture of village-banking institutions is a powerful tool that can help VBIs reach their objectives, including steady growth, high productivity, and deep outreach. Institutional culture is the set of values, attitudes, and practices pervasive in an organization. If wielded effectively by management, the commitment to improving the lives of the poor

can be an incredibly motivating factor for carefully selected employees. Chapter 3 presents variety of ways that institutions can harness a culture of commitment.

Integrating Market Research

Market research enables an institution to adjust its products to better respond to clients' demands. By helping a VBI attract and retain clients, market research can also contribute to growth and sustainability. Simple low-cost tools can yield significant improvements in product design and service delivery (see Chapter 4).

Developing and Delivering the Right Products

A VBI needs more than a single, standardized credit product to advance its mission. Yet, offering a long product menu will probably impede an institution from reaching large scale and sustainability. Furthermore, if sustainability is highly valued, then product changes that increase costs can make it difficult to reach the very poor. Choices are essential. VBIs should offer a set of client-responsive services that, together, maximize client value while being simple and profitable enough to be taken to large scale. These products should be manageable by profitable retail units and senior managers whose primary focus is scaling up. And they should provide the greatest value to the extreme poor.

What are these services? From the client side, market research will reveal what services best meet their demands. To limit mission drift, VBIs will want to focus on products and flexible features that are particularly attractive and relevant for poorer market segments without excluding higher-income clients (see Chapter 4). From the VBI side, managers should recognize that some services will demand more from their institutions than others. Table I-2 assesses the management demands of the product options discussed in Chapters 6 through 9

Table I-2
Management Demands of Different Types of Services

Management Demands	Low	Moderate to High	High and High Risk
	If operations and management information systems are designed well, these services can be relatively easy to manage after the initial investment in new systems.	These services will require staff to have different or additional skills and will divert management resources from a single-minded focus on growth and efficiency.	These should be considered completely new businesses.
Type of Service	• Credit life insurance • Most adjustments to group loan product • Emergency loans • Active recruitment of extreme poor	• Non-financial services • Addition of individual loan product • Replacement of mandatory savings with mandatory-voluntary hybrid for borrowers • Insurance products offered with a partner insurance company	• Insurance, other than credit life, that is not offered through a partner • Savings services for non-borrowers

A sound product development process will consider the capacity of the institution alongside the demand of the client (see Chapter 5). Throughout that process, managers should question: Can my institution offer this new service, manage rapid growth, and still improve the lives of the very poor?

Overview

This book explores the new directions charted by the December 2000 forum, summarized in Box I-1, beginning in Chapter 1 with perhaps the most fundamental choice practitioners must make: What type of institution can best serve their mission? This first chapter considers the capacity of formal, semiformal, and informal organizations to meet village-banking principles.

Chapter 2 tackles a second critical question: What will it take to increase the scale of a sustainable poverty finance institution from, for example, 10,000 to 100,000 clients? The chapter examines four keys to growth: (1) adopting a relentless institution-wide drive toward larger scale, (2) reengineering operations, (3) developing the capacity of the back office to support aggressive growth, and (4) adopting fast-growth strategies.

Village-banking institutions have many tools that can help them achieve large scale as well as their other objectives. Chapter 3 discusses how VBIs might use two of the tools: (1) institutional culture and (2) human resource management. It presents possible elements of an institutional culture and describes ways that a VBI might turn the preferred values, attitudes, and behaviors into institutional habits. It also suggests methods for managing human resources that might promote staff loyalty and maximize productivity, while providing valued services to the very poor.

In Chapter 4, the focus shifts from the institution to the customer. It examines how VBIs might go about answering three questions: (1) Are we serving who we want to serve? (2) Are customers benefiting from our services? (3) What can we do to serve clients better? Whether VBIs should target the poor and whether they should assess impact are the subjects of heated debates. Although the chapter presents these debates and suggests that reaching the very poor may require **active targeting**, it does not advocate universal answers. On the other hand, it makes a strong case for why all poverty finance institutions should routinely use research techniques to learn about their market.

The second half of the book focuses on product options that might better meet customer demand. Chapter 5 presents keys to successfully developing new products, and in so doing, introduces the next four chapters, which explore options for making group loans more responsive and for developing an individual loan product (Chapter 6), offering voluntary savings services (Chapter 7), providing microinsurance, ideally in partnership with an insurance company (Chapter 8), and linking non-financial services with financial services (Chapter 9).

The length of this book may discourage some microfinance managers from reading it from cover to cover. Since VBIs probably should not try to make major changes to all aspects of their organization at once, however, they can use ***New Directions*** as an equally valuable reference manual.

Box I-1

New Directions Summarized

Institutional Choice. Institutional choice will depend on several environmental factors, suc as regulation and competition, as well as on the organization's priorities for balancing th tradeoffs inherent in the village-banking principles. Formalization seems to have an edg over semiformal and informal options, but it is not appropriate in all environments or for a organizations.

Large Scale. Serve 100,000 or more persons per institution. Adopt a relentless drive towar large scale. Reengineer operations to lower costs and increase productivity, and conside the following:

- Simplify retail operations to be low-cost, standardized, and decentralized;
- Drastically reduce dropout rates;
- Develop the capacity of the back office to support aggressive growth; and
- Adopt fast-growth strategies, such as grafting.

Institutional Culture. Because a VBI's culture is such a valuable tool, it cannot be left to chance. Conceptualize, guide, and nurture a culture that supports the institution in achieving its mission.

Human Resource Management. Build a solid institution with well-trained personnel who are committed to the mission; align personal and institutional incentives.

Depth of Outreach. Restructure incentives and develop an institutional culture to reach poor clients. Consider **active targeting**, identifying and recruiting the extreme poor.

Impact Assessment. Consider **impact monitoring**, the routine collection of selected client data, to verify whether objectives are being met.

Market Orientation. Integrate market research into the normal course of activities and use that information to influence product design.

Product Development. Better meet the demand of clients by making existing products more flexible or otherwise more responsive to client demand. In particular, consider clients' need to manage risk. New products may include the following:

- ***Loans.*** Redesign the loan product to be more attractive to extreme poor clients. Consider adding a new loan product to retain more mature clients and an emergency loan product for vulnerable clients. Consider dropping group meetings for frequent and individual borrowers.
- ***Savings.*** Offer voluntary savings services for members. Consider developing savings services for non-members, if possible, by partnering with a regulated financial institution.
- ***Insurance.*** If there is a demand for insurance, consider offering insurance services by partnering with an insurance company.

Non-financial Services. Consider partnering with a non-financial institution or incorporating informal education into group meetings if (1) this service responds to clients' needs, (2) it fulfills the institutional mission, (3) it is financially viable, and (4) comparable services are not already available.

1

Institutional Options

Microfinance traditionally has been provided by local or international nongovernmental organizations (NGOs). In the past decade, new players have become interested in providing microfinance, and innovative institutional structures have emerged, some of which use the village-banking methodology and target poorer segments of the market.[1] Institutional structures used to deliver village banking include the following:

- **Finance company.** Compartamos, a village-banking NGO in Mexico, established a regulated financial institution.
- **New product line for credit unions.** Freedom from Hunger provides technical assistance for credit unions and banks to offer village banking as a distinct loan product.
- **Linkages with the formal sector.** MEDNET, a credit NGO in Uganda, has an agreement with the postal bank to manage disbursements, repayments, and client savings.
- **Promoter.** The Women's Empowerment Project (WEP) helps to create self-managed village banks in Nepal based primarily on savings mobilization rather than on lending.
- **Owner and technical assistance provider.** Catholic Relief Services (CRS) has established an Indonesian finance company that invests in rural banks, while CRS provides them with training on how to offer a village-banking product.

A credit NGO is just one vehicle for delivering financial services to the poor. Other institutional options merit serious consideration.

Clearly, a **new direction** is the possibility of employing different vehicles to deliver microfinance to the poor, but which option makes the most sense? Using the principles presented in the Introduction (and summarized in Box 1-1) as the assessment criteria, this chapter examines the strengths and weaknesses of different institutional options.

[1] Judith Painter and Didier Thys drafted the content of this chapter.

Box 1-1

The Five Village-banking Principles

1. **Deep Outreach.** Village banking aims to improve the lives of the extreme poor, althoug institutions may not necessarily serve that market exclusively.
2. **Large Scale.** To make a major impact in the fight against poverty, village banking strive to serve large numbers of people.
3. **Sustainability.** Village banking must cover its full costs, including adjustments for subsi- dies and inflation, so that institutions can serve their clients over the long term.
4. **Client Focus.** Village banking maximizes customer value, at a minimum cost, by of- fering outstanding customer service, listening to clients, and providing demand-driven services.
5. **Culture of Innovation.** Village banking requires innovation as village banking institutions continuously strive to provide better services to more people—and to poorer people— more efficiently.

1.1 Institutional Typology

Given the tradeoffs posed by the principles as described in the Introduction, village-bankin practitioners must decide how to prioritize the principles as they pursue their mission within their specific operating conditions. Perhaps their biggest choice is what institutional type th will employ to provide village-banking services.

There are three types of microfinance organizations: formal, semiformal, and informal (see Table 1-1). The primary distinction between them is the degree to which they are overseen by external organizations. Formal organizations are regulated by governments, semiformal are authorized by governments but are monitored by boards of directors, and informal organizations typically are not recognized by government bodies and are monitored only by their members.

Table 1-1

Institutional Types

Formal	Semiformal	Informal
• Commercial banks	• Credit NGOs	• Village banks
• Finance companies	• Multiservice NGOs	• Self-help groups
• Regulated credit unions	• Unregulated credit unions	• ROSCAs and tontines
• Regulated rural banks	• Unregulated rural banks	
• Upgraded MFIs*		

*The term upgraded MFIs refers to credit NGOs that have transformed into banks or finance companies. Beginning in 1992 with BancoSol in Bolivia, the transformation of NGOs into regulated financial institutions has become a significant trend—there are at least 20 regulated MFIs (microfinance institutions) around the world that began as NGOs.

Over the past decade, village banking has proliferated in the **semiformal** sector among credit NGOs, which make up the bulk of village banking institutions (VBIs). Some NGOs specialize in microfinance, while others offer multiple social and financial services.

For many years, Grameen Bank was the only **formal** sector provider of group-based finance services for the poor. Today, an increasing number of formal financial institutions—finance companies, credit unions, and rural banks—have joined the ranks. Compartamos transformed from an NGO into a finance company devoted almost entirely to village banking. With technical assistance from international NGOs, some rural banks and credit unions have integrated village banking into their operations as a product line. In Indonesia, Catholic Relief Services has developed a finance company that invests in rural banks and a training unit to help these banks integrate village banking as one of their products.

The village-banking model evolved from promoting self-managed village banks to providing financial services to village banks

While some VBIs are formalizing, a few organizations have taken village banking back to its **informal** roots. In the original village-banking model described in the Preface, semiformal institutions helped the poor create their own informal community-owned and community-managed financial associations. By the mid-1990s, this model of **promoting** village banks evolved into microcredit NGOs **providing** financial services to the village bank. A number of institutions, however, particularly in South Asia, are now demonstrating the potential of informal, savings-led models.

The following sections examine these three institutional categories—formal, semiformal, and informal—in light of the village-banking principles.

1.2 Formal Institutions

Formal institutions offer two clear advantages for providing financial services to the poor. First, a formal institution can finance its loan portfolio with commercial equity, loans, or deposits. These funding sources are prerequisites for large-scale growth. Institutions considering formal options should be aware, however, that although formalization is necessary to attract commercial funds, formalization alone is not sufficient—investors' requirements can be more demanding than those of donors. Second, to meet regulatory requirements, institutions typically upgrade their staff and systems so that the institution has the capacity to offer multiple products. Indeed, one of the primary motivations for formalization is to become licensed to offer voluntary savings services, which may be in greater demand than microcredit.

Formalization has an equally clear and significant disadvantage: It can inhibit outreach to the extreme poor. Deep outreach can suffer as owners look for more profitable results and diversify the product mix to attract a better-off population. In some countries, regulatory frameworks prevent the formalization of village-banking services due to requirements about providing services from fixed locations and having set hours of operations and because of extensive reporting demands.[2] Furthermore, meeting regulations can impose costs that can reduce the viability of small transactions. Organizations should formalize only after they have reached and maintained financial sustainability.

Formalization can have other disadvantages as well. Minimum capital requirements for creating a regulated financial institution may be excessively high. Submitting to regulation may stifle innovation in products and systems, especially where regulations are founded on a formulaic understanding of microfinance best practices. If regulations cap interest rates, formal status can actual hinder sustainability. Regulation can also result in higher prices to clients if an institution passes on the additional costs of required systems, reporting, and

[2] In countries where credit bureau participation includes unregulated financial NGOs, the value of village banking institutions' participation is questionable since lending is to village banks rather than to individuals.

staff. This investment may or may not pay off in terms of better and longer-lasting servic[e.]
As the experience of Compartamos conveys (Box 1-2), transforming from a semiformal t[o]
formal institution involves tangible tradeoffs, which are summarized in Table 1-2.

Box 1-2

Transforming from Semiformal to Formal: Compartamos, Mexico

Compartamos, the world's largest village-banking institution, converted to a formal financ[e] company in January 2001. The organization chose this institutional option because it want[ed] to reach one million clients, thus requiring heavier inflows of equity and commercial loan[s] than it could access as an NGO. Compartamos ruled out creating a credit union becaus[e] of the unwieldy governance structure and the poor reputation that credit unions have [in] Mexico. Given the fairly high penetration of commercial banks that were not offering cred[it] to low-income clients but did accept savings, Compartamos did not feel compelled to offe[r] separate savings services.

While conversion to a financiera has paid valuable dividends in terms of access to funding, Compartamos is now under closer scrutiny regarding its high costs and interest rates. Historically, Compartamos has charged as much as 6 percent a month for its loans; however, the VBI is now working hard to lower costs and rates.

The table below evaluates Compartamos against the village-banking principles. Overall it rates well with the exception of client focus. Compartamos has found that offering one simple product, and simplifying systems around that product, has been key to its success. It has avoided diversifying its product range to maintain focus, although it has recently started to experiment with individual and solidarity group loans. Compartamos uses strong relationships with clients to promote repeat business, which has mitigated the effects of a limited product menu. Deep outreach has suffered somewhat because Compartamos' methodology depends on the proximity of bank branches, and therefore it operates more in periurban centers than in rural areas. But because Mexico is a middle-income country, Compartamos' loans are extremely small relative to gross domestic product (GDP) per capita (less than 5 percent).

The Mexican environment provides Compartamos with two distinct advantages: (1) little to no competition, thus allowing it to charge high prices; and (2) a developed banking infrastructure that has facilitated rapid outreach. Compartamos did not to attempt to formalize until it had reached financial sustainability.

Compartamos and the Village-banking Principles

Deep Outreach	Large Scale	Sustainability	Client Focus	Culture of Innovation
Good. Focuses mainly on periurban centers and not the rural poor; average loan size ($205) in relationship to GDP per capita is one of the lowest in the world.	**Excellent.** More than 70,000 clients and growing rapidly.	**Good.** Broke even in 1996 and continues to operate with high sustainability rates, but needs to improve efficiency.	**Fair.** Despite high interest rates, clients flock to Compartamos, partly because of its customer service orientation. Market research is integrated into operations.	**Excellent.** Creative marketing techniques have helped gain and retain clients; experimenting with new loan products and information technology to enhance efficiency.

Table 1-2

Advantages and Disadvantages of Regulated VBIs

Advantages	Disadvantages
Sustainability. The owners of formal financial institutions tend to be driven by profits. They create incentives to increase efficiencies and lower costs.	**Sustainability.** Interest rate ceilings can inhibit sustainability; minimum capital requirements may be excessive.
Client Focus. Regulated status is often a prerequisite for offering voluntary savings services that tend to be highly valued by clients.	**Client Focus.** Formal requirements may increase costs to clients if regulations demand more systems, staff time, reserves, or taxes.
Large Scale. Formal institutions have greater potential to access commercial equity or loans and to mobilize savings needed to finance large-scale growth in the portfolio.	**Deep Outreach.** Higher costs and a wider range of services may limit deep outreach. If the financial institution has for-profit owners, they too may steer it up-market.
	Culture of Innovation. Innovation of products may be curtailed by ill-conceived regulations that restrict products and delivery systems.

Alternative Formalization Strategies

When practitioners think about formalization, they usually consider transforming into a formal institution. Innovative VBIs, however, are now experimenting with other options for formalization that are less costly and, in some cases, quicker. These alternatives involve collaborating with existing formal financial institutions instead of creating new ones.

A promising model is emerging in Africa where poverty-focused microfinance institutions (MFIs) are linking with the postal system. African postal offices offer an established network of outlets that often double as savings banks. Because working with the postal system does not require an NGO to hire additional staff, it is a relatively low-cost delivery method. The Small Enterprise Foundation (SEF) in South Africa's Northern Province has undertaken this strategy with good results. MEDNET, a World Vision affiliate in Uganda, is also negotiating an agreement that would enable the post offices to disburse as well collect funds. While both SEF and MEDNET are semiformal credit NGOs, by partnering with formal financial institutions, they may achieve groundbreaking results in terms of deep, sustainable outreach in hard-to-reach rural areas.

Recent partnering between credit NGOs and postal banks may prove to be a groundbreaking means for achieving deep, sustainable outreach.

Another promising approach to formalization is to graft village banking onto credit unions. Credit unions are uniquely suited to offer village-banking services. Their member-oriented mission often includes social welfare goals that are in line with village banking. They also have a long history of member education that predisposes them to group lending. This approach is discussed in more detail in Chapter 2.

1.3 Semiformal Institutions

Semiformal institutions have several advantages in fulfilling the village-banking principles (see Table 1-3). They have more freedom to innovate and to focus on clients than do formal institutions, which may explain why semiformal institutions have generated most microfinance innovations. Credit NGOs, the most common form of semiformal institution, often receive subsidies that enable them to focus on reaching the very poor.

Table 1-3

Advantages and Disadvantages of Semiformal VBIs

Advantages	Disadvantages
Depth of Outreach. Semiformal institutions can focus on serving poorer markets since profit maximization is less of a concern.	**Large Scale.** Without access to commercia[l] equity or loans, capital may be insufficient t[o] serve significant numbers.
Client Focus. These VBIs are able to change policies to favor clients without government interference.	**Client Focus.** Semiformal VBIs usually do not have the legal status to offer savings accounts.
Sustainability. Donations can occasionally be a more stable source of income than operating revenues.	**Sustainability.** The principle of sustainabil[ity] can be threatened because—
Innovation. Often highly innovative; semiformal VBIs are not constrained by regulations and have access to funds and technical assistance for experimentation.	• The VBI may not be transparent and the board may not provide sufficient oversigh[t] • Organizational stability is usually linked to [a] few key staff. • Subsidies can be unreliable and often require burdensome reporting requiremen[ts]

Semiformal institutions, however, also have well-recognized drawbacks. Large scale can be sorely restricted by a lack of access to savings deposits or commercial funds. Semiformal institutions typically lack the legal authority to provide a range of products, especially savings. Finally, a lack of strong, reliable, and profit-oriented governance can result in weak accountability and can undermine a drive for large scale, efficiency, and high productivity.

Should We Formalize?

Formalizing can both enhance and hinder an institution's ability to pursue its mission. An NGO should weigh the decision in light of its regulatory environment and priorities.

The microfinance industry is pressuring credit NGOs to create regulated financial institutions; but for NGOs, the decision is not clear cut. Semiformal institutions, in examining how formalization might affect their ability to operate, should consider the following questions regarding village-banking principles:

- **Depth of Outreach.** Will the costs of regulatory compliance make it prohibitively expensive to serve the very poor? Will regulations make it difficult to deliver services when and where the extreme poor can take advantage of them?
- **Large Scale.** Will the organization be able to reach large numbers of low-income persons without becoming a regulated financial institution?
- **Sustainability.** Will formalization inhibit the organization's ability to charge appropriate interest rates? Alternatively, does the organization want to continue to acce[ss] donor resources for research and development or to deepen outreach? How reliable will future donor funding be?
- **Client Focus.** Will formalization enable the institution to increase the value it provides to customers through a wider product menu or more secure services? Will meeting regulations drive up prices due to costly systems and more expensive personnel?
- **Culture of Innovation.** To what extent would regulations limit the institution's ability to innovate?

Village-banking institutions should not make the selection of an institutional option in a vacuum. VBIs operating in countries with poorly developed regulatory frameworks, or ones that would work against a microfinance institution, may do better to maintain a semiformal status if they have adequate financial oversight on operations. Major conflicts between traditional regulatory requirements and microfinance include the following:

- Usury laws that limit the interest rate on loans;
- Minimum capital requirements that are excessive, given the small size of the loans and the portfolio;
- Restrictions on branch locations and operating hours;
- Risk-weighting requirements that do not take into account collateral substitutes such as peer group guarantees;
- Provisioning requirements that are inappropriate for short loan terms;
- Prudential norms that are not designed for the cost structure of microfinance; and
- Burdensome loan documentation requirements that undermine efficiency.

When analyzing an institutional option, the VBI also needs to consider the **degree of supervision** it would be subjected to if it formalized. Even non-prudential oversight, where regulators do not vouch for the financial soundness of the institution, will entail new reporting requirements. Full-fledged prudential oversight requires an institution to comply with external accounting practices and performance standards, and subjects it to severe scrutiny to monitor compliance with prudential norms. Furthermore, if bank supervisors do not understand the specific risks and operating conditions of microfinance, they are likely to employ traditional supervision techniques that are inappropriate for microfinance.

Formalization is not for everyone. Pro Mujer in Bolivia, for example, operates in a microfinance-friendly regulatory context, yet it has chosen to remain an NGO rather than to create a regulated financial institution. Pro Mujer is committed to an integrated approach to service delivery, combining village banking with business skills training, human development training, and basic health care (see Chapter 9). It believes that a formal structure, which requires an external board and owners, could undermine its commitment to a double bottom line—to social as well as financial objectives. To overcome key limitations of its semiformal status, Pro Mujer plans to partner with commercial banks to offer savings accounts to its clients, and it has put in place many of the prudential oversights normally required of a formal entity.

Poverty finance practitioners will also want to consider the **institutional landscape.** The type and strength of existing institutions will be a key determinant of what institutional option to pursue. For example, a network of reasonably strong credit unions, a postal savings system, or a set of rural banks may offer the opportunity to cost-effectively piggyback services for the poor onto an existing structure. Alternatively, a competitive formal microfinance environment might create a strategic advantage for a semiformal organization. For example, another reason Pro Mujer chose to remain an NGO is that a number of finance companies and banks are already serving the micro market, so its nonprofit status may give it a marketing edge.

1.4 Informal Institutions

There are two types of informal institutions: indigenous groups and those promoted by external organizations. Indigenous groups, such as rotating savings and credit associations (ROSCAs), are organized and overseen by their members. In contrast, self-help groups, village banks, and financial services associations (FSAs) are informal institutions that were promoted by external organizations, but which may not need to be supported indefinitely. This analysis is concerned with the second type—externally promoted village banks rather than indigenous ones. What are the implications of encouraging village banks to function as autonomous financial institutions? How well do externally promoted informal institutions fulfill the village-banking principles?

The promotion of informal institutions has tremendous potential for larger scale. Because the promoting agency does not lend to the village banks, this approach bypasses the costs, time, and technical capacity required to build an MFI that manages financial services. By delivering training through existing, local NGOs, this approach can quickly reach many clients. On the other hand, its scale is constrained by the availability of donations because the model does not generate revenues to cover the promotion costs.

Although informal strategies have tremendous potential for scale, two questions remain: How can they be sustainable and can groups without significant education offer more than very limited services?

The main challenge with the informal institutional option is long-term sustainability. The life span of informal groups promoted as village banks is still undetermined. Groups are often vulnerable to fraud and mismanagement, and they may not endure after the promoting agency has withdrawn. In fact, indigenous informal groups tend to come and go according to the needs of members. The original village-banking model evolved away from autonomous banks, in part because of the high rate of dissolution of "graduated banks." The difference between the original village-banking model and the new generation of promotion is that the latter are savings-led banks (see Box 1-3) or equity-based banks (see Box 1-4).

Savings-led or equity-based groups that are truly member owned are probably stronger than credit-led groups. Because they are mobilizing their own funds for on-lending, they are more concerned about loan repayment than they might be if the funds came from an external source. Without the injection of external capital, however, the loan portfolio will be constrained. In addition, their reliance on local funds to capitalize the loan portfolio creates covariant risk—if a number of members experience a common emergency, they may need to access their savings at the same time and cause a liquidity crisis.

Another drawback of the informal model is that autonomous village banks may not be able to provide members with significant value. The range and quality of services are limited by the bank's management capacity. Except where groups hire a bookkeeper or manager, savings is largely illiquid. On the other hand, members do not have to pay high interest rates to outsiders to receive these services. All revenues return to their group. Furthermore, community-managed institutions can have a social value beyond their utility as a delivery system for savings services. Nevertheless, research suggests that the poor generally prefer to pay for a convenient, flexible savings or loan service rather than manage it themselves.

As with the other models, the success of promoting informal institutions depends partly on the context. Because of their low cost structure, autonomous village banks have the potential to achieve deep outreach, and in fact may be the only means of extending financial services to remote areas.

Box 1-3

Savings-led Groups:
Women's Empowerment Project, Nepal

The Women's Empowerment Project (WEP) in Nepal, a partner of Pact, illustrates the potential of informal institutions. The $5 million project was funded from 1998 to 2001. During this period, WEP trained more than 240 local NGOs that served 120,000 savers, including more than 45,000 borrowers. Between 1999 and 2001, these informal groups mobilized $1.2 million in savings and retained earnings. The project included a literacy curriculum (by the end of the project, 82 percent of the group leaders could maintain their bank's books) and empowerment training, which led some groups to initiate social campaigns.

Each WEP group collects, manages, and lends its own savings. It receives no outside capital. The local NGOs provide groups with free training and technical support to run their village banks. WEP, in turn, provides the NGOs with training and accounting systems that are passed onto the village banks; it has no direct dealing with the groups. Since neither the NGOs nor WEP are burdened with providing financial services, they can quickly reach large numbers of clients. WEP's scale is also attributed to the Nepali setting: The plains of the terai have many competent NGOs that were already working with large numbers of savings groups, the population is relatively dense, and access to roads is good.

WEP did not aim to target the very poor. A survey determined that 45 percent of WEP members are poor, 35 percent are vulnerable non-poor, and 25 percent are better off. While WEP has reached underserved communities, few clients are considered extremely poor.

The group's long-term sustainability is a looming concern for WEP. A recent study over an eight-month period showed a repayment rate of 88 percent and a dropout rate of about 8 percent. During the same period, 5.4 percent of the groups either disbanded or no longer reported activity. Because the village banks are new, their sustainability is hard to assess; however, because WEP has run out of grant funds, no long-term strategy for oversight and expansion is in place. Nonetheless, existing groups have created more than 800 new groups with no financial support from WEP (spontaneous replication), with the number of new groups created exceeding the number of groups disbanded.

It is also unclear how well WEP's approach meets members' demand for financial services. Largely because a group's loan capital is limited to its own savings, less than 40 percent of members are borrowers. A member's access to her savings also tends to be quite limited.

WEP and the Village-banking Principles

Deep Outreach	Large Scale	Sustainability	Client Focus	Culture of Innovation
Fair. Reaches a range of income levels. The percentage of very poor borrowers is unclear.	**High.** 120,000 savers, including 45,000 borrowers. Many were already organized into groups before the program's initiation.	**Unclear.** The institutional sustainability of the village banks is untested. The sustainability of the support institution and its NGO partners depends on grant funds, which have run out. Existing groups, however, are constantly forming new groups.	**Fair.** Loan product is customized but is limited to the group's savings. Access to savings is severely restricted. Monthly meetings are required but many groups choose to meet more frequently.	**Fair.** Groups are encouraged to envision and take on new initiatives. Local group leaders promote other groups and member-led social campaigns.

Box 1-4

Financial Services Associations

Operating primarily in sub-Saharan Africa and promoted by external agencies, financial services associations resemble the original village-banking model without the external account. The model emphasizes shares, however, rather than savings. Investors/members understand from the outset that their shares are accessible once a year, when they can be sold at market price.

Only shareholders can use the FSA's services. Loans are adapted to the local environment. In Uganda, for example, the term typically ranges from three to six months, repayments are monthly, the average loan size is $50, and the way loans are used is flexible. Because FSAs are locally owned and operated, the loan approval process tends to be quick (less than one week). All shareholders must open savings accounts; while there is no limit to deposits, there is usually a 3 percent service charge for withdrawals. Deposits are not normally used for lending and, if possible, are maintained in a local bank.

The FSA share lending approach differs from village banking's internal account in several ways. First, services are primarily geared for the upper poor and middle poor. The very poor are not excluded ($5 consumption loans have been made) but are not expected to be the majority. FSAs are promoted as a business or money shop with little other social objective, although the model may be one of the few means of extending financial services to remote areas. Second, the FSA requires oversight and supervision and is not expected to operate on a stand-alone basis after a period of initial training. The owners (shareholders) hire a local manager to run the FSA and, in Uganda, are beginning to pay a third party for regulatory and supervision services. Finally, because shares are equity risk capital, they are not subject to the same prudential rules as deposits. The price of these shares goes up or down depending on the FSA's financial performance.

In Uganda, FSA development began in 1997. Seven FSAs now operate in the Masaka district (two hours from Kampala), and as of July 2000, 2,646 shareholders have borrowed $80,904 in loans and accumulated $155,242 in savings. The FSA experienced heavy arrears of up to 25 percent in July 2000, which prompted it to look into more formal methods of requiring repayment and to introduce more rigorous loan approval procedures, instead of relying solely on group knowledge and pressure.

Adapted from Jazayeri (2000)

FSAs Uganda and the Village-banking Principles

Deep Outreach	Large Scale	Sustainability	Client Focus	Culture of Innovation
Fair. Primarily reach upper and middle poor. May be a means to reach remote areas.	**Good.** Between 1994 and 2000, 160 FSAs in 8 countries grew to include 50,000 shareholders.	**Untested.** The FSAs themselves are financially viable but require ongoing external support and supervision. Within five years, an FSA might be able to pay for this external support through fees.	**Good.** Loan product is customized. Shares are accessible annually. Savings services are in low demand. Members own all returns.	**Good Potential.** Depends on initiative of individual FSA.

Table 1-4

Advantages and Disadvantages of Informal Institutions

Advantages	Disadvantages
Depth. Generally these groups reach women, some of whom may not be comfortable interacting with more formal institutions; may be the only method for reaching some remote areas.	**Sustainability.** Donor support is required for promoting and training groups; without ongoing external support, group longevity often is limited; groups are vulnerable to covariant risks.
Large Scale. Promoting village banks or self-help groups through existing local NGOs can achieve significant scale with relatively little overhead costs.	**Client Focus.** Flexibility and range of products may be severely limited by organizational capacity.
Innovation. Free of regulation and an MFI superstructure, groups can experiment with varied systems and approaches.	**Large Scale.** The amount of group savings limits the number of borrowers; each group's unique systems and standards for portfolio and savings management complicate attempts to link them into a larger system that could achieve efficiencies.
Client Focus. Interest income remains with the group; products can be adapted to members' needs if groups have sufficient management capacity.	

1.5 Conclusion

This chapter does not promote a particular institutional option. It presents the advantages and disadvantages of each, and then allows readers to determine which option makes the most sense for their organization, given its mission and operating environment. Most importantly, by illustrating the diversity of institutions that deliver village-banking services, this chapter may inspire village bankers to innovate and test new institutional options.

Relative to the village-banking principles, the formal model rates well in terms of scale and sustainability, but may have difficulty reaching the very poor. Informal institutions may have potential for serving remote markets, but typically can only provide limited services and require self-financing support structures if they are to be sustainable. The semiformal model falls somewhere in between the two, with its strength tending toward innovation.

Resources

The following resources provide additional information about institutional options.

Ashe, Jeffrey and Lisa Parrott. 2001. *Pact's Women's Empowerment Program in Nepal: A Savings and Literacy Led Alternative to Financial Institution Building.* Washington, DC: U.S. Agency for International Development (USAID), Assessing the Impact of Microenterprise Services (AIMS). www.mip.org

Campion, Anita and Victoria White. 1999. "Institutional Metamorphosis: Transformation of Microfinance NGOs into Regulated Financial Institutions." *MicroFinance Network Occasional Paper No. 4.* Washington, DC: MicroFinance Network. www.bellanet.org/partners/mfn

Christen, Robert Peck and Richard Rosenberg. 2000. "The Rush to Regulate: Legal Frameworks for Microfinance." *CGAP Occasional Paper No. 4* (March). Washington, DC: Consultative Group to Assist the Poorest. www.cgap.org

Hattel, Kelly and Sahra S. Halpern. 2002. *Challenges to Microfinance Commercialization*. Washington, DC MicroFinance Network and ACCION International. www.bellanet.org/partners/mfn or www.accion.org

McDonald, Jennifer. 1999. "Compartamos." *MicroBanking Bulletin*, no. 3 (July): 13–16. Washington, DC The MicroBanking Standards Project. www.microbanking-mbb.org

Stack, Kathleen and Didier Thys. 2000. "A Business Model for Going Down Market: Combining Village Banking and Credit Unions." *MicroBanking Bulletin*, no. 5 (September): 9–12. Washington, DC: The MicroBanking Standards Project. www.microbanking-mbb.org

2

Scale and Sustainability

Village banking can achieve financial sustainability while serving poor customers. Woller (2000) shows that village-banking institutions (VBIs) can achieve similar levels of sustainability as solidarity groups and individual lenders. His analysis of nine leading VBIs revealed that six were operationally self-sufficient and six had a financial self-sufficiency ratio above 90 percent. The financial performance of these VBIs is impressive considering that their average outstanding loan balance was less than $100 (see Table 2-1).

This chapter is not just about sustainability, however; it is also about scale. And on the measure of scale, VBIs have not shown impressive accomplishments.[1] As of 1999, 250 VBIs in 40 countries served 600,000 borrowers, a 650 percent increase since 1994 (Painter, McNelly, and SEEP 1999). On average though, each institution had just 2,400 clients. The data in Table 2-1 attest to this gap in scale between VBIs and organizations using other lending methodologies. Granted, village banking is a younger lending methodology; but what other reasons would explain why VBIs are so much smaller than institutions using solidarity group and individual lending methodologies?

Scale is important because it embodies village banking's social goal to reach large numbers of low-income persons. Achieving sustainability is only the beginning. Any small, well-run retail outlet can cover its costs in a relatively short time. For a VBI to achieve scale, however, retail outlets must generate sufficient revenues to fuel growth. Moreover, expanding and multiplying these outlets necessitates a strong and efficient superstructure.

VBIs succeed financially, in part, because they are willing to price for viability. In fact, village banking may have the highest interest rates in the industry. VBIs charge high rates to cover the costs of mobile services with income from tiny loans. Although productive, as measured by the number of borrowers per staff, their administrative costs are high relative to their average outstanding portfolio.[2] As competition increases, maintaining high interest rates to cover these costs will become difficult; VBIs must innovate to improve their efficiency.

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[1] Kathleen Stack drafted the content of this chapter.

[2] The number of borrowers per staff member at VBIs was 190, compared to 121 for solidarity group lenders and 96 for individual lenders. Relative to average loan portfolio, however, administrative costs were 49 percent for VBIs, 46 percent for solidarity group lenders, and just 21 percent for individual lenders (Woller 2000).

Table 2-1

Scale and Sustainability: Nine Village-banking Institutions Compared to *MicroBanking Bulletin* Participants by Credit Lending Methodology[a]

	Country	Number of Borrowers	Loan Portfolio ($US)	Average Loan Balance ($US)	Operational Self-sufficiency	Financi[illegible] Self-sufficien[illegible]
Lending Methodology						
Individual	—	57,255	23,852,221	1,341	121.8	[illegible]
Solidarity Group	—	45,171	8,137,669	222	92.6	[illegible]
Village Bank	—	13,879	1,672,098	109	103.4	[illegible]
Nine VBIs	—	17,938	1,842,203	94	113.3	[illegible]
AGAPE[b]	Colombia	4,887	359,546	80	110.7	[illegible]
Compartamos	Mexico	48,835	6,338,738	129	170.1	[illegible]
FINCA[c]	Kyrgyzstan	9,944	845,898	85	118.0	[illegible]
FINCA	Nicaragua	13,701	1,008,709	74	122.3	[illegible]
FINCA	Uganda	20,769	1,245,815	60	94.8	[illegible]
CRECER[d]	Bolivia	14,580	2,419,393	166	95.7	[illegible]
Kafo Jiginew (VB product)[e]	Mali	11,119	574,274	52	72.2	[illegible]
Pro Mujer	Bolivia	18,919	2,197,372	116	110.1	[illegible]
World Relief	Honduras	18,691	1,590,086	85	125.8	[illegible]

Source: Woller (2000)

[a] Each of these nine institutions waived its confidentiality agreement with the *MicroBanking Bulletin* to allow its da[illegible] to be published. The values for the nine VBIs are based on 1999 numbers, with the exception of FINCA Kyrgyzsta[illegible] which is based on 1998 data. The lending methodology data comes from Tables A and B in the September 2000 issue of the *MicroBanking Bulletin*.

[b] Asociación General para Asesorar Pequeñas Empresas. AGAPE is an affiliate of Opportunity International.

[c] The Foundation for International Community Assistance.

[d] Crédito con Educación Rural. CRECER is an affiliate of Freedom from Hunger.

This chapter tries to answer one question: What will it take to increase the scale of sustainable village-banking institutions from 10,000 clients to 30,000, 50,000, or even 100,000? To answer this question, the chapter sections discuss the following four key challenges:

1. Organizational mission and vision;
2. The service delivery model;
3. Growth strategies; and
4. Superstructure requirements for growth.

Each section describes a ***New Direction*** for village banking and then provides recommendations for pursuing that direction. While individual directions may not be new, their collective sum represents an important shift in outlook and approach for village banking.

2.1 Organizational Mission and Vision

New Direction *Embracing a mission that alleviates poverty while achieving a maximum return on investments; pursuing a vision to serve at least 100,000 poor people per institution.*

Large microfinance institutions (MFIs) have a relentless drive toward large scale that permeates their culture. Successful poverty lending organizations, such as the Association for Social Advancement (ASA) in Bangladesh, Compartamos in Mexico, and CARD Bank in the Philippines, have one important thing in common: the desire to achieve immense scale. According to Carlos Danel, the Co-Executive Director of Compartamos, "We had a clear intent from the start that we wanted to be massive."

These organizations defined their lending methodology, developed their systems, and made management decisions with a focus on achieving large scale. This effort includes a stubborn persistence to develop a methodology that is extremely simple. To achieve large scale, institutions must also think big. When developing a procedure, a VBI needs to look beyond its current circumstances and consider whether the proposed procedure will still make sense when the VBI has ten times as many customers.

The achievement of significant scale requires a commitment to thinking big, a persistent simplification of systems and procedures, and a resistance to diversification.

VBIs differ from many microfinance institutions because they provide financial services to achieve impacts of poverty alleviation, empowerment, and social change. Their mission is to sustain the flow of these social benefits to as many poor people as possible. Village bankers insist on achieving large scale and self-sufficiency in a manner that does not compromise their social goals (see Box 2-1).

> **Box 2-1**
>
> **Balancing the Scale and Sustainability of the Clients and the VBI**
>
> Since founding FINCA in 1984, I have been engaged in village banking for almost 18 years. But the longer I remain in this business, the less certain I am about how it should be conducted. I now see more questions than answers, more issues than solutions. Village banking was created to reach the poorest; yet I see large numbers of the poorest families being left behind. Within the context of mission drift, the topic of scale and sustainability raises a dust cloud of ambiguity.
>
> Whose sustainability are we talking about—the VBI's or its clients'? If it is the VBI, should we focus on its operating budget or its mission? If not both, why is one more important than the other? If we are talking about client sustainability, should we focus on her repayment performance or her capacity to keep her children in school? If not both, which is more important?
>
> What is being taken to scale, and in what direction? If it is the VBI, should we focus on growing the number of clients and the loan portfolio or shrinking client turnover and operating costs? If it is the scale of the client, should we focus on growing her sales, skills and self-confidence or shrinking her business risks and barriers to health care?
>
> Such questions suggest the following bottom line: improvements in scale and sustainability are relevant only in the context of the VBI's mission and measurable improvement in client well-being. If a VBI achieves scale and sustainability, is this a victory if its clients' welfare fails to improve or cannot be reliably measured? If scale and sustainability are achievable only at the cost of leaving behind those clients in greatest need, is this a victory? I don't think so.
>
> *John Hatch, Founder, FINCA International*

2.2 Seeking Efficiency: The Service Delivery Model

New Direction

Developing a service delivery model that is simple and decentralized and implementing supervision systems and procedures that promote maximum productivity, loan repayment, and client and staff retention.

The management options for guiding a village-banking institution to financial sustainabil are limited. VBIs can charge higher interest rates, or they can become more efficient. But interest rates are already high, competition is increasing, and the capacity and willingness of the poorest to pay high interest rates have limits (see Box 2-2). The focus must be on efficiency.

Up to a point, perhaps five or ten thousand clients, growth itself can enhance efficiency through greater economies of scale. After that point, however, efficiency is best enhanced through a reengineering process to determine how VBIs can lower costs and increase productivity. This section addresses three aspects of village-banking operations from which might be possible to squeeze additional efficiencies: (1) branch operations, (2) staff retentio and (3) client retention.

Branch Operations: The Building Blocks of Large, Sustainable VBIs

Besides offering simple products, ASA, CARD, and Compartamos have something else in common: a standardized delivery model. These institutions demonstrate the importance of organizing staffing, supervision, and operational procedures into simple, profitable

Box 2-2

Pricing for Sustainability When Microfinance Becomes Competitive

In an increasing number of countries, microfinance has grown to the point where MFIs are competing for customers. When this happens, the challenge of reaching poorer clients sustainedly gets more complicated.

Smaller loans involve higher administrative costs per dollar lent, which means the smallest loans will be the least profitable IF all clients pay the same effective interest rate. If it charges uniform rates, any MFI squeezed by competition will face an inexorable pressure toward larger transactions in order to survive; if it cross-subsidizes its smaller customers, the competition can take the big ones away by charging them a lower interest rate that does not carry the burden of a subsidy to the other customers. On the other hand, if the MFI charges a flat amount on each transaction, regardless of its size, to cover administrative costs, plus a percentage interest rate related to the cost of funds, the conflict between transaction size and profitability would disappear. This pricing structure is approximated—but only approximated—by tiered interest rates based on loan size. (A similar analysis could be applied to deposit rates as well.)

MFIs have been surprisingly slow to experiment with differential pricing. But once a market becomes genuinely competitive, such pricing can be an essential tool if the industry is serious about achieving deeper outreach and preventing mission drift.

Hiking interest rates is not the solution to all problems; most MFIs also need to improve efficiency. In addition, there is a limit to how much interest a client can pay and still benefit from the loan. But there's strong evidence that few MFIs are operating near that limit.

Richard Rosenberg, CGAP

retail units that can be easily replicated. As ASA's Managing Director, Shafiqual Haque Choudhury, says, "If you understand one branch, you understand the whole thing."

Table 2-2 summarizes the performance of four efficient retail outlet structures. Characteristics of these successful models include the following:

- Small retail units enable close management. Supervisor-to-loan officer ratio is approximately 1:5 to permit supervisors to monitor the work of loan officers, help solve problems, and provide feedback on performance.
- Service delivery units are located close to the clients to ensure loan officers can achieve high productivity ratios. Staff-to-borrower ratios are high, averaging 1:280.
- Interest rates are set to include the operating costs of the superstructure and expansion.[3]
- Portfolio at risk is less than 2 percent.
- Achievement of financial self-sufficiency of the branch occurs within 12 to 18 months.
- Policies and procedures for all operations are simple and well documented.

The proximity of staff to clients reaps important benefits in customer service, low transportation costs, efficient time management, and tight employee supervision.

Table 2-2

Four Retail Models: Outlet Performance

	FINCA (Central America)	ASA (Bangladesh)	Compartamos (Mexico)	CUES Credit Unions (Philippines)*
	Methodology			
	Village Banking	Individual Services through Groups	Village Banking	Village Banking (Credit with Education)
Number of branch managers	1	1	1	-
Number of coordinators	3	-	2	1
Number of loan officers	14	4	10	5
Number of other staff members	-	1	1	-
Number of village banks or groups	175	72	100	70
Number of borrowers	4,000	1440	2,200	2,185
Number of borrowers per loan officer	285	360	220	437
Outstanding portfolio (US$)	300,000	90,000	300,000	68,922
Outstanding loan/borrower (US$)	75	63	204	64
Operational costs (US$)	96,000	6,960	164,667	13,127
Financial income (US$)	108,000		300,000	12,556
Portfolio at risk (> 30 days) (%)	1.8	0.9	1.0	0
Time period to operational self-sufficiency (months)	18	9	12	18
Time period to financial self-sufficiency (months)	24	12	18	20
Operating cost ratio (%)	32	7.8	54	34
Yield (%)	36	25	100	32

* Figures refer to village-banking product only but include the cost of credit union overhead.

[3] In the case of Credit Union Empowerment and Strengthening (CUES) credit unions (in Table 2-2), there is no superstructure. The 11 credit unions receive technical assistance and training from a local technical support office operated by the World Council of Credit Unions (WOCCU).

- Orientation and training for staff are systematized and brief (5 to15 days); much training takes place on the job using an apprentice approach.
- The management information system (MIS) in the field is simple so loan officers do not have to learn sophisticated skills; a manual MIS avoids the costs associated with hardware purchase and maintenance.
- Decision-making is decentralized, avoiding bottlenecks that can occur when decisions depend on a distant manager.

Efficiency requires a clear and **simple lending methodology**. Compartamos' methodology involves four one-day sessions to train groups, 16-week loan terms, weekly repayments, and the same meeting agenda every week. There are no exceptions; there is no ambiguity. When Compartamos tried longer loan terms, repayments suffered and borrowers asked to return to a 16-week cycle. To maximize productivity, loan officers are assigned **geographic zones** within which they are expected to manage a target number of groups—not too many for adequate attention or too few for financial viability.

For efficiency, VBIs need to minimize the costs of field operations. They can rent branch offices and keep them small, with a minimum amount of furniture and supplies to support staff. They can keep transportation costs low where public transportation is available. If they need motorbikes, the VBI should have clear policies for managing their costs and repairs, including backup options so loan officers can be productive when their bikes are being serviced. ASA provides its staff with interest-free loans to buy their own bicycles.

Many village banking organizations, including Compartamos, have discovered the **internal account** to be costly and risky to manage. Either they do not encourage the development of an internal account or they leave the management of these funds entirely to the group (see Box 2-3).

Staff Retention

Salaries and benefits make up well over half of total administrative costs. Staff turnover raises these costs because of the expenses associated with recruiting and training new employees. Furthermore, replacing seasoned loan officers, who successfully managed large volumes of clients, with inexperienced employees decreases a VBI's productivity. Since the personal relationship between a field agent and her borrowers is an important aspect of the lending methodology, repayments and client retention can suffer when loan officers leave. Consequently, strategies to retain good-quality staff can make an enormous contribution to increasing efficiencies.

The demands and expectations a VBI places on its field staff often are not matched by the training, support, and compensation that they receive.

Too often the message from VBIs to their field staff is to work harder and longer so the institution can become sustainable. As a result, staff work for the viability of the institution; but the VBI overlooks the importance of supporting these most valuable personnel who are the institution's sales force and its face to the customer. The resulting pressure can lead to high turnover and unnecessary costs. To improve efficiency is to maintain dedicated, hard-working, and satisfied employees. A more detailed discussion of strategies for recruiting, training, and motivating staff appears in Chapter 3.

Client Retention

The original village-banking methodology assumed that members would increase loan amounts as their income-generating activities turned into viable businesses. In practice, many

Box 2-3
Scale, Sustainability, and Self-management

Self-management has been at the heart of village-banking operations. Village bank members assess each other's creditworthiness, disburse and collect loans, follow up on delinquency, collect and lend out savings (the internal account), and record all transactions (see Preface for a description of the village-banking model). According to some practitioners, village banking's greatest impact has been empowering women to manage their own financial institutions. Yet self-management can both advance and hinder village-banking objectives.

Self-management can be a key to covering costs when serving remote markets. Promoting groups rather than serving individuals can slash operating costs. Furthermore, depending less on staff is critical when operating in sparsely populated areas.

Yet, while self-management cuts some costs, it imposes others. When village banks begin, and for some time thereafter, they require intensive training and supervision from field staff. For this initial period, staffing costs are higher for self-managed groups than they might be for groups to which financial services are simply delivered. Even after this period, many VBIs find it more cost-effective for their staff to keep the books themselves than to assist groups with bookkeeping when the members have little education for handling the task.

Particularly costly is the staff support required to help groups manage and invest their own savings. The group's freedom to invest their internal account is arguably the most flexible and empowering feature of the village-banking model. Yet with this flexibility comes more complex record keeping and a higher risk of mismanagement. It is expensive to help village banks manage records and risks, yet the group's savings produces no revenues for the VBI, and the internal account may even cut into revenues by reducing the village bank's need for external loans.

Self-management tends to limit the flexibility of the VBI's products. Flexible services generally entail managing more risk and keeping more complex records. The skills needed to manage more flexible services may be beyond the capabilities of village bank members. Therefore, VBIs have to consider the tradeoffs between complete self-management and providing more flexible services.

Self-management may impede growth. Village-banking staff must be skilled in delivering financial and non-financial services. Staff recruiting and training is more complex when loan officers must know how to lend as well as train groups and facilitate their problem-solving. Yet efficient recruitment and staff training are critical to rapidly scaling up. For this reason, some analysts blame self-management for VBIs' relatively slow growth.

How can VBIs harness self-management to serve its objectives? As they contemplate new directions, village-banking managers should carefully consider why they promote self-management: To empower clients? To catalyze mutual support? To cut costs? Or to reach remote areas? They might then examine the different functions that groups might manage in light of these objectives. For example—

- If VBIs aim to empower clients, what functions must clients manage to create this impact? Must the group keep its own records? Or is managing savings the key to empowerment?
- If their aim is to cut costs, what management functions are cost-effectively delegated to groups? Do some functions cost more in training and supervision than they yield in benefits?
- If training nearly independent village banks is the only viable option for serving a remote area, VBIs may need to accept that this strategy necessitates simple, standardized services.

VBIs have experienced small or no increases in average loan size, partly because of high dropout rates.[4] A 1999 study of seven village-banking programs found that only 35 percent of first-cycle borrowers were still active by the end of year three (Painter, MkNelly, and SEEP 1999). At Compartamos, by the 11th loan, on average only 4 of the original 20 members remain.

It is time for VBIs to drastically cut dropout rates by using exit interviews and other market research techniques to understand the root causes.

These dropout rates are alarming because sustainability depends partly on loan portfolio growth. Long-term clients with larger loans provide a more efficient way to reach sustainability than does relying on the smaller loans of new borrowers who are expensive because of acquisition and training costs. If a VBI is constantly replacing lost clients, it will be severely hampered in its efforts to achieve larger scale.

VBIs have recognized attrition as a problem but are still figuring out strategies to combat it. Although some desertion is expected because VBIs serve a vulnerable market, client satisfaction with the product and services can have an important effect. Satisfaction embraces both what is being offered and how is it offered. Besides considering adjustments to the basic loan product (see Chapter 6), VBIs should look at ways to improve the quality of their **customer service**, such as approving loans quickly, arriving at meetings on time, ensuring that meetings do not last too long, and performing with courtesy and accuracy.

Perhaps most importantly, VBIs need to recognize that many people do not like being in perpetual debt or may not need to borrow year round. This realization requires a change in thinking about desertion and innovations to avoid penalizing clients who may want to borrow periodically rather than consecutively. As discussed later (see Chapter 7), if VBIs can offer voluntary savings products, they will be able to maintain relationships with clients who choose not to borrow all the time.

2.3 Seeking Larger Scale: Alternative Growth Strategies

New Direction *Thinking innovatively about how alternative growth strategies can affect the cost, speed, and efficiency of growing village-banking programs to scale.*

Two institutional approaches to developing and sustaining village banks are **creation** and **grafting**. The creation approach, which is the most common, involves establishing an institution for which the sole or primary product is village banking. The grafting approach integrates village banking as a product line into an existing financial institution, such as a credit union or rural bank (see Box 2-4). Whether creating MFIs or grafting the village-banking product onto existing institutions, the following three growth strategies are applicable:

- **Branch-by-branch establishment.** This linear growth strategy establishes one branch at a time. When a branch reaches self-sufficiency, a new branch is established. After a number of branches become viable, two new branches may be opened at once.
- **Multiple branch replication.** With this exponential growth strategy, multiple new branches are added at the same time. (See Table 2-3.)

[4] Other reasons that loan size increases have not met expectations include unrealistic predictions regarding business growth and the reality that many loans are not invested in the business.

Box 2-4
Grafting in the Philippines: World Council of Credit Unions and Freedom from Hunger's Credit with Education

In late 1996, Freedom from Hunger began working with the World Council of Credit Unions (WOCCU) to introduce Credit with Education, an integrated village-banking product, to financial cooperatives in the Philippines. Their aims were to—

- Increase loan volume through improved lending systems and loan products;
- Control rising delinquency through improved selection and collection; and
- Increase profitability for cooperatives and their members.

Freedom from Hunger made the first Savings and Credit with Education (SCWE) loans, as they were known in the Philippines, in August 1998. By the first quarter of 2000, the program had grown from four cooperatives and fewer than 2,000 clients to eight cooperatives and more than 13,000 clients. By that time, for six of the eight cooperatives, the product line was operationally self-sufficient. At the end of 1999, SCWE accounted for 33 percent of the cooperatives' total clients and 8 percent of their outstanding portfolio.

Village banking's high portfolio quality was key to interesting the cooperatives in offering the product. As WOCCU pushed managers to confront the poor quality of their loan portfolios and the heavy costs of provisioning for bad debt, the product's portfolio at risk of zero percent became attractive. Furthermore, cooperatives could promote the product to a new market that was not tainted by the institutions' previous loan practices. This repayment performance led the first four cooperatives to expand their support for SCWE and brought in a second batch of cooperatives intrigued by low delinquency rates.

Deep Outreach	Large Scale	Sustainability	Client Focus	Culture of Innovation
Good. Deep outreach among cooperatives improved with grafting VB product.	**Good.** Possible to achieve scale faster because of existing infrastructure, but is still under 20,000 clients.	**Fair.** Grafting enabled somewhat faster self-sufficiency for a village banking product.	**Excellent.** Cooperatives were offering up to 7 loan products.	**Good.** Example of using new approaches to address institutional problems.

Adapted from Stack and Thys (2000)

- **Amoeba division.** With this grow-and-divide strategy, branches grow until they become too large and divide into smaller units. The rate of growth falls somewhere between branch-by-branch establishment and multiple branch replication.

Table 2-4 models the results of four different growth strategies. All four models assume a tested methodology, ready systems, and the same staff structures and costs.[5] The models differ as follows:

[5] The staff structure, costs, and loan size assumptions are as follows: The central office has a national director or product manager, trainer, car, and driver. Central office personnel are added in relation to the number of branches and borrowers or, in the grafting model, the number of new field staff. A regional structure with a trainer, car, and driver is added when there are four branch offices; it serves up to seven branches. Branches are staffed by a branch manager, 3 coordinators, and 15 loan officers. One loan officer serves 400 borrowers. The average loan size of new borrowers is \$50 and increases by \$10 per year. The amoeba strategy is not modeled because it falls somewhere between the branch-by-branch establishment and multiple branch replication strategies.

Table 2-3

Multiple Branch Replication: Growth at Compartamos

	Loan Portfolio (US$)	Portfolio Growth (%)	Borrowers (#)	Borrowers Growth (%)	Financial Self-sufficiency	Portfolio at Risk (> 30 days)	Operating Efficiency	Cos pe Clie (US
1995	552,008	—	17,500	—	NA	NA	NA	[illegible]
1996	1,457,679	164	26,716	53	78	NA	68.8	[illegible]
1997	2,146,764	47	32,254	21	117	6.6	61.5	[illegible]
1998	2,879,518	34	43,401	35	122	3.4	74.1	[illegible]
1999	6,338,738	120	48,835	13	144	.75	62.6	[illegible]
2000	10,339,319	63	64,141	31	171	.58	58.0	[illegible]

Source: MicroBanking Bulletin, *with Compartamos' permission*

- In the **multiple replication model**, two branches are established the first year, four the second and third years, and eight the fourth year and fifth years.
- In contrast, the **branch-by-branch model** establishes one branch the first year and adds a single branch each year thereafter.
- The **creation model** assumes a six-month lag between when an office is initiated and when it can organize new village banks. The model assumes that all staff are new hires.
- The **grafting model** assumes that some central office operational managers already exist. There is no six-month lag because there is no need to establish new offices.

Multiple Replication vs. Branch-by-branch Growth Strategies

Compared with the branch-by-branch establishment strategy, the multiple branch replication strategy requires a greater financial investment early on and yields much greater outreach. With a creation approach, modeling suggests that multiple replication requires more than four times the investment than does branch-by-branch establishment; with a grafting strategy, multiple replication is 50 percent more expensive. When grafting and multiple replication are combined, however, by Year 2 the cost per client is lower than that of other strategies by Year 5. The payoff for the additional investment in multiple replication is the significant difference in the number of clients reached over time.

The multiple branch replication strategy assumes that the institution has the capacity to train and mobilize large numbers of new staff at once, and that its back office operations can handle spikes of increased transactions. The sequential approach of the branch-by-branch establishment strategy is less taxing on management.

Grafting versus Creation

Compared to the creation strategy, the grafting strategy demonstrates much lower costs, higher self-sufficiency, and more rapid growth. Grafting is less costly for the following reasons:

- It does not require establishing a new institution from the ground up, and
- Cost savings result from an institution's ability to spread out the costs of operations—everything from personnel activities to purchases—over multiple cost centers and lower costs for product operation through marginal economies of scale.

Table 2-4
Models of Growth Strategies

Creation—Multiple Replication Growth Strategy					
	Year 1	Year 2	Year 3	Year 4	Year 5
Clients	1,000	6,500	23,000	49,000	82,000
Investment costs	165,762	549,931	1,000,799	1,263,960	1,373,631
Cost per client	162	100	63	51	48
Financial self-sufficiency	0	.19	.37	.57	.71

Grafting—Multiple Replication Growth Strategy					
	Year 1	Year 2	Year 3	Year 4	Year 5
Clients	3,000	21,000	45,000	78,000	102,000
Investment costs	171,867	289,748	205,902	0	0
Cost per client	53.54	28.9	26.63	25.5	20.35
Financial self-sufficiency	0.59	0.87	1.05	1.20	1.20

Creation—Branch-by-branch Growth Strategy					
	Year 1	Year 2	Year 3	Year 4	Year 5
Clients	1,000	4,000	10,000	16,000	22,000
Investment costs	121,292	201,293	295,706	211,834	115,447
Cost per client	118	67	51	41	39
Financial self-sufficiency	0	0.30	0.49	0.74	0.89

Grafting—Branch-by-branch Growth Strategy					
	Year 1	Year 2	Year 3	Year 4	Year 5
Clients	3,000	9,000	15,000	21,000	27,000
Investment costs	137,866	163,953	122,342	1,855	0
Cost per client	42.21	35.47	32.01	29.34	28.37
Financial self-sufficiency	0	0.56	0.80	1.00	1.15

Freedom from Hunger has found it much less expensive to graft village banking onto financial cooperatives than to create new MFIs or work with existing ones. It spent US$6.4 million in grants and technical assistance to enable two specialized MFIs in Bolivia and Uganda to reach 30,000 women—or US$211 per client. In comparison, it spent only US$700,000 to enable two credit federations in Mali to reach 36,000 women—or US$20 per client. The cooperatives also reached those clients in half the time, with greater financial self-sufficiency, than did the MFIs (Stack and Thys 2000).

If grafting enables village banking to reach more people, more quickly, and more cost-effectively, then why is this approach not more common? First, it is new. Second, it requires an appropriate financial or retail infrastructure in which management is interested in breaking into a new market and clientele. Management must be convinced that the village-banking product can add value and profits. Third, grafting gives a VBI much less control than establishing a new institution in which it may invest, participate on the board, and directly affiliate.

Grafting a poverty loan product onto an existing financial institution is a promising new strategy for increasing scale.

Grafting requires strategic planning and negotiation with an entity that has its own mission, culture, values, quality standards, and systems of accountability. Client satisfaction, and

Table 2-5
Advantages and Disadvantages of Grafting

Advantages	Disadvantages
Institutional development is— • Speedier, which allows for faster initial growth. • Less expensive: The institution is likely to have an existing branch structure and systems for administration, financial management, and internal control.	It may be difficult to find a strong institution that is willing to go down market. The institution may— • Not be committed to the market or product • Be reluctant to allocate loan funds to poor clients.
Important elements of an MFI may already exist: • Loan capital from deposits, private investment, or debt financing; • Other financial services, such as savings that will support evolving needs of clients; • Stable governance structure; • Professional and social networks; and • Reputation among potential clients.	Lack of control over operations: The institution may not wish to modify MIS, staffing, and supervision. It may be difficult to innovate.

therefore growth potential, depends entirely on the quality of delivery by an institution the VBI does not control. For grafting to work, the VBI must convince the financial institution to change aspects of its staff recruitment, supervision, and training. The advantages and disadvantages of grafting are summarized in Table 2-5.

To dramatically increase the scale of village banking operations, further innovations are required. In addition to grafting with cooperatives, village-banking practitioners should consider alternative partners, such as rural banks, postal services, and even lottery outlets. Indeed, any organization that has the infrastructure to manage financial transactions could be a possible candidate.

2.4 Superstructure Requirements To Support Growth

New Direction *Developing the back office capacity to support growth, including training, middle management, MIS, business planning, and access to sufficient capital.*

Big thinking, efficient field operations, and aggressive growth strategies need to be supported by a superstructure that can provide inputs to enable expansion. This section reviews some critical head office functions and the role of the head office in going to scale.

Staffing and Training

Achieving significant scale requires hiring and training an enormous number of personnel, especially field staff. To process volumes of new staff, a VBI must have excellent communication between the operations and human resource departments. Three to four

months before new loan officers are needed, the operations department will inform the human resource department where staff will be required, enabling that department to recruit, interview, screen, and train personnel in time. It is especially important for the human resource department to adopt a systematic approach to staff training and to employ a strong team of trainers. Excellent human resource management is a cornerstone of the drive for scale. Chapter 3 presents additional information regarding recruitment, training, and motivation.

Middle Management

A major obstacle to growth is the availability of capable and affordable middle managers. Without a ready pool of experienced managers, many VBIs promote from within—but an excellent loan officer is not necessarily an effective manager. Often people are promoted to a management position without sufficient training. If a VBI is serious about achieving significant scale, then it has to develop its expertise in management training so it can create a strong cadre of middle managers.

Management Information Systems

An effective MIS is critical for managing large programs. As one village banking practitioner said, "MIS is the oven in the bakery"; without it, operations would cease. Information must be gathered and consolidated fast enough for management to make decisions. Until a program reaches approximately 20,000 clients, off-the-shelf software, such as an Excel®-based loan tracking system, can be adequate. Beyond 20,000 clients, external technical experts are needed to install more sophisticated commercial-quality systems. MIS development is never finished. The initial systems should be flexible enough to build in new requirements to accommodate growth and new products. MFIs often find that installing a new MIS takes two to three times the cost and time than estimated. Senior management should be involved in this process; it cannot be relegated only to the computer analysts.

Software is just one aspect of a management information system. To facilitate growth, VBIs need to simplify and streamline their paper work. If more than three people review a form, then there may be inefficiencies. If senior managers find themselves **blind signing** a stack

> **A Note on Personal Digital Assistants (PDAs).** PDAs, such as the Palm PilotTM, have not proven effective for village banking in rural areas for several reasons: (1) The information required by loan officers cannot be easily connected—hot synched—to the main system because of distance and the volume of data. (2) There is a high cost for using and managing battery supply. (3) Battery failure engenders a high risk of losing vital information. In summary, administration of palm pilot systems is complex, time consuming, and expensive. The technology does show greater promise, however, with individual lending methodologies, by processing key data and assisting loan officers in making credit decisions. They also have worked well in some urban village-banking programs.

of documents and scratching their names on the forms without looking at the content, that indicates the organization should undertake a thorough review of its documentation flow. This type of analysis, a paper trail audit, and bookkeeping simplification need to take growth into account—would each procedure still make sense if the VBI is processing five or ten times as many disbursements and repayments?

Planning

Significant growth requires significant preparation. VBIs intent on scaling up need to have detailed and credible business plans so they are not caught off guard by a sudden surge in capital requirements, and to ensure that new staff arrive in the field just as existing staff reach capacity. Business plans based on projections from the field provide the most realistic data because field staff can use local knowledge and an understanding of past performance to make their projections. Such plans also make it easier to hold staff accountable for reaching targets if they are the ones who made the projections.

A business plan does not do anyone any good if it sits on the shelf and collects dust; it needs to be part of a VBI's operation. The relevant parts of the plan need to be in the hands of every person responsible for achieving targets. The business plan should generate monthly or quarterly work plans that management reviews regularly, which ensures that the business plan is a working document that guides and propels the organization forward. Over time, the plan's initial projections should be updated with actual numbers to help managers adjust their plans and budgets accordingly.

Financing

Loan funds are essential for growth, but may be hard to find. While VBIs are committed to a business paradigm, including market orientation, efficiency, and cost recovery, not all VBIs intend to become commercial institutions and attract purely commercial capital. Most often, to borrow from local banks, organizations obtain guarantees in the form of standby letters of credit. VBIs may also want to experiment with other options, such as the following:

- Venture philanthropy that focuses on innovation and the social return on investment;
- Community debt or equity financing, concessionary loans that seek modest financial returns and assume social impact; and
- Socially responsible investment funds aiming for market rates of return while minimizing negative social impacts.

2.5 Conclusion: Moving Forward

Now that several village-banking institutions have demonstrated that it is possible to serve poor segments of the market sustainedly, VBIs have two new challenges: (1) to increase efficiency in order to become sustainable while charging lower interest rates; and (2) to grow exponentially in order to serve large volumes of low-income people. To address these important challenges, this chapter recommends the following:

- Define a vision for reaching 30,000, 50,000, or even 100,000 clients.
- Develop a standardized, highly cost-effective, and productive branch office structure and superstructure required to support retail operations.
- Slash client desertion rates through market research, product innovations, and improved customer service.
- Appreciate the central role of field staff; develop strategies to reduce staff turnover.
- Recognize that getting to "break even" is a way station" on the road to sustainability, not the end of the road.
- Develop and implement a strategy for increasing client loyalty.

- Consider adopting innovative faster-growth strategies.
- Develop new financing strategies to include venture philanthropists and social investors, as well as commercial sources of funds.

Resources

The following resources provide additional information about scale and sustainability.

Brand, Monica and Julie Gerschick. 2000. *Maximizing Efficiency: The Path to Enhanced Outreach and Sustainability.* Washington, DC: ACCION International. www.accion.org

Churchill, Craig F. 1997. "Managing Growth: The Organizational Architecture of Microfinance Institutions." *Management Tools for Microfinance, Review Paper 1.* Bethesda, MD: U.S. Agency for International Development (USAID), Microenterprise Best Practices (MBP) Project. www.mip.org

Gonzalez-Vega, Claudio et al. 1997. "The Challenge of Growth for Micro-finance Institutions: The BancoSol Experience" summarized by Greg Chen. *CGAP Focus Note No. 6 (March).* Washington, DC: The Consultative Group to Assist the Poorest (CGAP). www.cgap.org

Healey, Kurt. 1998. *ASA Experience in Action: A Guide to Microfinance Management.* Dhaka, Bangladesh: Association for Social Advancement.

Rhyne, Elisabeth and Linda S. Rotblatt. 1994. *What Makes Them Tick? Exploring the Anatomy of Major Microenterprise Institutions.* Washington, DC: ACCION International. www.accion.org

Stack, Kathleen and Didier Thys. 2000. "A Business Model for Going Down Market: Combining Village Banking and Credit Unions." *MicroBanking Bulletin*, no. 5 (September): 9–12. Washington, DC: The MicroBanking Standards Project. www.microbanking-mbb.org

Steege, Jean. 1998. "The Rise and Fall of Corposol: Lessons Learned from the Challenges of Managing Growth." *Management Tools for Microfinance, Case Study 1.* Bethesda, MD: U.S. Agency for International Development (USAID), Microenterprise Best Practices (MBP) Project. www.mip.org

3

Organizational Development

Village banking aims to achieve what many thought impossible: to provide sustainable financial services to the very poor. If this were easy, then banks would have been doing it for years. To meet this challenge, village-banking institutions (VBIs) wield two critical organizational development tools—institutional culture and human resource management—that enable them to create a pleasant working environment, encourage prodigious productivity levels, enhance customer and staff retention, and keep a lid on salaries.

This chapter explores these two aspects of organizational development and provides recommendations for VBIs to use the tools advantageously. The first section introduces the concept of an institutional culture and provides examples of how VBIs use their mission and values to influence it. The second section describes some cultural aspects that VBIs might find useful, and the third section discusses ways that VBIs can operationalize their culture, to bring it to life and continuously reinforce it. The final section summarizes key aspects of human resource management as they pertain to village banking, including recruiting, training, and rewarding staff.[1]

3.1 Culture Begins with Mission and Values

Institutional culture is a set of values, attitudes, and behaviors that is shared consistently throughout an organization—across departments and functions, up and down the hierarchy. It is imbedded in the VBI's policies and practices, in its systems and structures, and in the unwritten rules that guide the behavior of employees. Institutional culture is evident in the way staff, management, and governing bodies interact with each other, and how they represent themselves to the outside world, particularly to their clients.

If an institutional culture is to be a constructive force in helping VBIs achieve their social mission, it must be conceptualized, guided, and nurtured.

All organizations have a culture, but they do not necessarily have constructive cultures. If VBIs adopt a *laissez-faire* approach to their institutional culture, they are likely to find

[1] Craig Churchill and Beth Porter drafted the content of this chapter.

it evolve into an obstructive or even demoralizing force. An effective culture must be conceptualized, guided, and nurtured. Effective cultures require staff and managers to actively define what values, attitudes, and behaviors they want to prevail and how to imbue that culture in all facets of organization (see Box 3-1).

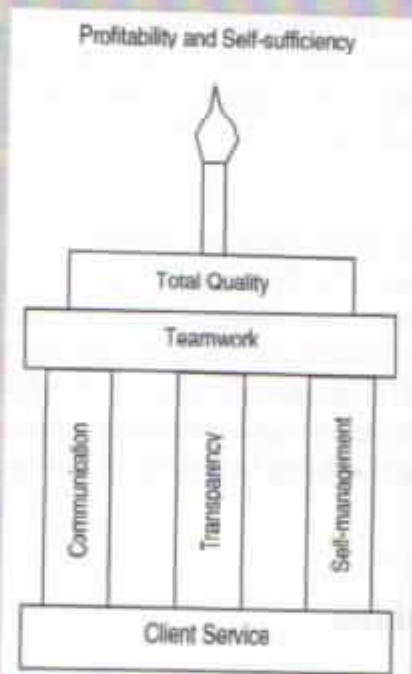
The first step toward proactively shaping the culture is to articulate the institution's mission and values. With broad brushstrokes, the mission and values serve as the conceptual framework for the institution's culture.

For VBIs, sustainability or profitability is a means to an end, not an end in itself. The desired "end" for village bankers is poverty alleviation, reduction of malnutrition, enhanced participation of women, or other social goals. This social mission shapes the institutional culture of VBIs.

Box 3-1

Baking a Cake: The Institutional Culture of Prodem

Prodem, a Bolivian microfinance institution (MFI), actively designs and propagates its institutional culture. Although the organization had been designing and redesigning its culture since before it started lending, in 1993 the human resource department assembled a diagram of the culture for new staff training. The visual rendition became known as the "torta" or cake.



The cake identifies all the major elements of the institution's culture. The first layer represents dedication to client service. Everything that the organization does depends on its ability to serve three types of clients: (1) the external client (the borrowers), (2) the internal client (one's colleagues), and (3) the personal client (oneself).

Three pillars stand on the foundation of **client service.** The pillar of **communication** represents the importance of sharing information, giving and receiving feedback, questioning and listening, and doing that in a way that treats others with respect. The pillar of **transparency** symbolizes the attitude of openness and honesty needed to build trust and be accountable to clients. The pillar of **self-management** characterizes Prodem's belief in the ability of staff members to complete their own tasks to the best of their ability, using their own initiative, skills, and creativity.

The three pillars support the second layer of the cake, **teamwork.** This layer makes it possible for members of the institution to work together toward a common objective, not by completing all tasks together, but rather, by having each person do his or her part to move the institution in the desired direction. Prodem believes that teamwork was the key to the institution's ability to operate efficiently and generate creative solutions.

The third layer of the cake, **total quality,** rests upon the foundation created by the elements described above. It represents the institution's commitment to excellence and to a continuous process of improvement in the quality of its operations. Finally, the candle on top of the cake represents self-sufficiency. It celebrates the institution's ability to achieve results over the long term by generating sufficient income to cover its costs.

Adapted from Frankiewicz (2001)

The **mission statements** of village banking institutions typically espouse a double bottom line, to achieve social impact and profitability, as highlighted in the following examples:

- To support women who live in socioeconomic exclusion with integrated participatory services so that they may achieve personal, family, and community sustainability. *Pro Mujer, Bolivia*
- Our mission is to offer financial and educational services at a national level through an efficient and profitable institution that responds to the demands and cultural characteristics of families in rural and marginal urban areas to generate increased income and improve their quality of life. *CRECER, Bolivia*
- CREDO's mission is to respond to the basic needs of the poor and through savings and credit in particular to provide the poor with the opportunity to achieve self-sufficiency. *CREDO, Burkina Faso*

Mission statements are meaningless unless they shape the institutional culture, guide behavior, and incite action. VBIs must take their mission statements off the shelf and put them to work.

A VBI's mission is often grounded in a set of **values** that guides staff and management in their work (see Box 3-2). The VBI's mission and values attract many staff members who could work elsewhere for higher pay and better working conditions and motivate many directors to volunteer their services.

Box 3-2
CRECER's Values

- ✓ Commitment to people with limited income.
- ✓ Honesty and transparency in the services we provide.
- ✓ Respect for the laws of Bolivia.
- ✓ Respect for the cultural practices of our clients.
- ✓ High standards of professional ethics in striving to achieve objectives.

3.2 Elements of an Institutional Culture

But what does an effective culture look like? What important values or behaviors should a VBI espouse and promote? There is no right answer to those questions (although there are plenty of wrong answers!). An institutional culture is, naturally, culturally specific. The cultures of CARD Bank in the Philippines, Small Enterprise Foundation (SEF) in South Africa, and Pro Mujer in Bolivia do not necessarily resemble each other. That said, it is still useful to consider some of the elements that organizations may consider vital, including several that embody the village-banking principles.

Serving the Poor

The institutional culture can play a critical role in perpetuating the VBI's commitment to the poor. The culture can create an environment in which poverty alleviation is the organization's whole purpose, and by extension, the purpose of everyone who works there. Staff members are constantly challenged to think of ways to serve the poor better or to serve poorer people. In this environment, field agents with large loans are frowned upon, the loan officers with the smallest loan sizes are cheered, and decisions to serve new communities are based on the poverty levels in those areas. Any new product or policy is carefully screened to consider what effect it might have on the institution's commitment to serving the poor.

VBIs need to find ways to use the institutional culture to perpetuate their commitment to the poor. VBIs can easily be sucked up market unless their culture keeps them rooted.

VBIs should be aware, for example, that offering individual loans can undermine a culture that focuses on the poorest. Because individual loans are new and the larger loan sizes place more funds at risk, the individual loan portfolio tends to demand more management attention. This attention can be perceived as a shift in priorities, and staff may believe that these loans are more important than the bread-and-butter village-bank loans that serve the poorest. VBIs should consider offering individual loans—to retain their best clients and to enhance sustainability—but they should balance this new product with an emphasis on the very poor.

Putting Clients First

If clients are leaving, if they are not satisfied with the products and services, then the culture is not sufficiently client focused.

VBIs want to provide maximum customer value over the long term. They can be helped toward this goal by a culture that promotes a client focus. To be client focused means (1) continuously learning about the needs and preferences of the target market, (2) recognizing that village-banking institutions exist to serve their clients, (3) building customer relationships for life, and (4) embracing customer service, satisfaction, and retention as central tenets. While these are nice sounding ideals, the challenge for VBIs is to put them into practice: What does it mean to establish customer relationships for life? How do you embrace customer service? How do you continuously learn about the changing needs of your target market?

Continuous Improvement

The success of any business depends on its ability to adapt and innovate. This is particularly true in a new industry like microfinance in which the environment is prone to change and in which new experiences and better practices are regularly emerging. Furthermore, the entire purpose of microfinance is to change the market conditions by helping clients improve their lives. It is therefore logical that VBIs should be learning organizations that strive relentlessly to improve so that they can build on their developmental accomplishments and continue to be relevant. This type of culture requires risk taking; inevitable failures must be viewed as learning opportunities.

Unfortunately, inertia tends to be more powerful than change. Instilling a culture of continuous improvement may be particularly challenging for VBIs that have historically adopted a formulaic approach to replicating a model—which is why this cultural element is highlighted as a village-banking principle. If VBIs really want to be client focused, if they are going to cope with the competition that will inevitably emerge (if it has not already), if they want to make an ongoing impact in low-income communities, then the entire organization has to regularly endeavor to improve. Personnel should envisage themselves as problem-solvers who are encouraged to think critically and are empowered to voice their opinions.

Communication

It is essential to ensure that communication is open and transparent, and that it flows horizontally as well as vertically—both up and down the hierarchy. Although information flows tend to be institutionally and culturally specific, in general people like being consulted and they prefer participatory processes to autocratic dictums. Plus, sharing more information with more people can promote transparency and avoid rumors spreading among staff. Personnel must have the skills, however, to interpret the information.

Teamwork

To achieve individual, unit, and institutional objectives, it is critical to promote teamwork. By using teams, organizations are able to produce more than if employees work individually. As VBIs get bigger, the use of teams enables them to maintain a culture of intimacy. To promote greater teamwork, some organizations require job exchange visits—for example, head office personnel may spend a day shadowing a loan officer and vice-versa—which enable staff members to walk in their colleagues' shoes and develop a greater appreciation for their situation. Organizations can also promote teamwork by providing group-based incentives, either instead of or in addition to individual incentives (see Compensation and Financial Incentives in section 3.4).

Reliability

Low-income persons access a range of financial services, typically from informal and semiformal sources. A primary disadvantage of such sources—for example, borrowing from friends and family—is that funds may not be available when they are needed or in sufficient amounts. To distinguish itself from "the competition" and increase its market share, a VBI could establish itself as the most reliable source of financial services, which involves commitment to timely disbursements, keeping appointments and fulfilling promises, among other things.

Cultural Changes

The requirements of growth may conflict with other aspects of an institution's culture. Many microcredit nongovernmental organizations (NGOs) have an informal culture that seems to work for a while. The challenge is to maintain the positive aspects of an informal culture—the family-friendly environment, a close alignment between personal and institutional values, lots of contact with the chief executive officer (CEO)—while removing those elements that block growth and undermine excellence.

A large VBI needs written policies and procedures, an internal audit department, job descriptions, performance appraisals, and other such formal elements. Yet these practices move a VBI toward bureaucracy; old guard staff may see the controls and the formalization of systems as a decrease in trust between the organization and its employees (see Box 3-3).

An institution's culture will change as it grows and matures, but it is helpful if the core elements are constant over time. For example, Box 3-1 depicts Prodem's culture in 1993, but

Box 3-3
Trust and Internal Controls

While VBIs may want to cultivate a culture in which staff are trusted, if there is money involved, there is a need for controls. Internal controls in village-banking institutions can be designed to send a positive message to field staff. The internal audit department can be presented as a valuable resource for staff members to help them do their jobs better, instead of a fraud detection agency that will constantly look over their shoulders.

Because services are delivered in the communities—under a tree, in a classroom, or in a member's home—typical internal controls will not suffice. In addition, many of the transactions occur within the village bank itself and are not necessarily recorded by the field staff. Some institutions, such as FOCCAS (Uganda) and CRECER (Bolivia), have addressed this issue by hiring a "field auditor" even before an internal audit function is created.

the organization unveiled a more detail image in 1998 in which the main elements remained the same, but some new ones were added, such as institutional values (trust, honesty, responsibility, and commitment) and a learning organization that pursues continuous improvement.

3.3 Operationalizing the Culture

The elements of an institutional culture described in the previous section illustrate the types of values, attitudes, and behaviors that a VBI might want to select when shaping its institutional culture. The list is not comprehensive; other cultural elements might include commitment, excellence, valuing staff, honesty, transparency, cost-effectiveness, arrears intolerance, high productivity, and of course scale, which was highlighted in the previous chapter.

The first step toward shaping an institutional culture is for an external evaluator to assess the current culture.

After a VBI determines what its culture should look like, the challenge is to bring that culture to life. If a VBI has not proactively shaped its culture in the past, a useful first step is to analyze what type of culture the organization has at present. When the organization identifies the prevalent attitudes and behaviors, then it can determine which ones it wants to keep and build on; which it wants to eliminate; and which additional values, attitudes, and behaviors it wants to introduce. This type of **culture assessment**—including staff surveys, individual interviews, focus group discussions, and a considerable amount of general observation—is best performed by an external evaluator who is removed from institutional politics and with whom staff might be more forthcoming.

It is not enough to know that cultural elements such as teamwork or valuing staff are important—the challenge is to turn these values into institutional habits. To create this link, VBIs use a variety of means, such as the following, to operationalize their institutional culture:

- **Recruitment.** Staff members who share the VBI's values will reinforce its culture; staff with different values may undermine the culture. For this reason, some VBIs prefer to recruit people who have never been employed before so they can shape their values and attitudes; other VBIs use diagnostic tools to screen for personal values (see section on Recruitment and Screening in section 3.4).
- **Staff indoctrination.** Orientation sessions use creative role playing exercises to indoctrinate new staff members into the institution's culture, to explain why the VBI does what it does, and to solicit new staff's commitment to the organization's values and attitudes. By learning the organization's history and traditions, new staff members begin to feel that they are part of something big and powerful. If the VBI has a particularly strong and pervasive culture, new staff members will find it easier to conform to the culture rather than to reject it (see section on Training in section 3.4).
- **Staff meetings.** To be effective, the institution's culture needs to be discussed regularly. Staff meetings provide the ideal opportunity for revisiting institutional values, attitudes, and behaviors. At least once or twice a year, such discussions could be on the agenda of staff meetings, or could be included in training sessions.
- **Visible reminders.** A poster or sign in offices could publicly proclaim the VBI's values and what it is trying to accomplish. Other signs or stickers could provide inspirational messages and propagate staff slogans, such as "He who does not work in a team does not work at Prodem."

- **Innovative training techniques.** VBIs can use innovative training techniques to help new staff members understand the culture and values of the institution. For example, to instill client commitment in new staff, the Grameen Bank (Bangladesh) asks trainees to interview a poor woman and write her life history, including how she coped with economic crises.
- **Client orientation.** By using the client orientation session to inform customers why the institution exists and what it is trying to accomplish, the VBI recruits clients as partners in achieving its mission. The process of repeating the mission and values to all new clients will also reinforce the mission for all field staff and help them remember and internalize it.
- **Unique language.** Unique language and terminology can reinforce a frame of reference and a sense of belonging to a special, elite group. For example, instead of calling field staff loan officers or field agents, they could be called poverty fighters or some other descriptive term that is unique to the organization.
- **Institutional rituals.** The sense of employee identification and belonging can be buttressed through institutional rituals, such as a certification ceremony for new hires after they have completed their training period where they are welcomed into the family by other employees. Some VBIs have annual social or recreational events for employees and their families, as well as milestone celebrations that help reinforce success (for example, the 50,000th client party). Some organizations begin all meetings with an institutional song, chant, or pledge that reinforces employees' psychological commitment to the organization.
- **Employee newsletter.** With articles from staff and management, an employee newsletter can enhance both vertical and horizontal communication. It can be used to document progress toward achieving organizational and departmental objectives and serve as a vital forum for reinforcing the institution's culture. A newsletter can make announcements regarding personal events (births, birthdays) and professional accomplishments.
- **Office layout.** For VBIs that deliver services out of branch offices, the office layout can reinforce the institutional culture. For example, if the organization focuses on customer service, then the office could be organized around a customer service representative who handles initial inquiries and directs traffic. If the VBI wants to avoid creating unnecessary hierarchy, then its office space and equipment would not denote special privileges or rank.
- **Ongoing training.** Facilitated by internal or external trainers, periodic training and team-building exercises can reinforce the institutional culture. Courses might cover customer service, sales and marketing, and time management.
- **Senior management team.** An institution's culture is most effectively propagated through the examples set by the senior management team. A VBI's managers must lead by example. If the VBI values communication, for example, then the CEO and other senior managers need to regularly update staff on institutional performance, and regularly solicit feedback from staff and clients.

In sum, the institutional culture needs to be designed to retain inexpensive and productive staff who want to serve the poor.

Whatever particular mechanisms a VBI adopts to operationalize its institutional culture, the key to successfully establishing and maintaining that institutional culture is through the leadership of management. Managers need to demonstrate in their daily decisions and actions a commitment to the institutional culture. Managers also need to stay attuned to whether the staff and board members themselves have internalized this culture into their

decisions and actions, and to undertake measures to re-center the institution if there is cultural drift.

3.4 Human Resource Management

VBI managers have the unenviable task of extracting Herculean efforts from staff, particularly field staff, who receive low wages. Successful VBIs use their culture and human resource management to cultivate a commitment that keeps staff working late hours and riding motorbikes to distant villages—even though many could get higher wages and better working conditions elsewhere. This section summarizes some human resource strategies—including recruitment and screening, training, incentives, and compensation—and highlights additional examples of operationalizing the institutional culture.

Recruitment and Screening

The recruiting process varies by institution and labor market, but two tips are fairly universal. First, a good source for new recruits is a satisfied and effective employee. Some organizations give bonuses to employees who refer others—with half at the time of the referral and the second half if the recommended person is hired.

Second, after a VBI has a handful of outstanding staff members, it should determine what mentors, books, or organizations helped to shape the character of those employees. If it finds some common sources, such as youth clubs, schools, or churches, then they would be fruitful places to actively recruit new staff. Both of these techniques also propagate the institutional culture because they ensure that like-minded people are being considered for employment.

To select the best staff, a VBI may also want to consider the following:

- **Use qualitative assessment tools to screen applicants.** Written tests, diagnostic tools, and role-playing exercises can expose the character and aptitude of applicants, and their attitudes toward the poor. These tools are particularly valuable for large or rapidly growing VBIs. This screening method also can promote teamwork: Co-workers who know they were selected through a rigorous and competitive process are likely to respect each other and feel a strong sense of belonging.
- **Screen for staff who are motivated by the organization's mission.** A VBI may be able to better retain staff if it hires people who want to get more out of their jobs than just a paycheck—people who want to make a difference in the world, work with amiable colleagues, and be respected and trusted.
- **To serve women, hire women** or, if necessary, hire men who respect women. In many cultures, women feel more comfortable with other women, particularly when they discuss health and reproductive issues, as is the case with some integrated village banking services. Yet the local culture may prevent women from working outside the home or riding motorcycles. If the VBI cannot hire a sufficient number of women field agents, then it needs to carefully screen male applicants for their attitudes toward women.
- **Consider employing less-educated staff.** Often less-educated people are less costly and more likely to stay than staff with greater opportunities. ASA keeps job responsibilities simple so that it can hire loan officers with little education and experience, at low salaries (see Box 3-4). Kafo Jiginew found that it could train and supervise literate village bank officers (e.g., clients elected by their peers into leadership

positions) to serve as field agents. This approach, however, may limit the product diversity or flexibility that the VBI can offer.

- **Consider employing staff with little or no work experience.** This is especially true in places where prevailing values conflicts with the desired institutional culture. Grameen Bank deliberately avoids hiring anyone with previous banking or financial experience.

Training

To ensure that it has top-quality employees, an organization may want to train more candidates than it needs and then only employ the best. New staff may be hired on "trainee" contracts; those that meet performance expectations after three or six months can then be hired as full-fledged loan officers.

Training for new staff transmits and propagates the institution's culture in the following three ways:

1. **Buy-in.** It is challenging to get new staff to embrace the institution's values and objectives as their own. During training, new recruits can be asked to discuss ideal working conditions, how they would like to see co-workers interact with each other and with clients, and how they would like to be treated by management. This discussion can be facilitated in such a way as to identify the core elements of the institution's culture and objectives and to give new staff a sense of ownership over those elements.
2. **Explicit messages.** Building on this discussion, the training should explicitly communicate the organization's mission, values, and culture. It should clearly transmit this message: "These are our aims, this is how we expect staff to treat each other and our clients, and this is why it is so important to us."
3. **Modeling the culture.** Trainers should "walk the talk," modeling their explicit messages and the behavior expected of staff. For example, if the VBI expects employees to be critical and analytical, then the training should encourage debates and welcome differing opinions.

Perhaps the most effective way to reinforce the culture is through the **apprenticeship** that follows classroom training. It is critical that mentors know how to train new staff effectively since they, above all, bring the institution's culture to life. Their actions should demonstrate what the mission, values, and culture mean in practice. VBIs should consider developing a mentorship course to teach experienced field staff how to provide on-the-job training. The human resource department should also follow up with new staff after they have been on the job for three or four months. By observing their performance in the field, HR staff can assess the skills of both the trainee and the mentor, and can recommend any additional training for either that might be required.

VBIs need to train staff mentors not just how to communicate policies and procedures, but also how to model the institution's values and demonstrate the expected interpersonal behavior.

Training should be ongoing. At Compartamos, all staff members participate in two weeks of training every year. These sessions are used to update skills, reinforce the institutional culture and values, promote teamwork, and motivate staff. In addition, every two weeks Compartamos has a one-hour human development activity at the branch intended to improve cooperation, enhance communication, and build morale (see Box 3-5).

Box 3-4
Human Resource Management at ASA

ASA challenges the conventional wisdom of human resource management. With more than 3,400 credit officers, it has developed highly efficient systems for managing its workforce. ASA does not expect that each individual will be exceptional. Instead, it keeps the job simple by—

- Standardizing its products and operations;
- Providing clear policies, and no discretion, regarding all decisions that staff make;
- Not expecting staff to train ASA's clients; and
- Maintaining close yet motivating supervision.

Who does ASA **recruit**? In its own words, "ASA hires those of mediocre qualifications that nonetheless show the ability to articulate, reason, and be sensitive to clients' needs and demands. They need not be particularly bright to perform well. Basic math skills are more than adequate.... Harnessing and developing a less qualified, but gratefully employed workforce allows ASA to operate in an extremely low-cost environment."

After placing an advertisement in the national daily newspaper, two staff spend one day interviewing and **selecting** from hundreds of respondents. Candidates apply, with resumes in hand, at a designated time at the regional office. Meeting with 25 to 30 at a time, the interviewers observe their physical fitness and question the entire group about poverty, credit, and development. They then ask each candidate questions individually while looking for quick, appropriate responses and attentiveness. Immediately following the interview, the interviewers select the trainees. Two or three candidates are chosen for each position. If the training ends with too many capable and interested candidates, some are put on a waiting list and assigned to the next available opening. The entire process involves no paper or secretarial work.

ASA initially **trains** new credit officers in nine days, with four days in the classroom and five in the field alongside a senior credit officer. Candidates sleep at the branch during training, but pay for their own food, transport, and other expenses, including training fees. ASA incurs no direct costs.

Training is ongoing. ASA expects each branch manager to help his four to five staff members to improve their performance. This is not hard to do. Branch staff members live together in rooms adjoining their office. When they are not in the field, they are together and their interactions often focus on work. New policies are introduced through ASA's monthly circular. Branch managers read and discuss these with staff. During weekly visits, the regional manager questions credit officers on their knowledge and understanding of the most recent circular.

ASA does not have a financial incentive system. Instead, it **motivates** credit officers with—

- Its institutional culture that is easily transmitted by branch staff who live together;
- Ample opportunities for promotion afforded by ASA's rapid expansion; and
- Standards that staff must meet to continue their employment accompanied by generous support from colleagues and branch managers to help them meet these standards.

(Muhit 1998; Jain ND; Brennan, et al. 2000)

Non-financial Incentives and Staff Loyalty

A primary objective of human resource management is to retain well-performing, experienced employees. To make a profit providing very small loans, however, most VBIs probably cannot afford to pay employees what they deserve. To compensate, VBIs can employ a variety of non-financial incentives, including the following:

Box 3-5
Staff Retention Strategies of Compartamos

- Employee stock options and profit sharing
- Competitive salaries and performance-based incentives
- Staff-centered management approach; regular feedback on progress and formal performance reviews
- Employee newsletters
- Personal link to directors and senior management
- Toll-free telephone number for problem resolution and staff support
- Uniforms
- Public recognition and rewards
- Staff development opportunities: lateral job moves, rotation, promotion, training
- One-hour human development activity two times per month, geared to improve communication and cooperation among staff and to maintain and improve morale

- If labor laws allow, VBIs can **link seniority to increased benefits,** such as vacation *time, sabbaticals, staff development grants, pensions, employee stock ownership* plans, or employee loans. For example, after two years employees earn an extra week of vacation time, or after five years they become eligible for matching pension funds. Time-linked benefits create incentives for staff to stay and then, once they reach the milestone, disincentives for them to leave.
- Cultivate a committed **working environment.** If people like their jobs and their colleagues, if they feel respected and needed, if they believe that they are making an important contribution, then employment will give them intangible rewards. A VBI can use its social mission as a powerful motivating tool. For example, impact studies and client success stories can remind staff why they do what they do and can quantify the difference they are making.
- Forge a strong **sense of belonging.** Integrate an employee's personal identity with the institution's identity. Through staff uniforms, slogans, employee newsletters, and social events, staff members think of themselves first and foremost as members of the organization, and would be reluctant to work elsewhere.
- Use **job enrichment strategies** to keep personnel interested and engaged. These strategies may include participating in committees or task forces that are working on innovations or improvements, engaging in market research, or learning new skills to become a more versatile employee.
- **Recognize accomplishments.** Recognition can be as powerful an incentive as a bonus check. Many VBIs designate the employee of the month that conveys special privileges, such as lunch with the executive director, an article in the newsletter, a picture on the wall, or a special nametag. Other recognitions include most-improved loan officer, best innovative idea, and most promising new staff member.
- **Create the social infrastructure to support staff.** The VBI needs to demonstrate that it cares about its employees. Often the human resource department is tasked with the responsibility of attending to the staff's social needs, such as assisting employees during personal crises. Larger organizations may even have an in-house social worker or ombudsman, and may have particular benefits to support mental health.

- **Adapt reward systems to staff's preferences** and expectations. By giving employees a voice in shaping their work environment—through staff surveys, employee advisory committees, and open communication channels—a VBI can improve its reward system and enhance employee loyalty.

The ways in which a VBI can increase its value to employees are limited only by creativity. Each institution should holistically strategize about what might work best in its environment. Above all, staff members will be motivated by the sense that their employer cares about them, values them as people, and regularly demonstrates its appreciation.

Compensation and Financial Incentives

Financial incentives can work well if designed in concert with the institution's culture, but they can also be very destructive. Handle with care.

Although non-financial incentives can be worth a lot, people still need to be paid. Typically, compensation comes in two forms: a base salary and financial incentives. Where incentives are used—and it is not a given that they should be—a rule of thumb is that loan officers should be able to earn 30 to 50 percent on top of their base salary in incentives.

Financial incentives should align the goals of the institution with employees' personal goals so that in a decentralized organizational structure people will work toward institutional objectives without significant oversight. Usually this includes rewards for both **quantity** (number of borrowers, number of new borrowers) and **quality** (portfolio at risk or repayment rate). These must be carefully balanced, which is a tricky proposition because problems with quality often emerge slowly. Portfolio quality should be the most important variable in any loan incentive scheme. Two other variables that VBIs might want to consider are **recruitment of the extreme poor** and **client retention**.

Financial incentives need to be approached carefully because, if not properly designed, they can seriously undermine the institutional culture. They may encourage aggressive sales techniques or unsavory methods to manage delinquency. They can create individualist behavior whereby staff members do not assist each other, or a sense of entitlement that can demoralize staff if they do not meet the eligibility threshold. Some organizations have found the effect of incentives to be so insidious that they have eliminated them altogether.

When developing or refining an incentive scheme, consider the following suggestions:

- **Shift gradually from high salaries to incentives.** Lowering salaries to introduce an incentive scheme will breed resentment. Where base salaries start high, the ratio of salaries to incentives can be decreased over time by freezing salaries and gradually increasing incentives.
- **Adjust incentives to account for inequities.** Incentives should be adjusted for different environments. For example, urban loan officers may have different targets than rural staff, or there may be different expectations for staff in new branches.
- **Reward healthy growth**. Incentives should encourage loan officers to grow at a steady and stable pace until they reach (but do not exceed) maximum productivity levels.
- **Encourage innovation.** Monthly staff bonuses for the most innovative idea tend to fuel creative thinking.
- **Keep it simple.** To achieve its goals, a scheme should be simple; a scheme with too many variables will not convey to staff how they should allocate their time and energies to maximize their financial return.

- **Promote teamwork with group incentives.** To promote teamwork, VBIs should consider group incentives (or a combination of group and individual) based on the performance of the branch or the organization as a whole. Group incentives include profit sharing, whereby a percentage of any surplus is distributed to staff members, and employee stock ownership programs (ESOPs).
- **Reward current priorities.** This year, the organization may be suffering from repayment problems; next year, growth might be a priority. Priorities may differ by region or by loan officer. Incentive schemes should allow the VBI to emphasize and reward immediate priorities.

When designing an incentive scheme, allow flexibility for changing institutional priorities and recognize that the emphasis may vary by branch.

Management

The discussion thus far has focused on field staff. Yet senior managers play a pivotal role in shaping and maintaining the institutional culture, managing and motivating staff, and enabling the institution to meet its objectives. Management creates a vision of how the organization should operate and then empowers others to make that vision become reality. They are the link between the board and the staff, and they communicate the vision of the institution to staff and outsiders. They lead by example. Without a ready pool of experienced managers, many VBIs promote from within—but an excellent loan officer is not necessarily an effective manager. Often people are promoted to a management position without sufficient training. If a VBI is serious about achieving significant scale, then it has to develop its expertise in management training so it can create a strong cadre of middle managers.

How should managers treat staff? A **staff-centered supervision** approach will increase the likelihood that field staff will stay in the job and perform well. Loan officers spend most of their days on the road visiting groups. Given their mobility and independence, VBI managers must make special efforts to provide field staff with the support and signaling they require.

Staff-centered supervision means that middle managers see their primary role as problem-solvers and mentors, not as taskmasters or overseers.

Effective village-banking supervisors see themselves primarily as enablers, problem-solvers, and mentors, instead of as managers or bosses. They spend most of their time in the field and operate close to their loan officers. At Compartamos, supervisors meet 50 percent of their promoters' groups each month. They attend each loan disbursement. Branch managers oversee up to three coordinators and fifteen promoters. The branch manager also spends most of the time outside of the office visiting groups and attending disbursements of large loans.

Branch managers should use incentives as a management tool by regularly monitoring loan officers' progress on incentive variables and showing them what they need to accomplish to earn additional benefits. With monthly incentives for example, the branch manager should sit down with each loan officer before the last week of the month and figure out what they need to achieve to maximize their bonus. If branch managers receive incentives based on the performance of their staff, then it aligns interests at the branch level and will encourage managers to actively support their loan officers.

3.5 Conclusion

Village banking is extremely difficult, but enough successful VBIs are operating in a range of conditions to show that it is not impossible. One of the primary ways that these VBIs overcome the challenges is to use organizational development to increase productivity, bolster

staff and client retention, and create a good working environment without enormous salary bills.

Village-banking institutions cannot leave their institutional culture to chance. They need to make a concerted effort to design and propagate the culture, beginning with the mission and values. A similar holistic human resource strategy is required to recruit, train, and motivate staff. A heavy dose of creativity and innovation can help make organizational development particularly effective.

Resources

The following resources provide additional information about organizational development.

Brand, Monica and Julie Gerschick. 2000. *Maximizing Efficiency: The Path to Enhanced Outreach and Sustainability.* Washington, DC: ACCION International. www.accion.org

Churchill, Craig F. 1997. "Managing Growth: The Organizational Architecture of Microfinance Institutions." *Management Tools for Microfinance, Review Paper 1.* Bethesda, MD: U.S. Agency for International Development (USAID), Microenterprise Best Practices (MBP) Project. www.mip.org

Frankiewicz, Cheryl. 2001. *Building Institutional Capacity: The Story of Prodem 1987–2000.* Toronto: Calmeadow. www.pactpub.com

Rhyne, Elisabeth and Linda S. Rotblatt. 1994. *What Makes Them Tick? Exploring the Anatomy of Major Microenterprise Institutions.* Washington, DC: ACCION International. www.accion.org

Stearns, Katherine. 1993. "Monetary Incentive Schemes for Staff." *GEMINI Technical Note #5.* Washington, DC: U.S. Agency for International Development (USAID). www.pactpub.com

4

Understanding the Customer

Because they deliver financial services to groups, village-banking institutions (VBIs) can efficiently accomplish social objectives by serving a number of people at one time. Because they deal primarily with the group, however, field staff do not always develop keen insights into the needs and demands of individual customers, and the impact of services on them.

A greater understanding at the individual level is required for several reasons. A VBI needs to know more about its clients to ensure that it is fulfilling its social mission, both in terms of whom it reaches and the impact it has on clients' lives. Without a good understanding of customers' needs, VBIs may experience high levels of desertion. And as competition increases, a deeper understanding of customer expectations will enable VBIs to protect and perhaps expand their market share.[1]

VBI staff must go beyond the village bank meetings to gain a sufficient understanding of who clients are and how well services are meeting their needs.

To help focus on clients and reduce the vulnerability of the poor, this chapter guides VBIs through the process of answering three important questions:

1. **Are we serving who we want to serve?** While VBIs are known for their commitment to serving the poor, it is a rare organization that actually goes out of its way to target and actively recruit the poorer segments of the community. While **targeting** the very poor as an exclusive market niche may not be for everyone, some organizations, such as Small Enterprise Foundation (SEF) in South Africa (see Box 4-2), persuasively promote this practice as a means of fulfilling their social mission.
2. **Are customers benefiting from the services that we offer?** The debate continues on the costs, benefits, and validity of **assessing impact.** This chapter presents an approach that forges a middle ground between expensive academic impact assessments and the conviction that repeat borrowers serve as a proxy for impact assessment. This approach, impact monitoring, is intended to give VBIs sufficient confidence that they are fulfilling their social mission without overly burdening staff or clients with time-consuming and expensive research.

[1] Craig Churchill and Gretel Figueroa drafted the content of this chapter.

VBIs need to be more actively involved in conducting market research and using that information to improve their services.

3. **What can we do to serve customers better?** A commitment to improving impact leads to one of the most important new directions presented in this book: VBIs should integrate **market research** into their normal course of activities. The emphasis on market research implies that VBIs should then use that information to continuously improve the services and possibly provide new services.

4.1 Target Markets: Finding and Serving the Very Poor

The approach of most poverty lenders toward finding clients is best described as **indirect targeting.** They assume that by (1) using a group lending methodology, (2) offering very small initial loans, and (3) working in poor communities, they are reaching their intended market. The wealthier members of the community would have little time for group meetings, little desire to guarantee loans of poorer people, and little use for such a small loan.

These indirect targeting methods, however, have caused some VBIs to reach a better-off market than they envisioned. Their customers do not always include the large number of the extreme poor that they expected to serve. Research done on the poverty levels of microfinance clients across seven microfinance institutions (MFIs) in four countries found that most borrowers were just above or below the poverty line, classified as moderate poor or vulnerable non-poor, but few clients were extreme poor or destitute (see Figure 4-1) (Sebstad and Cohen 2000). While VBIs often reach deeper than most, few are serving large volumes of extremely poor persons.

This finding is not particularly surprising. Village bank members are naturally risk-averse and tend to select other members who have similar socioeconomic profiles. The product design itself may unwittingly create incentives to filter out the extreme poor (see Box 4-1).[3] Human nature pushes sustainability-focused VBI employees to seek out the less poor, who are easier to reach, seem to be a lower credit risk, and have the potential to absorb larger loan amounts.

These results do not trouble all village-banking institutions. Some VBIs see an emphasis on the poorest as an evolutionary approach; they choose to achieve sustainability first before reaching out to the poorer segments of the population. Other organizations intentionally serve a broad client market so they can cross-subsidize the smallest loans (to poorer clients) with income from larger loans. Others believe that it is too costly and unnecessary to invest in deliberate methods to target the extreme poor.

Exclusively targeting extremely poor clients is not appropriate for all VBIs, but some good reasons exist for considering it.

Some VBIs, however, place a higher priority on reaching the extreme poor from the outset and accept slower progress toward sustainability. These institutions actively target and exclusively serve the extreme poor for the following reasons:

- **Social barriers to participation.** The extreme poor often lack the confidence to participate in a borrower group voluntarily. Extra effort is required to identify, recruit, and support the involvement of the extreme poor in borrower groups. Heterogeneous village banks that include non-poor members of the community are likely to intimidate poorer members and discourage their involvement.

[3] This document uses the Sebstad and Cohen (2000) definitions of poverty levels: "*vulnerable non-poor* clients are in households above the poverty line but are vulnerable to slipping into poverty; *moderate poor* clients are in the top 50 percentiles of households below the poverty line; *extreme poor* clients are in households in the bottom 10 to 50 percentiles of households below the poverty line; and *destitute* clients are in households in the bottom 10 percentiles of households below the poverty line."

Box 4-1

Does Group Lending Penalize the Poorest?

Initial group loans are a test: Does the client have a willingness to repay the loan? Does the village bank have the cohesiveness and capacity to function as a credit delivery vehicle? Based on the group's recommendation, anyone who applies for a loan receives one, but a very small one. Those who repay on time receive a slightly larger loan, while those who have difficulty repaying are not permitted to receive subsequent loans.

This product design does an excellent job of minimizing credit risk, but it sets some people up to fail. Poorer group members, whose irregular income streams do not coincide with the rigid repayment schedule, tend to be weeded out and publicly censured. The high price, in terms of lost social capital, for not repaying the loan can leave more vulnerable persons worse off and less confident than they were before they joined the group (Montgomery 1996; Sebstad and Cohen 2000). Gossip about this experience discourages other poorer members of the community from joining a village bank. Furthermore, this approach creates an operational culture in which VBI employees are encouraged to exclude borrowers over time.

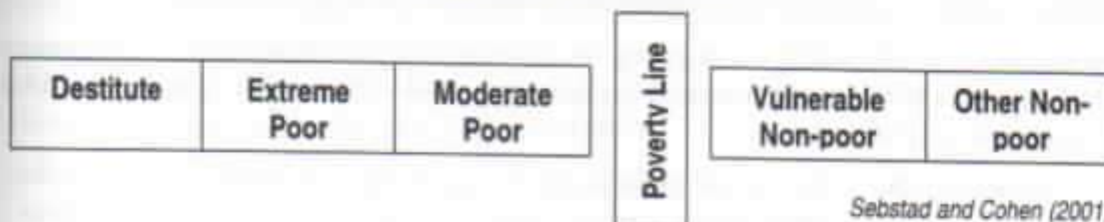
These points are not intended to suggest that VBIs should ignore credit risk. Instead, they highlight that VBIs really committed to serving the very poor need to find ways of specifically catering to the unique circumstances of that market.

- **Staff culture.** Field staff are naturally going to serve customers who are the easiest to reach, especially if employees receive bonuses for quickly achieving large volumes of good-quality portfolios. The best way to forge a commitment to the extreme poor is if it is steeped in the institutional culture and staff are rewarded for serving that market.
- **Client focused.** Consider the dark side of being client focused. Non-poor members of a community tend to be more outspoken than the extreme poor. A client-focused VBI will naturally try to respond to the demands and suggestions of its clients, which could lead it away from the very poor if it were serving a heterogeneous market.
- **Market forces are inadequate.** If VBIs serve the easiest clients first, their borrowers will move up the economic ladder creating a greater distance between the moderate and extreme poor. Subsequent efforts to improve the conditions for the very poor and enable them to compete effectively in the commercial markets will be even more challenging. There is a real risk that they may be permanently discarded as too poor to benefit simply because the organization did not get to them sooner.

Some organizations that are concerned about whether they are actually reaching the poor have employed a new methodology to compare the poverty level of their clients with the local population as a whole, as described in Box 4-3. Research using this **poverty assessment** methodology has found that organizations that use active targeting techniques are much more effective in reaching the poorest segments of the communities (Sharma et al 2000).

Figure 4-1

Defining the Poor



Sebstad and Cohen (2001)

Box 4-2

Targeting the Very Poor: The Case of the Small Enterprise Foundation

In 1992, Small Enterprise Foundation (SEF) began providing Grameen-style financial services to low-income persons in one of South Africa's poorest provinces. Four years later, SEF launched the Tshomisano Credit Programme (TCP) to target and serve the very poor exclusively.

After experimenting with a means test and a housing index, SEF settled on a **participatory wealth ranking** (PWR) system to identify those persons in the community who would be eligible to participate in TCP based on their poverty level. Most of the targeted persons are not involved in an income-generating activity, so their first loan is intended to help them start a business. The targeting method consists of four discrete steps:

1. **Mapping.** The village is divided into manageable sections of approximately 100 households each. A reference group of three to five volunteers from each section then draws a map of the their area. A household list is generated from the map, with the name and number of each household written on a separate card.
2. **Poverty discussion.** The SEF facilitator leads a discussion on how to identify a poor person and what makes one person better off than others. This enables all of the resource persons to have the same understanding of poverty criteria.
3. **Wealth ranking.** The reference group considers each household in the section and ranks them by wealth. Typically the group will make five to eight piles of households ranging from poorest to richest. After all households have been ranked, the group discusses the characteristics of each pile and what differentiates one from the next. The ranking process is repeated with two other reference groups to triangulate the results.
4. **Analysis of data.** The results from the ranking process determine a score for each household. Scores are based on this formula: 100 divided by the number of piles, multiplied by the pile number, then averaged for the three reference groups. The lower the score below 100, the less poor the household. The next step is to determine the cut-off point for very poor households. This process determines who is eligible for the TCP loan product because it is only available to the very poor.

The staffing for this exercise consists of a facilitator, who is at a branch manager level, and an assistant for each section. The assistants are usually the local loan officers, so they gain considerable market information from this exercise. The total process takes about two days and the only costs besides personnel are meals for the volunteer reference groups.

Poverty wealth ranking takes into account the dynamic nature of poverty. The process provides a great deal of information on the socioeconomic environment of the community and is a good way for SEF to generate interest from the very poor. PWR requires good facilitation skills and is suitable only in communities where people know each other well.

Development professionals should be aware that there is always a possibility of doing more harm than good. This is particularly true when working with the most vulnerable. Thus, to complement a targeting tool, a program must ensure that it is making a positive impact. Simply using targeting tools to bring the most vulnerable into a program that was not designed for them is like playing with a loaded gun.

John de Wit, Managing Director, Small Enterprise Foundation

Regardless of whether VBIs are targeting the extreme poor exclusively when serving this market, products and services, such as the following, need to be suitable to their particular socioeconomic conditions:

- **Loan product.** To provide credit to the very poor, the loan product needs to reflect the circumstances of the target market. Loan size is the most obvious issue—clients

Box 4-3
Assessing the Relative Poverty of Microfinance Clients: A CGAP Tool

The Consultative Group to Assist the Poorest (CGAP) Poverty Assessment Tool, developed by the International Food Policy Research Institute (IFPRI), provides transparency on the depth of outreach of MFIs. It produces data on the levels of poverty of clients relative to other people within the same community through a multidimensional poverty index that facilitates comparisons between MFIs and across countries. It was primarily designed for donors and investors who would require a standardized, globally applicable and rigorous set of indicators to make poverty-focused funding decisions. The tool involves a survey of 200 randomly selected clients and 300 non-clients, takes about four months to complete, and costs around $10,000. For more information see Other Documents on the CGAP Web site at www.cgap.org/html/publications.html.

should be able to start with even smaller loans and not be expected or encouraged to take larger loans every cycle. Other points to consider include (1) smaller, more frequent installments over longer periods, (2) repayment holidays, so that clients have a certain number of opportunities to skip repayments (or pay only interest) without penalty, and (3) innovative repayment methods, such as the offspring of a cow.

- **Other financial products.** Credit may not be the most important product for the poorest segments of the market. Borrowing involves taking a risk that the extreme poor might prefer to avoid. Savings products that allow small transactions might be more appropriate. Some organizations provide initial grants (coupled with training) to help the very poor start an income-generating activity, and then allowing them to borrow after the enterprise starts generating a cash flow.
- **Minimalist is not enough.** Efforts to serve the extreme poor by only providing loans may not succeed. Reaching this group requires a credit plus approach that involves handholding, advice, and encouragement provided by group members and the field agent. To provide a conducive learning environment for the poorest, business skills training may be provided on a facilitation basis, whereby the facilitator encourages members to teach each other.

Not all VBIs choose the very poor as their market niche. These observations offer some guidance to help village bankers rethink that target market. They question the conventional wisdom and challenge village bankers to reassess their assumptions and motivations. They also contest the heavy emphasis on achieving sustainability as soon as possible: This expectation could undermine a commitment to the very poor, and can even hurt the poorer segments of the community who will have further to catch up once the VBI turns it attention to them.

One of the greatest impediments in serving the extreme poor is the heavy emphasis on achieving sustainability expeditiously because it implicitly encourages VBIs to go up market.

A middle ground exists between exclusively targeting the extreme poor, which may significantly delay the attainment of sustainability and hinder scale, and going up market to make ends meet. VBIs should consider focusing the product design, staff incentives, and institutional culture on serving the extreme poor, but not serve this market exclusively. If the organization is then able to serve a range of clients with a tiered pricing system that does not involve significant cross-subsidies from large to small transactions, it may be able to strike a balance among deep outreach, scale, and sustainability.

4.2 Determining Impact

Targeting (and actively recruiting) the poorer segments of the market helps VBIs to know that they are serving the customers that they intend to reach. The next step in verifying if a VBI is fulfilling its social mission is to establish if these clients are better off and less vulnerable because of their participation. This is accomplished by assessing impact—by determining whether clients are benefiting from the services; whether they are increasing their income and assets; whether their families are moving above the poverty line, and whether customers, especially women, are becoming empowered.

Historically, impact studies were conducted primarily to meet the needs of donors. Many of the early studies were expensive, cumbersome, and difficult to integrate into daily operations. Designing studies that would yield findings rigorous enough for researchers has proven difficult, if not impossible. Hence, some practitioners argue that if clients continue to access services, they must be deriving some benefit from them. The debate on impact assessments is complicated by the vast array of purposes, objectives, and methods, as summarized in Table 4-1.

With their commitment to reducing the vulnerability of the extreme poor, village-banking institutions tend to be particularly concerned about whether their services are having the desired effect and are therefore perhaps more engaged in impact assessments than other types of MFIs. There is an emerging consensus (although not unanimous) on the usefulness of middle-range impact assessment tools to help practitioners verify that they are achieving their objectives. To this end, the AIMS-SEEP toolkit (Box 4-4) provides practitioners with a set of techniques for assessing impact (along with market research tools).

Table 4-1
Range of Impact Assessment Methods

	Simple	Middle Range	Complex
Description	Carried out by practitioners for practitioners; often based on anecdotal evidence or client stories.	Simple surveys or routine collection of client data to understand how products affect different types of users; offers insight about who stays and who leaves; identifies changes in business operations and household assets.	Uses a quasi-experimental design including data on a control group of persons who do not receive loans; tracks changes over time through baseline and follow-up design.
Purpose	To provide basic insights and feedback to senior program managers and possibly some donors.	To demonstrate plausible impacts and trends; to test if the VBI is improving the lives of its clients (or at least not contributing to a decline).	To establish with a high degree of confidence that the results are attributable to the services provided by the VBI (causality).
Cost	Low	Moderate to low.	High.
Reliability	Low to moderate.	Moderate to low.	Moderate to high.
Comments	Limited usefulness.	Without a control group, cannot attribute changes to the client's participation in the program.	Typically requires external expertise and funding.

Box 4-4
AIMS-SEEP Tools for Market Research and Impact Assessment

Learning from Clients: Assessment Tools for Microfinance Practitioners (commonly known as the AIMS-SEEP Toolkit) is a manual that includes five assessment tools for practitioners to gather information about their programs—information that is useful for impact assessment and market research. The manual, developed by the Small Enterprise Education and Promotion (SEEP) Network and funded by the U.S. Agency for International Development (USAID), responds to the needs of practitioners in determining how their programs and services are affecting clients. The following set of five tools—three qualitative and two quantitative—are included in this manual:

- **Impact Survey.** The principle quantitative tool in the set, the Impact Survey, comprises 37 questions that test numerous hypotheses. It is administered to a sample of clients and to a comparison group of persons who have chosen to join the program but who have not yet received services.
- **Client Exit Survey.** This short quantitative tool is administered to clients who recently left the program. It identifies when and why clients left, and what they think its impact, as well as its strengths and weaknesses, has been. This survey identifies client satisfaction with the program. It is a valuable management tool that can be applied regularly.
- **Loan Use Strategies.** This qualitative tool is an in-depth individual interview focusing on how the client used his or her loans and business profits over time. Its multiple purposes include determining how loan use and allocation decisions change over time, as well as documenting changes in the individual borrower, enterprise, family/household, and community that are associated with participation in the program.
- **Client Empowerment.** This qualitative tool focuses on women clients and uses an in-depth interview to determine if and how women have been empowered by their participation in the program. Clients are asked a series of questions about themselves, their enterprise, their family/household, and their community at different points in time (past and present).
- **Client Satisfaction.** This qualitative tool is a focus group discussion that explores clients' opinions—what they like and dislike—of specific features of the program, as well as their recommendations for improvement.

This set of tools offers many possibilities to the user. Although each tool complements the others, they can be used individually or in any combination.

Adapted from SEEP Network (2000)

Another middle-range method is **impact monitoring**, the routine collection of selected client data during each loan cycle to build an understanding of how products affect different categories of users (see Box 4-5). Typically, this involves asking a short series (five to ten) of additional questions on the loan application related to family welfare such as poverty level and expenditures on food. This data is entered into a client database, along with enterprise-related information, such as weekly sales and value of business assets.

VBIs that are concerned about whether their services are having the desired effect on their clients should consider developing an impact monitoring system.

By collecting this information with each loan, the VBI can monitor changes in the client's situation. A negative change would trigger the VBI to ascertain the extent to which the decline is attributable to the program or to other causes, such as a poor economy or natural disaster. If in general the clients' conditions are improving, even if it cannot establish that it was the cause of those improvements (because impact monitoring does not involve control groups of non-borrowers), the organization can probably conclude that it is making a positive contribution and fulfilling its mission.

Box 4-5

Impact Monitoring: Jamaica Workers Bank

The Jamaica Workers Bank offers a full range of banking services to a socially diverse client base through bank branches located in post offices throughout Jamaica. Its services include a microfinance program modeled on a traditional Jamaican form of rotating savings and credit associations (ROSCAs). From 1997 to 1998, the bank developed a computer-based client monitoring system and integrated it into its loan application and review processes. Known as the Client Profiling System (CPS), it provides information about the impact of program participation on the clients' enterprises and households.

CPS was developed in three stages. First, with technical assistance, the bank identified what outcomes were most relevant to their monitoring needs and used those to select a preliminary set of monitoring indicators. Second, technical assistance providers ensured that all actors understood the capabilities and limitations of a client monitoring system. The bank originally wanted a system to assess the impact of its microcredit program. Managers came to see that the system would be able to assess change in key indicators and generate some information on whether the program appeared to be producing positive results. To assess the full extent of program impact, however, a comprehensive impact assessment, which includes longitudinal comparisons and control groups of non-loan recipients, would be required, however, to assess the full extent of program impact. Third, the bank developed the monitoring system. They revised the loan application form, developed and installed the database system, and drafted a "Book of Values of Commonly Owned Assets" to ensure standardization in the valuation of assets.

In choosing indicators for the system, the bank sought to find a cost-effective yet methodologically sound way to report on impact. It ultimately chose to include the following variables:

Enterprise level. Value of sales (revenues), value of fixed assets of enterprise (all enterprise machinery and equipment), and number of employees by gender (paid, unpaid, and working proprietors).

Household level. Value of durable goods including major household appliances and vehicles, expenditures on food, level of income, and value of client's savings.

Strategic objective level. Number of new and repeat loans by gender, size of new and repeat loans by gender, and number of jobs created by gender.

The process of developing CPS yielded several lessons for other institutions interested in developing an impact monitoring system. First, the selection of indicators requires dialogue between the implementing agency and technical specialists. Second, some indicators may be difficult to measure as part of an ongoing client monitoring system, particularly those associated with income, expenditures on food, and value of assets. Finally, it is important that all actors understand the capabilities of an impact monitoring system relative to those of an impact evaluation. This level of understanding is necessary to ensure that all players have realistic expectations about the types of questions that a monitoring system can answer.

Adapted from Blank (1998)

4.3 Integrating Market Research into Village Banking

While some VBIs may decide not to measure or monitor impact, all institutions should have a clearly articulated market research agenda. Market research refers to any effort to better understand clients' needs in order to improve products and services. Market research is a critical means for better understanding how a VBI can assist poor people.

Market research is at the core of grassroots development: It allows poor people to contribute to the design, management, and evaluation of the services intended to benefit them. Poverty

is complex and multidimensional. If a village-banking institution wants to transform the lives of its clients, it needs to discover what services must be in place for this change to occur.

Market research is the process of understanding the needs, behaviors, and preferences of the target clientele—both current and prospective—and how those change over time.[3] The market research process enables VBIs to listen to clients in a systematic and continuous manner, and to become client focused. Village-banking institutions with an effective market research capacity are better positioned to accomplish the following:

- Improve existing products and services;
- Develop new products that are responsive to client needs;
- Determine the root causes of customer desertion and loan losses;
- Learn what demand factors may be limiting the organization's growth;
- Find ways to improve the impact that a VBI has on its clients;
- Monitor levels of customer satisfaction;
- Diversify into new market niches; and
- Receive feedback on the quality of customer service that staff provide.

To many people, market research involves gathering lots of data through hundreds of interviews or questionnaires with scores of variables, and then crunching all the numbers to see what different segments of the market think about things. While this large-scale, quantitative study may become an important part of a VBI's market research toolkit, it is probably not the best place to start.[4] To develop or improve an organization's market research capacity, consider the following:

- **Research and development (R&D) team.** Small VBIs should have an **interdepartmental committee** that meets regularly to initiate and manage data collection activities, analyze the results, and recommend changes. The interdepartmental aspect, sometimes called cross-functional, means that persons from different parts of the organization—field and head office operational staff, management information systems (MIS), human resources, and finance—are involved. This cross-functional representation ensures that the process will consider the implications of the product on all aspects of the organization, and it creates a broad base of ownership over the new product.

  After a VBI reaches a certain size, perhaps 5–10,000 clients, it should consider creating an R&D department that is tasked with designing and implementing the organization's market research activities. It should be staffed by people with strong qualitative and quantitative research backgrounds, as well as by people who have worked as field staff.

- **Exit interviews.** If an organization does only one type of market data collection, it should involve learning from lost customers (see Box 4-6). A VBI that knows why clients are leaving is in a good position to modify existing products, introduce new products, and improve service delivery. And sometimes the process of listening to lost customers and caring about what they have to say is enough to convince them to return.

If a VBI does only one type of market research, it should regularly conduct exit interviews.

[3] The market research discussed in this chapter focuses on information about current and prospective customers. Two important aspects of market research are missing from this discussion: (1) gathering information about the competition and (2) gathering information about the business environment.

[4] Microfinance managers are strongly encouraged to consider the outstanding qualitative market research tools and techniques developed by MicroSave-Africa.

Box 4-6

Exit Interviews

Microfinance institutions are increasingly concerned about their "desertion rate." This choice of words implies a negative judgment about ex-clients and does not consider the wide variety of factors that influence a person's decision to withdraw. A family emergency may have called the entrepreneur away from her business; his business may be seasonal requiring that he borrow only at certain times during the year; perhaps family medical bills are consuming business income; maybe the family is leaving the area. Or, just maybe, the client has gained all she can from the program and needs different services.

An exit interview is needed to find out **why** clients leave without any prejudice regarding their departure. This information can be invaluable for program managers. Knowing why clients leave can help managers decide how to change the program to improve services. Exit interviews at Kafo Jiginew in Mali, for example, revealed that clients were leaving largely for problems unrelated to either the program requirements or the health of the business activity. The major reasons included the following:

- **Seasonality.** Some 50 percent of the clients quit the program in May, just before the rainy season. Knowing about this reason could help managers plan their cash flow. It could also encourage the program to think about what business activities could be developed or promoted during the rainy season.
- **Health.** Another 30 percent left because of sickness, death, or a related crisis in the family, which created huge expenses and prevented them from engaging in their normal income-generating activities, ultimately forcing some to leave the program. In these cases, management could set up an emergency fund for serious illness or death.
- **Lack of Profitability.** One quarter of the women indicated that they were unable to use the loans profitably. It would be useful for an organization to consider how it can help clients select or develop their businesses to improve their profitability and increase the length of time that they can participate in the program.

Adapted from Nelson, ed. (2000)

- **Complaint and suggestion feedback loops.** If it is systematized, informal data collection is sometimes more valuable that formal research methods. All employees who interact with customers should regularly and actively solicit complaints and suggestions. Besides trying to resolve complaints as quickly as possible, the "data collectors" should document the exchanges. Documentation of complaints and suggestions should then be centrally analyzed and used to guide the organization's drive for continuous improvement.

  Two important aspects to this process are often overlooked: (1) regular and active solicitation is important so that many voices are heard, not just the most vocal who tend to be less poor; and (2) customers who offer their opinions deserve an institutional response, thanking them for their concern or advice and informing them of what actions are being taken.

- **Village banks as focus groups.** Qualitative research methods can often provide valuable insight into customer behaviors and preferences. One of the most effective of such methods is the use of focus groups—moderated discussions with a group of customers who are asked to provide their feedback on issues that are important to the group, or that the institution wants to learn more about. Since village banks already meet regularly, it is quite easy to engage them in a focus group discussion moderated by someone other than their field staff (in case they have customer service complaints about that person).

- **Questions on loan applications.** Similar to the logic behind impact monitoring, a few additional questions during the loan application process can be an important market research tool. With new customers, the questions may explore why they selected the organization and what they hope to gain from the relationship. With repeat clients, these questions could try to determine their levels of satisfaction, whether or not their expectations were met, and their ideas for improved services.
- **Learning from non-clients.** One of the more difficult aspects of microfinance market research is trying to learn from people who are not accessing the VBI's services. Yet VBIs that are experiencing growth problems or want to target a new market niche need to learn about the behaviors and preferences of persons who have not been associated with the organization in the past. This need may be particularly critical for VBIs that find they are not reaching as poor of a clientele as they intended. Unless the VBI has a strong R&D team, this type of research may be best outsourced to a university or local research organization.
- **Staffing.** The success of informal data collection methods, such as the complaint and suggestion feedback loop, depends on the effectiveness of field staff to gather and document information, and sometimes even to interpret it. Field staff are the interface between the VBI and its customers. They have a critical market research responsibility to learn as much about the clients as possible. Instruction on sampling procedures, interviewing methods, data analysis, and common mistakes should form an important aspect of field staff training.

Field staff, who serve as the interface between the VBI and its clients, need special training in market research techniques.

4.4 Conclusions

This chapter discusses ways of answering the following three questions, which are important to many poverty-lenders:

1. Are we serving who we want to serve?
2. Are customers benefiting from our services?
3. How can we improve our services?

To answer these questions, a VBI needs to look past the village bank to better understand the characteristics of individual customers. An organization's concern about the answers to these questions largely stems from its mission. Some VBIs are committed to serving clients who are extremely poor, and they use targeting methods to ensure that they are accomplishing that objective. Other organizations, however, are comfortable serving a higher income or broader client market and choose not to invest specifically in finding and recruiting very poor clients.

The same division occurs with regard to the second question. While all VBIs want clients to benefit from their services, not all organizations feel compelled to measure that improvement through impact studies. The use of impact monitoring—tracking several variables with each loan cycle to give the organization insight into the types of benefits that customers are enjoying—seems to be a cost-effective compromise between complex studies and not doing anything at all.

Unlike targeting and impact assessment, conducting market research is not a choice; it is a necessity. How a VBI learns from its customers and what it does with that information depend on its mission and maturity. Successful VBIs are learning organizations that want to continuously improve the products and services they offer to their clients to enhance

customer satisfaction, retention, and loyalty, and to improve impact. This challenge requires cultivating a willingness to question assumptions and building in systems to listen to clients and staff—this is market research.

Resources

The following resources provide additional information about understanding the customer.

Targeting and Outreach Studies

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Market Research

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5
Product Development

Microfinance began as an innovation. The Grameen Bank's center (group of groups), ACCION solidarity group, and FINCA's village bank were all revolutionary means of overcoming market imperfections that prevented traditional banks from serving low-income customers. Over time numerous variations on the original models have emerged.

But not all innovations are successful. Although failures are not often discussed openly, the short history of microfinance is probably littered with more bad practices than good. Innovative institutions are risk takers, which means they must be prepared to fail and to learn from the effort. Risk taking, however, does not have to be reckless. When trying to improve in response to customer demand, village-banking institutions (VBIs) can avoid falling into the worst practices category if they follow a logical and strategic path toward product development.

This chapter presents such a product development path, from the process of gathering product ideas all the way to rolling out the product.[1] In reality, however, this process is not linear. Rather, managers will engage in many elements of the process at the same time. Therefore, when reading this chapter, it is more important to consider the characteristics of a successful product development process than strictly following a prescribed path. Elements of the process include the following:

- **Be open minded.** Product development requires imagination. Innovative ideas come from people who question assumptions and recognize that things do not have to be the way they have always been. Step back and look at the big picture—see the forest and not just the trees.
- **Assess capacity.** All organizations should strive to improve their existing products; but not everyone is ready to engage in *new* product development. Of particular concern is whether an organization has the (1) financial resources, (2) human resources, and (3) management information systems (MIS) flexibility to move forward.

Efforts to innovate and improve a VBI's products need to be approached deliberately and holistically—even small changes can have big implications.

[1] Kim Wilson and Craig Churchill drafted the content of this chapter.

- **Take it one step at a time.** VBIs that try to accelerate the product development process or attempt to develop several new products at once are lessening their chances of success.
- **Be participatory.** The product development process should involve representatives from each part of the organization to ensure that all perspectives are considered and to create a broad base of ownership over the product.
- **Consider the implications.** One of the biggest pitfalls that many organizations experience in product development, especially when they are improving their existing products, is that they do not consider the broader implications. Sometimes small changes have unforeseen and undesirable consequences. A new product may (1) interfere with the efficient delivery of other products, (2) dangerously divert senior managers' attention, or (3) create incentives for clients to behave in an unexpected or undesirable manner.
- **Consider linkages.** VBIs do not have to do everything themselves. Often the best solution involves a partnership or collaboration that enables each organization to focus on what it does best.
- **Keep at it.** Product development is an ongoing process, not a one-time event. A product is never going to be perfect, and even if it seems perfect now, it will not be for long, because customers' preferences change or new financial institutions enter the market. VBIs should strive to continuously improve their products.

5.1 Defining Product Development

Product development is the process of improving existing products or developing new ones, either for existing or new markets.

To define product development, one must first define **product**. For village-banking institutions, a product is a financial service that customers purchase because it fulfills a particular need. The most common types of products are credit, savings, and insurance. Some products also combine two of these categories—like the original village-banking product that combines savings and credit—and some integrated products combine financial with non-financial services (as described in Chapter 9).

The definition of a microfinance product includes the manner in which it is delivered. A savings product available from a distant office between 9:00 and 14:00 is different from one available five minutes away during weekly meetings—and both differ from a product that is delivered daily to the client's doorstep. Each product provides different value to customers, and imposes different costs and demands on the institution.

The term **product development** does not mean the same thing to all people. In this book, product development is the process of improving existing products or developing new products, either for the organization's existing market or for new types of clients. This broad definition leaves the door open to a variety of initiatives, some of which are riskier than others. Table 5-1 outlines recommended priorities for product development based on the associated risks and benefits.

As shown in the table, the first priority in product development is to improve existing products for the organization's existing clients. The second priority depends on the organization's circumstances: Either it will want to deliver an existing product to new markets, or it will want to develop new products for existing markets. The lowest on the priority list, and the riskiest, is the new-new combination of new products and new markets.

Table 5-1
Product Development Options

	Product Improvements	New Products
Existing Market	**Top Priority.** Customer retention is one of the biggest challenges for many VBIs. The first step toward enhancing retention is to see if the **core product** can be **adapted to suit** the organization's **existing clientele.** ***Example:*** There are numerous examples of organizations modifying term length, meeting requirements, loan size, etc., to accommodate client demand (see Chapter 6).	**Medium Priority.** After trying to refine the existing product to meet the needs of existing clients, some VBIs may consider developing **new products for their existing clients**, either to (1) replace the existing service they receive or (2) supplement it. ***Examples:*** (1) Many VBIs are developing individual loans for village-bank graduates (see Chapter 6); (2) FINCA Uganda is testing insurance products as complementary services for existing customers (see Chapter 8).
New Market	**Medium Priority.** If an organization has saturated its existing market, or feels compelled to begin serving a new type of client, if possible the first step would be to modify an **existing product** to the needs of the **new market.** ***Example:*** Small Enterprise Foundation (SEF) developed Tshomisano by modifying its core microcredit product to suit the characteristics of extremely poor clients (see Chapter 4).	**Lowest Priority.** The riskiest and most difficult type of product development is to create **new products for new markets** because the organization enters into completely unfamiliar territory that may be beyond its core competencies. ***Example:*** Before it got a good handle on managing voluntary savings, Association for Social Advancement (ASA) also began offering savings to non-members (see Chapter 7).

Adapted from Ansoff's Product Market Matrix; see Churchill (1997)

5.2 Analyzing a Product Opportunity

A successful loan, savings, or insurance product meets the objectives of both the customer and the village-banking institution. Satisfying only customer wants may sacrifice the institutional mandate for sustainability; conversely, meeting short-term institutional objectives may compromise customer satisfaction and retention. A successful product offers the greatest degree of overlap possible between customer and institutional objectives, as depicted in Figure 5-1. Analyzing a product opportunity requires a careful study of the benefits to both customer and institution. Market research will disclose which product features customers perceive as beneficial. An organizational analysis identifies which will most benefit the institution.

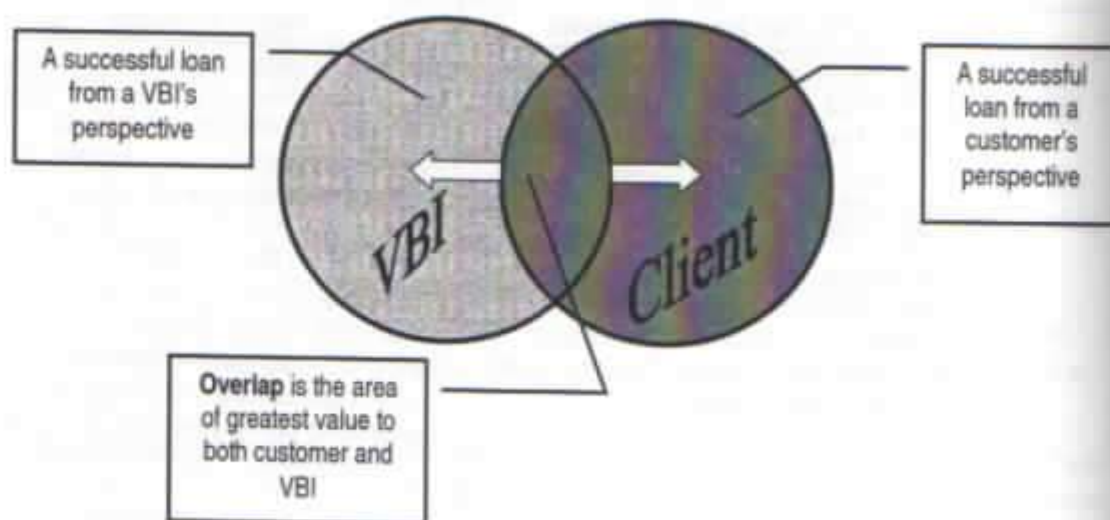
Product development is a balancing act between the preferences of the customers and the VBI's objectives. The challenge is to locate where those two perspectives overlap.

Product Desirability from a Customer Perspective

Customers have many wants and preferences in a financial product. Some preferences, however, are more important than others. Important preferences bring value to customers, as evidenced by their willingness to pay for them. There is no point in designing a loan product that meets all customers' needs; it would be hard to do and it would compromise an

VBIs need to know what benefits customers value, and then develop products around those benefits.

Figure 5-1
In Search of the Product Development Overlap



institution's sustainability. The challenge is to find the benefits for which customers will pay and focus product development around those benefits.

Product Desirability from an Institutional Perspective

To assess the appeal and appropriateness of a financial product from the VBI's perspective, an institution considers the following four criteria:

1. **Mission.** The product must meet the VBI's stated mission. The organization needs to look at the product in its "mission mirror" and see if it fulfills and advances the mission.

2. **Growth.** The product must improve one or more of the following objectives: (a) number of customers reached, (b) per client loan or savings balance, or (c) customer retention. If it does not achieve any of the above—if it is an innovation with no clear marketing purpose—it is probably not a priority.

3. **Manageability.** The product should have a minimal or manageable impact on the institution, particularly on its financial requirements, information system, and human resource capacity. When product development fails, it is usually because the organization did not have sufficient capacity.

4. **Profitability.** Finally, the product must be profitable, which requires a balance between initial investment, revenue potential and ongoing costs. To measure the profitability of its products, a VBI needs to disaggregate both income and expenses (see Box 5-1).

Framework for Product Analysis

A product's potential for success requires an analysis from both the customer's and the institution's perspectives. Each market segment and each institution will naturally have different priorities. Market research will disclose what customers believe is of greatest value. An organizational review will determine the institution's priorities. Table 5-2 illustrates a framework for analyzing a financial product: in this example, a loan.

Box 5-1
New Products and Cost Accounting

The addition of new financial products requires a significant change in the way VBIs often account for income and expenses. For each product, the VBI will need to separate out the relevant income and expenses in order to assess product profitability. Where products are offered in conjunction with each other, such as a life insurance policy that is linked to a loan, it is necessary to estimate the operational expenses that are associated with each financial service, including both direct costs (e.g., staff time, stationery) and indirect costs (e.g., rent, senior management). If the pricing of the product is also integrated—for example, if the insurance premium is included in the loan interest rate—for accounting purposes the VBI should separate out the relevant income for each to ensure that it is accurately pricing both products.

Another accounting technique that VBIs may find useful is activity-based costing. This costing method disaggregates the costs associated with each step in the product delivery process to identify where significant costs occur. It also determines how different those costs are for new clients versus repeat clients, or good versus delinquent clients." For example, the steps in the lending process might include (1) acquisition, (2) screening, (3) loan processing, (4) disbursement, (5) repayments, and (6) delinquency management. If VBIs did this exercise, they might be quite surprised at the huge cost burden of weekly repayments.

For more details, see Brand and Gerschick (2000)

Context

The overlap between the preferences of the customers and the needs of the institution must be considered within the local context, which has three main elements:

1. **Competition.** A VBI's financial products should be compared to other services available to the target market from both formal and informal sources. Almost all village-bank clients borrow and save through other channels, especially informal ones. By understanding what other services clients use, a VBI may gain insight into the product features that are attractive to them.
2. **Regulation.** The parameters imposed by the legal environment may determine certain product features (e.g., usury laws stipulating interest rate ceilings) or may limit the types of services the VBI can offer (e.g., the common restriction preventing nongovernmental organizations [NGOs] from providing voluntary savings).
3. **Macroeconomic conditions.** The macroeconomic conditions, such as inflation and economic growth, may influence the design of a financial product (such as interest rate) or the timing of its launch.

After the perspectives of the customer and the institution, the third dimension of product development is the context. Product development must take into account other available services, the regulatory environment, and macroeconomic conditions.

5.3 Product Ideas

The first step in the product development process is identifying innovative ideas for new products or product improvements. Where are these ideas likely to come from? Customers? Staff? Board? Advisors? Probably from all quarters. The schematic in Figure 5-2 shows possible idea sources for financial products.

While many good suggestions originate from customers, they often do not know what is possible in terms of product design. For example, a client accustomed to a term loan may know intuitively that the product does not meet her needs. If she has not been exposed to a line of credit, however, she might find it difficult to articulate such a solution. This means

Market research is an essential yet insufficient means for generating product ideas. Clients unfamiliar with the range of possibilities may find it difficult to articulate appropriate solutions.

Table 5-2
Framework for Product Analysis

A New Loan Product's Perceived Value from a Customer Perspective	A New Loan Product's Potential for Success from an Institutional Perspective
Availability and Accessibility • Product requires limited or no training • Limited or no collateral required • Easy and quick access; product is or has— > Simple paperwork (e.g., one-page loan application) > Available when needed (on demand, not at prescribed times) > Quick turnaround (time between application and receiving the loan is one to three days) > Convenient location (loan disbursed close to home or work) > Easy to understand (to compute interest, payments, other requirements, and benefits) **Restrictions and Requirements** • Eligibility requirements become less restrictive over time as credit worthiness is proven • Fewer meetings **Incentives** • As credit worthiness is proven, incentives increase > Promise of continued access > Lower interest rates for best clients > Higher loan amounts **Loan Amounts** • Appropriate to loan use • Have possibility of increasing **Repayment Model** • Matched to customer's capacity to repay > Choice of term or flexible terms > Repayment matches cash flow **Loan Uses** • Multiple, flexible, based on customer needs **Loan Price** • Matched to value of product • Price is a more important factor when— > Alternatives exist (family, savings, competition) > Cash is not needed immediately **Staff and Service** • Staff are— > Friendly, non-intimidating > Knowledgeable about product and can inform customers > Speak local language > Have authority to make decisions > Efficient, do not burden customers **Other Product Features** • Product comes with protection > Against unexpected events > Defaults in solidarity groups, etc. > Repeat loans not tied to success of group	**Mission Responsiveness** • Product reaches target customer • Has desired impact • Can be priced in keeping with the institutional mission **Customer Satisfaction** • Attracts new customers easily • Increases per customer balances (where appropriate) • Retains older customers **Competitiveness** • Is competitive vis-à-vis current competition and potential competition • Is competitive with customers' alternatives (such as borrowing from family or using savings) **Profitability** • Breaks even much sooner than initial core product > Should be sharing infrastructure and costs • Satisfies institution's targets for an appropriate financial return **Scalability** • Has high initial customer demand, appropriate for significant percentage of current customer base • Is easily explained to and understood by customers • Requires limited training of customers • Requires limited new procedures for customers • Offers repeat utility; same customers can borrow repeatedly • Uses same staff (ideally) **Repayment Incentives** • Are built into product design • Opportunities for customers include: > More loans > Lower interest rates > Less strict requirements • Penalties for customers include: > More collateral > Late fees > Peer pressure > Higher interest rates **Impact on Staffing and Systems** • Manageable impact on: > MIS > Staff and staff training > Organizing and outreach models > Financial management **Legal and Cultural Issues** • Product must be in compliance with local laws • Product must be suited to cultural context

that staff, management, and even board members must be able to listen to customers and observe their behavior, and then translate that information into solutions.

Product ideas may emerge from a variety of people and may be collected in numerous ways—from observations to brainstorming, from surveys and focus groups, and most of all from good listening by staff and management. Product ideas typically come from the following four major sources:

1. **Customers' Suggestions.** Customers may suggest ways to improve products. The complaint and suggestion feedback loops mentioned in the previous chapter are designed to capture and process these ideas. In addition, people whom a VBI has not reached but would like to serve can also offer product information and marketing strategies. Potential customers are often ignored in the product development process.
2. **Customers' Behavior.** Dropouts provide a wealth of valuable product information, including insights about competitive services, suggestions for changing the existing product, and specifics on how staff behavior may have affected their decision to leave the program. Because former clients have less to lose than existing customers, their responses are often more candid. Another behavior that should influence product development is repayment performance. Consider delinquent loans as an excuse to find out more about customers. Most late payments are not caused by unwillingness to pay; the inability to pay signals that a product may not be designed to meet customers' needs or that a flaw exists in client screening techniques.
3. **Insiders.** Observation and intuition can be great generators of product ideas. The idea for CARD's CLAP loan came from a janitor (see Chapter 6). Field staff have ample opportunity to observe customers and prospective customers; the insights of front line

Figure 5-2
Sources for New Product Ideas

To generate product ideas from employees, a VBI needs to have a strong culture of continuous improvement that enables them to know that no idea is too far-fetched to suggest.

personnel should be heeded. To cultivate ideas from insiders, a corporate culture of continuous improvement can be reinforced through the following methods:

- Train staff members how to analyze customers' preferences, to probe and inquire to identify customers' problems, and to analyze the information to produce solutions.
- Create opportunities for staff to share findings. The agenda for staff meetings should regularly include a slot to discuss product ideas.
- Reward staff through recognition and financial bonuses for ideas that turn into new products or enhancements.
- Bring board members to the field to get their ideas. This activity has the additional benefit of keeping them informed and involved.

4. **Outsiders.** Consultants, donors, researchers, and other visitors may generate good ideas, especially if they have spent time working with other VBIs. The fresh perspective of visitors should be welcome, though many ideas may not be appropriate.

5.4 Research, Development, and Roll Out

The diagram in Figure 5-3 presents a flowchart depicting the product development process. (The arrows with "C" in the diagram represent points of customer input.) In practice, however, the process of moving an idea into a viable financial product or product improvement is not usually linear (see Box 5-2 on BURO Tangail and Box 5-4 on UMU). Regardless of the sequencing, at some point during the development process, the institution should have addressed each of the following five activities.

1. Establish an R&D Team

Product development requires a tireless commitment from a core research and development (R&D) team, which includes representatives from each of the VBI's departments. It is not critical that departmental representatives are senior personnel; sometimes the inclusion of a few junior staff members brings fresh ideas and fewer assumptions about limitations.

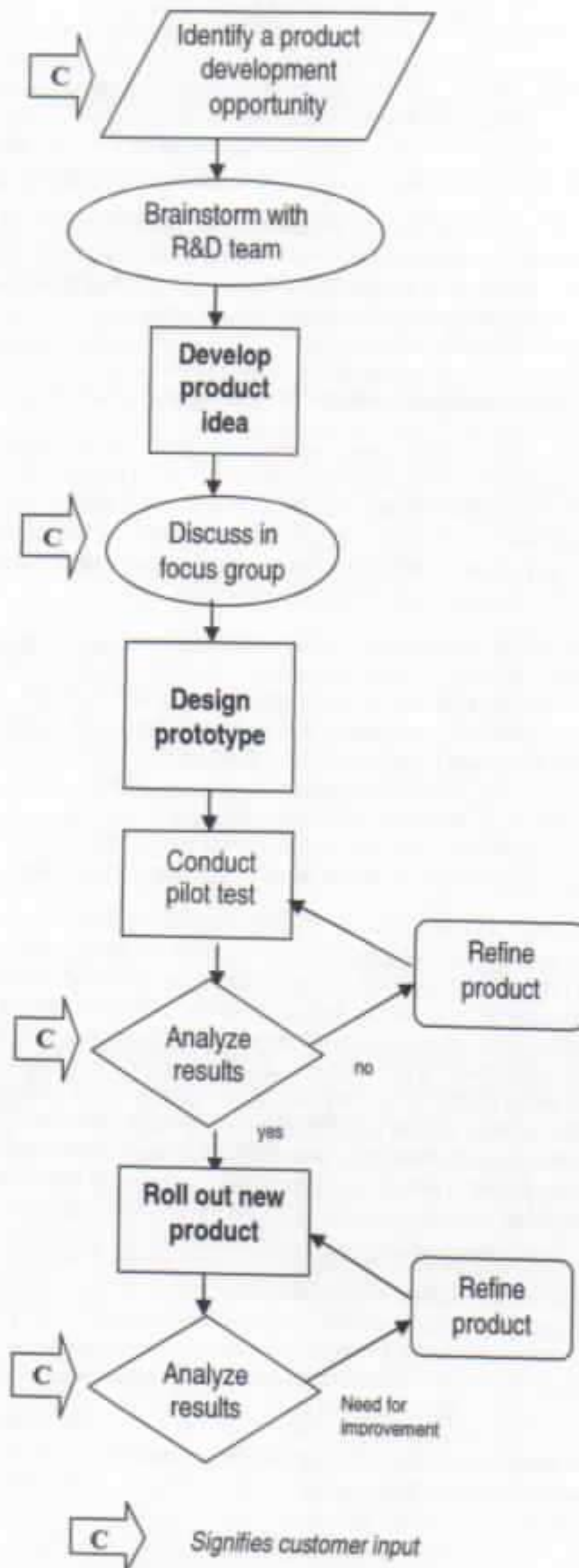
The team leader is known as a **product champion** because she or he is responsible for managing the development process. The success of the product development depends on the champion's ability to motivate the team and forge a consensus.

The R&D team has an important responsibility to update the organization on their activities, and to solicit suggestions throughout the process. If the R&D team is perceived as a secret club operating in isolation, they will encounter tremendous resistance when it is time to roll out the product. But if they are communicative and participatory, they are likely to find a more receptive audience at the end of the process.

2. Conduct Market Research

Successful product development requires customers' contributions at various stages. Before trying to pin down the details of the product, VBIs should use focus group discussions to check the range of possibilities with clients. At the beginning of the process, market research should help answer the following questions:

Figure 5-3
The Product Development Process



Box 5-2

Imagination in the Product Development Process: The Case of BURO Tangail

BURO Tangail (BT) is a medium-sized microfinance NGO in Bangladesh. Based in the district of Tangail, BT has a deep commitment to deploying innovative financial products. Over the years, BT has developed nine loan products and three savings products that answer many needs of poor villagers. Savings and loan services can be accessed independently, providing convenience and flexibility.

The description of BT's product design process in its 1999 Annual Report, which sounds like a well-structured and rather cut-and-dried affair, includes (1) meeting with members' consultative groups, (2) carrying out participatory rural appraisal exercises out, (3) holding workshops with members and staff, (4) consulting with external consultants, (5) scrutinizing products used by other providers, formal and informal, (6) doing detailed design, costing, and pricing, and (7) establishing and systematically reviewing pilot tests. When all is well, BT launches the new product in phases throughout the organization.

When I recently visited BT, I was relieved to find that this linear process isn't quite the case. One ingredient is missing in the dry description in the Annual Report—imagination. In reality it is there within BT, working like yeast, bubbling up here, short-circuiting the process there, or lying dormant for months only to spring to life when a director wakes up one morning and thinks, "Aha! Why don't we try this?" For example, take a look at the following account given by the directors of how they devised an emergency loan:

Three years ago the BT directors read about Indian pawnbrokers who serve the need for cash in the event of an emergency with loans that are often repaid in a few weeks or months. The directors had observed clients who struggled to make the standard 12-month loan fit short-term needs. They were particularly struck by an onion producer whose production cycle was 3 months long and who would have preferred a loan term of that duration. The directors began discussing what kind of short-term loan product BT could offer. They then enlarged this discussion by involving other staff informally and asking questions of clients. Encouraged by the responses, they held a few formal meetings with key staff to discuss the idea of a field trial. A branch close to the head office was chosen to pilot a few short-term loans.

The first borrower was a woman who needed cash quickly to send her son to work in the Gulf. She was offered a 20,000 taka loan for 4 months at 20 percent per annum (flat rate). Several other loans of various terms and values followed. At that time there was little documentation, and only a few staff were involved. The 1998 floods then intervened and little more was done for several months. After the impact of the floods subsided, the idea was raised at regular staff meetings and many staff showed interest. A few clients were consulted via focus group discussions; feedback from clients on the term length was particularly useful. Trials were then encouraged on a limited scale (not more than five such loans per month) in branches where staff were interested. It wasn't until 2000 that rules were formalized and the product was extended to all branches.

Asked if they would use this process again for their next product design, the directors replied that it would depend on the nature of the product. Less innovative products can be adaptations of standard products. Alternatively, they would consider using more sophisticated market research methods for more innovative products. The directors remarked that product design is ongoing, not a one-time process; products may need frequent modifications as an organization accumulates experience with them.

This account rings true. The process did not follow a structured path, but depended essentially on inspiration—on sensing that there was a need that could be met by a financial product, and playing with the idea until it fell into a shape that they believed could be tried out.

Stuart Rutherford, Founder, SafeSave

- **What need does the product fill?** For a product to be viable, customers or potential customers must perceive that it addresses their needs better than alternative solutions.
- **What is the potential value of the product?** A product's viability depends on its perceived value to the customer. How much is the customer willing to pay for the product? It will be difficult to gauge the pricing exactly at this point, but it is still worth getting a rough estimate.
- **What is the possible demand for the product?** This analysis depends on whether the product is designed primarily for new or existing clients. If a product does not appeal to a significant portion of the current customer base, the VBI misses an opportunity to leverage the acquisition investment it has already made in its clients. If the product is for an entirely new market, then a large-scale survey of prospective customers will be necessary to gauge demand.
- **What product features would generate the greatest customer value?** Focus groups provide good forums for discussing the features in which customers find value. It is also possible to use these discussions to quantify the customers' product priorities by conducting preference ranking techniques in which participants (a) rank various features of the product in the order of importance to them and (b) compare numerous pairs of features and indicate which of the two is a higher priority.

Product appeal to existing customers is crucial if the VBI wants to leverage the investment already made in its clients.

3. Design the Prototype

When designing the prototype, it is critical that the VBI try to think through all the implications. A review of the product according to a comprehensive analytic framework, such as the one presented in Table 5-2, can make an initial contribution. Some information will be missing, but a preliminary review will help identify the gaps. Most importantly, the R&D team needs to answer a few key questions:

- Is the product in line with the **mission** and focused on the right customer?
- Is it in line with **institutional strategies**? If not, is it worth changing the business plan?
- Will the new products merely take away clients from existing products for no net gain, or will it **generate additional demand**?
- What **capacities and resources** will the product require? Specifically, what staffing, skills, and management systems will be required in the field and the office? Will the management information system accommodate the new product or product changes? Does the VBI have the financial resources to undertake the proposed innovations?

VBIs should resist the temptation to try to do it all on their own. If the proposed product will be too taxing, consider providing the product in **partnership** with others. This solution is particularly applicable to insurance and to savings if the regulatory environment prohibits a VBI from mobilizing voluntary deposits.

Finally, the prototype should also be accompanied by three additional preliminary studies:

a. **Breakeven analysis.** This study includes projections of costs and revenues and a break-even time line. While many of the original assumptions will be pure guesswork, if the projections do not stand up to early scrutiny, it is not worth conducting the pilot test.

b. **Risk analysis.** Offering a new product carries risks to the institution. Managers should assess what and how much the institution might lose if the product fails to attract clients, costs more than anticipated, or has other negative side effects.

c. **Context analysis.** Poor people access financial services of varying degrees of quality and from a range of sources, both formal and informal. It is important to consider what competitive services this product would be up against, if any, and to review the other two aspects of the context: (i) What do the current and projected macroeconomic conditions mean for this product? (ii) What are the regulatory implications of this product?

The various analyses that accompany the prototype do not need to be formal presentations with glossy covers. At this stage, all of the thinking is preliminary, pending real results from the field that comes from the pilot-testing phase.

4. Test the Product

The pilot should achieve high degrees of success before the VBI introduces the product on a wide scale.

The pilot test is the critical phase in the product development process. The analysis thus far has been theoretical: What is the **estimated** demand and how much does the organization **think** customers would be willing to pay? But an expressed interest does not always translate into an actual demand. The pilot test moves the process from the theoretical to the practical and includes the following considerations:

a. **Purpose.** The pilot test uses a controlled environment to determine the actual demand for the new product or product refinements. It enables the VBI to see how the performance of the product compares to its assumptions. For example, with a loan product, are the loan sizes, repayment performance, and renewal rates similar to the projections? The pilot test also enables the organization to collect more information about customer preferences and behavior to refine the product before making it widely available, or to shut it down entirely if it appears unlikely to succeed. The VBI also uses the pilot test to revise its assumptions regarding capacities and resources.

b. **Location.** The pilot test needs to take place in an environment that is easy for the R&D team to monitor, such as village-bank clusters that are close to headquarters. The pilot should take place with village banks that are reasonably representative of the intended market so that the conclusions from the pilot can be generalized. Ideally, some of the field staff involved in the pilot test should be members of the R&D team because they will have the commitment to ensure that the test is performed properly. Pilot testing is an iterative process. It is best to begin with a small number of village banks. As initial lessons are learned, the VBI makes refinements and gradually adds more village banks to the pilot.

c. **Duration.** The length of the pilot depends on three factors. First, the iterative refinement process needs to continue until the VBI hones in on the product that it is actually testing. Second, the performance of the refined pilot product needs to mature—for example, with contractual savings and term loans, the VBI wants to see if customers renew their participation when the term ends. Third, most products will be affected by seasonal changes, so it is important to see how it performs during holidays and rainy periods.

d. **Evaluation.** The pilot is designed to test the assumptions that were made in the preliminary analyses during the prototype stage. The information from the pilot test is therefore used to go back to answer the "Design the Prototype" questions, but this time with actual performance information. Now the organization should have sufficient

information to make realistic cost and revenue projections to see if the product is financially viable.

The pilot study provides information on actual customer behavior, but during the evaluation it is also necessary to conduct another round of focus group discussions with clients who participated in the pilot to understand what they think about the product. As with all data analysis, the information should be disaggregated by market segments (see Box 5-3).

Because it is natural to want to launch a product after the pilot phase, VBIs should take the evaluation seriously and not just use it to justify roll out.

VBIs should evaluate the results of the pilot very critically and not just use the evaluation to justify the roll out. There is a natural tendency to want to launch a product after investing so much into getting it through the pilot stage. If the results from the pilot do not point conclusively to a successful roll out, then refining and testing should continue, or the product should be withdrawn.

5. Launch the Product

If the evaluation of the pilot test concludes that the VBI should launch the new product or product refinement, then the hard work begins. Before the product is available on a large scale, it is necessary to obtain board approval, secure funding, and develop policies, manuals, staff training materials, financial management systems, and internal controls. If the preliminary findings from the pilot seem positive, some of these activities can take place before the pilot evaluation is completed so that the roll out can get under way fairly quickly.

The organization also needs to develop a **marketing strategy**. While there are numerous aspects to marketing a new product (Brand 1998b and Wright 2000a), the following are the most important for VBIs to consider during the roll-out phase.

- Field staff need to recognize that they have a sales function.
- Field staff should be trained in how to sell the product. The training should include what features to highlight, what arguments to make, and how the product compares to the alternatives.
- Field staff should have the necessary marketing materials (e.g., posters, brochures, and flipchart presentations) and implementation materials (e.g., loan applications or savings books).
- The organization should design appropriate incentives to encourage field staff to sell the product. (Note: Incentives do not always have to be financial.)

Product development will fail if the VBI does not provide sufficient training to field staff on why and how to implement the product, and does not reward them for selling it.

The VBI should monitor and manage the launch very carefully. It is not sufficient to train field staff and then send them on their way. The organization needs to observe staff

Box 5-3
Market Segmentation

The analysis of market research and product performance is strengthened by disaggregating the data by market segments, or groups of clients that have similar characteristics. Market segmentation enables the VBI to better understand levels of potential demand, contributes to more accurate projections, highlights risks that are hidden in general data, and identifies underserved market niches. Possible segmenting characteristics include income, gender, business type and size, length of participation, repayment and savings history, demography (e.g., age, marital status, level of education), and geography.

interacting with clients to ensure that the delivery is working, the message is clear, and staff members have answers for all the clients' questions. Follow-up training may be required.

Use of a new product may gradually expand as the product is refined and the number of users increases.

Product launch does not necessarily mean that the new product is immediately available everywhere. In large VBIs, the line between pilot testing and roll out may be blurred; instead, the number of branches participating in the pilot is gradually expanded. In this cautious scenario, refinements are regularly incorporated into the product as the circle of participating branches gets wider. The implementation should also improve as the circle widens, since the VBI can work out the problems and improve staff training along the way.

One of the major obstacles to the product development process is inertia. The R&D team needs to find ways to overcome the natural **resistance to change** that they will encounter as they try to introduce the product throughout the organization. Several of the strategies to reduce resistance have already been highlighted, but are worth reiterating.

- A cross-functional team with representatives from each department drives the R&D process.
- The R&D team regularly communicates its activities to, and solicits suggestions from, employees throughout the organization.
- The VBI launches the product with appropriate training and incentives for "sales" staff.
- The organization cultivates a culture of continuous improvement so that employees are ready for change and even embrace it (see Box 5-4).

Finally, the launch of the product does not mean that the development process is over. Product development is ongoing. VBIs should continue listening to their customers and make adjustments as necessary.

Box 5-4

Unconventional Product Development at the Uganda Microfinance Union

The Uganda Microfinance Union (UMU) breaks with conventional wisdom in its approach to product development. The institution offers several loan products, all geared to meet the needs of its 15,000 customers.

Unlike most programs whose services are shaped by a model, the UMU shapes its services to its market, choosing and changing the model to meet customers' needs. "Our approach to product development is simple," says co-founder Rodney Schuster. "If a potential or current customer wants a new kind of loan, we try to say Yes. First we determine if the loan fits within our existing framework, even it stretches the boundaries some. If it does, we move forward. For example, one client—a good one with a track record—wanted to borrow an amount larger than we were offering. We said Yes and have monitored this loan closely. If successful, we might offer larger loans to other good clients."

What if the loan does not fit the current framework? "We still try to say Yes," says Schuster. "We will go to the trouble of developing a new loan as long as we identify a market—a solid block of similar customers also interested in the product. We then design and test the new loan for about a year and closely monitor its performance. For example, we recently gave a loan to a new type of customer, a local school. School fees ebb and flow throughout the year, with income dipping to its lowest point when school is out of session. However, that is the best time for a school to upgrade assets and infrastructure—repair a classroom, improve a playground, build an office. We created the Development Loan as a test to help one school. If the loan allows the school to make a good investment and pay us back based on cash from school fees, we will look to a broader launch, maybe within just one branch. From there we can expand to other branches. Creating a new loan, of course, is only worth the effort if the size of the potential market warrants it. Uganda has thousands of schools so in this instance we know we have a market."

Even UMU's **bread and butter loans,** its Working Capital and Capital Asset loans, are made for the market. While they require a group guarantee, members may borrow at different times for different terms. Savings are also flexible. Customers may withdraw savings whenever they wish. This flexibility keeps customer retention high (less than 10 percent dropout per year), far higher than other microfinance programs in Uganda.

The organization's philosophy is to offer loans the customers want, when they want them. To keep agile, the UMU's watchword is change. "From the very beginning," says Schuster, "we have inculcated **change** as a supreme value. We even say to new staff, 'Group lending is not our model; change is our model.' We knew that if we did not make change our guiding principle, staff would get comfortable with one model and soon that model would be cast in stone. As soon as we get too comfortable, we will lose our competitive edge."

Resources

The following resources provide additional information about product development.

Brand, Monica. 1998a. "New Product Development for Microfinance: Evaluation and Preparation." *New Products for Microfinance, Technical Note 1.* Bethesda, MD: U.S. Agency for International Development (USAID), Microenterprise Best Practices (MBP) Project. www.mip.org

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Wright, Graham A.N. 2000a. "Beyond Basic Credit and Savings: Developing New Financial Service Products for the Poor," in *Micro-Finance Systems: Designing Quality Financial Services for the Poor.* Dhaka, Bangladesh and London: University Press and Zed Books. www.zedbooks.demon.co.uk

6
Flexible Loans

Group-based lending has a severe limitation: It does not do a good job of keeping most borrowers for long periods. The standard model suits the needs of some clients who remain in credit groups for years and continue to borrow regularly. At the same time, high desertion rates likely reflect high levels of client dissatisfaction. If village-banking institutions (VBIs) want to retain most of their clients, greater flexibility and additional credit products may be necessary. VBIs need to move beyond the flawed expectation that poor people want to remain in perpetual debt. They also need to recognize that the group as a lending vehicle may not last indefinitely, and the group as a guarantee mechanism is flawed if it punishes the best clients by forcing them to pay for the losses of bad borrowers.

Some institutions have adapted their group loan product, or supplemented it, to focus on the needs of customers. By using market research methods (see Chapter 4) to inform the product development process (see Chapter 5), they have produced the following two related results:

1. Adjustments to the standard group-lending product to enhance flexibility and respond to the heterogeneous character of their target market; and/or
2. The introduction of additional loan products to address the diverse demands for credit in low-income communities.

While the introduction of new loan products may reduce desertion and provide better customer value, it comes with costs and risks to the institution. Only VBIs that have mastered the delivery of the basic group product should consider diversifying into additional lending services. There is room, however, for the basic product to be adjusted so that it better fits with client demand—all VBIs should look carefully to see if their core product appropriately balances the costs and risks to the institution and the client.

Flexible loans and new products may provide customer value and reduce client desertion, but they come with costs and risks to the institution.

This chapter begins by describing ways in which the standard group-lending product might be made more flexible. The chapter goes on to discuss some of the issues and decision points faced by institutions considering adding an individual loan product. The chapter concludes by reviewing the challenges posed by increased flexibility.[1]

[1] Kim Wilson and Judith Painter drafted the content of this chapter.

6.1 Flexibility within the Group-based Product

A number of VBIs have already responded to customer needs by making their group-based loan products more flexible; for example, by allowing borrowers to select loan amounts, repayment frequency, and/or loan terms.

This increased flexibility can occur at various levels. Village banks often consist of five or six solidarity groups with five members each. The greatest flexibility happens when the individual member has full choice over a range of options. Adding this kind of flexibility, however, has a major impact on costs and systems. To create flexibility without jeopardizing efficiency, VBIs can also make options available at the solidarity group or group-of-group levels, whereby all members would agree to follow the same set of conditions. Figure 6-1 illustrates that the greater the flexibility, the greater the corresponding costs.

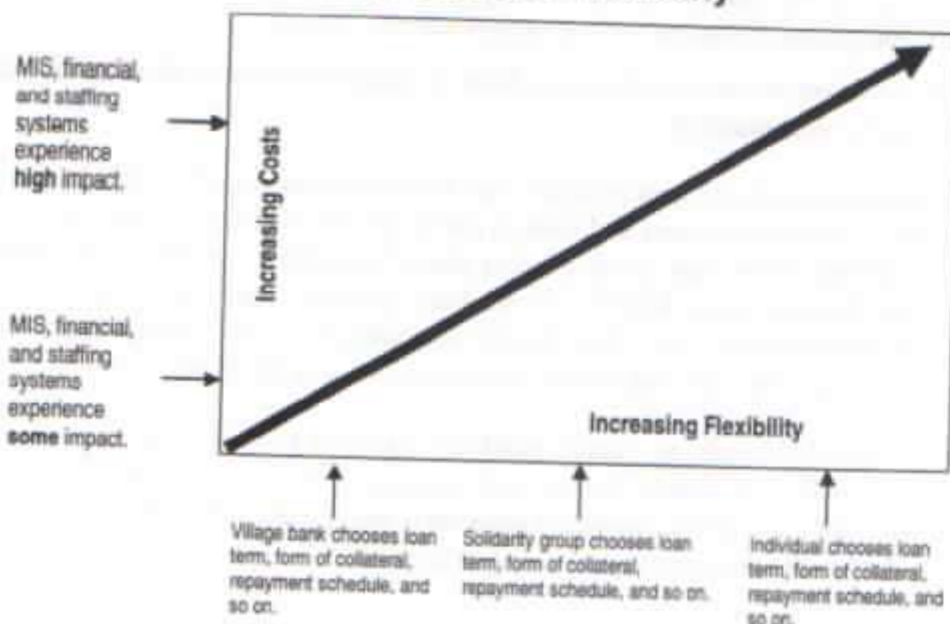
Options for increasing flexibility include adjustments to (1) the loan amounts, (2) repayment conditions, (3) the loan term, (4) the requirements for accessing a loan, and (5) the loan purpose. These examples highlighted below represent various degrees of flexibility, some of which are simple adjustments, while others require significant management capacity and higher costs.

1. Loan Amounts

Group members can receive different loan amounts. Thaneakea Phum Cambodia (TPC) Village Banking Program, a partner of Catholic Relief Services (CRS), allows individual customers to have different loan amounts, although the difference between the maximum and minimum is limited. For efficiency purposes, all village-bank members have the same loan terms, but they may choose 4-, 5-, or 6-month terms, and after the third loan, an 8-month term becomes an option.

Loan sizes can be linked to repayment performance. The link between flexibility and repayment performance is exemplified by FINCA Uganda's grading

Figure 6-1
The Costs of Flexibility



system. Based on the number of late payments, grading of village banks and individual members is from A to E. Future loans are linked to the grading system; grade A clients can borrow four times their savings balance, B clients up to 3 times, and so on. Clients classified as E are asked to leave the program.

Loan size ceilings can be raised or eliminated. Because they do not want to lose their best clients, many VBIs have gradually raised their loan size ceiling, up to $1,000 or more. At some point, however, the difference in loan sizes between village-bank members gets too large—it may be inappropriate for persons with $100 loans to guarantee $800 loans for example. In these situations, some VBIs have introduced individual loans (see Section 6.2).

2. Loan Repayments

Repayments do not have to be weekly. Pro Mujer in Bolivia allows individual customers to choose initial loan amounts between $50 and $130 (average is about $100). After two cycles of weekly payments, solidarity groups within the village bank may choose weekly or monthly payments. Less frequent repayments significantly lower transaction costs to both clients and the VBI, but are only available to groups with a good track record to avoid increasing the organization's credit risk. The Uganda Microfinance Union (UMU) allows group members to choose weekly, biweekly, or monthly repayment frequencies.

Clients can have a grace period before they start repaying the loan. Some VBIs allow borrowers to use the full loan amount for a couple of weeks before they start repaying. If a **grace period** is offered, either the loan term is extended by the length of the grace period or the installments are slightly increased.

Repayment holidays are one of the most useful features for accommodating the irregular incomes of poor borrowers.

Repayment holidays can be built into the loan product. In recognition that poor clients are going to have lean weeks, some VBIs increase flexibility by offering **repayment holidays.** For example, if the loan is for 16 weeks, the weekly repayment amount is based on 14 installments. During the loan term, borrowers can select 2 weeks when they do not have to attend the meeting or make a repayment without incurring a penalty. If staggered terms are possible within a group, then members who do not use their holidays can access subsequent loans two weeks earlier.

3. Loan Terms

Members can receive loans at different times or for different lengths of time. Recognizing that not all members need the same amount of money for the same amount of time, the Egyptian partners of CRS offer individual bank members a choice of seven product variations. The loans range from $80 for 5 months to $457 for a year. Group members guarantee each other's loans by signing a contract whenever a new loan is disbursed. This means that members may be liable for a loan even after their own loan is repaid and, in some cases, they have dropped out of the group.

Client satisfaction with this flexibility has led to greater demand and lower desertion, which has increased the program's average loan size and enhanced profitability. At the same time, the product range is more difficult and time consuming to administer than the standard village-bank loan. To manage the new product, CRS Egypt had to refine its management information system (MIS), focus more on cash management and loan processing, increase its training of loan officers, and implement more internal controls to manage the greater risk of fraud that arises from less uniform terms.

Members do not have to be borrowers all the time. Many microenterprises or income-generating activities do not require ongoing injections of new capital. Some VBIs allow group members to rest or skip a cycle and just remain in the village bank as savers. BURO Tangail in Bangladesh provides all loans through groups but allows members to take loans only when they want them—an innovation that clients value highly. In theory, these rest periods may also enable an MFI to attract extreme poor clients with irregular incomes. The reality is more complex. Unless the group size is increased accordingly, allowing group members not to borrow will drive up a VBI's cost per loan. To offset this, the VBI may either need to increase its interest rate or target clients who want larger loans.

4. Loan Requirements

Meeting requirements can be relaxed. Exit interviews commonly find that some clients get tired of attending meetings. While they may value them for a while, the opportunity costs of being away from their businesses for an hour or two each week eventually exceed the benefits. In response, some VBIs make meeting attendance optional after a certain number of loan cycles. Members need only assure that their loan payments are made—sometimes group leaders or treasurers will go around and collect repayments; sometimes members will send their children with the money.

Members can access their savings under certain circumstances. If clients have to leave the program to access their savings, it creates an incentive to desert. Some institutions, such as Association for Social Advancement (ASA) in Bangladesh, allow clients to access their savings without leaving the program and without having to start over with entry-level loan amounts (see Chapter 7, Box 7-3).

Group members do not even have to guarantee each other's loans. In the late 1990s, ASA introduced a radical innovation by dropping its group guarantee requirement. For efficiency purposes, groups continued to meet; however, they do not have to pay for each other's delinquency or default. Because it has a strong culture of arrears intolerance, ASA's repayment rate remains over 99 percent without a group guarantee.

5. Loan Purposes

Loans do not have to be just for working capital. Some village banks of CRS partners in Senegal extend loans for animal husbandry. The village banks make a single balloon payment of principal and interest at the end of the loan term. Although this repayment schedule was developed in response to client demand, the VBIs benefit as well; transaction costs are much lower and balloon payments reduce security risk as money is infrequently transported to the distant bank branch. To control credit risk, other VBIs that extend agricultural loans ask borrowers to pay interest on a weekly basis and repay the principal at the end of the term, which is scheduled to coincide with the harvest. Other organizations are experimenting with loans for housing, fixed asset, and education.

Borrowers may be eligible for more than one loan at a time. With approval of the village bank, it is possible to extend supplemental loans to individual members. In Russia, FINCA Samara offers **holiday loans** to members with excellent repayment records after the 3rd loan cycle. These loans have bullet payments, where principal and interest are paid at the end of a five-week term. The interest rate is 5 percent and the maximum loan amount is $290. Similarly, FINCA Kyrgyzstan offers seasonal loans,

additional loans for clients during peak businesses periods such as festive seasons. Seasonal loans are for less than half the original loan size but not more than $200, payable in one month in a single bullet payment.

Emergency loans are available to assist clients in need. Flexibility in the original village banking model was intended to be available from the internal account (see Box 6-1). Members in need of emergency loans could borrow from the village bank. Although still popular in some programs, other VBIs have removed this aspect of the methodology. Some group-based lenders, such as the Grameen Bank and its replicators, do not have an internal account but provide emergency loans instead.

Flexibility and Credit Risk

While these innovations probably increase customer value, what about credit risk? For many group lenders, talk of grace periods, repayment holidays, and customized repayment schedules raises the specter of spiraling delinquency. The experience of some institutions, however, suggests that credit discipline is not necessarily undermined by customized repayment schedules.

Customized repayment schedules do not necessarily undermine credit discipline.

For example, Uganda Microfinance Union's solidarity group product allows members to borrow when and as much as they need and to repay according to a schedule that coincides

Box 6-1

Internal Account: The Ultimate Flexibility

The relationship between internal and external accounts has distinguished village banking from many group-lending methodologies. The internal account offers members an opportunity to save and accumulate assets, and it provides village bank members with ultimate borrowing flexibility.

Generally an internal account includes funds from several sources, including:

* Savings of bank members (this usually accounts for most internal account funds)
* Interest income generated from lending internal account funds
* Fees and fines levied by the village bank (i.e., for tardiness or absenteeism)
* Additional income generated from bank investments or other fundraising activities

Village banks have an internal account for three principal reasons. First, it *creates an additional loan fund*, owned and operated by the bank members. This fund provides loans to supplement the external account, including loans for consumption, additional working capital, and emergencies. Second, the internal account *encourages capital accumulation* at the village bank level to eventually reduce or eliminate the need for external funds. The third reason is to empower members through solidarity and the management of their own funds. Business skills are developed in basic bookkeeping and financial decision-making.

How a VBI uses the internal account varies with its experience and vision. Some impose few policies on the internal account and leave it to members to sort out. Other VBIs maintain strict control. Tight control reduces the risk of fraud and mismanagement, but it also can limit access, reduce potential returns, and diminish opportunities for self-management.

Some institutions even view the internal account as competition that can undermine the sustainability of the VBI. Although the internal account rarely eliminates the need for external funds, it can reduce demand for them because the terms and amounts for internal account loans are invariably more flexible.

Adapted from Painter (1999)

with their cash flow. From UMU's experience, fixed loan cycles, repayment schedules, and loan amounts are not necessary for a group guarantee to work. In fact, different loan terms ensure that members will apply at different times and place pressure on all members to be current all the time, not just at the end of the term. UMU has experienced 1 percent arrears on both its working capital loan and its capital asset loan, with both products affording customers the benefit of selecting their own terms.

It is appropriate for VBIs to relax some credit risk controls for customers in good standing.

Furthermore, many institutions limit their flexible options to more mature clients. In general, the examples above have a common characteristic of increased flexibility over time. The logic behind this is twofold. First, new clients are high risk because the VBI does not know them well. Once the client or the village bank demonstrates creditworthiness, then some of the controls designed to minimize credit risk can be relaxed. Second, increased flexibility can be used as a reward to encourage timely repayments and to retain customers over time.

Some adaptations can be delivered through the village bank, and others require a parallel structure; but there is no agreement on where that boundary lies.

There is no consensus on which adaptations can be offered within a group product. Some VBIs may find utility in redesigning systems to allow individually customized loan terms and repayment frequencies within a group product, despite the complications such flexibility causes for record keeping and repayment monitoring. Others may find it difficult to offer different loan terms—for example, within a group—because their systems are designed for all loans to end at the same time. For many institutions, there comes a point beyond which making the group product more flexible is less feasible than offering an individual loan product.

6.2 Individual Loan Products

Group lending has much to recommend it. Group lending methodologies can do an excellent job of quickly disbursing loans to large numbers of new borrowers. The group is a superb vehicle for human transformation, economic support, and community prosperity. It is an excellent method for delivering enterprise loans to people with limited business experience, who have not borrowed from a financial institution, and/or lack collateral. It gives individuals a structured environment in which to manage credit and build a credit history. The group is the locus for exchanging intimate knowledge about neighbors (essential to loan reviews), for relaying important community news (essential to enterprise prosperity), and for providing ideas and support to fellow members.

Group guarantees, however, can punish the best clients, and group meetings can become a burden, which can lead to dissatisfaction and desertion. Fortunately, experience demonstrates that the function of the group can change over time. Clients can reach a point where even an uncollateralized individual loan can be feasible.

VBIs should question their assumption regarding the purpose of the group: Is it always needed to guarantee timely repayments?

CARD Bank, which uses the Grameen methodology, considers the group a vehicle for building a customer's credit history, which then becomes the bank's primary means of controlling credit risk. After four years of borrowing within a group, an individual with an excellent credit history may apply for a **line of credit** without a group guarantee—the CARD Loan Acceleration Program (CLAP) loan. At this point, CARD believes that neither collateral nor a group guarantee is required to maintain portfolio quality. Its success is partly attributed to the ultimate flexibility of a line of credit, which allows clients to draw down when they need to and repay when they can afford to.

For some institutions, adding an individual loan product, particularly for mature clients, may be advisable. The two products featured in Table 6-1, CARD Bank's CLAP loan and UMU's capital asset loan, offer flexibility to repeat customers with excellent repayment performance. Both products fare well according to the analytical framework introduced in Chapter 5. Customer benefits are high and institutional objectives are fulfilled.

Should an individual product be offered through the group or outside it? There is no universal answer. FINCA delivers individual loans through parallel structures (see Box 6-2), while the Aga Khan Rural Support Programme (AKRSP) offers them through the village bank. If the best clients leave a group in order to take individual loans, the village bank could lose its leadership and cease to function effectively; but if the VBI does not offer individual loans outside of the group, it may lose those clients anyway. The product development process described in the previous chapter is the best way to determine what the clients prefer and what is feasible for the institution.

Whether through the group or outside it, adding an individual loan product can improve customer value, decrease desertion, attract new clients, and improve sustainability. At the same time, it can divert an institution from its primary market and can slow or even hinder its growth. To maximize benefits and minimize costs, institutions that aim to develop an individual loan product should consider the readiness checklist in Box 6-3.

Box 6-2

FINCA's Individual Loans in the Former Soviet Union

Countries such as Georgia, Russia, and Kyrgyzstan have different client markets than the Latin American environments in which village banking began, requiring significant modifications to the original model. Village banks tend to be much smaller (FINCA Kyrgyzstan averages just 12 members per village bank) and loan sizes tend to be higher.

FINCA's programs in these countries serve a broad range of clientele. The programs offer individual loans targeted at two different markets: (1) village-bank members with excellent repayment records who need larger loans than would be prudent for the group to guarantee; and (2) established businesses for which the village bank is not an appropriate starting point.

Before applying for an individual loan, applicants attend four to five meetings to learn the terms and conditions of the loan and prepare the necessary documentation. Loan officers help applicants develop business plans, which must be reviewed and approved by a credit committee.

Loans are secured with collateral that must be at least 70 percent of the loan amount; cosigners with a salaried income are also encouraged, but are not always available. Loan sizes and terms are linked to the repayment capacity of the business before it receives the loan; for example, weekly payments may not exceed 60 percent of the business' average weekly net income. Common loan sizes are $1,000 to $2,000, but can go as high as $10,000 for two years.

After disbursement, the loan officer visits the business at least once per month to maintain a good rapport with the client, to check on the health of the business, and to ensure that the collateral is still on site. The internal auditor also makes at least one inspection visit per loan cycle for each individual loan client.

Repayments may be weekly, biweekly, or monthly. Interest and fees vary by program, but usually there is a 1 percent application fee up front and an interest rate of roughly 4 percent per month. Interest rates are lowered for repeat borrowers in good standing.

Table 6-1
Flexible Loan Products from CARD and UMU

CARD Bank CLAP Loan Line of Credit Introduced in 1997	Uganda Microfinance Union Capital Asset Loan Introduced in 1999
Customer Requirements	
• Complete 4th loan with perfect repayment • 95% attendance rate for past 3 years • Viable/sustainable income-generating activity • Endorsement of group • Business permit, business plan, and feasibility	• Complete 6th loan cycle of core working capital loan with perfect repayment (could be less than 1 year total) • Application guaranteed by group members • Staff visits customer and reviews application • Initial savings of 20% required
Product Features	
• Loan term: unlimited based on performance • Repayment: weekly, monthly, quarterly • Pay % principal plus interest • Start with ceiling of $3,500 and grow from there; borrow up to ceiling • Loan use: for business purposes • Interest rate: same as other products	• Loan term: 6–12 months • Repayment: weekly, biweekly, monthly • Start with ceiling of US $240 to $800 • Loan use: for business purposes; most must be for the purchase of an asset; some can be allocated to cash flow • Interest rate: same as other products
Customer Benefits	
• Loan is to individual • No meetings required; limited paperwork • Can repay and draw down at any CARD branch • No collateral • Flexible repayment; borrow as needed • Only apply once for unlimited use • No compulsory savings (only initial 5% compensating balance)	• Loan is to individual • Can be used to purchase a variety of assets, from farm animals to refrigerators • Individual selects loan amount, terms, and repayment schedule (with staff approval) • Apply and receive when needed, not according to group needs • Interest paid on declining balance • Initial savings may be withdrawn in emergency • Customer may hold capital asset loan and working capital loan simultaneously • Customer is not required to borrow to maintain good status
Institutional Benefits	
• Mission responsive: retains customers who constitute target market • Competitive: keeps customers from switching to rural banks • Profitable: yield is 44% annual, 99%+ repayment • Savings show substantial increase • Scalable: easily understood; repeat utility; useful to clients over time; 40% demand by existing customers	• Mission responsive: reaches target market; is effective (customers now have assets that they previously did not have) • Competitive: is attracting customers away from competitors • Profitable: average loan term is 12 months (fewer transaction costs); product reaches break-even at branch level in less than 1 year • Scalable: easily explained; repeat utility; useful to clients over time; 60% demand by existing customers of working capital loans • Few additional specialized staff required

Box 6-3

Checklist for Introducing an Individual Loan Product

1. **Strategic Issues**
   a. **Is It Ready?** Does the VBI have the capacity to manage an individual product?
   b. **Mission.** What effect will individual loans have on the VBI's culture and its mission?
   c. **Is the Environment Conducive?** What conditions need to be in place for the individual loan to be effective (e.g., credit bureau, collateral registration, contract enforcement)?
   d. **Distribution of Limited Resources.** If the VBI has limited resources, how will it avoid being drawn up market?

2. **Product Design**
   a. **Eligibility Criteria.** At what point will members become eligible for individual loans? Are village-bank loans and individual loans for different market segments, or will customers choose which product they would prefer?
   b. **Loan Decisions.** How will the VBI make credit decisions and customize loan sizes? Who will participate on the credit committee?
   c. **Collateral.** If individual loans are issued outside of the village bank, what will replace the group guarantee? Is the legal environment favorable to collateralized lending?

3. **Organizational Structure**
   a. **Specialists or Generalists.** If the loan products are delivered from the same retail outlets, will the same person offer them or will loan officers specialize?
   b. **Reporting Structure.** If the products require specialists, to whom will they report? Will the VBI have integrated or parallel management structures?
   c. **Cost Accounting.** Will the VBI separate the income and the (direct and indirect) expenses associated with each product?
   d. **MIS.** What are the MIS implications of offering an individual product and how will the organization address this issue?
   e. **Internal Controls.** What effect will individual loans have on the VBI's internal controls?

4. **Staff Training and Human Resource Policies**
   a. **Institutional Culture.** If the organization uses the specialist approach, how will it avoid giving higher status to staff responsible for individual loans? How will the organization achieve synergies and a unified culture?
   b. **Staff Incentives.** Will incentives encourage loan officers to concentrate on one product or the other? Will group loan officers be rewarded for "graduating" clients?
   c. **Recruitment and Training.** Again, if the specialist approach is adopted, how will the recruitment and training of staff for each product differ?

5. **Marketing and Sales**
   a. **Pricing.** Will the VBI price the two loan products differently, and if so, how?
   b. **Market Segmentation.** How will the VBI segment the market in terms of marketing strategies and messages?

6. **Results**

   Product Analysis. How do the results of each product compare in terms of portfolio quality, productivity, efficiency, and profitability? Is there cross-subsidization between the products?

6.3 Conclusion: Implications of Flexibility

Whether adapting the existing group product or introducing an individual product, increasing flexibility may affect many aspects of a VBI's operations, including its mission, staffing requirements, cost structure, information system, internal controls, growth rate, and ability to attract and retain clients. In sum, developing more flexible loan products can affect both mission and financial sustainability.

Mission Drift or Deeper Outreach?

Efforts to diversify loan products often draw VBIs up market as they try to retain their most profitable customers—repeat borrowers with larger loan balances. When VBIs offer larger loans, it is natural for those borrowers to receive a disproportionate amount of staff time, and to divert management's attention away from its core market.

A possible ethical challenge that some VBIs may encounter as they diversify loan products is whether they should offer **loans for consumption** purposes. Are they engaged in development work if they are lending money to buy televisions and sofas? Money is fungible, and some clients use loans for those purposes already; but does that justify designing a loan product explicitly for consumption?

Market research into the financial landscape in low-income communities regularly reveals that microfinance is only a small share of the debt portfolio of many customers, who also borrow from family and friends, rotating savings and credit associations (ROSCAs), suppliers, and moneylenders, among others. A possible customer loyalty strategy for VBIs is to increase their share of an individual's debts, and that may mean developing a versatile loan to compete with lay-away plans or store credit. CARD's multipurpose loan is designed to achieve this very objective. Extreme caution, however, is warranted to avoid over-indebting consumers.

Increased flexibility may make village banking more suitable for lower-income persons.

At the same time, more flexible loan products may enable a VBI to reach poorer clients. Although group-based lending intends to serve poor customers, the extreme poor may in fact be excluded by the rigidity of the basic product. Flexible loan products can more effectively accommodate the irregular cash flow of poorer customers. These products also may be more expensive to deliver, however, which can motivate the VBI to target a higher-income market.

To limit mission drift, VBIs should consider credit products and flexible features that are particularly attractive to poorer market segments. Flexible features that tend to suit poorer clients include repayment holidays, grace periods, the option for frequent repayments and longer terms, and the elimination of automatically increasing loan sizes. VBIs should also have a judicious **refinancing policy** that takes into account the vulnerability of their target market. If someone is willing but unable to repay, and their neighbors ostracize them, the VBI has done more damage than good. In terms of new products, if a VBI does not encourage the use of the internal account, then it should seriously consider developing an emergency loan product.

A VBI should seriously consider developing an emergency loan product if it is not encouraging the use of the internal account.

Staffing and Costs

The simplicity of the original model enabled VBIs to hire promoters with strong interpersonal and social skills, without requiring extensive education or a finance background. The more variations to the lending methodology, the more options offered to clients, and the more loan products on the menu, however, the more complicated it becomes

for field staff. Flexibility also reduces the likelihood that village banks will be able to manage their own books. Before increasing the complexity, VBIs should consider the corresponding costs of more expensive staff and/or additional training. On the other hand, the addition of new dimensions may make a credit officer's job more interesting and challenging, and may lower staff turnover.

The biggest skills challenge occurs when VBIs begin offering large and individual loans. With standard village-bank loans, field staff do not actually make credit decisions. As long as the village bank meets all the preconditions (pre-loan training, savings, etc.), loans are automatically approved based on the group's recommendation. Large loans, however, require an ability to appraise a business, estimate its repayment capacity, and determine the appropriate loan amount and terms. To provide larger loans, VBIs have to fundamentally change their job qualifications and training, and possibly their compensation and incentive schemes.

Management Information Systems

Another major obstacle that impedes VBIs from increasing flexibility and offering new products is information systems—both administrative procedures and computer software.

- **Administrative Procedures.** The efficiencies of batch management are so compelling that it is difficult for many village bankers to think about customization, which would require a radical, and perhaps unsettling, reengineering of procedures, systems, and documentation. In such circumstances, it is sometimes helpful to involve an outsider who is not so close to "the way things are" to help innovate and design "the way things could be." It is also useful to look at the systems of group lenders who offer maximum flexibility, such as CARD and UMU, to see if their systems could be adapted to the local environment.

The process of reengineering systems to increase flexibility often benefits from involvement of external consultants who are distant from the current approach

- **Software.** Many organizations are unable to manage multiple products or offer flexible features because of limitations in their loan-tracking and accounting systems. In contrast, organizations committed to continuous improvement often have in-house computer programmers who regularly modify software to accommodate product changes, although this approach is not feasible or affordable in all labor markets. A good time to introduce a flexible loan is when the organization has to invest in new information systems. When CARD reached 25,000 customers, pressure was placed on its financial and MIS systems; CARD used this opportunity to add new products.

Internal Controls

Greater flexibility can significantly increase a VBI's vulnerability to risks, especially to fraud and mismanagement. Internal control systems become much more complicated when staff can customize loan amounts, loan terms, and repayments. These variations increase the likelihood that loan officers and data clerks will make mistakes in their paperwork and in the information system, requiring heightened vigilance and error detection systems. Furthermore, if loan officers are allowed to determine loan sizes and terms, some clients may be tempted to bribe them for larger loans or more favorable terms. Flexibility opens up a Pandora's box of potential problems, which suggests that VBIs should adopt a very cautious approach.

Scale

Rapid growth is not achieved by chance. It requires intense focus by senior managers and extreme productivity on the part of staff. For staff, more flexible products often translate into more complex and time-consuming procedures, which can eat into productivity. For management, an individual loan product can demand considerable attention that can divert managers from the all-consuming task of scaling up. The introduction of more responsive products can seriously impede the drive for scale. It is notable that Compartamos, the largest and fastest-growing VBI, has thus far avoided adding either flexible features or an individual loan product.

Client Retention and Revenues

More flexible products can potentially increase revenue. If a VBI attracts and retains customers because it offers more flexible products, then it will generate additional income that may offset the higher staffing and MIS costs. This is particularly true with the retention of good clients who have been through four or five loan cycles, whose acquisition costs (marketing, recruiting, training) have already been covered, and who are likely to have higher loan balances. If flexible loans enable a VBI to retain these profitable customers, then the benefits may outweigh the costs.

This chapter is about making loans more attractive to customers. It proposes that VBIs reach beyond the standard group-loan product and return to their original objective: to serve poor customers with services that meet their needs and that will have a favorable impact on their lives and the lives of their families.

Resources

The following resources provide additional information about flexible loans.

Berenbach, Shari and Diego Guzmán. 1992. *The Solidarity Group Experience Worldwide*. Washington, DC: ACCION International. www.accion.org

Churchill, Craig. 1999. *Client-focused Lending: The Art of Individual Microlending*. Toronto: Calmeadow. www.accion.org

Matin, Imran. 1997. "Repayment Performance of Grameen Bank Borrowers: The 'Unzipped' State." *Savings and Development*, vol. 22, no. 4: 451–473.

Navajas, Sergio, Jonathan Conning, and Claudio Gonzalez-Vega. 2002. "Lending Technologies, Competition, and Consolidation in the Market for Microfinance in Bolivia." Columbus, OH: Ohio State University; Department of Agricultural, Environmental, and Development Economics; Rural Finance Program. www.age-con.ag.ohio-state.edu

Nelson, Candace, et al. 1996. *Village Banking: The State of the Practice*. New York: Small Enterprise Education and Promotion (SEEP) Network and the United Nations Development Fund for Women (UNIFEM). www.seepnetwork.org

7

Voluntary Savings Services

Village-banking practitioners originally required savings to enable groups to accumulate and manage their own capital. Lending was to be character-based rather than secured by savings. In practice, however, village-banking institutions (VBIs) discovered that inadequate systems and unclear ownership led to the mismanagement of these deposits. As institutions became more concerned with financial sustainability, they saw these funds as an important untapped source of loan capital; so they increased their control over mandatory savings. One new direction for village banking is to return to its roots, with lending based on character and savings that serve the client.

Mobilizing and on-lending voluntary savings are much more demanding than managing mandatory savings and credit. Voluntary savings services can involve a larger number of unpredictable transactions. Such transactions necessitate more complex internal controls, information systems, and liquidity and asset liability management. These more demanding management systems, in turn, require staff with more skills. Yet small savings transactions tend to generate little revenue to cover those greater requirements. For VBIs, covering the costs of voluntary savings services for small depositors can be so difficult that some claim it cannot be done.

Most village-banking institutions have virtually no experience with voluntary savings services. The microfinance industry is just beginning to develop the know-how for delivering these services. This chapter documents those preliminary experiences by—

1. Considering mandatory services from the perspective of the client and the VBI;
2. Examining different types of voluntary savings services;
3. Identifying the criteria VBIs should meet before developing full-fledged voluntary savings services, and alternatives if they do not meet those criteria;
4. Exploring the challenges that VBIs, wishing to offer members voluntary services, face; and
5. Assessing the options for delivering services to non-members.

The purpose of this chapter is to build a knowledge base for pioneering VBIs to start developing these important new services.[1]

7.1 What about Mandatory Savings?

Group-based lending often is tied to mandatory savings services. Borrowers are required to deposit a fraction of their loan amount as savings along with each loan repayment. Loan size may be tied to the amount of the clients' savings at the start of the loan cycle. Access to savings varies. Some institutions allow members to withdraw their savings at the end of the loan cycle. Others allow savings to be withdrawn only when an individual terminates her membership. In many cases, individuals may access the savings of the group in the form of a loan. Typically, the opportunity to save is available only to members who, by and large, must be borrowers.

VBIs may link mandatory services to credit because they believe that mandatory savings services—

- Provide clients with the **discipline to save**;
- **Protect clients' savings** from less important uses;
- **Function as collateral** for clients who otherwise have only social collateral (the group may use these savings to repay its loan if an individual member defaults); and
- Serve as an important **source of loan capital**; for example, before offering voluntary savings, Association for Social Advancement (ASA) funded 40 percent of its loan portfolio with mandatory savings.

For clients, however, these services also have the following major drawbacks:

- **Limited access rarely matches their needs.** Clients want access when disasters strike or when investment opportunities arise. Even for expected needs such as school fees, the end of the loan cycle rarely matches the times when funds are required.
- **Savings tied to loans often exclude the very poor.** The extreme poor are less likely to have a reliable income stream to commit to regular savings as well as loan repayments. Rather than taking the risk of borrowing money, they may prefer to save intermittently and have access to these savings.
- **Tied savings is perceived as a cost of borrowing** rather than a service. In many programs, the percentage of required savings increases with the loan size. Clients dislike seeing an increasing portion of their money tied up in inaccessible savings, which also raises the effective interest rate. They may also lose some of their savings if another member of the group does not repay her loan.
- **Clients can lose access to credit** when circumstances require them to withdraw their savings. Accessing their savings may be possible only by discontinuing their membership and, along with it, their access to loans.

For the institution, these disadvantages can translate into unanticipated negative effects: **limited outreach**, particularly to the very poor; **loan plateaus** that are unrelated to client debt capacity; and **client desertion**. Customer dissatisfaction with inaccessible savings can manifest in a variety of ways. For example, in 1995, Grameen Bank members in Tangail

[1] Madeline Hirschland drafted the content of this chapter.

District went on strike to demand access to their locked-in savings. During that same year, a study found that nearly 57 percent of the members of BRAC (formerly Bangladesh Rural Advancement Committee) deserted because of their desire for access to savings during emergencies (Wright 2000b).

Furthermore, the benefits of mandatory savings to VBIs might be obtained in other ways. There are numerous examples of microlending with excellent portfolio quality that do not require forced savings, which suggests that character assessment, peer pressure, and access to a follow-on loan can replace the need for collateral for small loans.

The argument that VBIs need forced savings as a source of loan capital may be less clear cut than it seems. BURO Tangail (BT), a Bangladeshi nongovernmental organization (NGO), found that, within a year of **switching from mandatory to voluntary**, clients saved as much or more, and the organization did not experience a portfolio quality problem. If that is typical, then voluntary rather than mandatory savings could finance the loan portfolio. At the same time, because managing mandatory accounts can cost much less than managing voluntary accounts, mandatory savings may provide a more financially viable means to finance the loan portfolio (see Section 7.3 and Box 7-4). In any case, mandatory savings represents only a fraction of the loan portfolio, so additional funding would be needed.

An assessment of the advantages and disadvantages of mandatory savings, summarized in Table 7-1, reveals that most of the advantages lie with the institution, while the client bears the brunt of most of the disadvantages. In fact, the bulk of the advantages, to clients as well as to VBIs, may be achieved through certain types of voluntary savings services, as explained in the following section. For VBIs that aim to reach the poor, however, the high costs of some savings products present a significant challenge.

7.2 What Are Voluntary Savings Services?

Voluntary implies that savers determine both the amounts and the timing of their deposits and withdrawals. Voluntary savings services fall into the following three categories:

Table 7-1
Mandatory Savings Assessed

	Advantages	Disadvantages
Client	• Discipline to save • Protects savings from trivial uses*	• Cannot access savings as needed • Cannot save unless willing to borrow; may exclude the extreme poor who cannot risk taking a loan • To access savings may have to forfeit access to credit
Institution	• Illiquid, reliable source of loan capital • Loan guarantee for clients without traditional collateral • Less costly than liquid savings services	• Clients desert to access savings • Clients do not take larger loans because they want to avoid the increase in the effective interest rate

*These advantages are also inherent in voluntary contractual savings services.

Passbook accounts—the most difficult and costly savings product to provide—are probably best suited to the needs of the largest number of customers.

1. **Demand Deposit Accounts.** In a demand deposit account—also known as **regular savings accounts** and **passbook savings**—the amount and timing of deposits and withdrawals are not set in advance. Two variations of passbook accounts are (1) a completely **liquid** or **open access** account, which allows customers to deposit and withdraw funds as frequently as they please, and (2) a **semi-liquid** account, which restricts the number of transactions, such as two withdrawals per month.

   While, in aggregate, these accounts tend to be quite stable, they are costly for the institution, with high administrative expenses overshadowing low financial costs. Yet, if only one savings product can be offered, a demand deposit account is often the one that best meets the demands of most clients (see Box 7-1).

2. **Contractual Savings.** With **contractual savings**, also known as an **accumulated deposit fixed-term account**, the client agrees to deposit a set amount on a regular basis for a specific period of time. After the maturity date, the client can withdraw the entire amount plus interest. Early withdrawal is prohibited or penalized.

   This type of product is common in informal finance in some regions. In Ghana, for example, **susu collectors** are in high demand. Typically, they collect savings daily from traders, fishermen, farmers, and artisans. Clients, the majority of whom are women, deposit identical payments for 31 days. At the end the month, they receive back the deposits from 30 days and leave one payment with the collector as a service charge. The fee?—39 percent annually for the opportunity to save.

   Typically, microfinance institutions (MFIs) offer a limited range of terms from which the client can choose; for example, weekly payments in any increment of $2 with a 3-, 6-, or 12-month term. An accumulated fixed term account can be designed to coincide with specific events, such as an education fund that can be accessed at the beginning of the school term. On the surface, contractual savings appears to be similar to mandatory savings.

   To the client, however, the differences between contractual and mandatory savings are significant. Contractual savings enables clients to set the amount and the term, based on their ability and desire to save. In sum, contractual savings is client focused.

3. **Time Deposit Savings Products.** With a **time deposit**, such as a **certificate of deposit (CD)**, a client deposits one chunk of money and promises not to touch it for a

Box 7-1

What Do Poor People Want Most in a Savings Service?

For all savings needs, the poor require services that are—

- **Convenient**—close by, quick, and offered during convenient hours.
- **Secure** relative to other convenient options with similar terms.

For unexpected savings needs, poor people tend to strongly prefer—

- **Voluntary deposits**, with frequent opportunity to deposit small and variable amounts.
- **Unrestricted access**, with unlimited withdrawals without prior notice.

For expected needs, however, the poor may prefer **restricted access** and even **fixed regular amounts.**

For all savings needs, they prefer—

- **Competitive returns** vis-à-vis similar alternatives.
- **Confidentiality**.

specific period of time. As with contractual products, the institution provides a range of possible terms from which the client can choose. Time deposits usually pay the highest rate of interest because they require the fewest transactions.

There is often little demand for this product among low-income clients because it requires an upfront deposit of a large sum of money, although it may suit the cash flow of farmers. In general, this product is more appropriate for institutional depositors and less poor individuals if the VBI is prepared to provide different services to different segments of the market. If they do attract larger depositors, time deposits can be a profitable, though volatile, means to finance the loan portfolio.

Time deposit accounts tend to be less relevant for the poor than contractual and passbook savings accounts.

Voluntary savings services tend to be highly valued by the poor (see Table 7-2). They are particularly important to the most vulnerable groups, who lack reliable income to take advantage of group-based credit. These are compelling reasons for village-banking institutions to develop voluntary savings services for non-members as well as members. Is it wise for them to do so? The following section answers that important question.

7.3 Should VBIs Intermediate To Provide Savings Opportunities?

Financial intermediation—mobilizing savings to finance a loan portfolio—is not appropriate for many VBIs. In many environments, it is illegal for VBIs to mobilize deposits. Even

Table 7-2

Product Choice from the Client and Institutional Perspectives

	Client Perspective	Financial Viability Perspective	Management Capacity Perspective
Demand Deposit Accounts	• For emergencies and unexpected opportunities, for smoothing consumption by offsetting irregular income stream, or for storing excess cash	• Large amount overall, though relatively small average balance • Less profitable: low financial costs but high operating costs • Relatively stable	• Heavy demands for staff, MIS, and internal controls because of large number of accounts with frequent and irregular transactions • Requires attention to liquidity management
Contractual Savings	• For expected needs such as school fees • Provides discipline • Has higher interest	• Longer-term funds • Larger amount per account • More profitable: much lower operating costs, higher financial costs • May be volatile	• Much more predictable • Fewer administrative requirements • Requires attention to liquidity management
Time Deposit Products	• For expected needs and for storing long-term surplus • Requires large deposit	• Longer-term funds • Larger amount per account • Most profitable: lower operating costs • May be volatile	• Very low management requirements: two transactions per account • Requires more attention to liquidity management

Source: Wisniwski (1999); Hirschland (2000)

Mobilizing and on-lending deposits from the public requires a transformation of an organization from a lender to a financial intermediary. Being entrusted with the savings of poor people is an enormous responsibility for VBIs.

if it is not illegal, many institutions do not have the capacity to mobilize deposits. Akin to borrowing from the poor, intermediation is a risky and demanding business. If a VBI mismanages loans, the resources of donors or financial institutions are at risk. If this same institution mobilizes and then lends out deposits, however, it jeopardizes the savings of the poor. If savings come only from members who are, on average, net borrowers, the risk is less severe. In any case, VBIs that choose to mobilize and on-lend savings should have the internal capacity and an external environment that ensure that deposits are secure (see Box 7-2).

Box 7-2

Prerequisites for Financial Intermediation

Undertaking financial intermediation requires an institutional change greater than the sum of a set of new systems and incentives. Ideally, a financial intermediary should have a strong board of directors that consists of respected and knowledgeable persons. Since individual depositors cannot ensure that management is not putting their savings at unnecessary risk, they have to rely on the board to oversee management.

Before intermediating mobilizing and on-lending voluntary savings, an organization should already have a strong capacity that it is prepared to enhance. Specifically, the executive director and board should consider the following checklist of requirements:

1. **Proven stringent credit management and high portfolio quality**, such as a 30-day portfolio at a risk rate under 5 percent and a default rate below 2 percent for at least the last fiscal year.
2. **Strong liquidity and asset-liability management.** The institution should be able to anticipate and manage the likely consequences of external shocks. Finding a back-up source for liquidity—a bank or other liquidity pool—is essential to providing high-quality and financially viable services. It must be able to manage its interest rate risk—the risk that changes in the economy will squeeze its financial margin.
3. **Information systems** that provide timely, accurate, and sufficient information and transparent simple reporting systems.
4. **Sufficient internal controls** to protect savings from fraud and mismanagement and to assure the physical security of funds. Before offering voluntary savings, a VBI should have an experienced internal audit department that reports directly to the board.
5. **The trust of clients** that comes from well-defined and transparent services and a customer service orientation.
6. **Financially sustainable operations and sufficient capital** to cover initial operating losses and possible losses due to catastrophic events.
7. **High productivity.** Staff must reach many more savers than borrowers and must mobilize larger deposits along with small ones.
8. **A profitable place to invest excess savings.** If subsidized loan capital is abundant, investing savings at enough profit to cover costs may be difficult.
9. **An enabling external environment**, which is characterized by the following:
   - Inflation that is under control, neither high nor erratic;
   - Unregulated interest rates;
   - The absence of widely available subsidized credit; and
   - Government regulations for minimum reserves, management, and monitoring that the VBI can meet and still deliver services viably.

Uncontrolled inflation, government regulations, or subsidized credit may prevent a VBI from offering positive real returns on savings. Some VBIs contend, however, that many clients may still prefer to save in an institution rather than informally and should be provided that choice.

Some microfinance professionals also advocate that, unless MFIs are regulated, they should not mobilize deposits. The only way to assure that institutions have the strength and accountability to maintain the security of deposits is through regulation.

Other experts disagree. Limiting deposit mobilization to institutions that are regulated and that operate in the stable environments denies services to many of those most in need. They argue that potential clients likely understand the risks involved in depositing with unregulated institutions. Potential clients may find these institutions to be safer than their other informal options for saving (Wright [Forthcoming]). From this perspective, it may be acceptable for small or remote community-based institutions to mobilize savings even if they are not supervised, as long as they frequently disclose this fact to their members.

Still others argue that in small, member-based institutions, direct "supervision" by members assures sound risk management. In addition, supervision may be less necessary if the majority of customers are net-borrowers anyway. This perspective suggests a possible middle ground: Small, community-based or membership organizations should freely mobilize savings, but should not lend these savings out. Not lending out savings, however, makes it difficult to cover costs.

Alternatives to Intermediation

Many institutions do not have the capacity or legal ability to serve as a financial intermediary. These institutions, however, may be able to offer their clients voluntary savings services in other ways. Several possibilities include the following:

1. Savings could be mobilized only from group members and could be managed by the group—this strategy is pursued in India by the National Bank for Agriculture and Rural Development (NABARD), through a program that serves nearly 8 million savers.
2. Savings could be mobilized only from group members and could be deposited in a group bank account by the VBI. Serving members with a simple voluntary product will involve more limited institutional changes than opening services up to non-members.
3. The VBI could arrange for savings to be mobilized from non-members as well as members by collectors who are employed by a regulated institution.
4. The VBI could mobilize savings from non-members and could deposit these funds in a regulated institution rather than lending them out. This approach is viable only if the VBI could cover its own costs with interest that it receives from depositing these funds in a regulated institution. A key to viability is the fact that clients may be willing to forego interest or even pay for a secure savings option.
5. Establish or transform into an alternative institutional form such as using a trust to hold the savings or becoming a cooperative or non-banking financial institution.

If the environment is not accommodating or the VBI does not yet have sufficient capacity to offer voluntary savings, consider interim or transitional measures such as partnering with a bank.

Any institution that wishes to mobilize deposits will have to undertake considerable institutional changes. The extent of those changes depends on whom the institution chooses to serve with what type of services. Savings services for non-members will necessitate major changes in the organization's structure, culture, and systems. In contrast, integrating voluntary savings into an existing credit methodology will require major systems and staff upgrades, but will not fundamentally change the nature of its operations.

Mobilizing savings from non-members may be neither legal nor wise for many VBIs. For these organizations, providing voluntary savings services to members can be a low cost and

legal means for providing greater value to existing clients. For VBIs that have the capacity for full-scale intermediation, serving members with voluntary savings services first is a good way to test their systems before opening up the doors to non-members (see Table 7-3).

7.4 Developing Liquid Savings Services for Members

Institutions that wish to develop voluntary savings services for members face four major challenges: (1) preventing fraud, (2) covering costs, (3) managing liquidity, and (4) reorienting staff. These challenges vary by product type. Passbook savings services present the greatest challenges. Yet, they are also the most likely add-on to a group-based credit product; members can easily deposit and withdraw amounts at the same time as they would make mandatory savings payments (see Box 7-3). Therefore, understanding what it takes to offer passbook savings services illustrates the requirements of other types of savings products.

1. Preventing Fraud

Passbook savings services pose a significant fraud risk, particularly when they are delivered by individual field agents. Fraud is much harder to detect with irregular voluntary deposits than with uniform mandatory payments. Furthermore, savings services delivered by field agents lack an important internal control, **dual control**. Dual control protects against fraud by requiring that the person who handles the money be different than the person who records the transaction.

Where dual control is absent, managers must vigilantly check that the transactions recorded in passbooks are identical to those in field agents' records, a process called **passbook verification**. To deter and detect fraud, a branch manager should check all transactions in each passbook every two to three months. Discrepancies should be systematically noted and immediately investigated. Pay should be tied to low error rates and the detection of all discrepancies. Fraud should be immediately and severely penalized. Although all these measures will detect fraud, they will not prevent it. This is a risk inherent in using individual field agents to collect savings.

Table 7-3
Implications of Serving Members Only versus Members/Non-members

Serving Members Only	Serving Both Non-members and Members
Costs of small demand deposits can be manageable	To cover costs, must attract large number of new depositors, including larger depositors
Does not require major change in orientation	Requires major changes in infrastructure, staffing, culture, and incentives
More likely to be legal for NGOs and cooperatives	May require transformation or a higher level of skills to manage reporting required by supervisory authorities
Will not reach clientele who are poorer than those already reached	Can reach poorer clientele if this is an explicit goal that is ingrained in product design, delivery system, institutional culture, and staff incentives
	Greater volume of funds for lending; much easier to meet demand for credit

Box 7-3

Are Mandatory and Voluntary Products Compatible?

Many MFIs require clients to save, despite the drawbacks of mandatory savings products. Is it possible to offer both mandatory and voluntary savings? Numerous MFIs and credit unions have demonstrated that clients will save large amounts voluntarily at the same time as they make mandatory payments. Yet, offering these services side-by-side poses real challenges for staff and clients.

It is argued that mandatory and voluntary savings services are so different in nature that MFIs cannot successfully offer them simultaneously; clients will not trust that they can access their voluntary savings if they must make mandatory deposits with the same institution. If an MFI enforces a group guarantee on loans, clients will be unwilling to deposit any more than the mandatory minimum for fear that their savings may be taken to cover others' defaults. Furthermore, staff who are accustomed to demanding fixed payments will not solicit voluntary ones.

ASA's experience offering a hybrid product reveals the potential culture conflict between voluntary and mandatory savings. It also demonstrates that the conflict is surmountable. In ASA's general member savings account, clients were required to hold 10 percent of their loan size as savings, but had complete access to their other savings. They also were required to save 10 taka ($0.21) a week. According to policy, clients could save as little or as much over this amount as they chose.

Field agents received word of this new policy by memo. Many did not see the value in accepting these smaller, irregular amounts. Rather than clearly explaining the terms, some conveyed to members an expectation that they must pay 20 taka per week, 10 in mandatory savings and 10 in voluntary. The vast majority of members saved precisely that. In fact, many members deposited their excess savings in an associate member account (described in Box 7-5) outside the group.

Client comments on the new product were striking: "Why will I save more in an account that does not allow me to save less when I'm in trouble?" "Yes, of course there are times when I can save more (than 20 taka)—but I'll always save 20 taka—it was 10 taka before and now it's 20 taka—it's simple and easy to remember—that's that."

At the same time, other ASA field agents did implement the new policy. To this day, they allow members to save as much over the minimum as they like. Members take advantage of this service. In any given meeting, for example, two-thirds of the members might save an average of more than 3 times the mandatory amount. The largest deposit might be more than 10 times the mandatory requirement. The branches that offer voluntary services have the same staffing and costs as the branches that do not.

Adapted from Wright, Christen, and Matin (2001)

Furthermore, passbook verification will not catch fraud if field staff are able to record an incorrect amount in both the passbook and the transaction sheet. To avoid fraud of this type, VBIs must train depositors to review their passbooks while the collector is present and to expect their collector to tell them the amount of their transaction and their new balance. Finally, branch managers should visit clients at random to make it likely that they hear about fraud.

2. Covering Costs

When institutions that offer mandatory savings introduce voluntary services, they often find that withdrawals as well as deposits increase significantly. As a result, net savings grows only slightly or may even decrease while the number of transactions escalate. This increase in

the volume of transactions without an increase in the volume of deposits could potentially translate into much higher costs with little growth in revenues. Indeed, some institutions that have shifted from mandatory to voluntary services find the new service to be very costly. Yet, others have found just the opposite; the savings services add almost no cost. Why the difference? These latter institutions have implemented a number of strategies that help them manage and cover costs. They have found that the cost of providing voluntary savings services can be minimized by—

a. Where mandatory savings are still required, offering voluntary and mandatory savings services together as a hybrid product with just one account per member. Members must deposit a minimum amount but can deposit more. These hybrid transactions minimize additional record keeping and ledgers, which otherwise would result in added costs in staff time.

b. Assuring that the management information system is highly efficient. For example, at ASA, transactions are recorded just twice, in the passbook and in the subsidiary ledger that also serves as a collection sheet.

c. Balancing new burdens, such as time spent verifying passbooks, with new innovations that save managers' time. For example, when BURO Tangail required managers to verify more passbooks, it also streamlined its loan decision-making process.

d. Where politically feasible, paying low or no interest on liquid accounts, which reflects the high costs of service delivery.

3. Managing Liquidity

Passbook services pose greater challenges for liquidity management than either credit or mandatory savings. After all, mandatory savings are deposited in expected amounts and times and are rarely withdrawn. With passbook savings, however, matching loans to the inflow and outflow of voluntary savings requires more planning and management. What liquidity challenges should organizations that wish to open up their mandatory savings services expect and how should they prepare? Experience suggests the following guidelines:

a. Plan to maintain a higher level of liquid reserves. This level of reserves will lower overall financial returns, and this alone justifies offering a lower interest rate on passbook than on mandatory savings.

b. Plan for a significant **initial** drop in savings and consider motivating members not to immediately withdraw their savings. At first, members will want to test whether they actually can withdraw their savings. This drop in savings tends to be short lived, lasting for less than a year and perhaps only several months.

c. If members are poor, do not anticipate that the total volume of savings will be much higher than with mandatory accounts. Of course, the volume will depend on the required amount of mandatory savings payments.

d. Expect a high level of account activity for both deposits and withdrawals. In particular, plan for a large demand for withdrawals at particular seasons, such as before festivals and planting.

e. Institute a bottom-up business planning process to project the need for funds. To manage liquidity, consider policies that require clients to give advance notice for larger withdrawals or an interest rate or fee structure that discourages withdrawals.

4. Reorienting Staff

New savings services will succeed only if staff members promote them. Yet getting the support of field staff can be difficult. Field agents must be able to clearly explain the product and they must be motivated to do so. Field agents who are accustomed to collecting uniform savings and loan payments may not accept a more flexible product. They also may be preoccupied with recovering loans, which they perceive as more critical to their institution's viability. Finally, they may not be willing or able to manage non-standard payments that require more careful record keeping. Training and incentives are essential to ensure staff support.

7.5 Delivering Savings Services to Non-members

Suppose that an institution that offers savings services to its members through borrowers groups now wishes to deliver savings services to non-members. Its main objective is to meet the greatest savings needs of large numbers of savers. It is particularly interested in serving the poor and therefore needs to offer services conveniently close to clients. It has the following three primary delivery options:

1. Serving savers through **existing borrowers groups**.
2. Collecting savings from **new or existing savings groups**.
3. Using **savings collectors** to gather deposits from individuals.

How well might each of these options meet the above objectives? This will depend on many factors in the environment—regulations, the physical security of field staff, population density, and the region's physical infrastructure. Each option is assessed below.

1. Existing Borrowers Groups

Adding savings-only members to village banks and serving them during bank meetings may be a feasible means to serve small numbers of savers. Including large numbers of non-borrowing members in meetings, however, might undermine the solidarity that keeps delinquency in check. Collecting their savings would lengthen meetings for borrowers. For the savers themselves, sitting through a meeting would be a heavy price to pay simply to make a deposit. Above all, to the extent that savers take the place of borrowing members, they cut into the VBI's financial viability; they contribute to group management costs yet generate minimal revenues. A similar but more feasible alternative would be to serve savers at the same site and time as groups meet (see Savings Collectors below).

2. New or Existing Savings Groups

The savings group approach has two variations: **self-help groups** and **VBI savings groups**. In the first, a promotion agency organizes, trains, and supervises savings groups that **collect and manage their own savings**. They might store their savings in a bank or, over time, make loans to themselves or lend to other savings groups. This self-help group strategy is assessed in Chapter 1 as an informal institutional type.

In the second variation, the VBI organizes **savings groups to collect deposits for the institution**. The product is so simple that only minimal training of the group is required. The terms of savings are like those of a rotating savings and credit association (ROSCA); all members save the same amount at the same regular interval.

The strengths of the second option are that it can increase outreach and lower costs in sparsely populated areas that might not otherwise be served. In remote areas, collecting savings from a group that in turn collects savings from individuals may be a key to managing costs. In effect, the model simply shifts some of the costs of collection from the VBI to the group.

A weakness of both these options is customer value. Although the product provides the discipline to save and protects savings from daily demands, its terms and amounts do not respond to individual needs; instead, they typically are the same for the entire group. In addition, the client has to bear part of the costs of collection. In many cases, payments are mandatory and uniform for the entire group and can be accessed only in the form of a loan, or by withdrawing from the group.

3. Savings Collectors

Employing savings collectors can yield large-scale outreach and, in theory, excellent customer value. Compared to the groups discussed above, savings collectors should have greater capacity for tracking and managing demand deposits. In reality, whether they actually can deliver more valuable services will depend on the collectors' education level, their management information technology, and whether they must stick to products with standardized payments to make it easier for others to detect fraud. Even if payments are standardized, however, as with contractual products, collectors can vary the standard amount by customer, unlike in many savings groups.

On the other hand, this option may not be feasible in many environments. In many places—

- There may be no legal way to employ collectors. Collectors typically face regulatory hurdles not faced by member-managed services. A VBI must meet these requirements or find a regulated institution willing to deploy collectors on its behalf.
- Salary costs and security risks might not make collectors financially feasible. In remote areas, this option may be prohibitively expensive, even if collections are only weekly. Alternatively, costs can be minimized if the field agents that manage village banks double as savings collectors at the time and site of the weekly meeting (although this method also has drawbacks as discussed below).

Because savings collectors can individualize their service, they can provide customers with greater value. But whether this customized approach can be cost-effective depends on the local conditions.

Several methods for employing savings collectors include the following:

a. The VBI could arrange for **collections by another, regulated institution** rather than making collections itself. This option ensures that the institution that accepts deposits is supervised and has the capacity to manage savings. For the VBI, the option minimizes new management demands because the partnering, regulated institution assumes those demands.

b. The **field agent can double as a deposit collector** for non-members. By using existing staff, this model lowers administrative costs. The strategy may fail, however, unless the VBI recognizes that mobilizing deposits requires great changes, particularly in human resource management. Motivating credit agents to focus on the different and demanding task of mobilizing savings from large numbers of clients may be difficult. Staff's focus on timely repayment may clash with the service orientation required to establish trusting relationships and knowledge of local cash flows. Without new incentives, training, and marketing systems, outreach will be limited because field

agents will be unlikely to extend their services much beyond their existing clientele (see Box 7-4).

c. In some areas, the VBI could arrange to collect savings through **existing informal-sector savings collectors**. For example in Ghana, Action Aid arranged a collaboration between informal savings collectors and some rural banks. This arrangement makes sense only if the institution can intermediate legally, where the collectors cannot. For example, a VBI that can on-lend savings may be able to pay a higher rate of interest on deposits than a collector can.

   This option offers several advantages. Existing informal collectors—

   - Are likely to already have the trust of potential clients and practical experience with managing financial transactions;

Box 7-4

ASA's Experiment: Field Agents Doing Double Duty

In 1997, ASA instituted a new associate member savings product. The field agents responsible for ASA's credit groups accepted voluntary savings deposits and withdrawals at the site of the weekly credit group meetings. The product was intended for relatives and friends of ASA members. It was not actively marketed outside of the current membership. Many of the depositors were ASA members who valued the confidential and voluntary nature of the accounts. While some associate members used the accounts simply to store cash, others actively deposited and withdrew from their accounts. By the end of 1997, the average account balance was $2.87; a year later, the average balance was only $4.18. Although clients valued the accounts, ASA found that the cost of administering them and of holding larger liquidity reserves far exceeded the marginal revenues that they generated. By 2000, ASA had largely phased out the new product.

What lessons can ASA's experience provide other VBIs? First, without retraining and new incentives, field agents were understandably reluctant to broadly market a new savings product. ASA staff were already working hard before the introduction of the associate member product. They perceived their primary business as managing credit and understood repayment to be critical to ASA's viability. In contrast, they did not see savings mobilization as important to their job or to ASA. Therefore, they did not seek out new clients for the associate member product.

Second, despite minimal marketing by ASA staff, tremendous outreach was achieved in just 18 months. This result suggests that demand deposits may be highly valued by clients, even by clients who already have access to a semi-voluntary, group-based savings product.

Third, although many clients used the new product, they did not save as much as expected. Existing clients, who already make weekly loan repayments and mandatory savings payments, may not have excess liquidity to make large voluntary savings payments. Therefore, for a demand deposit product to be financially viable, it may need to be marketed broadly, beyond current members and their associates to higher-income persons who have excess liquidity. The cost of serving the smallest depositors must be cross-subsidized by larger accounts.*

Wright, Christen, and Matin (2001) conclude that for institutions that efficiently deliver standardized, group-based credit, full-fledged savings mobilization requires a radical shift in institutional culture and significant investments in systems, additional staff, and training. The systems, staff, and culture that make institutions effective at delivering standardized credit can hinder them in mobilizing savings.

* Yet, as an unregulated institution, ASA might have been ill advised to mobilize deposits more broadly. Larger depositors would also have been reluctant to deposit with ASA rather than with a competing local bank.

- Are likely to be highly motivated, be experienced in marketing, and know the communities in which they operate; and
- Will cost less than other new hires (although they will cost more than using existing field agents). Furthermore, VBIs may be able to reduce their financial costs. Because informal collectors often charge for their services, clients may not expect to receive positive financial returns.

d. The VBI could employ and train its own savings collectors. This option has many of the same advantages and disadvantages as working with existing informal sector collectors. If the community chooses the collector, he or she is likely to have its trust.

7.6 Conclusion

How do these options measure up? The following general conclusions can be drawn:

- At a minimum, VBIs may be able to provide **voluntary savings for borrowers**. This option will be low cost and, in most cases, legal. Although the scale and depth of outreach of this strategy are limited, the option represents a significant improvement in product quality that members will value.
- **Savings collectors** have the greatest potential for serving large numbers of clients with high-quality services. Because this option assumes an environment in which staff can safely carry cash, collectors should be deployed only where an institution, with the internal capacity to ensure the security of deposits, backs them.
- Since most VBIs do not have the management capacity to provide secure services, the most promising option is to arrange for **collections by a regulated institution**. In challenging environments, and for some of the least advantaged client groups, however, this option may not be feasible. Regulated financial institutions may not exist or may not be interested in mobilizing small deposits.
- In less-densely populated areas, **savings groups** may lower costs and increase outreach. Not all such groups will have the capacity to track different sizes of deposits. If all group members contribute the same amount regularly, however, the value to the customer is likely to be lower than when individuals are served.
- In sparsely populated areas with little infrastructure, **self-managed savings groups** may be the only option that is financially feasible over the long run. From the VBI's perspective, this is a development strategy that is not financially sustainable. Establishing each group requires an investment in training that will not be covered by revenues. Limited capacity for record keeping and liquidity management is likely to limit product quality.

Voluntary savings has great potential for addressing the financial needs of the poor. Yet the delivery of these services is considerably more demanding than standardized credit and mandatory savings. Furthermore, mobilizing deposits from the poor is akin to borrowing from them. It should be undertaken only with great care. Many VBIs should not consider directly mobilizing and on-lending savings themselves, although through partnerships with banks they can still increase the outreach and quality of savings services. Other VBIs should simply consider shifting from mandatory to voluntary services for their members.

Poverty finance institutions are just beginning to test these possibilities. Over the coming years, experiments with these options should begin to yield low-cost management systems, innovative delivery strategies, and valuable lessons about how to deliver voluntary savings services to the poor while covering their costs.

Resources

The following resources provide additional information about voluntary savings services.

Bald, Joachim. 2000. *Liquidity Management: A Toolkit for Microfinance Institutions*. Frankfort, Germany: Bankakademie, Micro Banking Competence Center. www.ids.ac.uk/cgap/liquidity.htm

Branch, Brian and Janette Klaehn, eds. Forthcoming. *Striking the Balance in Microfinance: A Practical Guide to Mobilizing Savings*. Washington, DC: Pact Publications and World Council of Credit Unions (WOCCU), Inc. www.woccu.org

Hirschland, Madeline. 2001. "Developing Savings Services for the Poor: Preliminary Guidance for Donors." Washington, DC: The Consultative Group to Assist the Poorest (CGAP). www.cgap.org

Fiebig, Michael, Alfred Hannig, and Sylvia Wisniwski. 1999. "Savings in the Context of Microfinance: State of Knowledge." CGAP Working Group on Savings Mobilization. www.microfinancegateway.org (Search the library.)

Hirschland, Madeline, ed. *Savings Services for the Poor: An Operational Guide*. Forthcoming. Washington, DC: Pact Publications. www.pactpub.org

Robinson, Marguerite S. 1997. "Introducing Savings in Microcredit Institutions: When and How?" summarized by Joyita Mukherjee. *CGAP Focus Note No. 8* (April). Washington, DC: The Consultative Group to Assist the Poorest (CGAP) and The World Bank. www.cgap.org

Wright, Graham A.N., Robert Christen, and Imran Matin. 2001. "ASA's Culture, Competition and Choice: Introducing Savings Services into a MicroCredit Institution." Nairobi, Kenya: MicroSave-Africa. www.MicroSave-Africa.com

8 Microinsurance

INSURANCE IS A FINANCIAL SERVICE that helps people manage risks, but it is not the only financial service that can do this. This chapter begins by describing risk-managing financial services and explaining the limited conditions in which insurance is preferred over savings and credit. The next section provides some examples of microinsurance products offered by village-banking institutions (VBIs) and other microfinance practitioners. The third section describes different structures for delivering insurance, followed by practical suggestions for forging relationships with traditional insurance providers, which is the preferred delivery model. The chapter concludes with practical recommendations to VBIs that are interested in providing insurance.

Insurance is not just another financial product—it is an entirely different business that requires expertise not commonly found in microfinance institutions.

The main point of this chapter is that **insurance is a new business for microfinance institutions (MFIs) and not merely another product.** The insurance business has a more complicated risk structure that requires different management skills than those commonly found in MFIs. Therefore, VBIs should tread carefully, recognizing that insurance is significantly outside their area of expertise.[1]

8.1 Risk-managing Financial Services

Risk management has always been an objective of microcredit customers. Most VBIs admit that clients occasionally use business loans to pay for medical expenses or funerals, or to smooth household cash flow. Even if they do not have an immediate emergency, some customers invest only a portion of the loan in their businesses and save the rest so they will have a cushion to fall back on if they experience repayment problems. In these examples, clients use a product designed for one purpose to fulfill a different objective because that is the only financial service that is available.

Client-focused VBIs are beginning to provide products that more accurately fit the purpose for which clients use them, including risk management. Three classes of risk-

[1] Craig Churchill and Judith Painter drafted the content of this chapter.

managing financial products are (1) liquid savings accounts; (2) emergency loans; and (3) microinsurance, which includes coverage for death, illness, disability, and theft.

Risk-managing financial services have the potential to deepen and broaden the outreach of village-banking institutions.

In theory, these risk-managing products can deepen the outreach of a village-banking institution. As described in Chapter 4, the poorest households often exclude themselves from village banks because they are unwilling to take the risk of not being able to repay and because of the public censure that may accompany a delinquent loan. They may also be excluded by the VBI or by other members because they are perceived as bad credit risks. Risk-managing financial services might be more appropriate for the poorest segment of the market than the traditional microenterprise loan product.

The provision of liquid savings, emergency loans, and insurance can also broaden the outreach of a VBI by preventing better-off clients from falling into poverty. Risk-managing financial services can reduce the reliance on desperation measures, such as selling off assets or borrowing from a moneylender, and may help halt the slide into deeper poverty.

Savings, Credit, or Insurance?

Although all three can help reduce vulnerability, when is insurance a more appropriate response than savings or credit? The diagram in Figure 8-1 depicts areas that insurance products can best address based on the following two variables:

1. The degree of uncertainty about whether, when, and how often a loss will occur; and
2. The cost of the potential loss.

Insurance is not an effective response in three areas. First, for losses that are very certain to occur, the risk-pooling mechanism cannot work (see Box 8-1).[2] Second, insurance is also not appropriate for small losses because administrative and transaction costs would make the product too expensive. Third, insurance is not always effective in addressing **covariant risk**, when many people in the risk pool are affected at the same time (see Box 8-2 for a brief glossary of insurance terms).

Box 8-1

Defining Microinsurance

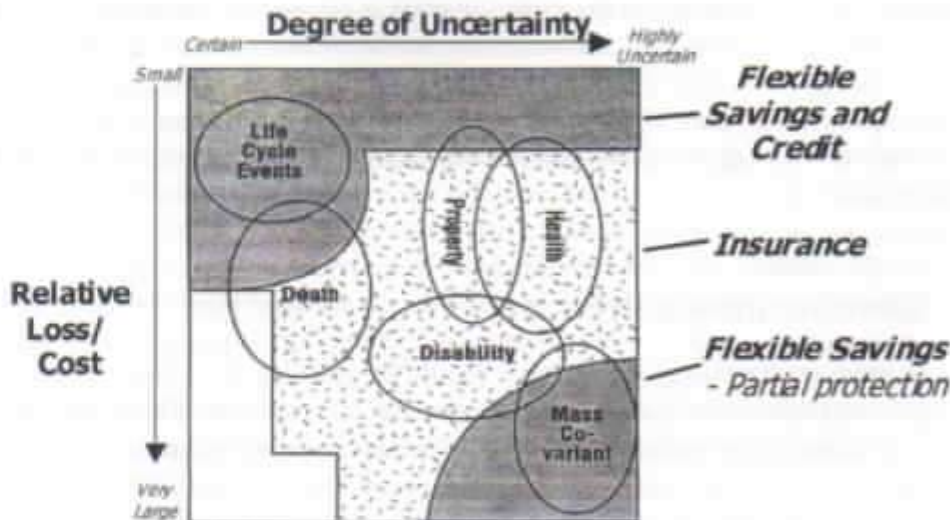
Insurance is commonly a misused term. People often say insurance when they are referring to savings or credit products that fulfill a risk-managing function.

For insurance to be insurance, it needs to involve a **risk-pooling mechanism**. This mechanism combines the resources of the many to compensate for the losses of the few. In effect, policyholders pay premiums for the average loss suffered by the group rather than for the actual cost incurred when a risk event occurs. Risk pooling benefits the few who suffered the loss, while the **many** basically receive "peace of mind" in exchange for their premium payments.

Because of this risk pooling, the value of an insurance benefit is related to the cost of the loss; it is not related to the value of the premium payments that have been made. If the pay-out amount is directly related to the value of the "pay-in," then the client is receiving a savings or investment service, not insurance.

[2] Although it is certain we all will die, uncertainty arises because we do not know when.

Figure 8-1
Credit, Savings, or Insurance?



Brown and Churchill (1999)

On the basis of this assessment, normal life cycle events (births, weddings, education) are better addressed through various savings products. Even unplanned but relatively inexpensive losses can be served through liquid savings accounts.

The poor cannot always save for a rainy day. For them, emergency loans could address sudden and unforeseen needs—this was an original intent of the internal account. If the internal account is not active or equipped to handle emergency loans, then the VBI could provide individually tailored loans to meet specific needs of members (see Chapter 6).

Box 8-2
Defining Insurance Terms

Moral Hazard. Danger arising from any nonphysical, personal characteristic that allows the policyholder to increase the possibility of loss or that may intensify the severity of loss. For instance, bad habits such as alcoholism increase the likelihood of premature death and high health care claims; a livestock policyholder may not take proper care of his cow because he knows that he will be covered if the animal dies.

Adverse Selection. Tendency of persons with a higher-than-average chance of loss to seek insurance at standard (average) rates, which, if not controlled by underwriting, results in higher-than-expected loss levels.

Covariance. Tendency for either (1) many households to be affected by a risk at the same time or (2) several risks to consistently occur together (at the same time or under the same circumstances).

Reinsurance. Shifting of part or all of the insurance risk from one insurer to another. Reinsurance allows insurers to share risk with other insurers in different regions, effectively developing large risk pools by combining the risks of many insurers, which makes it possible to cover covariant risk.

Underwriting. Process of selecting risks for insurance and determining in what amounts and on what terms the insurance company will accept the risk.

Savings and credit are much more flexible than insurance. A life insurance policy, for example, will not help someone who is robbed or whose house burns down. Most losses experienced by low-income households are small. To help reduce their vulnerability, liquid savings and emergency loans are the most appropriate responses to deal with the bulk of their risks. Before venturing into the confusing world of insurance, a VBI would provide its customers with greater value if it first developed these other risk-managing financial services. Once an organization helps its clients to reduce their exposure to most of their risks, then it can consider how to reduce vulnerability to the fewer, but more expensive, risks that can be covered by insurance.

8.2 Microinsurance Products

Insurance products for village-bank clients should be geared to the various risks they face. Their exposure to financial harm is severe in the event of prolonged illness, property loss, disability, and death. For each of these risks, a different type of insurance could be offered.

Types of Insurance

Some insurance products are much more difficult to provide than others. Basic life insurance is the simplest, while health insurance is by far the most complicated.

Some types of insurance are more difficult to provide than others.[3] In general, **life insurance** is the most straightforward because (1) the event—death—can happen only once; (2) it is fairly easy to verify that it occurred; and (3) few moral hazard problems arise because most policyholders do not purposely increase the chances that the event will occur by engaging in risky behavior. Certain types of life insurance, such as annuities and endowment policies, however, are extremely complex.

Property insurance is complicated because theft, fire, or other damage can occur repeatedly, and because it is more difficult to verify that the event occurred, especially theft. In addition, significant moral hazard problems are associated with property insurance: A policyholder with this protection may be less likely to take proper care of whatever is insured.

The most difficult coverage to provide is **health insurance**. Part of the difficulty stems from the fact that another agency, the health care provider, is involved. Health insurance is also complicated by the many different types of illnesses and treatments possible, and because it requires significant controls for fraud, moral hazard, and over-usage.[4]

Delivery Issues

VBIs should look at three basic delivery issues when considering the development of an insurance product: (1) integrated distribution, (2) group vs. individual policies, and (3) mandatory or voluntary products.[5]

One of the biggest challenges of providing microinsurance is the high cost of managing large volumes of small transactions. This challenge is similar to other microfinance products, but with insurance the payment of premiums tends to involve even smaller amounts of money.

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[3] Other types of insurance include disaster and agriculture insurance; they are not discussed here because VBIs do not yet have experience with these types of services.

[4] For examples of these types of insurance products, see Brown and Churchill (2000).

[5] Many other product issues—pricing, premium frequency, verification procedures, and controlling for adverse selection, moral hazard, and fraud—are not addressed in this chapter. For more details on these issues, see Brown and Churchill (1999). While it is important to understand these issues, VBIs that employ the recommended partner-agent model can rely on their partner to handle them.

The best solution to this problem is **integrated delivery** with another financial service so that the insurance transaction can be combined with a loan repayment or savings deposit. If insurance were linked with credit, however, then only people who have an outstanding loan would receive coverage. A savings-insurance link would broaden the potential market and enhance the value of the service, which reinforces the importance of the slogan "Savings First."

"Savings First" is an appropriate motto because convenient and open-access savings services are a better solution to most crises experienced by low-income households, just not the ones that produce big losses.

Another issue that affects delivery costs is whether to provide **group** or **individual** insurance. Providers of individual insurance assess the risk associated with each policyholder and may adjust their policy as required. Group insurance, on the other hand, offers the potential for a lower-cost insurance through coverage of many people under one contract. By enrolling many people under a single contract, the insurer reduces its marketing and administrative expenses. In general, group-based products are better suited to the microfinance market.

Another key decision is whether insurance should be **mandatory** or **voluntary**. Either approach can be taken; however, the coverage must be consistent within each village bank. In other words, if a village bank decides to have insurance, then all group members must carry it. Because of joint liability, it would be unfair for some members to pay premiums and therefore relieve the group from the burden of paying for them in the event of default caused by an insured risk, while others continue to depend on the group as the fallback. Overall, voluntary insurance tends to be better for clients, while mandatory insurance is easier and less risky for the provider, as summarized in Table 8-1.

The best delivery combination is a group insurance policy offered on a voluntary basis that is integrated with a savings service. Unfortunately, this is a difficult combination to create.

Table 8-1
Advantages of Voluntary vs. Mandatory Loan Coverage

Voluntary	Mandatory
1. Voluntary insurance requires that the **client and staff understand the product**. This ensures a sufficient investment in developing the product in clear, communicable terms for marketing purposes.	1. Mandatory insurance requires a **simple tracking and management** system. It is easier to track insurance for all clients than to distinguish those who are insured and those who are not.
2. It enables the institution to **assess the demand** for the product.	2. It **reduces the risk of adverse selection**. Because all clients are required to join, there is not a high percentage of high-risk policyholders.
3. A voluntary service provides better **value to clients** because it does not force them to purchase products they do not want.	3. It enables the insurance provider to **reach large numbers** of policyholders, which allows for both economies of scale and a higher likelihood that actual losses will track closely to the expected losses.

Starting Point

While this chapter recommends that village banks provide insurance in collaboration with a formal insurance company (the partner-agent model), partners do not exist in all areas. Until the insurance market develops, **credit life insurance** is one product that a VBI could potentially offer on its own.

The only type of insurance that VBIs should consider implementing on their own is credit life, but even this relatively straightforward service can be complicated.

Credit life typically provides coverage for the outstanding balance of a client's loan should she die before repaying it. Sometimes this type of policy is extended to include a cash benefit

Box 8-3
Credit Life Insurance at KMBI (Philippines)

KMBI introduced its Death Benefit Fund (DBF) program in 1992. By 1998, the fund had grown from 100 to 5,284 clients. KMBI acted as a full-service provider, entirely administering the fund. Each client paid in $4 and the family received $1,200 maximum in the event of the client's death. The MFI also extended life insurance to family members, with a policy that paid a $600 benefit.

Despite the significant income that DBF generated for KMBI, the organization found it increasingly difficult to track clients' premium payments and administer benefits to a growing number of clients. The need to simplify the Death Benefit Fund became more pronounced when the organization moved to decentralized credit operations. KMBI no longer had the proper legal structure or the appropriate tracking systems. It is now looking to establish a formal insurance firm or find a partner in the area.

Currently KMBI no longer offers the DBF and has scaled its insurance product back to a Mortgage Redemption Fund, which covers only the outstanding loan balance. New clients starting in 1999 pay 1 percent of their loan into the fund, which is used to pay off balances in the event of the borrower's death; no additional benefit is provided to the surviving family or group.

Box 8-4
Insurance Is No Joke: The Experiences of CARD Bank (Philippines)

CARD Bank established the Members Mutual Fund in 1994 to offer insurance to its borrowers. It started with a 5-cent weekly premium, which provided $50 for burial in case of death and $50 to the spouse and any legitimate children. Since this product was so profitable, CARD expanded the benefits by offering a disability payment of $10 a month for 3 months in case of injury and a pension of $20 a month for 5 years for persons over 60 years of age—all for the same premium amount.

The response to the product was enormous. Between 1995 and 1997 membership increased from 12,000 to 27,000. The premium incomes to CARD were substantial. The organization seemed to have found a major new income source. The client profile, however, was quickly changing. A study in 1997 showed a large and growing number of members in their upper 50s. About 40 percent of the clientele were within 5 years of being able to collect the pension. The projected payouts would break the fund and collapse the bank. CARD's first response was to raise the premium to 10 cents per week.

In 1999, operating a mutual fund or insurance company became illegal for Filipino nongovernmental organizations (NGOs). In response, CARD registered its insurance fund as a separate entity, CARD-Mutual Benefit Association or CARD-MBA, with a separate board of directors drawn from its membership. This change was necessary to construct a firewall against liability to the MFI.

CARD conducted a legal resolution to extract itself from legal liability. The first step of the new entity was to get an actuarial study to determine life expectancies and projected payouts.

Jaime Aristotle Alip, Chair, CARD Bank

to the family for burial costs. It may even provide a cash benefit to the borrower if a family member dies during the loan term. This type of policy has the potential to help both the institution (by maintaining portfolio quality) and the client or the client's family.

While it is less complicated, credit life insurance can also become an administrative hardship, as shown in the case of Kabilikat para sa Maunlad na Buhay, Inc. (KMBI) in the Philippines, which is now switching from providing insurance on its own to forging a partnership with an insurance company (see Box 8-3). The types of problems experienced by KMBI's credit life insurance are exacerbated when an MFI tries to offer more complicated products. Box 8-4 describes how CARD Bank in the Philippines entered into the life insurance business and then ill advisedly expanded to other products (pensions, disability insurance).

Before developing this product on its own (that is, before operating as a full-service insurer), a VBI should examine the checklist in Table 8-2 to determine what it needs to have in place.

Table 8-2
What Do You Need To Offer Credit Life Insurance?

	Voluntary	Mandatory
❑ Number of clients that can be expected to join	✓	✓
❑ An actuarial study, which is required to price the product	✓	✓
❑ A simple system to track fees or premium payments	✓	
❑ An accounting system that will distinguish between customers that do and do not want the product	✓	
❑ Adaptation of current management information system (MIS) tracking system to include credit life coverage	✓	✓
❑ Record keeping of claims requests and payouts	✓	✓
❑ Staff training in "what is insurance"	✓	✓
❑ Staff training on how to market insurance to clients	✓	✓
❑ Staff incentive system for successfully selling the insurance	✓	
❑ An assigned staff person to oversee the business within the institution	✓	✓
❑ Mechanism for collecting premiums	✓	
❑ Investment options besides the loan portfolio for premiums and reserves	✓	✓

8.3 Institutional Structures

The best way to avoid the risks and challenges of providing insurance is by partnering with a traditional insurance company. This approach, the partner-agent model, is one of three ways of providing insurance. The other two are the full-service model and the community-based model.

Besides the preferred partner-agent model, two other ways ucturing microinsurance are (1) as a full-service insurer and (2) through a community-based model.

Full-service Model

As a full-service insurer, a VBI handles all aspects of providing insurance, including product design, pricing, marketing, screening and underwriting, premium collection, reserving, and paying claims. This model generally is regulated by the government and requires a

professional staff with specific qualifications, significant cash reserves, and advanced tracking systems to monitor premium payments, claims payouts, and the cost of services provided. Village-banking institutions are not advised to enter into this model, with the possible exception of offering credit life insurance. Even with credit life, it is recommended that professional insurers help in pricing the premiums through an actuarial study.

Community-based Model

An alternative approach to the full-service model is a mutual benefit society managed by volunteers within the community. As owners of the scheme, members determine the services that will be covered, set premiums, and manage the day-to-day operations. Since they are involved in shaping the product, presumably this model has high potential to provide customer value. This approach, used most commonly to deliver health insurance, may also reach deeper by providing services to poorer segments of the community.

The community-based model, though, is not without its challenges. The time commitment for executives of the society can be significant. Moreover, managing an insurance fund requires skills and knowledge not typically found in low-income communities. The enthusiasm of volunteers is notoriously short lived. This model has the added risk of being easily bankrupted because of limited reserves and vulnerability to covariant risks. Typically, as the insurance group grows, which it should do to create a sufficiently large risk pool, the capacity of the local management is stretched.

Village banks easily lend themselves to this model because it dovetails with many of the traditional village-bank characteristics, including community participation and control, the ability to serve poorer community members, and peer oversight to reduce fraud and adverse selection. Of course the following disadvantages of village banking are also apparent in the community-based model:

- The cost and time of training;
- Lack of security;
- Limited reserves, making it more vulnerable to multiple claims at once; and
- Exposure to fraud and moral hazard.

An effort to create a reinsurance fund—Social Re—to support mutual health insurance societies and provide the external involvement to overcome these disadvantages is now under way by the International Labour Organization, but it is still in its infancy.[6]

Partner–agent Model

The partner-agent model enables both parties—the VBI and the insurer—to do what they do best.

In this model, the VBI delivers insurance by partnering with a traditional insurance company. This arrangement is similar to the one insurance companies have had with agents for years, whereby the agent sells and services the product in exchange for a commission. Some agents even offer a range of products from different insurance companies. The insurance company does the actuarial analysis, designs and prices the product, manages the administrative functions, and holds all the insurance risk (at least the risk that is not passed on to a reinsurer).

This model provides value to the client because it enables both parties to do what they do best. The VBI's field agents effectively become sales agents for the insurance company. This

[6] For more details on Social Re, see www.ilo.org/socialre.

arrangement benefits the VBI since (1) it gets a new income source; (2) it has a new product to offer its customers (which may improve the performance of other products) without draining the organization's financial and management resources, and most importantly, without imposing insurance risk; and (3) it can focus on its core business of savings and loans.

The partner-agent model also benefits the insurance company since it gains access to a previously untapped market (which it could not have reached on its own) through an existing infrastructure that clients already trust. An insurance company would be particularly interested in working with large VBIs where it could quickly reach 20,000 to 30,000 customers, because this volume creates economies of scale and increases the likelihood that actual claims will track closer to expectations.

The village-banking methodology makes it easy for a VBI to serve as an insurance agent. For example:

- The payment of premiums can easily be integrated with mandatory savings payments.
- The group is accustomed to having a reserve—the internal account—as a buffer, but often is uncomfortable with the complications involved in its management. This experience makes a professional insurance partner an attractive option.
- Village bank cohesion minimizes moral hazard because members can monitor each other.
- Village-banking institutions offer a captured client market with a long-standing relationship with the proposed "agent" (the loan officer or group promoter).

FINCA Uganda uses the partner-agent model to offer two types of insurance. The first, with American International Group (AIG), Inc., a formal insurance company, is an **accident/life policy** that covers the outstanding loan balance and pays a $650 benefit if a member dies or has a disability. This same policy pays $325 in the case of a spouse's death and $163 in the case of a child's death. On behalf of its clients, FINCA Uganda purchases a mandatory group policy for 0.45 percent of the loans disbursed (down from 1.0 percent during the first years of operations when the product was voluntary). The second type of insurance that FINCA Uganda offers in partnership with a semi-autonomous health care financing unit within a local hospital is for **health care** (see Box 8-5).

Establishing a Partnership

A VBI should choose its insurance partner carefully. Because the VBI is the face of the insurance policy to the client, it can be adversely affected if the insurer pays claims late or regularly rejects claims for small print violations. The checklist in Box 8-6 provides guidelines for VBIs to consider before entering into a partner/agent relationship.

A VBI should choose its insurance partner carefully. If the partner does not fulfill its end of the bargain, clients will blame the VBI, not the insurer.

Managers must know how to analyze an offer from an insurance provider based on the demand from its clients and the VBI's needs. To make this initiative worthwhile, the VBI must recover the direct and indirect costs related to implementing and monitoring the insurance product. When negotiating with an insurance company, managers should consider the following six issues:

Box 8-5

FINCA Uganda and Nsambya Hospital Healthcare Plan: Using a Partner-agent Model for Health Insurance Delivery

FINCA Uganda recognized that health problems were the number one cause of late repayment. Whether it was the client herself who was ill or a family member, health care obligations resulted in a loss of household income and simultaneous increase in expenses—a bad combination. Additionally, illnesses were often treated late because of financial constraints, which resulted in a more expensive treatment. Many clients who had used village-bank loans to improve their economic situation were pushed back into poverty by the burdens of a family illness.

FINCA Uganda recognized that managing health insurance was significantly outside its expertise, an assessment reinforced by its previous experiences. It had tried providing health coverage to its staff on a reimbursement basis, which had proven time consuming and fraught with fraud. The organization then purchased health policies from an insurance company. Fraud again surfaced as a problem. FINCA Uganda continued searching for other options.

At about the same time, Nsambya Hospital, a Catholic facility in Kampala, wanted to expand its outreach to neighboring, low-income communities. Nsambya invited the management of what became the Nsambya Hospital Healthcare Plan (NHHP) to develop a strategy and business plan for serving this market. NHHP, the health insurer, now operates within the hospital but is independent of it.

Managers of the new healthcare plan recognized that not having enough cash at the right time to make premium payments could prevent the poor from purchasing insurance. They believed that a savings facility would help overcome this problem. They also found that the scheme worked more effectively if policyholders were served as groups. Besides enabling the provider to serve a number of people at once and reach scale quickly, groups helped enforce timely payment of premiums and reduced adverse selection and moral hazard.

Thus, a natural partnership emerged between NHHP and FINCA Uganda. NHHP recognized that the clients of a village banking program would compose an ideal market because they came as groups that were already accumulating savings. FINCA perceived significant indirect dividends from a healthier clientele, including improved attendance and on-time repayment. Plus, by offering this additional service, FINCA hoped to improve customer retention and gain an advantage over competitors.

This partnership, which began issuing policies in late 1999, is summarized in the diagram in Figure 8-2. Thus far, FINCA's role has been limited to introducing clients to NHHP and helping groups prepare their premium payments (although this transaction is between the clients and NHHP). During the testing phase, this minimal role was considered necessary to allow NHHP to begin the pilot quickly and to deliver accurate information to potential clients. This arrangement also served as an informal training for credit officers as they watched the sales techniques and learned from the explanations of the NHHP staff. In the future, as volume begins to increase, FINCA Uganda staff will assume more of a sales role.

During the early stages of this initiative, the British Department for International Development (DFID) is covering deficiencies in claims and operating costs above NHHP's premium income. This critical donor/reinsurance role makes it possible for a new, private insurance project to test systems and methodologies for serving the poor. NHHP has no reserves, which would normally be the first line of defense for an insurer when claims exceed premiums. The next line of defense is reinsurance, for which NHHP is ineligible since it is not (yet) a regulated insurer. DFID's time-limited subsidies and reinsurance makes this program possible. It is important, however, that the insurer avoid depending on this support. Therefore, both DFID and NHHP carefully and continuously monitor pricing and the achievement of business plan objectives.

Box 8-5 (continued)

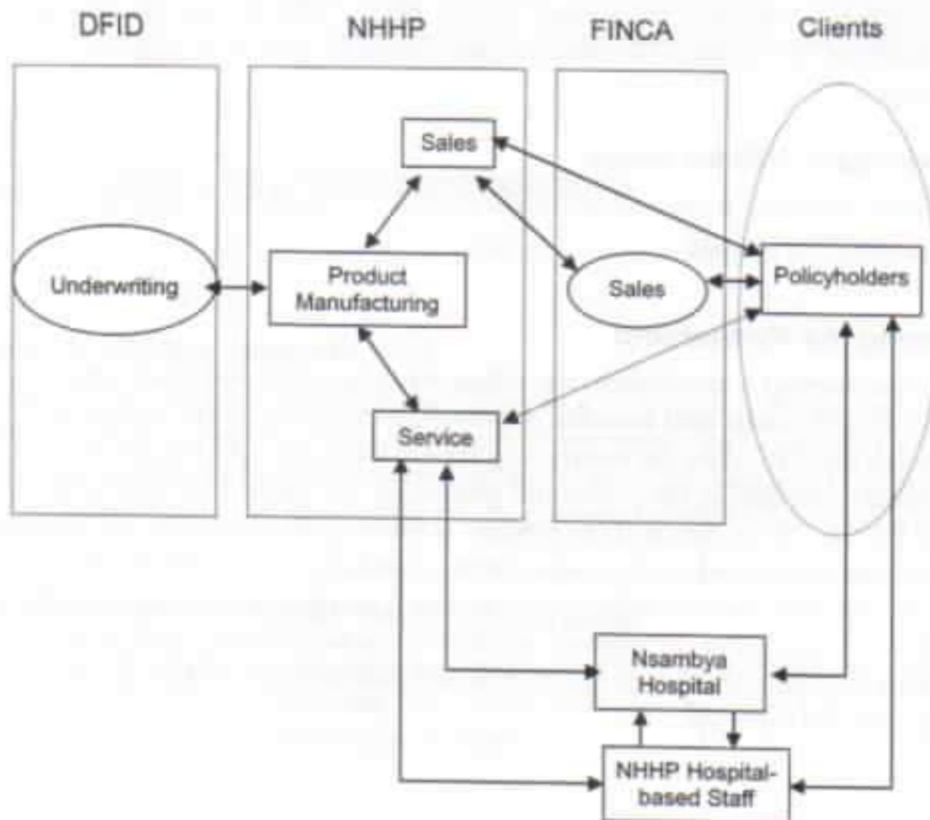
Overall, this arrangement enables each party to do what it does best. FINCA Uganda can concentrate on its credit and savings business, while providing clients with access to health insurance—and FINCA does not bear any of the insurance risk. NHHP can easily test ways of delivering health insurance to low-income communities by serving ready-made groups. Nsambya Hospital can deliver health care to poor people. And DFID can facilitate the collaboration of these three organizations.

The partner-agent model places the incentive for preventative care on the insurer. Within the first year, NHHP quickly realized that it had three times more claims for malaria than for any other illness. With this information in hand, the insurer began exploring options for helping policyholders prevent malaria infection, such as providing them with mosquito nets impregnated with insecticide.

Another early lesson from the FINCA Uganda-NHHP-Nsambya relationship is that the insurer should reach out to other customers—from other MFIs and other ready-made groups—and should reimburse services from additional health care facilities. By working with several hospitals, the insurer can improve customer choice (not everyone is comfortable going to the Catholic hospital) and can theoretically improve health care by increasing competition. Partnering with multiple MFIs and other groups expands the number of clients and the risk pool, while reducing the insurer's concentration risk (e.g., in the unlikely event that FINCA Uganda would go bankrupt.)

Adapted from McCord (2000)

Figure 8-2
NHHP/FINCA Uganda Health Financing Product



1. Scope and Service

- How will clients pay for the service?
- What are the prices of services and premiums?
- How much will a claim payout cover for each incident?
- What are the specific roles and expectations of the partner and agent?

2. Service Expectations

- How quickly will claims be paid?
- Are coverage and claim forms consistent with the VBI's existing forms and are they clear to clients?

3. Client Information

- What is the average age of clients?
- What is the gender composition?
- What is the number of risk incidents for a given period (for example, number of deaths if it is for a life insurance policy)?

4. Expected Commission

Managers should know what the expected income from commissions will be and should be able to compare this amount to the VBI's expected costs for product-related training and monitoring.

5. Financial Information of Partner

Financial information about the partner will enable the VBI to assess the solvency and dependability of the partner. This information should be monitored regularly throughout the partnership.

6. Incentives to VBI for Sales

Incentives for the VBI to sell policies might include (1) benchmark sales quotas and (2) lower insurance rates for the staff.

Monitoring the Partnership

Careful monitoring of the partnership is required to ensure that the arrangement is meeting the objectives of the VBI, the insurer, and the customers.

After the partnership is established, the village-banking institution should have a system for monitoring the **costs and benefits** of providing insurance to the institution. If claims pass through the VBI, then the monitoring system must also take into account all the issues related to producing the policy and processing the claim. This type of monitoring is critical for the VBI to decide if the product is fulfilling its objectives. For instance, has health insurance increased on-time repayment, attendance, and client retention?[7] The VBI should also regularly monitor whether the service is meeting its **customers' expectations**, and with which aspects of the product or delivery mechanism they are and are not satisfied. Before finalizing the partnership, the VBI should pilot test the product to assess the partner's dependability and capacity.

[7] For a detailed list of performance metrics that a VBI should consider monitoring, see Brown and McCord (2000).

Box 8-6

Due Diligence Checklist for Selecting a Partner

- ❑ What is the national reputation of the insurance provider?
- ❑ How is the insurer currently financed? Does it have a stable, conservative asset portfolio?
- ❑ What is the claims experience of the insurer and its history of claim payouts? Is the provider willing to guarantee a fast turnaround on claims from VBI clients?
- ❑ How interested is the insurer in serving the low-income market?
- ❑ Will the insurer adjust its products so that they are responsive to the needs and preferences of low-income households?
- ❑ Is it willing to make a medium- or long-term commitment to the VBI?
- ❑ Is it willing to pay a commission to the VBI for performing the agent role?
- ❑ Are there issues related to regulatory compliance?
- ❑ Will the insurer give the VBI responsibility for verifying claims?
- ❑ What can the insurer do to minimize the number of exclusions, without jeopardizing the sustainability of the plan?

Adapted from Brown (2001)

In addition, the VBI should monitor the **insurance company's overall financial status** to assess long-term solvency and judicious management. The VBI should have regular access to audited financial statements. If possible, insurance companies should carry reinsurance and have demonstrated they can handle the many simultaneous claims that result from large shocks.

8.4 Conclusions and Recommendations

In conclusion, VBIs that are thinking about offering insurance services should consider the following recommendations:

- **Develop savings products first.**

  Several risks or financial hardships that clients face are common or expected expenses. These should be addressed through savings and emergency loans, not through insurance. Insurance should be reserved primarily for unforeseen and large economic shocks, and it may not be appropriate for the poorest segments of the market (see Box 8-7).

- **Train staff and clients on "what is insurance."**

  Most village-bank clients and many staff will have difficulty with the concept of paying premiums for something they may not receive. Staff must be trained to understand this concept so they can communicate it to clients.

Box 8-7

Is Insurance for the Poor?

There are two lines of thought on the relevance of insurance for the poorest segments of the market. On the one hand, the poorest are the most vulnerable segments of the population, and the most risk averse. From this perspective, the lowest-income households might have the highest demand for insurance to help reduce their vulnerability. This expectation is borne out in some environments with certain types of coverage. For example, households in South African townships indicated that their number-one priority expense each month was to pay the premium on their funeral insurance policy (Roth 1999).

The counter argument is that insurance is a luxury that only people with excess income can afford. If a low-income household must choose between putting food on the table and paying for protection against a future calamity that they do not know will occur, they are likely to spend their money on food. Furthermore, if the risk does not occur, they will believe that they have spent their limited resources unnecessarily, and all they have to show for it is peace of mind. One cannot eat peace of mind.

- **Use the partner-agent model.**

  Insurance is a separate and complex business requiring highly technical skills and staff. VBIs should not attempt to manage this business themselves. If no partners are available locally, VBIs should market themselves to an outside company. This may require joining with other organizations to offer a sufficiently large client pool.

- **Consider offering simple credit-life insurance directly if no partner is available.**

  Insurance that covers only the outstanding loan balance can be managed by a VBI. Beware, however, that the administrative and monitoring systems to offer even this product can become cumbersome.

- **If feasible, make credit-life insurance voluntary; but for groups that choose to participate, require all members to participate.**

  Voluntary participation is recommended because it forces institutions to better market and deliver the service. Within a village bank, however, either all or none should participate.

- **Assess demand, costs, and benefits to the MFI before introducing a new product.**

  Besides assessing whether or not clients' perceived needs translate into willingness to pay, the institution will also want to know if insurance positively impacts its core business of savings and loans. The VBI must continue to focus on the delivery of its core products and should recognize that insurance is not just a new product, but a new business.

- **Make sure insurance is priced actuarially.**

  A professional actuary should assist in the pricing of premiums based on life expectancy projections or other types of risk that are insured.

- **Research and prepare for negotiations with an insurance provider.**

  It is critical that managers keep in mind the terms, expectations, costs, and profits that it expects to come out of a partner-agent relationship. They will want to negotiate a product structure that is efficient and priced right for their clients. At the same time, they will want to ensure that, as the agent, the VBI does not have to assume an undue administrative burden.

- **Pilot test the product to assess its design and to test the monitoring system.**

  New systems for tracking and storing information should not strain the existing MIS. Forms should fit with existing paperwork and the VBI should not be responsible for processing undue amounts of information.

Resources

The following references provide additional information about microinsurance.

Brown, Warren and Craig Churchill. 1999. "Providing Insurance to Low-income Households. Part I: A Primer on Insurance Principles and Products." *New Products for Microfinance, Review Paper 1.* Bethesda, MD: U.S. Agency for International Development (USAID) Microenterprise Best Practices (MBP) Project. www.mip.org

Brown, Warren and Craig F. Churchill. 2000. "Insurance Provision in Low-income Communities. Part II: Initial Lessons from Micro-insurance Experiments for the Poor." *New Products for Microfinance, Review Paper 2.* Bethesda, MD: USAID MBP Project. www.mip.org

Brown, Warren, Colleen Green, and Gordon Lindquist. 2000. "A Cautionary Note for Microfinance Institutions and Donors Considering Developing Microinsurance Products." *New Products for Microfinance, Review Paper 5.* Bethesda, MD: USAID MBP Project. www.mip.org

Churchill, C., D. Liber, M.J. McCord, and J. Roth. 2002. *Making Insurance Work for Microfinance Institutions: A Guide to Developing and Delivering Microinsurance.* Geneva, Switzerland: International Labour Organization (ILO). www.ilo.org/socialfinance

ILO-STEP/ILO-SEED. 2001. *Mutual Health Organizations and Associations of Micro-entrepreneurs: Guide.* Geneva, Switzerland: International Labour Organization (ILO). www.ilo.org/step

McCord, Michael J. 2001. "Health Care Microinsurance—Case Studies from Uganda, Tanzania, India and Cambodia." *Small Enterprise Journal,* vol. 12, no. 1: 25–38. www.microinsurancecentre.org

Valuable Microinsurance Web Sites

Microinsurance Centre: www.microinsurancecentre.org

Microinsurance Focus: www.microfinancegateway.org/microinsurance/index.htm

9

Integrating Non-financial Services

Financial services are powerful tools, but they are not sufficient for reducing poverty. The factors that keep disadvantaged people in poverty are multiple and inter-related, and cannot be overcome solely by microfinance.

For example, a poor, illiterate woman from a rural town with access to few social services may be fortunate to borrow money and grow a small business. But without education, her economic and social options are limited. She may struggle in an economic activity with limited profitability because she cannot keep business records or because the market for her products is saturated. Her children may suffer from preventable diseases, reducing her ability to dedicate time to her business. She may lack self-confidence to play an active role in local governance that could bring basic infrastructure—electricity, potable water, or schools—to her community. Despite the small benefits her growing business may provide, her family will remain poor.

Hence, many village-banking institutions (VBIs) link their financial services with education, health, and other non-financial services to broaden the impact of their programs. Critics, however, challenge the wisdom of this strategy. While not disputing the need, they question whether it is appropriate for microfinance institutions (MFIs) to provide non-financial services. This chapter explores this debate, highlights the conditions in which VBIs can become multiservice providers, and describes how best to do so.[1]

9.1 What Are Integrated VBIs?

Before discussing the wisdom of integrating financial services with non-financial services, it is important to define **integration**. Along with providing traditional microfinance services, integrated VBIs directly or indirectly provide non-financial services such as adult literacy and numeracy, health education and health services, business skills training, and personal development courses. Non-financial services might be integrated into village banking in the following three ways (Dunford 2001 Draft):

Integration is the provision of non-financial services, such as health education or business skills training, along with microfinance.

[1] Gretel Figueroa and Judith Painter drafted the content of this chapter.

1. Partnership or Joint Venture

Services can be provided in parallel by two independent organizations. In this model, the VBI does not directly provide non-financial services; it partners with a non-financial service provider. For example, a VBI may ally with a local clinic and allow health care professionals to give presentations at village bank meetings and attend to the health needs of members and their families.

In this arrangement, both parties focus on what they do best. A partnership approach is particularly appropriate when the expertise or infrastructure required to deliver the non-financial service is quite different from village banking. A potential disadvantage is that the VBI does not have control over the quality of the partner's services. Tension also may arise as each organization competes for the time and attention of clients.

2. Sister Programs or Holding Company

A more integrated approach is the delivery of parallel services by two programs of the same organization. An organization committed to providing multiple services could create two distinct programs with separate, specialized personnel who share the same organizational name and, perhaps, the same physical and administrative infrastructure. This arrangement is similar to a private-sector holding company. Using the example of health services again, an organization might run parallel programs employing specialized educators and care providers to offer health services to their clients while employing a separate staff for financial services.

This arrangement has a clear division of functions. Quality control is in the hands of the single overarching organization. Fundraising and accounting for each program can be distinguished to assure donors and other sources of capital that their funds are allocated to the program of their choice. This model, however, places a larger financial and management burden on the organization than does the partnership approach.

3. Full Integration

The third option is to completely integrate financial and non-financial service delivery. In this model, the same personnel provide multiple services to the same clientele. This model can lower direct costs for a VBI since it requires only one delivery channel to provide two services. Field workers must learn to wear multiple hats, however, and perform services that require different sets of skills, which may impose less-obvious costs. Staff with multiple skills may need to be paid more. If loan officers are to remain productive, the scope of the non-financial services must be limited to activities that can fit into regular financial service delivery. In the health services example, loan officers might be able to deliver a health education curriculum, but they could not provide health care.

Full integration is experiencing a resurgence as some VBIs demonstrate that this model can fight poverty and achieve financial self-sufficiency

Integrated services are not new. Industry pioneers in Bangladesh had always linked an education element to credit delivery. Contents ranged from health discussions such as the importance of clean water, pit latrines, and family planning, to empowerment issues such as fighting injustice and not paying dowries. But integration went out of fashion in the early 1990s as experts advised the clear separation of financial and non-financial services, similar to the first two models discussed above, so that VBIs could specialize and focus. The *New Direction* is the resurgence of full integration as a plausible solution—one that can more effectively attack poverty *and* achieve financial self-sufficiency.

9.2 To Integrate or Not To Integrate?

Is it appropriate for microfinance institutions to provide non-financial services? The debate over this question reflects the sustainability-outreach tension at the heart of microfinance. Proponents of integration argue, above all, that non-financial services are essential to overcoming poverty and can be provided without detracting from the quality and ultimate sustainability of the VBI. When compared to minimalist credit models, integrated programs can achieve a wider impact beyond higher incomes and asset accumulation. Furthermore, integration can potentially enhance the VBI's financial operations by increasing client loyalty, improving portfolio quality, and differentiating the VBI in the market.

Critics of sister programs and full integration contend that financial service providers should focus on their core business. The high cost of providing small loans already leads to tight profit margins. Adding non-financial services increases the challenge of reaching sustainability. It also can undermine competitiveness. Finally, critics say, financial service providers are not appropriate purveyors of non-financial services.

This chapter section does not settle the debate but examines the main arguments to understand the potential risks and benefits of integration, as summarized in Table 9-1.

Table 9-1
Pros and Cons of Integration

Potential Benefits	Potential Risks
Has broader impact in more areas of a client's life and on her community	Has lower impact because VBI takes on too many services that lie outside its core competency or has no additional impact because not enough time and resources are invested in the non-financial service for it to be effective
Provides much-needed basic services that might not otherwise exist	Provides redundant services if similar services and resources are already available in the region
Can be financially sustainable	Increases costs, compromises operational efficiency, and takes longer to reach sustainability
Increases customer loyalty from clients who appreciate the VBI's concern	Increases client desertion from among clients who dislike increase in transaction costs
Heightens incentive for timely repayment	Is harder to control costs because of complex accounting that also makes VBI less marketable to funders
Strengthens institutional and staff commitment to the social mission	Requires a stronger institutional structure because management is more complex
Differentiates the VBI from competitors and increases its marketability to clients and donors	Puts off donors and clients because of confusion over corporate culture; financial programs project a tough, serious image, while non-financial services present a softer quality

Costs and Sustainability

Adding non-financial services can make the challenging task of achieving sustainability even more difficult. Unless outsourced to a partner, these services increase operating costs. Furthermore, managing additional services and accounting for the costs of each is complex, making it hard for managers to control costs and for stakeholders to evaluate the organization's efficiency. In fact, most sister programs fund at least part, if not all, of their non-financial activities through grants. And while fully integrated programs can cover their full costs, most do not.

On the other hand, the additional cost of integrated services may not be huge. It is estimated that fully integrating education services, for example, increases administrative cost ratios 6 to 10 percent (Vor der Bruge, Dickey, and Dunford 1999). Some fully integrated programs cover these costs with revenue from their credit program.

Competitiveness and Sustainability

Providing non-financial services may help a VBI secure its market share through improved client loyalty and market differentiation. Certain segments of the population show a strong preference for banking with an organization that cares. With these customers, an investment in the provision of non-financial services may reap returns in the form of high repayment rates and a stronger brand association. Clients who benefit from business-skills training, for example, may have higher profit margins. Those who receive health education may be more profitable because their health and the health of their family have improved.

At the same time, full integration can also present a marketing challenge. Linked services oblige clients to invest time and pay higher interest rates to receive services they did not request. If these services are not high quality, do not appeal to clients, or lose their attraction over time, the non-financial service could harm a VBI's position in competitive markets.

While few impact studies have rigorously compared clients of integrated programs with those who receive only financial services, some evidence suggests that quality high-quality education services enhance customer loyalty (Nteziyaremye, Stack, and MkNelly 2001). (See Box 9-1.) In any case, integrated VBIs that perform well in highly competitive markets, such as Pro Mujer in Bolivia and BRAC in Bangladesh, indicate that there are ample clients who prefer integrated programs even when they have access to non-integrated services.

Value to Clients

With fully integrated services, clients do not have a choice about whether they want the linked services. In fact, the non-financial services are often precisely those—such as health education or literacy—for which clients may not initially be willing to pay. Are supply-driven services appropriate?

Since integrated services are essentially supply driven, VBIs need to ensure that clients will eventually come to value the non-financial services.

Non-financial services tend to provide benefits over time. Unlike credit, which appears immediately as cash in hand, the benefits of health education, for example, are not immediately tangible. For that reason, low-income clients may not initially be willing to pay for them. Yet, studies by Freedom from Hunger reveal that participants come to value the education services over time (MkNelly and Lippold 1998). Once in the program, clients indicate a willingness to pay more for these services and cite the education component as a principal reason for continuing to borrow from the organization, even if other credit

Box 9-1

Building Client Loyalty through Integration

In Mali, the Kafo Jiginew and Nyèsigiso credit union federations treat their Credit with Education clients as associate members. At first, these associate members do not have access to other credit union services, but after four years, they can "graduate" to become full-fledged credit union members. Freedom from Hunger recently investigated whether new graduates left their *Credit with Education* groups upon joining the credit union directly, and if not, why they continued to participate.

Of the 72 new members who had graduated from *Credit with Education* groups, 69 percent chose to continue participating in their village banks. Their most frequent reasons were as follows:

• Like the solidarity provided by group	96%
• Like the education	91%
• Like the opportunity for more than one loan at a time	89%
• Want to save with their group	85%
• Want other *Credit with Education* services	34%

According to the survey, most of the other respondents chose to leave the village banks and participate solely in the credit union because they wanted financial services that better met their needs, such as larger, longer-term loans at lower interest rates with less-frequent repayments. Only 10 percent indicated that they disliked the frequent meetings or had difficulties with group members. No one mentioned dissatisfaction with the education.

This study suggests that even in a situation where leaving the integrated program would be relatively simple, many clients remain active in their village banks, and the education component is an important reason for staying.

Christopher Dunford (2001 Draft)

programs are available. Hence, integrated programs can provide services that poor people need, that they may not otherwise seek, and that will come to value.

The fact that the "need" for these services precedes the "want" may justify an integrated, supply-driven service that does not, by itself, aim to cover its costs. Freedom from Hunger's *Credit with Education* model, for example, assumed that women would pay for financial services but not education because clients would not immediately experience the benefits of better health. Hence, *Credit with Education* never intended health training to be an income source. Rather, training is provided because it is needed, is complementary, and can be effectively integrated into the credit program without detracting from the quality of either service. In fact, studies show that programs that integrate health education have significant impacts on child health (Cerqueira and Olson). By cost-effectively bundling this service with a potentially sustainable demand-driven service—credit—VBIs can deliver significant value at minimal cost.

Integrated approaches make sense for organizations that are committed to achieving social, as well as financial, returns.

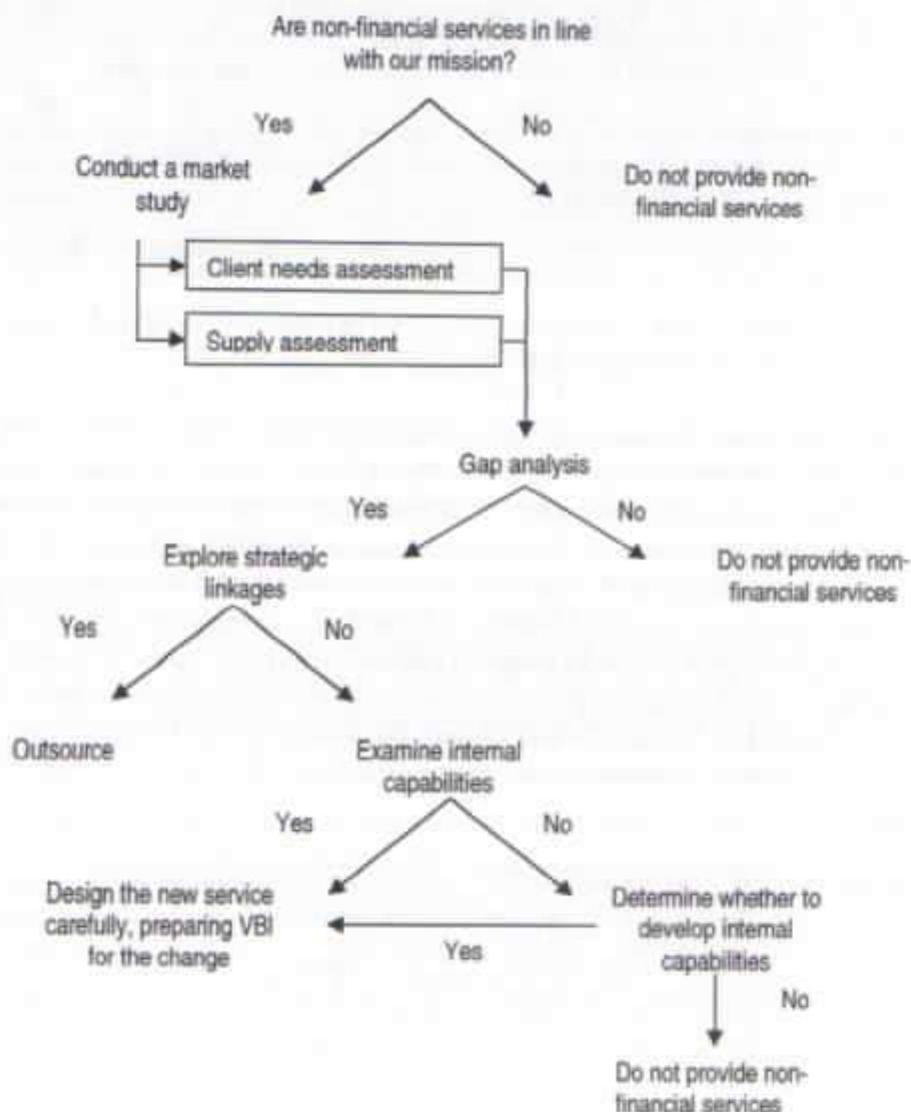
On the other hand, if VBIs are not careful, integrating non-financial services may have the opposite effect. Working in an isolated environment where the needs are many and the service providers few, a VBI may attempt an assortment of non-financial services that extend beyond its core competencies. The impact on clients' lives may be lower if the quality of the services is inadequate.

If the services are high quality, however, an investment in delivering non-financial services can generate long-term payoffs for both the VBI and its clients. For the client, access to training and other non-financial services can facilitate a higher quality of life. For the VBI, integration improves efficiency—if efficiency is defined as getting the greatest impact for one's investment—because the increased impact comes at minimal additional cost to the VBI. Integrated programs make sense for well-managed VBIs that embrace a double bottom line, institutions that expect investments to produce social and financial returns.

9.3 Conditions for Integration

Given the strong arguments for and against integration, perhaps the relevant question is not whether integration is wise, but rather when does it make sense, for whom does it make sense, and how do organizations minimize risks and maximize benefits? The decision tree in Figure 9-1 illustrates how a VBI could approach the question of expanding its services to include non-financial services.

Figure 9-1
The Integration Decision Tree



This decision tree illustrates that VBIs should consider integration only if the following external and internal conditions enable it to perform multiple tasks effectively. Specifically, expanding to non-financial services makes sense if—

1. The VBI has a strong commitment to providing the complementary services.

Successful integration depends on a clear commitment from all levels of the organization—from its board of directors to its loan officers—to the provision of *both* financial and non-financial services. Half-hearted attempts at forging the delicate balance that integration requires cannot succeed. It is difficult to create a corporate culture that simultaneously provides basic human services while not tolerating delinquency (Dunford 2001).

2. The strategy to provide these services matches the VBI's timeline for sustainability.

Clients may need a particular service and the VBI may have a strong social commitment, but if the VBI intends to become sustainable within a specific period of time, it may have to compromise on how the non-financial service is provided. Options include linking with an existing NGO, creating a new NGO, or selecting only services that can be fully integrated into existing operations without overburdening clients or staff.

3. The supply of services in the area is insufficient or cannot be adapted to village-bank members.

VBIs should conduct a market study to determine the non-financial needs of clients and the supply of services available to meet those needs. VBIs often are among the few agencies operating in remote areas with vulnerable populations. In those environments, VBIs can use their infrastructure and staff to provide additional health and education services that would not otherwise be accessible. The ADEMCOL case (see Box 9-2) illustrates these conditions.

9.4 How To Integrate

While there are no certain rules for success, the following principles can help VBIs move down the path of integration.

> The decision of what service to provide depends on three factors: what services members need most, what the organization can realistically offer, and what is already available.

1. Seek Out Potential Partners

The external environment is important. If specialized institutions already offer high-quality services, but lack the VBI's outreach, then consider partnering with them. VBIs working in regions facing AIDS, for example, might team with health providers, government programs, and local pharmacies to bring services to clients. A VBI can also lower the costs of these services by providing village bank meetings as an entry point to services delivered by others (see Box 9-3).

2. Design the Service with Care

To increase impact, offer a service that will make the biggest difference in clients' lives. Market research should identify what services will respond to real wants and needs. At the same time, introducing non-financial services can undermine a VBI's financial focus. This risk may be lessened by selecting services that complement the VBI's core competencies or that fit easily into the lending process.

Box 9-2

Considering the Market for Business-skills Training: ADEMCOL in Colombia

The Asociación para el Desarrollo Microempresarial Colombiano (ADEMCOL), a Colombian NGO, began in 1993 to organize village banks to provide financial services to women. Through market research with its members, ADEMCOL identified a large demand for business-skills training. Since it did not want to veer from its primary function as a microfinance institution, ADEMCOL first explored the possibility of partnering with a training organization. A study of the options revealed, however, that training centers were either too costly or not geared for microentrepreneurs. Thus ADEMCOL took it upon itself to design and deliver training that fit client demand.

In 1995, ADEMCOL began offering basic business training such as accounting, bookkeeping, inventory management, and pricing. In 1996, in response to client demand, it added modules in personal growth, including time management, conflict resolution, and public speaking. In 1999, another client survey revealed that mature clients wanted strategic management training such as accessing new markets, coping with economic shocks, and managing human resources. The shift from basic skills to strategic training demonstrated ADEMCOL's effectiveness in identifying and meeting customer demand. It also emphasizes the importance of continual monitoring to remain in step with changing client needs.

ADEMCOL uses its loan officers to deliver the training because it is more cost effective. Yet the organization was realistic about the client load and portfolio size that loan officers could carry in light of their new responsibilities. ADEMCOL lowered the number of village banks it expected loan officers to manage from twelve to seven because it expected that its training services would increase client retention and expand outreach. It also expected the services, over time, to increase sustainability.

If these assumptions proved true, then ADEMCOL's investment in training services would represent a net gain for the institution and its clients. Although the organization has not yet realized these benefits due to a variety of factors, ADEMCOL's challenges seem unrelated to the provision of training. In fact, loan officers believe the training modules make their jobs easier because they make the weekly meetings more engaging. Also loan officers find that clients who receive business training and remain with ADEMCOL are often the best performers.

Adapted from ADEMCOL and Women's Opportunity Fund (2001)

Non-financial services must be designed to continuously engage new and old clients. This is especially important if participation requires clients to invest time or money (in the form of fees or higher interest rates) for the new service. The service should be developed professionally. If the additional service involves training, for example, then it is critical to involve experts in curriculum design and adult education to develop the course materials.

If clients do not value the service or find it engaging over time, integration may become a liability for the VBI. For this reason, the VBI should consider whether the service is mandatory or voluntary, or whether it should become voluntary over time. Depending on the type of service, it may make sense to target particular sets of clients: women, parents, rural clients, new clients, or young clients. Participation requirements and content can then be tailored to these subsets.

3. Prepare for the Human Resource Requirements

Adding a non-financial service will strongly affect the VBI's human resource needs and corporate culture, especially if the service is fully integrated. Management and staff will need to be trained, responsibilities expanded, and incentive schemes modified. Retraining will

Box 9-3

Responding to Surroundings: Prevention of HIV Infection in Uganda

The Foundation for Credit and Community Assistance (FOCCAS), a microcredit NGO, was founded to provide *Credit with Education*. FOCCAS offers village banking together with education in health, nutrition, family planning, and business skills to more than 13,000 women in rural and peri-urban areas of eastern Uganda.

FOCCAS provides its members with family planning training and links them to the services of other organizations. When the FOCCAS field agent completes the family planning module, a representative from Marie Stopes, a UK-based family planning organization, attends a group meeting. The Marie Stopes agent reviews family planning methods and answers questions, particularly on technical aspects with which the FOCCAS staff may be less conversant. The agent then provides on-the-spot access to any contraceptive method. Although it is still a pilot effort, the partnership seems to work well because it equally benefits both organizations.

Because of the high rate of HIV/AIDS in Uganda, FOCCAS sees addressing the epidemic as a high priority. Although both prevention and mitigation services are necessary, FOCCAS could not realistically finance health care with revenues from its credit operations. Instead, FOCCAS focuses on prevention by providing the best available information for reducing the risk of HIV exposure. The field agent also helps members think about HIV/AIDS in the context of the community, to better support those dying of the disease and to encourage others to change their behavior to prevent new infection.

Having access to information does not ensure its use. The field agent must address the reasons why women do not adopt beneficial practices. It is a real challenge to identify and respond to the obstacles to behavior change in relation to HIV/AIDS. The field agent facilitates a process of problem-solving, decision-making, and motivation to action that involves a number of steps before members are prepared to change ideas or practices. Group facilitation skills are central to successful behavior-change education. Fortunately, staff training for group facilitation serves FOCCAS' microcredit component as well as its education component.

Although FOCCAS limits its non-financial services to education, it recognizes that education alone is insufficient to properly address the HIV/AIDS crisis in eastern Uganda. In the near future, FOCCAS intends to facilitate member access to complementary HIV/AIDS services such as testing and counseling.

Christopher Dunford (2001 Draft)

take considerable effort, both in a classroom setting as well as through modeling in the field. VBIs will need to reconsider the current profile used to hire field staff. Is it easier to train a health educator to be a good loan officer or vice versa?

Senior managers and the board will have to change the corporate culture, even in cases where the integration is less complete—as in the partnership or holding company models. Managers overseeing the financial and non-financial services should be trained together to develop sensitivity for each other's work. Upper management and the board need to convey to the staff that the organization equally values all services (that is, performance evaluations should depend on the results of both). If loan officers get the impression that one service is more important than the other, they often will not give sufficient attention to the secondary service. Financial services must not lose seriousness, while non-financial services must be provided in a sensitive manner. This tough-love culture must be carefully promoted among all those involved.

4. Consider the Effect on Sustainability

The addition of a non-financial service can adversely affect an institution's sustainability or at least lengthen the time it will take to break even. For VBIs that directly provide non-financial services with existing staff, costs will increase and the number of clients per loan officer may fall. Not all stakeholders will view this change positively because it will impact conventional performance ratios used to evaluate productivity, efficiency, and sustainability. A case can be made for developing unique performance standards for fully integrated organizations. Until such standards emerge, integrated VBIs need to consider the effects of non-financial services on performance ratios because they compete for funds with minimalist MFIs. Clear accounting policies and separate cost centers will enable the VBI to monitor efficiency and productivity of the delivery of their services separately and jointly.

5. Determine Sequencing

In a new VBI, it may be wise to fine-tune the delivery of financial services before offering non-financial services. After staff has become familiar with their external environment and their clients' needs, then they may begin an informed search for the right service and structure to add non-financial services to their credit program.

It is an open debate about whether the integration of non-financial services should occur from the inception of the program or only after the credit product has been perfected.

On the other hand, a strong case can also be made for beginning operations as an integrated program. Introducing a non-financial service later on brings its own set of challenges. Maintaining the quality of the credit services may be difficult. Staff members often resist change, particularly one as dramatic as offering a completely new service that requires them to learn new skills. Existing clients may dislike the new activities being inserted into their village bank meetings.

Resources

The following resources provide additional information about integrating non-financial services.

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The SEEP Network

The Small Enterprise Education and Promotion (SEEP) Network is the foremost association of North American-based private and voluntary organizations that support micro and small businesses and microfinance institutions in the developing world. SEEP's mission is to advance the practice of small and microenterprise development among these organizations, their international partners, and other practitioners. In doing so, SEEP provides a vehicle for the collective examination of agency experience from which emerges learning that advances the professional development of its members, increases program impact, fosters continuing methodological innovation, and informs the policy arena.

54 member agencies of the SEEP Network assist more than 5 million people worldwide, expending roughly $112 million on enterprise development, and extending more than $705 million in loans annually. Members provide financial services using individual, solidarity, village bank, credit union, and cooperative methodologies. They offer training, technical assistance, and technology services. Members also engage in strategies that link enterprise development to interventions in the fields of health, nutrition, vocational training, environment, and others.

ACCION International
Action for Enterprise (AFE)
Adventist Development and Relief Agency (ADRA) International
Agricultural Cooperative Development International (ACDI)/Volunteers Overseas Cooperative Assistance (VOCA)
Aid to Artisans
American Near East Refugee Aid (ANERA)
American Refugee Committee International
Canadian Centre for International Studies and Cooperation (CECI)
CARE
Catholic Relief Services (CRS)
CHF International
Christian Children's Fund
Concern Worldwide USA
Conservation International (CI)
Counterpart International, Inc.
The Crafts Center
Développement international Desjardins (DID)
Enterprise Development International
Enterprise Works Worldwide
FINCA International, Inc.
Food for the Hungry International (FHI)
Freedom from Hunger
Friendship Bridge
Grameen Foundation USA
Helen Keller Worldwide
International Development Enterprises (IDE)
International Rescue Committee (IRC)
Katalysis Partnership
Medical Ambassadors International
Mennonite Economic Development Associates (MEDA)
Mercy Corps
National Cooperative Business Association (NCBA)
Opportunities Industrialization Centers (OIC) International, Inc.
Opportunity International
Pact, Inc.
Partners for Development
Plan
Pro Mujer
Project HOPE
The Salvation Army
Save the Children
Société de Coopération pour le Développement International (SOCODEVI)
SosteNica
Strategies for International Development (SID)
Trickle Up Program
Volunteers in Technical Assistance (VITA)
Women's World Banking
World Concern
World Council of Credit Unions (WOCCU), Inc.
World Education
World Relief
World Relief Canada
World Vision Canada
World Vision Relief and Development

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