Why I think that community-managed microfinance programmes should be careful about borrowing from banks.

The recent enthusiasm for community-managed microfinance (CMMF) arises out of the fact that it has, beyond reasonable doubt, proven capable of providing safe, profitable, accessible and well-adapted 'entry-level' financial services for people who live in remote rural areas and urban slums, where formal service providers (banks and MFIs) have found it difficult to cover their costs.

The SHG 'movement' in India and the work of CARE, CRS, Oxfam, PACT and Plan International in Africa has shown that CMMF is received with enthusiasm and creates sustainable groups whose owner-members set their own rules and get to keep the profits, while helping their members to accumulate assets, manage household and IGA cash-flow and negotiate fairer terms of trade - while increasing their voice in social and political affairs.

In India, about 2/3 of the estimated 2-3 million SHGs are linked to banks, almost exclusively to increase access to credit for their members. This is achieved through a variety of mechanisms. Some are federated in order to strike deals with banks: some approach a local bank as independent entities. But the fundamental presumption about SHGs is that they are formed in order to get access to formal sector credit, the rationale being that access to regulated institutions will increase access to loan capital, which is seen as a key pre-condition for creating economic security and capital formation.

The general success of this approach has led a number of agencies to think that this is desirable and a replicable approach that will work in other places, particularly in Africa.

Why do I strongly disagree?

Why debt?

First, I don't know why there is such an emphasis on borrowing and hardly any on savings, which is safer, easy to engineer and a lot more useful. I usually ask the enthusiasts who want to make it easier for poor people to get into debt about their own priorities for financial services. It's always the case that everyone's got a current account. Nearly everyone will have a savings account and most have access to some form of insurance (health, life, car etc.) When it comes to credit, a sizeable minority will have taken out a loan to acquire a household asset, such as a refrigerator or to add a room to the house. Almost always, however, only one or two will have taken out a loan to start a business or to increase its capitalisation. All of this is very much in line with Thomas Dichter's assertion that the history of credit in the West is that of financing consumption and the acquisition of household assets – not business investment.

The obvious question is to ask is *why* people who are economically secure wouldn't be investing in business. The answers vary, but usually boil down to the belief that business is too darned risky; that they don't know enough about it and they'd rather depend on their salaries. Thus, people who have multiple sources of income and a sizeable asset base consider it too risky to start businesses, but have no hesitation in recommending debt-based survival strategies for people whose economic vulnerability is much greater and for whom the failure of an investment may be catastrophic. I am acutely aware that my simplistic enthusiasm to help people to borrow more money can end up with them taking their children out of school, forgoing a meal, or worse, and the current financial crisis is a salutary lesson in the dangers of making it too easy to borrow.

Several years ago, in Malawi, I visited a group that offered some very funny theatre, in which the contrast between savings-led and credit-led microfinance was played out in terms of risk, with the 'silly' CMMFI securing its members' livelihoods and the 'serious/professional' MFI carting off people's furniture. It would have been hilarious (and full marks to the village for having retained its sense of humour) if it hadn't actually happened. The difference between debt in the West and debt in Africa is that we don't often end up with nowhere to sleep and cook. It's a serious distinction.

Purpose

The second reason I disagree is that it is assumed that everyone wants to run growth-oriented businesses. Do they? Most of the poor who run businesses do it because they have no other choice and tend to maximise drawings and minimise reinvestment. They limit their purchase of fixed assets and retain only sufficient working capital to finance the next day's production/trade. Their strategy tends towards diversification, rapid movement of working capital between enterprises and minimal investment in machinery, skills, systems and market knowledge. As practitioners we tend to think that this is undesirable. A 'better' strategy would be towards bigger investments in technology, systems, market knowledge, skills and specialization, all of which more or less mandates full-time engagement in the enterprise. We also think that full-time quasi-formal entrepreneurs are the people who can create real jobs at lower cost than the modern sector and generate new capital, if they can get access to sufficient credit.

I don't disagree with all of this. It's desirable for capital and wealth to be generated by micro-enterprises and, if access to loans is the major constraint to development of a sector, then efforts to supply them on a sustainable basis can only be welcome. But how many people are we talking about? Where do they live? And how do they live?

Most of the very poor simply don't have the luxury of being full-time in business, especially in rural areas where investment opportunities may be few. They (especially women) have multiple responsibilities, only one of which is income-generation, and limited time and opportunity to invest in the acquisition of skills and market knowledge. Their very high level of risk aversion thrusts them towards very low cost investment in a basket of economic activities, characterised by inter-activity working capital flows and by very short and changing business life-cycles. These are not people who are in the least interested in taking on serious levels of debt to finance growth: *and they are in the vast majority*, well below the radar screen of most MFIs. If such investments are to be made, there is a clear preference for them to be made from savings, or from local financial systems that are very well informed, not only about the local economy, but their members' very personal circumstances, so that if things go wrong they will get a fair hearing.[1]

Why do people really want financial services?

This goes back to my first point. Most of us don't use financial services to start businesses, or even to acquire household assets (although that's nice). We use them to smooth income. I get an overdraft at the end of the month to tide me over to the next pay cheque. I save against a rainy day, or to meet a predictable large expense. I pay insurance fees so that I won't be bankrupted by illness or the house burning down. In

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[1] What some people think of as a problem with community-managed microfinance – lack of privacy – becomes a tradable asset that allows the poor to be serviced: *because they are understood* and can frequently benefit from peer experience. How many of us have felt that our bank manager's ludicrous expectations about financial disclosure when making a loan would be so much simplified if only (s)he knew more about the real me?

other words, entrepreneurship is *way* down my list of priorities and household money-management is right at the top. Why would we think that poor people have other priorities? Or are we just blinded by our assumptions about people wanting to invest their way out of poverty? A recent FinScope study in Uganda came up with a list of reasons why people save and why they borrow. There were absolutely no surprises as to why people save.

Table 1: FinScope Uganda. Why people save

Why people save	% responses
Household basic needs such as food, clothing and health services	82%
Emergencies (burial, medical)	70%
Education	35%
Business	19%
To leave something for the children	12%

What was counter to orthodox belief, was why people borrowed.

Table 2: FinScope Uganda. Why people borrow

Why people borrow	% responses
Household basic needs such as food, clothing and health services	61%
Emergencies (burial, medical)	32%
Education	19%
Business	15%
To pay off debts	9%

Where, I asked myself, were all these budding entrepreneurs; this rush to get ahead? Mostly what I concluded is that financial services are seen principally by the poor as a way of making sure they protect their assets, pay their bills, keep their kids in school and don't fall by the wayside. Rather like everyone else.

What is striking is not only that the top 4 categories were the same for borrowing as they were for savings (and had nothing to do with business), but that more people preferred to finance business through savings than debt. It is also noticeable that there was a higher incidence of response, by purpose category, for savings relative to credit: a finding constantly validated by the roughly 6:1 ratio of savers to borrowers in MFIs, where savings are offered. This study is only one of many similar FinScope studies in Africa that consistently show the same purposes and preference.

So where does this idea come from that people want bigger and bigger loans? Mainly, I think, from a failure of imagination, empathy and analysis.

Why do we think that outside capital is needed at all?

I am not saying that people don't want to borrow and I don't want to be falsely characterised as a paternalist who doesn't think the poor are smart enough to manage their finances and need to be protected from themselves. And there is no doubt that community-managed financial services provide an opportunity to increase economic investments and enterprise activity, at a pace that accommodates the need to become incrementally more experienced as entrepreneurs. So, at some point there *will* be a need for more capital and it is argued that community-managed micro-finance groups can't ever generate the sort of money that will make a real difference from local savings and interest earnings, and must therefore borrow from banks in order to increase their loan funds.

Really?

I have visited dozens of groups that over time have significantly increased their capital base, even when using a time-bound methodology that calls for the distribution of all current assets every year. In Zanzibar, between 1990 and 1992, CARE started 43 groups, averaging 25-30 members that shared out an average of $1,500 at the end of the first year. 4 years later, after CARE was long gone, the number of groups had mushroomed to about 150 and were sharing out $4,000.[2] In December 2008 this figure had risen to a reported $6,000. I have visited 5-year old groups sitting under trees 50 Km out of Vilankuolos in Mozambique managing $9,000. Even in Niger, the poorest country in the world, these groups are managing between $800 and 1,500. In other words, the money's usually enough for all but the rare exception (who can, very often, be an MFI member). What makes the difference is giving these groups enough time to learn to roll over a proportion of their current assets from one cycle to the next – not rushing in to indebt them.

If we look at CMMFIs after just a year we can conclude that everyone had a good time and the money was nice, but not that useful. If we look at them 5 years down the line we see a wholly different picture and we usually see diversification into group-based trade. It is normal for average share values to double from cycle to cycle as members get to be confident that the system actually works. It is normal for loan sizes to increase dramatically, year on year, and to be repayable over a longer period of time. All without outside capital and without outside technical support.

If we didn't all the time fall for the rhetoric that we nominally reject (that the poor can't save and have solid capabilities), and if we were less determined to be at the 'cutting edge' we might get to see some remarkable results, with a lot less risk and pain.

The evidence,

There is increasing interest in bank linkage programmes in Africa, but to date the evidence from agencies that are heavily vested in CMMF is mixed, at best. There have been cases where CMMFIs have been flooded with external credit, with as many as 25% struggling to repay and many groups, of long-standing, forced into liquidation, owing to predatory and irresponsible lending practices by MFIs that over-lend and fail to adapt repayment schedules to rural cash-flows[3]. Where working models exist, such as in Rwanda, the institutional delivery system, based on apexes, can neither cover its

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[2] *Village Savings and Loan Associations in Zanzibar:* Ezra Anyango, Lydia Opoku, Susan Johnson, Markku Malkamaki and Chris Musoke. DFS and FSDU 2006

[3] Author's study in Niger in 2007, validated by study by Paul Rippey in 2008. *Etude sur l'impact des crédits extérieurs Sur les groupements et réseaux MMD Et les mesures de minimisation des risques*. Réalisée pour CARE Niger et ses Partenaires Janvier 2008

costs, nor elicit real enthusiasm from the banking sector – and this in the only country in Africa where there is an extensive rural banking network.[4] This is not to say that the effort is misplaced, not foredoomed, but it isn't going to be easy and will certainly be expensive. And every penny spent on creating these relationships is a penny that is denied to an expansion of the basic model, providing entry-level financial services to people who, presently,have none at all.

Uganda is a crowded MF market, yet 50% of people have no access to savings services of any type and 60% have no access to credit. Only 4% of the population are able to save with MFIs and SACCOs and 2% receive credit from these sources. Meanwhile, over 30% receive savings services and 33% receive credit from informal sources. Surely it makes strategic sense, for the moment, to invest in extending informal services to the 50-60% who have no services at all, rather than seeking to link the 30% who do to purportedly superior product offerings. There is a real benefit-cost trade-off here that hasn't been carefully explored.

If SHGs are successfully linked to banks, what is your problem?

I must preface this section by noting that I will be making general remarks about SHGs, when SHGs themselves almost defy definition and operate in very different ways. I also know that SHGs are a remarkable phenomenon and it only surprises me that so many people still think that CMMF lacks legitimacy: as if 40 million people have been afflicted with a common irrationality. But the sheer scale and speed of change makes it hard to ignore that something is going on that poor people seem to find useful. And there is clear evidence from India that they do. But because SHGs are mainly linked to banks it is often assumed that this is the way CMMF ought to be implemented worldwide. But is this necessarily the case?

While the SHG model is being exported it has not yet been tried in many places in Africa and, as already noted, the effort to link CMMFIs to banks is usually difficult and sometimes negative. Why should this be the case?

First of all, the environment is different. The government of India mandates banks to provide 40% of their lending to pro-poor sectors. Institutions such as NABARD refinance SHG portfolios at a discount. And, critically, the banking infrastructure is extensive, with a branch in every 3-4 villages. None the above applies in Africa

Secondly, nearly all of the CMMF models used in Africa cash-out at the end of the annual cycle, but SHGs do not. Cash-out is popular, because it provides a useful lump sum to every member at a time of the year that is normally associated with expense (festivals, the planting season etc.) and it significantly reduces systemic risk and complexity. As a result, most African CMMFIs are fully independent of their parent agencies after one year or less: SHGs take several years to achieve independence, if at all.[5]

Thirdly, because it is expected that most SHGs will not cash out (but pay dividends) and also be linked to banks, they normally maintain comprehensive records. Because it is usually not possible for the members to maintain these records to a standard that will

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4 *Linkages between CARE's VS&Las with financial institutions in Rwanda. Case Stud*y Jan Maes and CARE EDU, August 2007

5 The average SHG needss parent NGO support for between3 - 5 years until it can operate independently and a further 3 – 5 years when linked to a bank. See *Self-help Groups as Financial Intermediaries in India: Cost of Promotion, Sustainability and Impact:* Ajay Tankha, 2002

satisfy an MFI or bank lender, most SHGs remain tied to parent NGOs for many years, with a lot of technical functions being permanently externalized.

Finally, NGO coverage is much more extensive in India and much lower cost than in Africa. Thus, while this may be broadly applicable and affordable in India (although a much-noted dependency) it is much less so in Africa

Conclusions

In sum, what I am saying is that debt-based bank linkage is not a *sine qua non* for CMMFIs.[6] I believe that it thrives under the favourable conditions that pertain in India but are largely absent elsewhere. My basic point is that bank linkage is not needed by a lot of the poor; that it is not that simple; that an overweening determination to pursue it may divert resources from providing entry-level services to a lot more people and that it poses real risks, especially to rural CMMFIs.

I am also amazed that so quickly after being standardised and moving to scale, so many people want to change CMMF into something that's a lot less elegant, full of risks and, by the way, expensive.

But, to end on a more positive note, if it is to be done, I would recommend the following principles be considered:

- *Start with savings.* There is very little risk to the CMMFI and term deposits are useful when members want to meet a predictable expense, such as to pay school fees. The CMMFI can be a useful mechanism for aggregation of deposits and reducing transaction costs, both for the members and the financial institution.
- Encourage individual members whose needs for loans cannot be met by the CMMFI to become MFI/bank clients, but do not allow individual liability to a bank that lends to CMMFI members to be backed by group guarantees.
- Don't lend to CMMFIs for at least two years: let them develop experience in managing their own money.
- *The CMMFIs should be the borrower,* on-lending at a spread. That way they can offer more flexible services, make a profit and retain their independence. By building on the experience of CMMFIs that know how to manage their money (and making it profitable for both parties), banks and MFIs will strengthen - not undermine - the group's autonomy and capacity
- CMMFIs should not allow the lender access to information on individual loans made to members.
- Members' savings should not be used as collateral: this is one of the safest types of loans a bank can make.
- Total debt assumed by a CMMFI should not exceed the total value of paid up shares and, in later cycles, not more than double.
- Loans to CMMFIs should be reimbursable on flexible terms, usually at the end of a 1 year loan cycle as a single payment, or, in varying amounts throughout the loan repayment period.
- Programmes should concentrate initially on areas that are economically dynamic, served by markets and reliable road networks and focusing on clients who are regularly engaged in enterprise activity.
- Consumer education should be provided to CMMFIs about the risks and benefits of linkage

[6] It can be an effective strategy for full-time, urban and peri-urban entrepreneurs who are full-.time in business, but a dangerous complication for the majority of rural CMMFIs

- Efforts should be made to develop a code of practice and a consistent technical approach amongst MFIs and banks regarding lending to CMMFIs