Expanding the Frontier in Rural Finance

Financial Linkages and Strategic Alliances

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Edited by
Maria E. Pagura

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Preface

Today millions of poor people in developing countries have access to financial services. In 2004, the Consultative Group to Assist the Poor (CGAP) studied all types of 'alternative financial institutions' dedicated to serving people not normally served by banks. It estimated that these institutions held about 660 million small savings and loan accounts. However, when only loans were counted, the number of accounts fell to about 150 million loans outstanding, a much less impressive number compared to the millions that are estimated to demand small loans (Christen, Rosenberg, and Jayadeva, 2004). This problem exists in spite of the much acclaimed microfinance revolution in which thousands of specialized microfinance institutions (MFIs) have been created specifically to serve the poor with non-collateralized loans.

The poor in rural areas represent a particularly difficult target group to serve even for MFIs because of the high operating costs of reaching dispersed populations and in making small loans to farmers with risky enterprises and seasonal cash flows. Even though increased levels of competition are forcing MFIs to expand into new market niches, most tend to compete for non-farm clients located in densely populated rural and peri-urban areas.

This book reports on the study of one important strategy that innovative financial institutions are pursuing to help meet the challenge of sustainably serving additional poor clients in rural areas. This strategy involves the creation of linkages between two or more formal and informal institutions through which they expect to capture the comparative advantages that each possesses in offering financial services. The premise is that there are natural complementarities because of differences in access to information, creation of incentives and ability to enforce contracts so that together two institutions will be able to reduce costs and risks in ways that each would be unable to accomplish by itself. The expected benefits include a more rapid expansion, a broader variety, and a higher quality of products and services offered to clients.

An important strength of the research was that a common research framework was used by the authors to study eleven linkage cases selected for study in Africa, Asia and Latin America. Several of the findings were unexpected. For example, in spite of the heavy involvement of donors in microfinance, most of the linkages were driven more by market opportunities than donor interventions. Most of the linkages were more oriented to credit than to other services. Therefore, the most significant impact of these innovations has been to expand the rural outreach of loans, rather than improvements in the variety or quality of services offered. The country's economic and financial system affects the

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possibilities for establishing linkages, but the process has not been easy or costless for any of the cases studied. The lessons extracted from these linkages provide a rich variety of lessons for policy makers and donors, and for both formal and informal intermediaries.

The general conclusion is that in fact formal and informal institutions do have comparative advantages in supplying rural financial services, but tapping these advantages has not been easy. The book provides further evidence in support of the view that there is no simple silver bullet to solve the rural finance challenge.

Richard L. Meyer
Professor Emeritus
The Ohio State University

Reference

Christen, R. P., Rosenberg, R. and Jayadeva, V. (2004) 'Financial Institutions with a "Double Bottom Line": Implications for the Future of Microfinance,' *CGAP Occasional Paper* No. 8, Washington, DC.

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Acronyms and abbreviations

ACA	Academia de Centroamérica
ACORDE	Asociación Costarricense para Organizaciones de Desarrollo
ADA	Appui au Développement Autonome
ADB	Asian Development Bank
AFD	Agence Française de Développement
AFP	Administradora de fondos de pensiones
AGUADEFOR	Asociación guanacasteca de desarrollo forestal
AMPRO	Asociación de Microempresarios y Productores de Occidente
ANDI	Asociación Nacional de IndusTriales
APRACA	Asia–Pacific Rural and Agricultural Credit Association
ASAPROSAR	Asociación Salvadoreña Pro-Salud Rural
ASHI	Ahon Sa Hirap, Inc.
ASONOG	Asociación de organismos no gubernamentales
BANADESA	Banco Nacional de Desarrollo Agrícola
BANHPROVI	Banco Hondureño para la Producción y la Vivienda
BASIX	Bhartiya Samruddhi Financial Services
BCIE	Central American Bank for Economic Integration
BI	Bank of Indonesia
BIM	Banque Internationale pour le Mali
BISWA	Bharat Integrated Social Welfare Agency
BKD	Badan Kredit Desa
BKK	Badan Kredit Kecamatan
BKS-LPD	Badan Kerjasama LPD
BMB	Barangay Microenterprise Business
BMS	Banque Malienne de Solidarité
BMT	Baitul Mal Wat Tamwil
BNDA	Banque Nationale de Développement Agricole
BNR	Banque Nationale du Rwanda
BP	Banque populaire
BPD	Bank Pembangunan Daerah, Regional Development Bank (Indonesia)
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
BRS	Banco Regional de Solidariedad
CAF	Corporación Andina de Fomento

CAFTA	Central American Free Trade Agreement
CARD	Centre for Agriculture and Rural Development
CAREC	Centre d'Appui au Réseau des Caisses d'Epargne et de Crédit
CAS/SFD	Cellule d'Appui et de Suivi des Systèmes Financiers Décentralisés
CCE	Communal credit enterprise
CCP	Certificados de contribucíon patrimonial
CDC	Comité de Développement Communautaire
CGAP	Consultative Group to Assist the Poor
CIA	Central Intelligence Agency
CICAL	Cooperativa Industrializadora de Alimentos Limitada
CIDA	Canadian International Development Agency
CIDR	Centre International de Développement et de Recherche
CINDE	Coalición Costarricense de Iniciativas de Desarrollo
CMDT	Companie Malienne de Développement des Textiles
CMEC/SAN	Caisse Mutuelle d'Epargne et de Crédit / SAN
CNBS	Comisión Nacional de Banca y Seguros
CODESPA	Fundación Cooperación al Desarrollo y Promoción de Actividades Asistenciales
CONADECO	Confederación Nacional de Asociaciones de Desarrollo Comunal
COOPEC	Cooperatives d'épargne et de crédit
COPEME	Consortium of private organizations to promote the development of small and micro enterprises
CPIP	Credit Policy Improvement Project
CRDB	Cooperative and Rural Development Bank
CREHO	Fundación Crédito Educativo Hondureño
CVECA	Caisses villageoises d'épargne et de crédit Autogerées
CVECA-ON	Caisses villageoises d'épargne et de crédit Autogerées – Office du Niger
DABANAS	National Private Commercial Bank Foundation
DANIDA	Danish International Development Agency
DEG	Deutsche Entwicklungs- und Investitionsgesellschaft, Cologne
DELSAR	Agency for the Development of Santa Rosa
DFID	Department for International Development
DKK	Danish krone
ECC	Employees Compensation Committee
ECLA	Economic Commission for Latin America and the Caribbean
ECOCOMF	Expanding Competitive Client-Oriented Microfinance
EDESA	Empresa para el Desarrollo S. A.
EDPYMEs	Entidad de Desarrollo de la Pequeña y Micro Empresa
EIB	European Investment Bank

ESAF	Enhanced Structural Adjustment Facility
FADES	Fundación para Alternativas de Desarrollo
FAO	Food and Agriculture Organization
FCRMD	Fédération des Caisses Rurales Mutualistes du Delta
FDC	Fonds de développement communautaire
FFP	Fondo Financiero Privado
FHIA	Honduran Foundation for Agricultural Research
FIDAGRO	Fideicomiso agropecuario
FIE	Centro de Fomento a Iniciativas Económicas
FINCA	Fundación Integral Campesina
FINRURAL	Asociación de Instituciones Financieras para el Desarrollo Rural
FINTRAC	Financial Transactions Reports Analysis Centre
FOMIN	Fondo Multilateral de Inversiones
FONADERS	National Fund for Sustainable Rural Development Project
FONAPROVI	Fondo Nacional para la Producción y la Vivienda
FONDESIF	Fondo de Desarrollo del Sistema Financiero y de Apoyo al Sector Productivo
FUNBANHCAFE	Fundación Banhcafé para el Desarrollo de las Comunidades Cafeteras de Honduras
FUNDASIN	Fundación Aquiles Samuel Izaguirre
GDP	Gross Domestic Product
GEMA PKM	Gerakan Bersama Pengembangan Keuangan Mikro
GFI	Government financial institutions
GSIS	Government Service Insurance Fund
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH
HDH	Hermandad de Honduras
IADB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IGA	Income generating activities
IMAS	Instituto Mixto de Ayuda Social
IMF	International Monetary Fund
INCA	Empresa comercializadora
INEC	Instituto Nacional de Estadística y Censos
IRDA	Insurance Regulatory and Development Authority
ISI	Import substitution industrialization
JICATUYO	Fundacíon Jicatuyo
KfW	Kreditanstalt fuer Wiederaufbau
KPKM	Kredit Pengembangan Kelompok Mandiri
KSP	Kalimantan Sanggar Pusaka
KUD	Village cooperative unit
LBP	Land Bank of Philippines
LDKP	Lembaga Dana dan Kredit Pedesaan (Village credit fund institution)

LIC	Life Insurance Corporation of India
LKP	Lembaga Kredit Pedesaan
LPD	Lembaga Perkreditan Desa
MACS	Mutually aided cooperative societies
MAG/PIPA	Ministerio de Agricultura y Ganadería/Programa de Incremento a la Productividad Agropecuaria
MCPI	Microfinance Council of the Philippines
MDR	Ministère du Développement Rural
MFI	Microfinance institution
MFO	Microfinance organization
MMC	Microfinance mega centres
MOB	Microfinance-oriented banks
MOU	Memorandum of understanding
MSME	Micro small and medium enterprise
MYRADA	Mysore Rehabilitation and Development Association
NABARD	National Bank for Agriculture and Rural Development
NCC	National Credit Council
NCL	Non-collectible loan ratio
NEF	Near East Foundation
NGO	Non-governmental organization
NLSF	National Livelihood Support Fund
NMB	National Microfinance Bank
NOVIB	Dutch Organization for International Development Co-operation
NPL	Non-performing loans
NTB	Nusa Tenggara Barat
OIKOS	Dutch privately owned cooperative society
OIMC	Organización Internacional para el Desarrollo de las Microfinanzas Comunales
ON	Office du Niger
ONILH	National Organization of the Lenca Indians
OSU	The Ohio State University
PAAF	Pratica Administrativa da las Autoritads Federalas
PACCEM	Cereal Marketing Assistance Program
PAR	Portfolio at risk
PCFC	People's Credit and Finance Corporation
PDCD	Programme d'Appui au Développement des Communes Rurales du Cercle de Dioila
PDO	Private development financial organization
PERBANAS	Persatuan Perbankan Nasional
PILARH	Asociación Proyecto e Iniciativas Locales para el Autodesarrollo Regional de Honduras
PLBS	Project Linking Banks and Self Help Groups (Philippines)
PLPDK	Pusat LPD Kabupaten
PRBC	Producers Rural Banking Corporation

PRODAPEN	Proyecto de Desarrollo Agrícola de la Península de Nicoya
PRODEM	Promoción y Desarrollo de Microempresas (Promotion and Development of Microenterprises)
PROMICRO	Proyecto Centroamericano de Apoyo a Programas de Microempresa
PRONAMYPE	Programa Nacional de Apoyo a la Micro y Pequeña Empresa
PSS	Services for Progress Organization
PT HM Sampoerna	PT Hanjaya Mandala Sampoerna Tbk.
REDMICROH	Red de Instituciones de Microfinanzas de Honduras
RESAFI	Réseau d'Epargne Sans Frontière
RMFP	Rural Microenterprise Finance Project
ROA Kiruvi	Ruaha Outgrowers Association in Kiruvi
ROSCA	Rotating savings and credit association
Rp	Indonesian Rupiah
SACCO	Savings and credit cooperatives
SADESC	Sociedad para el Apoyo al Desarrollo Económico Social Comunitario
SANAA	Servicio Autonomo Nacional de Acueductos y Alcantarillados
SBEF	Superintendence of Banks and Financial Entities
SBS	Superintendence of Banks and Finance – Peru
SCA	Savings and credit associations
SCCULT	Savings and Credit Cooperative Union League of Tanzania
SEC	Securities and Exchange Commission
SELF	Small Entrepreneur Loan Facility
SEWA	Self-Employed Women's Association
SHG	Self-help group
SIDBI	Small Industries Development Bank of India
SIDESA	Sistema Descentralizado de Sanidad Agropecuaria
SME	Small and medium enterprise
SNV	Netherlands Volunteer Organization
SUGEF	Superintendencia General de Entidades Financieras – Cost Rica
SUP	Debt instruments
SYCREF	Systèmes de Crédit et d'Epargnes pour les Femmes
UBPR	Union of People's Banks in Rwanda
UMA	Unidades Municipales Ambientales
UNDP	United Nations Development Programme
UNHCR	United Nations High Commissioner for Refugees
USAID	United States Agency for International Development
USP	Unit Simpan Pinjam

Contributors

Chet Aeschliman is an Investment Officer for the Food and Agriculture Organization (FAO) Subregional Office for Africa, in Libreville, Gabon. Chet has 35 years of broad experience in rural and micro finance throughout the developing world, specializing in French-speaking Africa, and has worked in the rural finance arena in over thirty different African countries, including every West and Central African country but three. He previously carried out consultations for USAID, the World Bank, the French AFD, and was a Chief of Party for an MFI development project in Togo for seven years, an MFI adviser and microenterprise officer for 2 years in Mali, and adviser to an MFI network in Cameroon for 4 years. He has substantial experience in financial analysis, accounting and financial systems development, database design, project formulation, technical manual writing, and technical training, mastering all components of MS Office, including automation with Visual Basic for Applications. He has an MBA in Finance, from the University of Washington in Seattle and is fluent in English and French, with a working knowledge of Spanish, Continental/African Portuguese and certain African languages.

Iketut Budastra is an independent consultant. Born in 1961, he completed undergraduate study in Agricultural Economics at Mataram University in 1987, then proceeded to Master of Regional Planning from Cornell University in 1996 and to Doctor of Agribusiness from Queensland University in 2003. He has been a senior lecturer in Agribusiness Mataram University since 1987. He is also a senior researcher in several research centres within Mataram University.

John Conroy has been a development economist since 1968, with extensive periods of residence in Papua New Guinea and Indonesia, and field experience in much of South and East Asia. He is co-author of two books on linkages, *Banking with the Poor*, (FDC, 1992, republished by Verlag Breitenbach, 1993), and *Best Practice of Banking with the Poor*, (FDC, 1995). He co-authored a seven country comparative study, *Getting the Framework Right: policy and regulation for microfinance in Asia* (FDC, 1997) and a 12 country comparative study, *The Role of Central Banks in Microfinance* (ADB, 2000). He was consultant to the government of Mexico on microbanking during that country's chairing of the APEC process in 2002. More recently he has conducted studies for the World Bank in Fiji and post-conflict East Timor, and for FAO in Indonesia.

Mayra Falck is a Honduran macroeconomist specializing in development policies and rural development topics. Her broad experience includes work in applied research, teaching and project development. During nearly 30 years of professional life she has worked with universities and other public institutions and international bodies on agricultural and environmental projects at regional and national levels. Her areas of specialization include financial services, analysis of policy impact and design of markets for environmental services among others. She has carried out consultancies for various bilateral and multilateral organizations, such as the World Bank, GTZ, UNDP, FAO, European Union and has presented her work in meetings with the Governors of the IDB, at the Microcredit Summits and other international fora. Presently she is a teacher, researcher and director of the Carrera de Desarrollo Socioeconómico y Ambiente de Zamorano. She has been acknowledged for the Best Graduation Index of the Faculty of Economic Sciences from the UNAH, and she has been honoured by the Junta Interamericana de Agricultura for her contributions as a female researcher in rural development. She holds a Bachelors degree in Economics from the UNAH and a Masters degree in Agricultural and Rural Development Policies in Latin America and the Caribbean from the Rural Federal University of Rio de Janeiro and the University of Naples, Italy.

Claudio Gonzalez-Vega, economist and lawyer from Costa Rica, has been Professor of Agricultural, Environmental and Development Economics and Professor of Economics at OSU since 1982 and currently is Director of the Rural Finance Program, a centre of excellence in finance and development. With his colleagues at OSU, he received the Distinguished Policy Contribution award from the American Agricultural Economics Association in 1989. Over two decades of association with OSU as professor, researcher, and consultant have resulted in theoretical contributions and policy recommendations that have established him as one of the world leaders in the field. He has conducted pioneering research on rural financial markets, financial reform, and microenterprise finance in several countries. Recently, he has investigated issues related to rural poverty in Latin American countries. He has published extensively in the areas of finance and development, rural financial markets, microenterprises, macroeconomic management and commercial policy in developing countries.

Malcolm Harper was educated at Oxford University, the Harvard Business School and the University of Nairobi. He worked for nine years in a medium-sized household hardware manufacturing business in England, mainly in marketing. He then taught in Nairobi, from 1970 to 1974, before coming to Cranfield School of Management, where he was Professor of Enterprise Development. Since 1995 he has worked independently, mainly in India. He has published over twenty books and numerous articles on various aspects of self-employment, enterprise development and microfinance. His research and consultancy work has been supported by a wide range of national, international and non-government development agencies. He has advised and evaluated a number of enterprise development and microfinance programmes and institutions in India and in East and West Africa, Latin America and the Caribbean, the Middle East and Gulf area, South and South East Asia, as well as in the United Kingdom. From 1996 until 2006 he was Chairman of Basix Finance of Hyderabad, a leading 'new generation' micro-finance institution, and he is Chairman of M-CRIL of New Delhi, the pioneer of micro-finance credit rating in Asia. He was also the founding Editor-in-chief of the journal Small Enterprise Development, and is a director and trustee of a number of other institutions, including Homeless International, EDA (UK) Limited, APT Enterprise Development and Intermediate Technology Publications in the United Kingdom.

Marié Kirsten is the coordinator for the Institutional and Financial Programme in the Research Unit in the Development Bank of Southern Africa (DBSA). Marié is also on the Board of Directors of the Small Enterprise Foundation, South Africa's most successful and currently only sustainable microfinance NGO. Marié has a Masters degree in Economics from the University of Stellenbosch, and has worked at the DBSA for over 15 years. During this time she has been seconded to the United Nations FAO in Rome and to the South African Department of Trade and Industry. She specializes in microfinance and poverty related research.

Janina León is an Associate Professor and Director of the Masters Programme in Economics at Pontificia Universidad Católica del Perú. Her teaching areas include applied microeconomics, development and labour economics. She is an expert in the following research areas: microenterprise and microfinance; efficiency of microfinance institutions; poverty and labour markets. Besides short articles, her recent consultancy and publication work include: Incorporación de género en la investigación CIES: Balance y propuestas; Typology of Rural Microfinance Institutions: literature review; Evaluation of the National Programme for Microenterprises in Mexico Pronafim; Microfinance for Microenterprises: the state of the art; Cost Efficiency of Peruvian Municipal Banks.

Fiacre Murekezi is a financial accountant with 20 years of experience in the community-based development sector, including developing microfinance businesses with international and local organizations. He led the Rwandan Microfinance Network to promote and implement national policies of microfinance institutions in Rwanda. In this capacity he conducted microfinance studies, developed business tools and advised organizations. Recently, he has started a non-profit association, whose main work is to strengthen linkages between savings and credit groups and formal banks in Huye District, Southern Province of Rwanda.

Jean-Paul Ndoshoboye is an economist and certified trainer of CAPAF (Renforcement des Capacités des institutions de microfinance en Afrique Francophone/CGAP) in capacity-building of microfinance institutions. With a bachelors degree in economics, he has over seven years work experience in the microfinance sector. He coordinates the 'Family strengthening and poverty reduction program' for SOS Rwanda Foundation.

Maria Pagura is a Rural Finance Officer at the Food and Agriculture Organization in Rome, Italy. At FAO she helps design and review programmes and projects in rural finance. Currently she is working on financial products and services for agribusinesses and strengthening formal–informal financial sector linkages. She has over 14 years experience examining rural and micro finance and small enterprise development issues in Africa and Asia, with extensive experience in Mali. She has facilitated project evaluation training in South Africa and Uzbekistan and reviewed microfinance sectors in Bangladesh, India, Indonesia, Mali, Peru and Rwanda. She is fluent in French and holds a Masters in Economics and a PhD in Agricultural Economics from The Ohio State University.

Nilotpal Pathak was a senior analyst for M-CRIL Ltd, the local company employed to conduct the study on AVIVA Life Insurance in India.

Gerda Piprek is a Senior Specialist in enterprise development, micro- and rural finance at ECI *Africa* (Johannesburg). Other fields of specialization include research (micro and rural finance, benchmarking studies, impact studies) and financial education. She has successfully led and implemented multiple projects in these fields in Mozambique, Angola, Tanzania and South Africa. Ms Piprek was previously a Rural Finance Consultant in the Sustainable Development Division of the World Bank (Washington, D.C.) where she co-authored the publication, *Rural Finance: Issues, Design and Best Practices* (2007) with Jacon Yaron and McDonald Benjamin (jnr). Before shifting to microfinance, she worked for several years in commercial retail banking and insurance, where she focused on market research, product development, business and marketing strategy. Ms Piprek holds a Bachelor of Economics from the University of Stellenbosch (1984) and an MBA from Georgetown University (1995), Washington, D.C.

Benjamin Quiñones is presently the Chairman of the Coalition of Socially Responsible Small and Medium Enterprises in Asia (CSRSME Asia), an association of organizations from various Asian countries providing technical and consultancy services to SMEs (small and medium enterprises). CSRSME Asia is convenor of the Asian Forum for Solidarity Economy and it operates a financing programme that links socially responsible investments to socially responsible enterprises. Mr. Quiñones previously served as Secretary General (1986–92) of the Asia–Pacific Rural and Agricultural Credit Association (APRACA) in Bangkok, Thailand. He was instrumental in launching the APRACA Project Linking Banks and Self Help Groups. His published works on linkage banking and microfinance include Social Capital in Microfinance; Microfinance and Poverty Alleviation: Case Studies from Asia and the Pacific; Linkage Banking in

South Asia – The Experience of India, Nepal, and Bangladesh; and Linking Self Help Groups and Banks in Developing Countries.

Rodolfo Quirós is a Costa Rican economist, with degrees in Economics from the Universidad de Costa Rica and in Agricultural Economics from The Ohio State University. For over 19 years he has been conducting evaluations and research on rural finance and microfinance organizations and projects as well as analysing diverse issues in economic development. He has been a consultant in many Latin American countries for a multiplicity of international organizations, most recently conducting studies in rural finance, agricultural value chain finance, microenterprise technical assistance facilities and investment climate. Until 2004 he worked in Bolivia as development finance specialist and Deputy Director for SEFIR, a financial services project funded by USAID and implemented by DAI. Before and since his work in Bolivia, he has been associated with Academia de Centroamérica, a research institute based in Costa Rica.

Hans Dieter Seibel is emeritus professor at Cologne University and senior fellow at the Development Research Center (ZEF), University of Bonn. He specialized in rural and microfinance, agricultural development bank reform and SHG-bank linkages. From 1999 to 2001 he was Rural Finance Adviser at IFAD in Rome, and author of its Rural Finance Policy. From 1988 to 1991 at GTZ he was teamleader of 'Linking Banks and Self-Help Groups in Indonesia'.

CHAPTER 1

Introduction: Linkages between formal and informal financial institutions

Access to a broad range of rural financial services can have a significant impact on people's ability to weather economic shocks, make investments and build up financial and physical assets. But, supplying financial services in rural areas continues to be a formidable endeavour. Faced with high costs and risks of doing business in harsh economic and physical environments, most financial institutions are reluctant to enter rural markets. In their absence informal financial institutions emerge, but typically they are only able to offer a narrow range of financial services in a small geographic area. Through strategic partnering formal and informal financial institutions are finding new ways of establishing a presence in rural markets. As the cases presented in this book reveal, strategic partnerships and alliances allow them to surmount many of the cost and risk obstacles that preclude them from expanding financial services at and beyond the rural market frontier.[1] However, although conceptually valid, establishing and maintaining such linkages in practice may be harder than it looks.

In this book we examine eleven financial linkage cases from Africa, Asia and Latin America. The cases were funded by the Ford Foundation with additional contributions from the Food and Agriculture Organization (FAO) of the United Nations. Over a period of 18 months one country overview and 11 case studies were conducted from late 2004 to early 2006. The aim of the study was to evaluate the degree to which financial linkages increase the supply of a broad range of financial services, not just credit, in rural areas. We defined a 'financial linkage' as a mutually beneficial arrangement between formal (commercial, state, apex banks, etc) and semi and informal financial institutions (microfinance institutions, NGOs, credit cooperatives, village banks, self-help groups, etc.). The linkages were considered successful when based on market principles and resulting in sustainable expanded access to financial services for new segments of the rural population not traditionally served, broadening the variety of products and services already offered and/or creating quality improvements of current products through better terms and conditions.[2]

The rationale for linking is based on the premise that natural complementarities exist between the formal and informal financial sectors that,

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when joined, reduce the costs and risks in supplying services in rural areas. The complementarities principle is derived from modern economic theory that attempts to explain information, incentive and contract enforcement problems of credit markets and how they result in a mismatch of resources and abilities between formal and informal lenders (Armendáriz de Aghion and Morduch, 2005; Bell, 1990; Fuentes, 1996; and Varghese, 2005). On the one hand, formal financial institutions have extensive infrastructures and systems, access to funds and opportunities for portfolio diversification, permitting them to offer a wide range of services. However they are usually at a distance from rural clients, making obtaining adequate information and enforcing contracts difficult. In contrast, informal financial institutions operate close to rural clients, possess good information and enforcement mechanisms and are typically more flexible and innovative. However, constrained by regulation (e.g. not authorized to take deposits) and a lack of resources and infrastructure, informal financial institutions are only able to offer a narrow range of services in a small geographic area (Figure 1.1). In theory linkages between formal and informal financial institutions appear to have much potential in overcoming the persistent difficulties in supplying rural financial services.

A variety of institutions exists to enable the transmission of financial information and transactions (Johnson, 2005). According to Johnson all the institutions along this continuum represent 'solutions' to the problem of financial intermediation – how to match the supply and demand of funds. Not only the institutions, but the relationships between them as well are designed to address information asymmetries, resolve enforcement problems and reduce the cost associated with the transaction. In essence, linkages afford the players,

FORMAL FINANCIAL INSTITUTIONS	INFORMAL FINANCIAL INSTITUTIONS
❖ Strengths • Wide range of financial services • Existing infrastructure and system • Access to capital markets • Diversification opportunities	❖ Strengths • Are closer to rural clients • Are more flexible and often innovative • Know local cultures and markets
❖ Weaknesses • Further removed from rural clients • May not have ability to analyze credit risk of rural clients • Lack local knowledge • May have inflexible systems and cumbersome procedures	❖ Weaknesses • Limited range of financial services • Lack access to capital markets • Lack necessary infrastructure to serve dispersed clientele • Have concentrated loan portfolios

Figure 1.1 Complementarities of formal and informal financial institutions
Source: Adapted from Pearce, 2003.

both formal and informal, the opportunity to overcome a weakness in what they can achieve on their own.

Since a wide variety of formal, semi-formal, and informal financial institutions exists, the possible financial linkages between actors along the chain are numerous. In Figure 1.2 we have illustrated this concept as a continuum of formality, with more formal institutions on the left side of the diagram on down to those institutions that are less formal on the right side. It is helpful to conceptualize linkages using a continuum of formality principle, especially since the meaning of 'formal', 'semiformal' and 'informal' varies widely across countries. In this way, it is helpful to think of linkages as mutually beneficial partnerships between upstream (more formal) and downstream (less formal) institutions. This includes linkages between institutions that are more towards the centre of the continuum, as well as those at the extreme ends.[3]

Using case studies we employed a common research framework to answer the following questions below.

- What was the main motivation behind the development of the financial linkage?
- What were the main preconditions for the linkage to emerge, such as a senior management buy-in, shared vision on financial service provision, minimum levels of institutional capacity, etc?
- What were the key design factors and processes that led to the success of the linkage?
- How did linkages impact the financial organizations that were linked together?
- In what way did linkages improve access to rural financial services for rural small-holders and micro-entrepreneurs?
- In what ways did the legal and/or regulatory framework help or hinder the establishment of the financial linkage?

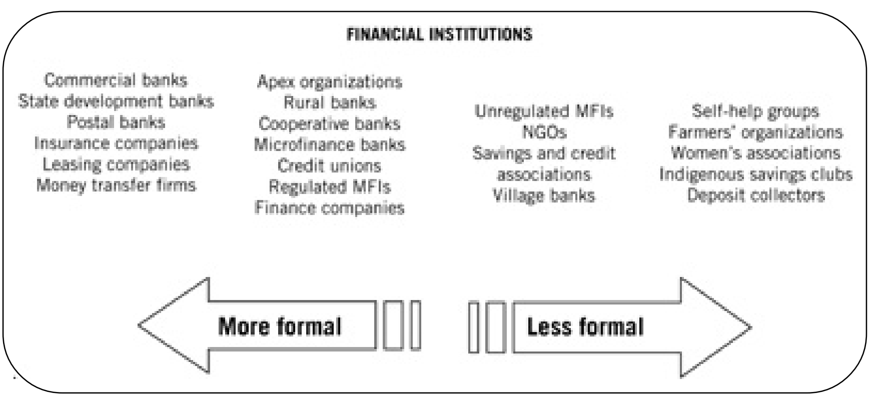

Figure 1.2 Continuum of formality

The case studies

In the following chapters, we present one country overview and eleven cases that met most of the following selection criteria:

- demonstrated success in expanding access to underserved rural market segments;
- were based on cost-covering principles, or had clear exit strategies if they were externally supported;
- had been in existence for two or more years;
- added to the diversity of linkage types reviewed.

The selected cases fell into four broad categories:

(i) Cases that are strategic in nature and driven by the informal institution;
(ii) Cases that are strategic in nature and driven by formal bank/insurer;
(iii) Cases in which mentoring and/or capacity building of informal institutions is a key component;
(iv) Cases that are externally driven by a third party (e.g. donors, governments), but that demonstrated a certain level of formal sector openness to engage with the informal sector.

The cases under each category are highlighted below.

Strategic – informal sector driven linkage

Under this category we highlight two informal institutions that successfully established linkages with a range of financial and non-financial partners in order to expand their service offerings and/or to establish more stable sources of funds.

In Chapter 2, we present the case of Fundácion para Alternativas de Desarrollo (FADES), a Bolivian non-regulated MFI specializing in the supply of financial services with significant outreach in rural areas. This is an interesting story of an informal financial institution's explicit strategy of increasing its supply of a wide range of non-traditional financial services by establishing a 'multiplicity' of inter-institutional linkages with financial and non-financial partners. This story highlights several lessons learnt about the benefits and costs of establishing and maintaining a multiplicity of linkages. The authors end the Chapter with insightful recommendations on the importance of picking the right partners, persuading staff of new partnership benefits, and knowing how to manage a set of inter-institutional linkages.

In Chapter 10 we present the case of Confianza, a regulated MFI in Peru with significant outreach in rural areas. This is a story about a newly regulated MFI, formerly an NGO, and the impact of its new regulatory status on the ability to source funds from a range of commercial and non-commercial providers. Trade-offs emerge for the organization in choosing the right mix of partners that is most appropriate for its long-term strategic interests. However, the author questions the impact of the institution's new regulation and interaction with commercial partners on rural outreach. She considers the possibility that

Confianza, in an attempt to cut costs and meet prudential requirements, relies more on increasing financial services in urban rather than rural areas. The data presented for recent years supports this view.

Strategic – formal sector driven linkages

In this grouping we describe two commercial banks and one insurer using linkages to reach rural markets. What may have begun as acts of corporate social responsibility and/or a response to priority sector targets soon became absorbed for these commercial actors into their mainstream business and long term corporate strategies.

In Chapter 5 we present the case of a now well-known private bank in India, ICICI Bank. Motivated by an internal drive to 'be a leader in every field of banking' and a belief that new micro clients will grow into mainstream banking clients, ICICI developed a unique model to tap into rural markets. The case describes the innovative 'outsourcing' model and provides two 'linkages in action' sub cases depicting the spillover effects of the ICICI linkage on two partner organizations and their sponsored SHG (self-help group) members. Although the authors state that ICICI Bank is no doubt demonstrating its effectiveness in profitably serving the rural poor, they are cautiously optimistic about the future and highlight some concerns for consideration. In fact, in February 2007 after the completion of the field study, ICICI Bank had to temporarily suspend its main partnership model with microfinance institutions (MFIs) because the Reserve Bank of India said that it was not meeting the 'know your customer' requirements through the partnership model. Since the suspension, ICICI Bank has worked with its partners to overcome this challenge by upgrading data systems to enable them to meet the requirements, but many MFIs, especially those that depended heavily on ICICI Bank for their funds, are still feeling the pain of suspension.

In Chapter 6 we present a second case from India about Aviva, a large private life insurer, and its unique approach of responding to priority sector requirements of the Indian government. This is a unique story about a massive international insurer's effectiveness in supplying life insurance products in remote rural markets. As with ICICI Bank, serving the rural poor became a long-term corporate business strategy and not just a 'requirement'. The author provides a good overview of the insurance market in India, including an historical review of the Insurance Regulatory and Development Authority (IRDA) and its regulatory norms. He highlights the challenges and successes Aviva faces in setting up 'tailor made' business models with an MFI and a trade union. The first case demonstrates the numerous advantages of working with a well-qualified local partner while the second tells the story of Aviva's success in beating out the competition to win over the business of a large trade union with over 500,000 members.

In Chapter 13 we present the case of CRDB Bank, the fifth largest commercial bank in Tanzania, and its desire to do 'something positive' about the majority of