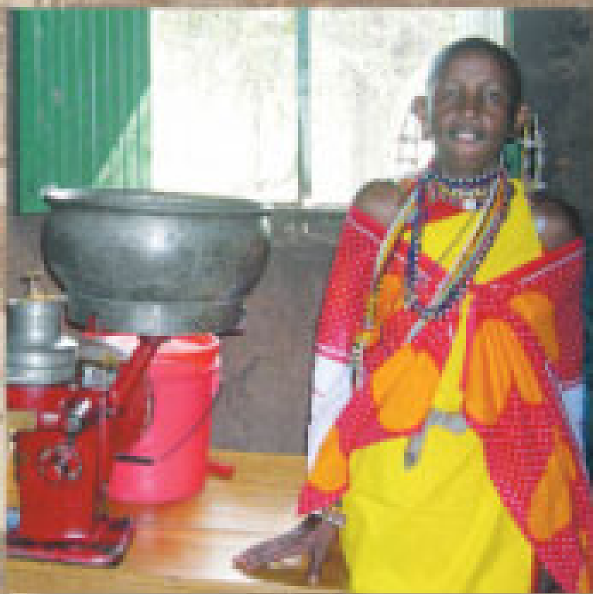
Cordaid

Investing in the Poor

Linking microfinance to social investors



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Text
Coert Meijer, Tony Fernandes

Photograpy
Jan Postmus, Tim de Rooij, Willem Tom,
Wilco van Dijen, Cordaid partner
organizations Shramik Bharti and Fondeco,
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Finance Business Unit:
t +31 70 3136 366
or downloaded via www.cordaid.com

Cordaid forms together with Kinderstem, Memisa, Mensen in Nood and Vastenaktie one of the biggest international development organisations. Supported by half a million people in the Netherlands, Cordaid works with more than a thousand partners worldwide for an existence with dignity for poor people and those who are deprived of their rights.

Contents

Foreword

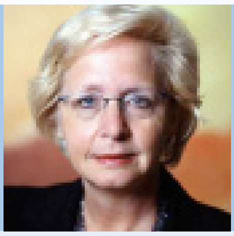
In 1996, Cordaid started to get involved in supporting the emerging microfinance sector in some developing countries by extending loans to microfinance institutions (MFIs) as a complement to the existing grant support. Bit-by-bit this involvement has grown into an extensive programme, in which some 90 MFIs have been supported with a variety of instruments, ranging from grants for capacity building and technical assistance to loans for financing the portfolios of emerging MFIs.
When the UN announced that 2005 was to be the International Year of Microcredit, Cordaid soon decided to capitalise on its experience and participate in as well as contribute to the exchange of ideas. In addition, Cordaid decided to actively facilitate this process by organising a seminar with 15 of its partner organisations and a congress specifically aimed at social investors in the Netherlands, recognising the challenge of finding new financial sources for investing in the fast-growing microfinance sector. The seminar was held in Soesterberg (6-8 June 2005) and the congress in The Hague (10 June 2005).

This booklet presents the speeches that were delivered during the congress and the major findings of both the seminar and the congress, outlining the needs of MFIs for finance in different phases of their development. The specific nature of MFIs as creatures with a 'social mother' (representing their mission) and an 'economic father' (representing their modus operandi) stands out as one of the determining factors when looking for solutions to attract funds for financing them. MFIs have often been founded by passionate people, looking for ways to alleviate poverty in their societies. It is an art in itself to preserve this passion in the mission of MFIs, while at the same time their marketing and operations must be led by economic principles like covering costs and managing repayment.

Now that we are on the brink of the 10th anniversary of Cordaid's loan and guarantees programme, I am convinced that the microfinance sector can go on flourishing as it has done in the past, continuously looking for new and innovative ways of creating access to financial services for the poor. In the next ten years, Cordaid hopes to continue contributing to that growth, but, as is described in this booklet, social investors are badly needed for microfinance to be able to realise its full potential. I hope that they will be inspired to invest in the powerful instrument to combat poverty that microfinance is!

Jacob Winter
Manager Finance Business Unit
Cordaid

Social investment: paving the road to the private sector



Agnes van Ardenne, Minister for Development Cooperation

Speech by Agnes van Ardenne-van der Hoeven, Minister for Development Cooperation

(Delivered by Rob de Vos, Director-General for International Cooperation)

Cordaid Congress: International Year of Microcredit 2005: "Investing in the Poor"

10 June 2005, The Hague

Ladies and gentlemen,

Sir Winston Churchill once compared the private sector to a variety of animals. He wrote: "Some people see private enterprise as a predatory target to be shot; others as a cow to be milked: but few are those who see it as a sturdy horse pulling the wagon." His clever comparison points directly to the success of microfinance. In our fight against poverty, we have come to understand that lending the poor only a small amount of money to start their own companies can go a long way. Microfinance has paved roads around the world. Roads on which sturdy business horses can pull the wagon of development away from poverty and pauperism, towards profit and prosperity.

As microfinance institutions develop, as they travel along the road of transformation, their financial needs evolve. The facilitating roles of governments, NGOs, social investors and the private sector are essential to the success of these institutions. But the balance between the different players is not always clear, and we do not always agree what steps to take next.

Cordaid's initiative to organise this congress has provided the perfect framework for a discussion on these issues. Its formula of bringing together partners from North and South ensures lively interaction between those with theoretical expertise and those with valuable, hands-on experience. I am especially appreciative of representatives from the developing countries who have come such a long way to share their thoughts and ideas with us today.

Microfinance and the MDGs

Today's event is of course closely related to 2005 being the International Year of Microcredit. This year is particularly appropriate for a focus on microfinance. We are exactly one decade away from the deadline for achieving the Millennium Development Goals. This challenges us to review our progress to date. Some progress has certainly been made, but we already know that we need to accelerate and intensify our efforts in order to reach our targets. I am convinced that a long-term focus on microfinance will increase our chances of doing so.

Despite 2005 being the Year of Microcredit, or perhaps because of it, setting separate targets for microcredit alongside all the other MDGs is neither necessary nor desirable. Microcredit is more of a contextual factor that can benefit a wide range of the MDGs. In that context, it is crucial to increase general access to financial services for the poor and to determine the role that different development partners can play in that process.

The transitional role of social investors

The most important aim of this congress was to explore ways to optimise the involvement of social investors. They can bridge the gap between a sector dominated by a mission-driven ethos and a microfinancial branch that is fully absorbed into the formal financial sector. This latter scenario is far from being a daydream. Look for example at ABN AMRO bank in India, which recently started funding local microfinance institutions with investment portfolios, whereby the microfinance institutions themselves serve as collateral.

Microfinance institutions pass through various stages of development, from being fragile start-ups to becoming respected retail-financial institutions. The support that brand-new microfinance institutions require is usually quite different from the assistance they need in later stages. To make sure that Dutch institutions can cope with such varied demands, the Netherlands Platform for Microfinance distinguishes between three categories of development partners. Firstly, we have the *medefinancieringsorganisaties*, the co-financing organisations or MFOs, like Cordaid, which receive grant funding. Secondly, there are social investors, like Oikocredit or Triodos, which typically use private funds, but share risks with some MFOs. And thirdly, there are commercial banks, which simply use deposits for investments.

When considering the different kinds of assistance that microfinance institutions need, I believe it makes sense to establish a clear division of labour between the different players. For example, one would expect MFOs to focus on microfinance start-ups until they attain operational self-sufficiency. Beyond this stage, social investors should become the main partners, while commercial banks can take over once microfinance institutions are completely financially viable. Such a transparent division of labour would mean that the typical relationship between an MFO and a start-up would have a clear-cut beginning, but also a well-defined end. Not only would this result in more start-ups getting access to funding, but it would also create more specialised expertise for microfinance institutions in their different stages. It could even foster competition, which can be quite healthy in the later stages of development of these institutions.

Let me conclude. On their journey towards a competitive and strong position in the private sector, businesses in developing countries are blossoming, and more and more of them are doing so on a sustainable basis. Microcredit has proven an irreplaceable tool in our efforts to enable as many of the poor as possible to realise their entrepreneurial dreams. To improve the benefits of microfinance, it is essential that we clearly define who supports whom. At this stage, valuing the transitional role of social investors is especially important.

I would once again like to thank you for coming here today to share your insights and thoughts. It is my hope, and that of Minister Van Ardenne, that a greater number of innovative people in the developing world will benefit from microfinance. After all, combining their ideas with only small amounts of money can create sturdy horses to pull the wagon of development.

Thank you

Renè Grotenhuis, General Director Cordaid

Microfinance, child of two parents

Speech by Renè Grotenhuis, General Director Cordaid

Welcome ladies and gentlemen, distinguished guests,

This is not the first and definitely not the last symposium on microfinance this year. Sometimes there are critics on the never-ending stream of invitations for meetings and workshops. When the United Nations declared this year The Year of Microfinance and on top of this appointed our Royal Highness its special advisor, they provoked this response. And even then: I don't believe that we have to be worried about the overwhelming attention to microfinance. Since we were able to pull - according to recent estimations - some 80 million people out of poverty, we have reasons to count our blessings and to look ahead.
When 80 million people have access to credit and can invest in their own future, no longer being dependent on irregular income, on employers who hire them - or not, then it is worthwile to sit down and look at this miracle and what it tells us about the struggle against poverty and about human potential.

Microfinance deserves all this attention and some celebrations but there is no reason to sit back. We have to realise that microfinance, although it has left behind its infancy, has not yet reached maturity. There is a lot to develop, there is a lot to learn, there are many challenges to be addressed. It left its infancy behind, yes, that's true. Microfinance has proven to be a viable concept and a necessary tool within the toolbox of development cooperation.
There is a lot to share and to learn. Cordaid experienced this earlier this week when twenty representatives of microfinance partners were in Soesterberg to exchange experiences and views on the possibilities and limitations of microfinance. Some of them are among our guests this afternoon.

Microfinance is also one of the signs that the stage of development work is changing, that new actors, new players are coming in, that the work of development-professionals can be and has been enriched and enlarged by professionals from - in the case of microfinance - the financial sector. We find ourselves in a new landscape, where the social logic of development work meets the financial logic of banking.

Microfinance did not appear out of the blue. We have gone through a long process of trial and error, of revolving funds (too social - not sustainable) of rural banks (too financial - not for the informal sector), of cooperatives (members only). None of these were the right answer to the problems of those living in the informal sector. With microfinance it looks as if we have found a sustainable solution: accessible to a large group of poor people, living in the informal sector, and at the same time a businesslike way of operating that gives microfinance its robustness.

Microfinance has its roots in development organisations, and more specifically in the anger of those in development organisations who saw the capacities of millions of people and their willingness to enter in entrepreneurship remain unused since they did not have access to capital, due to lack of collateral.
They noticed that it was a shame for the international community not to benefit from what people could contribute, not only to the improvement of their own livelihood, but also to the prosperity of their societies.
But those who started microfinance became aware that investing in social development has to go together with sound and strict financial management.

So microfinance - no longer an infant, not yet an adult - has two parents: social concern and financial keenness. Microfinance in its puberty doesn't know which of its parents it prefers. Should it follow the social parent, dreaming - as children at that age often do - to offer a solution to every poor woman and man?
Or should it mirror itself to its financial parent, dreaming to become a well-respected player in the financial world? And sometimes the parents quarrel among each other about the future of their child- as parents often do, claiming that it is in the best interest of the child to adhere to either its social or financial roots.

Cordaid has a microfinance experience of ten years in the three continents. And we are proud to be, behind Oikocredit, the second largest financing agency in The Netherlands, supporting MFIs with more than 26 million Euros.

From this experience we draw two conclusions on the balance between the social and the financial aspects of MFIs. The first is that development organisations are not able to meet the requirements of mature MFIs. The huge amount of capital and equity and the specialised knowledge that is necessary are far beyond our capacities (and we have many capacities!!). Only banks, both the commercial banks and the social banks like Oikocredit and Triodos, can meet the requirements of these mature MFIs. We welcome the growing commitment of commercial banks to MFIs and we are convinced that they can play - with their financial resources and their knowledge - an important role in microfinance which is becoming a significant tool in development cooperation.

Our second conclusion is that these banks, not even the social ones, are not the appropriate partners for small MFIs in their initial phase. Small amounts of outstanding credits, high transaction costs, investing in staff, building up networks in the social infrastructure, and high risks are features of this initial phase that deter banks from participating.
Cordaid is convinced that development agencies have a role to play in this process of building up MFIs.
According to recent estimations some 80 million people are participating in a kind of microfinance scheme.
But herewith we cover not more than 10% of those who could benefit from this instrument.

A month ago I met the director of the Social Faculty of the Central American University. We discussed questions of marginalisation and globalisation and he was convinced that globalisation, even if it offers lasting economic growth, will not be able in the next fifteen years to offer to all those hundreds of millions of poor people, who are dependent on the informal sector, a regular income and stability or security about their school fees and healthcare fees. For these millions microfinance is one of the tools to help them to break through the vicious circle of poverty.

There are a lot of white spots in developing countries, where MFIs are not yet working, where the process needs to be started from scratch. Supporting MFIs from a co-financing agency with a broad spectrum gives us the opportunity to mix grants and loans in these first phases of MFIs, giving them the opportunity to invest in knowledge and networks.
There is, for Cordaid, also an internal benefit in being involved in microfinance. It opens up a new range of financial tools to be considered in our relations with counterparts, questioning the automatic reflex of offering grants.

As I said before, there are still a lot of challenges for microfinance on its way to adulthood. Referring to the three-day exchange earlier this week it is clear that there is a great challenge to reach the poorest layers of societies. If it is a reality that many poor people will not participate in the formal economy and if it is true that social support schemes of governments like the 'Fome Zero' campaign in Brazil or the support for orphans and elderly in South Africa are still exceptions and if we don't want poor people to depend on foreign aid, then we know that microfinance is one of the, or perhaps the only real alternative to lift people out of poverty. But then we have to invest in research, in new processes of trial and error to find new approaches within the range of microfinance.
Related to this challenge of reaching out
to the poorer layers of society, there is the challenge to establish microcredit as a stable and widespread service in the rural areas. We realise that in these rural areas the problems of lending and repaying are more complicated, covering a longer time-period, facing more severe threats and risks of the natural environment and climate-conditions. But as the Sachs report told us earlier this year: family farming in development countries is crucial to beat poverty and to reach the Millennium Development Goals.

A second challenge to my opinion is the need to get more people here in The Netherlands involved in this sector of development cooperation. Up until now microfinance is the almost exclusive domain of development agencies and experts from the banking sector. When we look at other sectors of development cooperation we see a flourishing environment of private initiatives, local groups and small projects. These are an expression of their commitment and dedication. We know that there is an increasing number of private social investors who want to be engaged and want to invest directly. I'm glad that some of them, with whom we already have a long-lasting relation, are with us today. They also want to participate in young MFIs. They are satisfied with low interest-rates, sometimes they even accept some losses. The Dutch government could pull in these private social investors with tax exemptions similar to the social investment funds.
Wouldn't it be possible for the joint Dutch co-financing agencies, together with Oikocredit and Triodos, to organise a kind of certification of young MFIs on criteria of reliability, credibility and accountability, so that social investors, who invest capital in these young MFIs, could benefit from these preferential tax regulations? Then we will really capitalise on all the attention that has been

given and will be given to the International Year of Microfinance.
And we will benefit from the efforts of Princess Máxima, who helped a great deal to put microfinance on the agenda of a broader public.
Microfinance is for sure one of the success stories of the last two decades of development cooperation.
Microfinance is more than a development tool, a method. To me microfinance is fundamentally the conviction that every human being, even if she or he is poor and illiterate and lives in a remote area, is worthy of investment; that she, or he, is able to make something out of the capacities she or he has. Of course: microfinance is about correct calculations, but also and more fundamentally, about belief and trust in people.

Microfinance has two parents. It needs two parents.
I am happy to see that representatives from development organisations are sitting alongside representatives of multinational commercial banks. I hope that the talks that we have together this afternoon will serve the microfinance sector on its way to maturity.

Introduction 1

Microfinance is fundamentally the conviction that every human being, even the poor and illiterate or people living in remote areas, is worthwhile to invest in and that every person is able to make a decent living. As a system based on trust rather than certainties, it is a valuable and proven instrument to better the livelihoods of the poor. Moreover, it gives poor people opportunities to increase their incomes, develop their capacities and improve their well-being. Although it is not a panacea for all developmental problems, one should not underestimate the role microfinance can play.

Globalisation is not able to offer regular income to hundreds of millions of the poor so that they are able to meet their health and educational needs. Most poor people are unable to participate in civil society without access to financial services that enables them to fulfil their potential. The instrument of microfinance becomes vital even there where resources may be forthcoming from sources such as the government and development aid.

Cordaid has been engaged in supporting microfinance activities and microfinance institutions right from the start of its new set up in the year 2000, though the early beginnings of these can be traced back to 1996 in Bilance when the first contacts began with emerging microfinance institutions such as Fades and FIE[1] in Bolivia and Basix in India. Besides supporting emerging microfinance institutions, Cordaid has painstakingly cultivated and maintained strong relations with well-established microfinance institutions such as CARD in the Philippines, ASA in Bangladesh, KWFT in Kenya and ADOPEM in the Dominican Republic. Through them, it has maintained strong relations with a number of microfinance platforms that play a key role in advocating appropriate legislation in the countries they are working in. Relations with these platforms have helped Cordaid to be informed on new developments and trends in the microfinance sector. As of today, Cordaid has supported some 90 microfinance institutions in Asia, Africa, Latin America and Eastern Europe for a total amount of 30 million euros.

Cagayan d' Oro, the Philippines - Group leader of about 20 women, counts the money that she received from her group members for repayment of the loans and payment of the interest before handing it over to the credit officer of Milamdec.

With alleviation of poverty high on the development agenda of the G8 and the world's wealthiest countries, and with the naming of 2005 as the International Year of Microcredit by the United Nations General Assembly, microfinance has been getting the world's attention more than ever before. To commemorate this occasion, Cordaid took the initiative to organise a Seminar and a Congress, from the 6th to the 10th of June 2005 in the Netherlands.

The general objective of the seminar was to reflect on the so-called roadmap to transition that analysed the dilemmas and the choices entailed in the decisions taken by an NGO and other organisations engaged in savings and credit activities during their transformation to a microfinance institution. A selected number of partners - some fifteen of them - from Asia, Africa, Latin America and Eastern Europe that represented the different phases of transformation, were invited to present their case. The last day was reserved for the Congress where some 130 persons attended together with the fifteen partners. These invitees represented social investors, investment funds, banks, members of the Netherlands Microfinance Platform, the Ministry of Foreign Affairs (Development Cooperation) and experts in the field of microfinance.

This publication hopes to contribute to the discussion that focussed on this transformation process the emerging microfinance institutions go through and on the problems, the dilemmas, the choices, the difficulties and the decisions that were taken. In particular, the publication hopes to contribute to understanding the special nature of the microfinance institutions in their efforts to serve the poor in the widely prevailing environment of exclusion. It also aims at demonstrating the role social investors can play to help MFIs in this transformation process.

[1] An explanation of the abbreviations used in this publication is offered in the appendix.

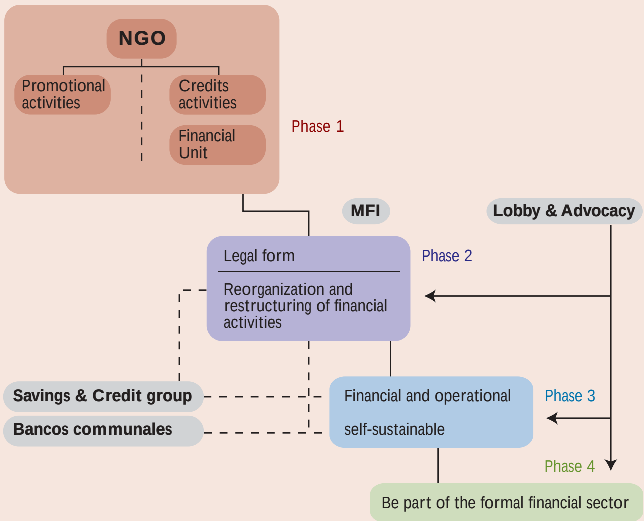
As a matter of policy and often as part of its development efforts, Cordaid supports the transformation process of saving and credit activities that, most often, is initiated by NGOs to the stage when these activities become operationally and financially self sustainable as a microfinance institution (MFI). A shared characteristic, therefore, of these emerging MFIs is their roots in development organisations and their strong social commitment to work exclusively with the poor. These institutions combine in them a mix of social and financial dimensions which makes them rather unique and special creatures.

One of the unique characteristic points that came through in all of the discussions was the fact that the MFIs and development NGOs worked from different perspectives, each with its distinct logic. The mission drive of the NGO is primarily social. They offer specialised technical, organisational and related services to the poor and their organisations on the basis of agreed objectives.
The financial resources they mobilise are used for the attainment of these objectives. And though the money is designed to be spent carefully, it is mainly used to cover their expenses and that of capacity building to better fulfil the needs of the target communities they work with.

MFIs, while sharing the social orientation and commitment with the NGOs, operate strongly from a financial logic. They are conscious that the costs of operation, the costs of borrowed funds, inflationary and other costs have to be recovered if they are to continue seriously and meaningfully in the business of providing financial services to the poor. From the start, they know they have to be self-sustainable and be on a path of earning surpluses if they are to grow and reach out to the increasing numbers of the excluded poor.

Being able to cover their operational and financial costs and going beyond, continuing to make profits in order to be able to reach out to the increased number of poor people necessitates having personnel specialised in managing savings and credit activities, having an appropriate organisational structure and an appropriate credit method with flexible financial products. Whereas NGOs use up their budget as they work towards their goals, MFIs, while committed to their social objectives, eventually “want their money back”. This implies a very different relationship with the target group than the one that the NGOs have. For this reason, a complete separation and reorganisation is initiated that results in a separate legal status for both institutions and in most cases, in the transformation of the NGO’s savings and credit activities into an MFI. When the latter becomes self-sustainable not only in terms of its operational and financial costs but also in terms of sustainable earned surplus, it is faced with the choice of whether to enter and confront the formal financial sector or not.
A few consolidated MFIs have made this choice. Two of these unique institutions, CARD from The Philippines and ADOPEM from the Dominican Republic, were present in this seminar. They gave us an insight into the dilemmas and the problems they faced and how they find their space within the financial sector, confronting the rules and regulations of the Central Banks and their Supervisory Bodies and the demands of the financial markets.

For purposes of analysis the transformation process has been divided into four phases.
The following figure visualizes these phases.



Jakarta, Indonesia - Woman repaying her loan to the credit officers of Bina Swadaya, during a meeting at the side of an alley in a slum.

It is important to note that the phases do not necessarily follow in a chronological order. An MFI may find itself in several phases at the same time. In some cases, organisations in more advanced phases still cope with issues that are normally dealt with in the first phase. In other words, the transformation of an NGO to a self-sustainable MFI is not necessarily a linear process, although sustainability has become a condition “sine qua non”. However, the four phases of transformation serve as a good instrument for the purposes of analysis.

Pressures regarding sustainability are strong from the start, coming from the investment community world-wide and from central banks in terms of regulatory norms. This pressure is felt at every stage of development and growth as mentioned by early start-ups as well as more established microfinance institutions during the seminar. All of them were grappling with the tension between their social missions on the one hand and the harsh economic reality on the other. Scaling up was felt and experienced to be a difficult and painful process and the organisations involved were confronted with many problems and fears. One of the major dilemmas faced was how and when to expand their financial services. Moreover, entering the formal financial sector meant being subject to rules and regulations that were at odds with its social and developmental mission. In some instances, compliance with these rules and regulation meant not being in consonance with its original objective of providing financial services to the poor. At times, this has meant even losing control over their institution. There are high costs involved in the transformation process and the need to make profit is often at odds with their commitment to the poor.

Kanpur, India - Rearing of eri-silk by self help group members and cutting er-silk cocoons to extract raw silk.

During the three-day seminar in June 2005, Cordaid invited a number of partners from each of the four phases to present their case. As will become clear from their experiences, every single one of them was confronted with specific problems and choices, depending on their phase of development and the external factors. These had to do with the size and location of the target group, with competition in terms of direct lending to self-help groups at below market rates from state financial institutions and most often, with non-conducive legal environmental conditions. While some of them experienced rapid growth, others were questioning if they should grow at all. One feature unifying all these different organisations was their strong commitment to work with the poor, no matter at what stage of their development and growth they found themselves in, as early start-ups, well-established MFIs or as banks.

This section will attempt to demonstrate the various issues MFIs are dealing with on their way to sustainability and the different processes and environments that not only distinguishes them from one another but, in particular, from the formal banking sector.

3.1 Phase One

NGOs usually get involved with providing loans to the poor because the poor, who do not have any significant collateral to offer, do not get the needed access to credit from the formal financial sector. In India for instance, Shramik Bharti started microfinance activities because of the strong need felt by the poor communities for small loans for household cash-flow management, improving their livelihoods and for housing. As the regular banks refused to serve them, they were left to get their credit needs from private money-lenders at exorbitant rates of interest and further had to rely on so-called fly-by-night companies. Elsewhere, as was the case with Nitlapán in Nicaragua, the NGO started providing loans in-kind initially in an attempt to contribute to the alleviation of poverty prevailing in the rural population.

WADEP (Women and Development Project) MFI - Ghana

The Women and Development Project started in 1995 as an NGO in the Nkwanta district in Ghana, one of the most isolated and deprived areas in the country. The district, with a land area of about 4,530 square kilometres, has only one financial institution to serve its large population and being a commercial bank, it resents serving the poor for being administratively expensive and high risk clients.
WADEP aims at sustainable improvement of the economic and socio-political position of the marginalized, especially women. In 1998 a credit scheme was established, aimed at diminishing dependency on subsistence farming and seasonal incomes. Currently WADEP has a loan portfolio of USD 33,000 and 1,500 clients who are organised in groups with on average 25 members, providing social collateral for the loans.

WADEP has set its targets for the future. Some of the challenges to be met are restructuring and reorganising the MFI, expanding the outreach and the loan portfolio, training the existing staff and finding qualified personnel willing to work in the deprived area without asking too high remuneration, and developing new products and strategies to attain sustainability.

DEC (Development Education Centre) - Nigeria

The Development Education Centre was established as an NGO in 1988 to provide financial aid and non-financial services to rural poor women and unemployed females in order to enable them to achieve self-reliance. DEC focuses on a number of issues, including food production, nutrition, natural resource management, training programmes for village health workers, literacy programmes for adult women, skills acquisition and job creation for unemployed female youths.
To date, DEC provides over 5,000 women with various types of loan, such as fixed assets loans, working capital loans and short term working capital loans. Loan tenures range from 6 months to 2 years. The average loan size is USD 100 and recovery is over 98%. The size of the portfolio is USD 400,000.

DEC is facing a number of challenges. There is a need for sufficient loan funds to meet up with the growing demands of clients. In order to increase both the total volume of loans and the size of individual loans DEC is planning to add new products, particularly longer term savings deposits, which will provide a more stable source of funds for advances to clients. Recently, the organization established the *Nnabuife Community Bank* which will become a major source for funds mobilization when it is fully operational.

Shramik Bharti - India

Shramik Bharti was established in 1986. Through the formation of self-help groups (SHGs) the organisation works on the empowerment of the poor and underprivileged in 125 slums and 500 villages of Kanpur & Kanpur Dehat districts of Uttar Pradesh, especially women and children.

Currently *Shramik Bharti* focuses on community health, grassroots democracy, livelihood and microfinance. Major achievements are the reclamation of 11,000 hectares of brackish land benefiting 30,000 families, change in reproductive health behaviour of more than 45,000 couples and increase in financial services to over 1,400 SHGs with over 20.000 members. Until 1994, the programme was run with a saving fund only. With loans from several donors since 1995, the organisation has increased its outreach and achieved operational and financial sustainability in 2003. So far 749 groups have been linked to the banks, 668 are under financial intermediation. By the end of 2004 over 10,000 members had deposited USD 585,000 in savings, whereas loans had been disbursed for a total of USD 593,000 to over 6,600 borrowers, the average loan size being USD 90.
Among the present challenges for *Shramik Bharti* are managing the dovetailing of development programmes and microfinance, the conflict between profit orientation and social responsibility, the lack of trained human resources and capacity building of members for management of SHGs.

A typical feature of organisations in Phase One is the combination of both promotional activities and financial services under the same roof. Eventually, they do establish a special financial unit for credit activities within the NGO. An example is WADEP *(Women and Development Project)* in Ghana. In addition to the small credits of USD 75 to USD 100 for the productive poor to improve, add value to or diversify their income generating activities, WADEP offers training and education on business management, primary health, gender education, legal and right issues and hiv/aids awareness.
At present, the implementation of the MFI programme faces several problems. Due to the high illiteracy rate of women, there is poor record keeping at community levels. Those who do take loans have inadequate technical know-how for improving or adding value to their products. Over and above, men are sometimes not in favour of their wives' participating in the credit scheme for fear of them becoming subordinated. WADEP looks for solutions by encouraging women to attend literacy classes, offering training them in micro-enterprise development and related skills, in-house training for clients and opinion leaders on the importance of women to be economically empowered to support the family.

Another issue often stressed by start-ups are the high costs involved in microfinance activities. In Nigeria, DEC *(Development Education Centre)* runs a village banking model based on group solidarity and compulsory savings serving 3,059 clients with another 2,000 clients in the urban branches. Providing financial services to the villages is costly. Sometimes a village in a remote area takes only one loan which brings with it rather high travel costs. Working in the cities is easier and more profitable.
As demands in the urban areas increase, it is tempting to shift to the urban market where scaling up and cost recovery and earning a surplus is easier. However, DEC has chosen not to do so as the organisation is not willing to give up its commitment to the poor in the countryside. This example shows clearly what it means to have a social and a financial parenthood. There is an immanent tension in working with the poor and aiming for sustainability.

Not every NGO providing financial services needs necessarily to transform itself into an MFI and certainly no one needs to start an MFI without doing a landscape study first. It is the needs of the target group that count, not those of the MFI. In communities that produce mainly for their own consumption, with very few monetary transactions, the need to begin with a microfinance

Near Nairobi, Kenya - Small scale farmers listen to an explanation about growing the artimisia annua, to produce artemisinin, a botanical extract for low cost malaria cures.

institution is not clear in the first instance. Nor is the need to have a microfinance institution clear in very sparsely populated areas where there are not enough possibilities for growth. Moreover, microfinance activities are seen as part of the development methodology.

Shramik Bharti has chosen not to focus on its own institutionalisation but instead on empowerment of the people by enabling SHGs (Self-Help Groups) to graduate to a higher level of programme management.
The organisation stopped taking loans for some time, recovered the loan portfolio and repaid its liabilities. Since then, a new model was put in place, based on the formation of user-owned federations of self-help groups. The SHGs still have access to the financial services of Shramik Bharti, but, as Federations, they also have direct access to credit from NABARD *(National Bank for Agriculture and Rural Development)* and, through NABARD, from the commercial banks who are obliged to provide a certain percentage of their portfolio for credit to the low-income clients. In this model, the poor can also avail of the policy of the Government of India obliging main stream insurance companies to provide micro-insurance to the low-income clients. *Shramik Bharti* provides training to the leaders of the SHGs and the Federations concerning decision-making and management.

3.2 Phase Two

The transformation of the NGO to a specialised microfinance institution or the establishment of a separate legal unit strictly devoted to the provision of financial services marks the transition to the second phase. Usually such a transformation is triggered by an increased demand for microcredit from the market which, in turn, triggers organisational growth. Depending on the legal framework of the country where it is based, this new entity can choose to continue having the NGO legal structure. Further, it can choose to be a for-profit or a non-profit organisation or a non-banking financial company. Building a strong organisation involves many costs and although quite some information is available from past experiences, there is no blueprint for transformation. *Sa-Dhan*, the Indian microfinance platform stressed time and time again in the Seminar that the processes are country specific, region specific and case specific.

MPL (Microfinance Partners, Ltd.) - Kenya

MPL is a Non-Bank Financial Institution with its roots in *SunLink*, an NGO established in 1999 by the American organisation Pride Africa. Its mission is to become a commercially viable microfinance institution providing affordable financial services to the working and productive poor in the peripheral urban areas of Nairobi (Kenya).

MPL applies the *Grameen* method, using a combination of group scheme loans and compulsory savings. By the end of 2004, MPL had over 5,300 members. The total of their savings amounted to USD 790,000. In the course of the year, 3,100 members took loans with an average size of USD 330.

The challenges for the future are to attract investment capital to be able to expand the organization, to access affordable financing for general operations and on-lending, to enhance client retention and stemming client dropouts. MPL aims for 14,000 clients in 2009, with 60% credit customers and 80% client retention.

FDL (Fondo de Desarrollo Local) - Nicaragua

FDL has its roots in *Nitlapán*, an NGO set up in 1990 by the *Universidad Centro Americana* to further permanence, solvency and autonomy of the rural development programmes. In order to enhance the living standards of the poor and promote their access to capital, *Nitlapán* started providing financial services to small and medium, rural and urban entrepreneurs in 1992 by means of revolving funds.

In 1993 *Nitlapán* set up the Local Banks Fund at the second level to finance local producers' organisations. Because of the high percentage of the portfolio in arrears and weaknesses in the decision-making structure, a more professional rural credit system was initiated between 1994 and 1996. This led to strong improvements of administrative structures, selection procedures, recovery policies, formulation of a territorial strategy for the financial operations and expansion of the credit portfolio.

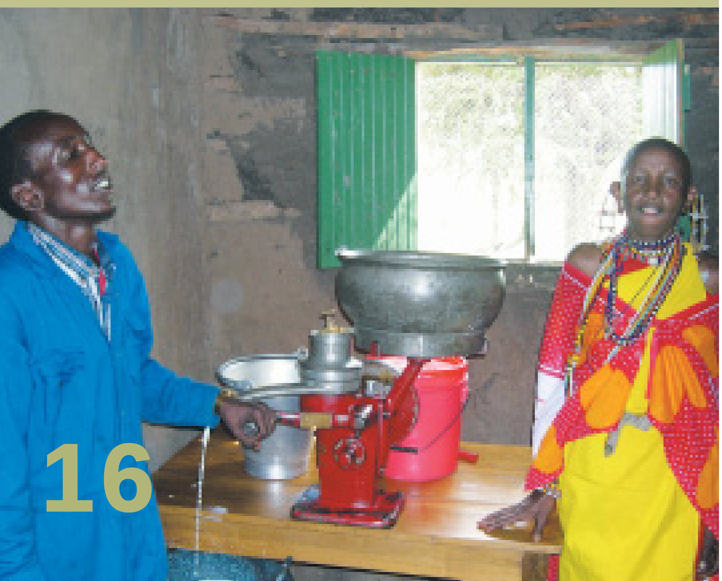
From 1997 onward, the organisation began setting up branches; specialised financial services were developed as well as a new strategy aiming for operational and financial sustainability and a separate legal status. In 1998, FDL became a separate MFI with a legal status of its own. It is now financially sustainable; with 29 offices in Nicaragua and a USD 21 million loan portfolio. It serves 33,000 clients in small enterprises and farming.

Bina Swadaya - Indonesia

Soon after its establishment in 1967 *Bina Swadaya* started supporting capital development for the rural population, either channelled to them via self-help groups or directly to individuals. Realizing that the capacity of the members of the SHGs was small, Bina Swadaya designed and promoted a solidarity savings and credit scheme aimed at increasing the volume of capital available for the groups to meet the needs of their members.

In the late 80s *Bina Swadaya* started formalising the saving and credit scheme as an activity of rural banks. During the 90s, a labour intensive, door-to-door a programme based on the ASA method was started, aimed at reaching out to the poorest sections of society. By the end of 2004, the loan portfolio of the rural banks exceeded
USD 1.8 million, with 3,363 active borrowers and an average loan size of USD 540. The rural banks collected savings from 16,750 clients for a total of USD 570,000. In the same period the ASA model was serving over 9,000 borrowers and savers, with an average loan size of USD 120 and over USD 90,000 in savings.

In cooperation with *Bank Indonesia* (the central bank) and BRI (*Bank Rakyat Indonesia*, the People's Bank of Indonesia) *Bina Swadaya* has initiated the *Self-Help Group Linkage Program*, linking SHGs directly to the banks. Now it is trying to consolidate rural banks, linkage program and ASA model into a single microfinance operation.



As the transformation process involves a number of complicated issues, there is, at times, the need to have competent people who can assist this trajectory for some time. This entails a significant rearranging that needs to be done in terms of having qualified, competent and professional personnel and an adequate organisational structure in terms of ownership, governance and management. Ultimately, the rearranging is required to reach out to the excluded poor in ever increasing numbers. Moreover, the rearranging brings with it another type of relationship with the clients from among the poor in keeping with the type and nature of the products and services that are offered. Accountability and transparency become important issues in this transformation process. Accountability is not only financial but also social for which it needs to have management information systems of monitoring and control and develop social and financial indicators. The microfinance institution feels urged to expand its credit and saving products and services and build up the needed surplus in order to continue meeting the credit and other financial needs of the poor. At this stage, it sees the need for private capital from private social investors, social investment funds and commercial (local and international) banks. In some cases, the NGOs choose for another model which does not envisage transforming its savings and credit activities into a microfinance institution but to link the self-help groups directly to commercial banks and their lending programmes as was indicated by the Indian and Indonesian partners in the Seminar.

As history has demonstrated, the complicated nature of the transformation process and the pitfalls that at times come with it requires that the NGOs be prepared before choosing for this process. They need to be prepared for the risks in order not to be taken by surprise and loose control as was indicated by *MPL (Microfinance Partners, Ltd.)*, from Kenya in 2003. MPL, at that time an NGO in the first phase that combined social and financial services, was confronted with a major internal crisis, due to (among others) weak management, ad hoc growth, lack of procedures, weak controls, operational losses and high client dropout rate, bringing the organisation to the very verge of bankruptcy. A temporary board needed to be put in place that struggled for years to transform MPL into a viable and sustainable for-profit organization. Although successful in the end, it was the result of an intensive crisis management that warranted more time and financial investments than any planned transformation process would have envisaged. The trouble MPL got itself into

Soitsambu (Loliondo), Tanzania - Masai people extracting the fat (ghee) from the milk. Ghee is sold at a good price in local markets and benefits are used, amongst others, to cover activities of a Masai women's group. Microcredit funds of the Pastoral Women Council enables Maasai people in this part of the country to start up income generating activities.

illustrates the inevitability for NGOs with extensive financial services to either transform into or set up a separate MFI and be prepared for the changes that are needed.

As was noted in the previous chapter, it is the needs of the target group of the poor that count, not those of the MFI. While dealing with the issues outlined above, MFIs are aware of their mission of working with the poor and being gender sensitive. As a matter of fact, MFIs often work out innovative strategies to be able to serve the needs of their target group and, in some cases, even design different approaches to suit the different strata of the poor. This very important characteristic of MFIs is not always recognised by the formal financial sector and governments. Two examples serve to illustrate this point in the Seminar.

Well aware of the stratification of its target group, FDL in Nicaragua worked with a credit methodology that subsidised the interest rates for those who needed their services most. The poorest farmers and the small agriculturalists that needed longer term loans were charged interest rates ranging between 20% and 30%.
As this was actually below the cost price of delivering this loan product, FDL had to balance the losses incurred in this product by charging a higher interest rate to small animal husbandry farmers and traders whose loan cycles are shorter and who can afford to pay more. Moreover, FDL provided Technical Assistance (TA) to clients, using the services of *Nitlapán*, its founding NGO, which costs needed to be recovered through the instrument of the interest rate. FDL therefore chose to go in for differential rates of interest to meet the needs of different segments of the poor. As part of its development strategy, it developed different products such as loans meant for irrigation equipment which were given at 12% rate of interest. Loans for working capital were charged 21%, while those segments of the poor engaged in trading were charged a higher percentage.
Another tailor-made approach was based on its analysis of the farm unit which determined the cash flow fluctuations over the year and the farmer's paying capacity. In stead of having to pay each month, a very special repayment plan was agreed with the small farmer family. It goes without saying that such individual and flexible approaches can be rather costly.

Bina Swadaya, one of the biggest NGOs in Indonesia, realised that different structures were needed to reach different sections of the poor. Formalizing the saving and

Eastland, Nairobi, Kenya - Shoe salesman who was able to start his business thanks to a microfinance loan, in discussion with the manager of MPL.

Nairobi, Kenya - Woman repaying her loan during the group meeting at the MPL office of the Eastlands Branch.

FONDECO (Fondo de Desarrollo Comunal) - Bolivia

FONDECO was set up in 1991 as a credit unit within CIPCA, a farmers organisation focussing on training and development. In 1995 it became an independent not-for-profit civil organization. Its mission is to facilitate financial resources and loans to peasants to enable them to actively participate in Bolivian society.

FONDECO provides loans for working capital and investment capital to small-scale farmers, entrepreneurs and small businesses in rural areas, who do not have access to the formal financial system because of their economic, legal, geographical, and cultural limitations. The organisation provides different kinds of credit. The village banking system still operates using solidarity, joint liability, chattel and obligatory savings as guarantuy. Farmers have access to micro-warrant business credits: the rice harvest or a guarantee from the Rice Mill Depository as collateral. Individual credits are granted with documents in custody, chattel, personal or mortgage guarantees.

Today FONDECO has 15 branches covering rural areas and a portfolio of USD 5,6 million, mostly for agriculture and fishery (70%). FONDECO has over 6,000 clients, one third of them being individual microcredits and two thirds being members of the village banks, serving 15-30 clients each. The majority of the target group are women (55%).

credit activities of the NGO into a rural bank enabled *Bina Swadaya* to mobilize public savings, and was even more effective to obtain credits (at market interest rates) from banks in Jakarta for the expansion of its operations. Thus, funds collected in the economic centre of the country could successfully be channelled to rural areas. Another contribution of *Bina Swadaya* to the accessibility of credit for the poor was the initiation of the *Self-Help Group Linkage Program*, set up in cooperation with the *Central Bank and the People's Bank of Indonesia*, linking self-help groups directly to the banks. The high amount of credits to groups by *Bina Swadaya's* rural banks and the high amount of credits secured with household items (which normally banks do not consider as collateral) differentiates them from other banks applying the programme. The low average credit amount extended to borrowers for a relatively long period (e.g. the equivalent of USD 45 for one year) indicates the kind of customers served, namely, the poor. Finally, a labour intensive, door-to-door project, applying the ASA method, was started, aimed at the poorest sections of society.

3.3 Phase Three

This phase, in particular, focuses on the aspect of having attained operational and financial sustainability.
The organisation begins to earn sufficient surplus to pay for its personnel, overheads and financial costs. This is, in fact, the stage of take-off of expansion and growth which requires additional funds from private social investors and the financial sector. With increasing earned surpluses that strengthen the social capital of the organisation, the MFI is able to broaden the scope of its lending activities by attracting new capital for the expansion of the portfolio and for product diversification. Social investors come in, understanding the social mission of the MFI, without expecting high returns. At this stage, strengthening the equity base of the organisation becomes crucial for further growth and expansion of the lending portfolio.

Sustainable organisations have come a long way in terms of cost control, monitoring, effectiveness and efficiency. As the MFI grows, it reaches out to more members. Depending on the credit methodologies and contextual situations, some MFIs have reached out to a sizeable number of poor clients. ASA in Bangladesh now reaches out to some 3,5 million poor and *Share* and *Spandana* in India to some 400.000 each. Although most of the well-established MFIs have clients who need comparatively larger loans, the average loan size remains small.

Cochabamba, Bolivia - Small scale potato farmers from Punata. These farmers have increased their production with small loans provided by Fondeco.

An illustration of the kinds of changes an organisation had to go through in order to reach sustainability is *FONDECO* in Bolivia. Before 2000, FONDECO had a low-quality, 100% agricultural portfolio. Most of the clients were subsistence farmers without identity documents with the result that loans could be guaranteed with social collateral only. There was one single subsidised rate, fixed remuneration for personnel; there were no centralised risk enquiry system and no adequate internal controls. As a result, many loans were in arrears and operations were not sustainable. In 2000, *FONDECO* introduced some important changes. From that year onwards, identity documents were required for client service and credit activities were directed to small farmers who had produce for sale. The portfolio was diversified, with primary, secondary, and tertiary rural activities. New credit technologies were introduced as well as new types of collateral (personal, chattel, machinery, custody of documents and mortgage). *FONDECO* started applying differential market rates, performance-based remunerations, developed risk appraisal systems and strict internal controls. As a result, the quality of the portfolio improved, the portfolio in arrears and the portfolio at risk decreased and *FONDECO* was able to reach the break even point and began to earn a comfortable surplus.

In the seminar, the presentations given by *FONDECO* in Bolivia and *FDL* in Nicaragua indicated the difficult choices they were faced with on their path to further growth. Technically, they indicated that they were capable of expanding and of establishing new branches and increase their clientele from among the poor that are still deprived of credit. But they were faced by all kinds of practical obstacles related to the low accumulation rate of social capital and the legal environment. An important source of funds for MFIs to help expand their portfolio is through the mobilization of savings but in many countries, civil organisations are not authorised to collect savings from their clients unless they have the legal status of a bank. *FONDECO*, faced with this dilemma and further realising that at this stage of its growth it was not opportune to enter the financial sector as a Private Financial Fund, decided for another alternative. It chose to establish strategic alliances with other regulated financial entities like cooperatives in order to promote savings from the rural population and find a new source for their funds from the cooperatives.

AgroInvest - Serbia and Montenegro

AgroInvest started as a microfinance programme of WVI *(World Vision International)*, a Californian non-profit corporation. Its mission is to serve and empower rural families through high-quality financial services. The target group are the economically active rural population, mainly excluded from formal financial sector services.

Microfinance operations were launched in 1999 in Montenegro and in 2001 in Serbia. In Montenegro, *AgroInvest* takes the institutional form of an NGO. In Serbia the operations are conducted through a division of WVI in partnership with a disbursing bank, although this institutional arrangement is not conducive to long-term sustainability of operations. Currently the organisation is working on the establishment of a formal legal for-profit entity that will suit the legal environment in both Serbia and Montenegro.

AgroInvest has an outstanding portfolio of over 11 million EUR, serving over 13,000 active borrowers, approximately 20% in Serbia and 80% in Montenegro. Over the last six years 2,000 jobs have been created in the micro enterprise sector. Microfinance clients have witnessed an average annual income increase of 47%. Recently the maximum credit has been raised from EUR 3,500 to 5,000. A new product comprises fast loans that can be disbursed within one day to existing clients without need for collateral.

Peru - Peruvian coffee farmers discussing their crop pre-finance programme.

FONDECO, in the meanwhile, is strongly advocating another regulatory space that recognises the manner of working of smaller microfinance institutions wanting to reach out to the rural poor.

FDL in Nicaragua faces a similar dilemma. In the current situation, *FDL* had not much room for growth. It felt that if it became a bank, it would have the advantage of attracting public savings and reinvesting these for greater outreach and again, would have greater access to private capital funds in general. However, there were a number of concerns and consequences that made this option unattractive. As a bank, *FDL* indicated that it would not be able to provide some of the special services it is providing now. It would not be possible to offer differential rates of interest so as reach out to the poorest sections of the population nor would it be able to provide Technical Assistance to the small agriculturalists that need more than only credit. Furthermore, laws regulating financial institutions are not conducive to understanding the types of risks that need to be taken based on trust and social collateral. The collateral offered by the poor does not have much legal value. Again, *FDL* was faced with the choice that should it decide to become a bank, it would have to deposit a substantial amount of cash as collateral (an amount that it does not have) and in the bargain lose out on its efforts to reach out to the poor.

Another organisation that had reached operational and financial sustainability that was present in the seminar was AgroInvest, which operates in Serbia and Montenegro. Unlike *FONDECO* and *FDL*, *AgroInvest* had decided to benefit from the establishment of a more formal legal for-profit entity in an environment that varies considerably in Serbia and Montenegro. Montenegro being a smaller Republic has a limited market size but does have a legal framework that is favourable to microfinance. In Serbia, the legal environment is not favourable and one that prohibits lending activities by any entity other than a bank. To adapt itself to the two environments, till now *AgroInvest* worked with two parallel legal structures. Operating separate entities with the same persons acting as director, finance manager, business development manager, HR manager and operations manager was not efficient, costly and created misunderstandings with the tax authorities. In a situation where donor grants were dwindling, *AgroInvest* decided to set up a for-profit institution with a clear ownership and legal structure.
A new structure with clear ownership was helpful to attract investors and open for outsiders such as tax officials and external auditors.

3.4 Phase Four

Having seen MFIs develop from small in-built entities within NGOs to operationally and financially sustainable organisations, the next question they are very often confronted with was whether they should enter the formal financial sector. On first analysis, this step would seem to be the most obvious one. Poor people would have access to financial services from the mainstream banking sector and overcome being labelled as being ‘unbankable’. Moreover, incorporation in the formal financial sector would have positive effects on the image and legitimacy of financial services for the poor. Commercial banks comply with the rules and regulations of the central banks in the countries where they operate and are well organised which makes them trusted institutions. In many countries only banks are allowed to mobilize savings as a source for credit. Furthermore, the competitive environment of the formal financial sector and the profit motive triggers increased efficiency and innovation.

However, transforming an MFI to a bank is a difficult matter, because the rules and regulations that apply to the regular banking sector do not recognise social collateral. Even the credit portfolio of MFIs with an excellent track-record and a near-100% repayment rate over several years is officially classified as high risk. According to the existing norms, this risk should be covered by reserves on the balance sheet and most MFIs do not have the amount of assets and equity central banks require as collateral. Thus far, transforming an MFI to a regular formal sector institution has generally proven not to be feasible.
The very few MFIs that have done so (e.g. *ADOPEM* in the

Jakarta, Indonesia - The Manager of the Johar Baru Branch (Bina Swadaya) explains the actual situation of the 79 groups that are served by the 5 credit officers of this branch.

Dominican Republic and *CARD Bank* in the Philippines) could embark on this path because of specific legislations passed in their countries.

For ADOPEM, the transformation was an appropriate answer to the environment the organisation was working in: the high level of institutional maturity in the Dominican Republic, the global trend to become supervised, dwindling grants from donors and increasing activities of commercial banks in reaching out to the micro sector. *ADOPEM* came to the conclusion that by becoming a bank it would considerably reduce costs and enabled it to provide more competitive rates to micro businesses. Last but not least, becoming a bank would enable *ADOPEM* to provide full-fledged financial products to the poor, tailored to meet their needs, competitively priced, with flexible conditions and sold by personnel that understand the culture of its clients. Next to microfinance, *ADOPEM* offered consumer loans, credit cards and business training (by the *ADOPEM NGO*) to improve the performance of clients' businesses. In addition, *ADOPEM* continued to encourage women's empowerment and leadership in the low-income neighbourhoods.

Further, *ADOPEM* has been very careful in selecting investors that subscribe to its mission, thereby making sure that it can carry on working with the poor providing them with the needed financial services. As of date, 40% of its shares are owned by the *ADOPEM NGO*, 30% by private investors and 30% by international investors.

Red de Microfinanzas Regionales del Perú - Peru

The closing of the *Agricultural Development Bank* in the early 90s had a negative effect on the access to credit for small farmers. Consequently from 1992 the *Cajas Rurales* emerged. These are: private, supervised rural banks that tried to fill the vacuum. Initially these rural banks were supported by the Ministry of Agriculture. Later they became independent institutions where regulation is just as strict and demanding as with other banks.

Recent developments have reduced the chances for regional banks to survive as stand-alone institutions. As many large companies start participating in the equity market and leave the commercial banks, the latter are looking for other areas to invest and are entering the microfinance sector. On top of the increasing competition, rural banks are threatened by the ever higher demands of the legal environment and the instability of the agricultural sector. In response to these threats in February 2005, a commercial enterprise was set up called the *Red de Microfinanzas Regionales*.

Today there are twelve *Cajas Rurales* in Peru, ten of which are part of this commercial enterprise. Co-operation will reinforce the competitiveness of the members and pro-active policies will mitigate their weaknesses (the corporate image of the entities, high funding costs, low interest rates for savings and high rates for loans) and exploit their strong points (decentralised presence, proximity to the clients and extensive experience with agriculture and cooperatives).

ADOPEM (Asociación Dominicana para el Desarrollo de la Mujer) - Dominican Republic

ADOPEM was established in 1982 and started its Microfinance activities in the same year. It aims to promote the economic development of Dominican women and help them and their families to play an active role in the formal economic system by providing financial services and training to strengthen their small businesses. ADOPEM's main challenge is to achieve a high level of operational efficiency, to become competitive in the long-term and to have a positive impact on the development of the country.

In 1999, ADOPEM started thinking over the possibility of becoming a bank, with the clear objective of seeking adaptive space for its operations that will allow it to continue reaching out to poor women in the urban area of Santo Domingo. After the economic and political crisis in 2003, ADOPEM was able to buy the licence of a bank in default and in a state of intervention by the central bank. In 2004 the new bank got licensed by the government.

Currently the ADOPEM Bank has a loan portfolio of over USD 12 million and nearly 50,000 borrowers. Although the bank is part of the formal sector, the client base has remained the same. The average size of the loans (USD 259) indicates that the majority of the clients are the poor.

CARD (Center for Agriculture and Rural Development) MRI - Philippines

CARD is committed to provide access to microfinance services to an expanding client base by organizing and empowering landless rural women. It has created a group of mutually reinforcing institutions (MRI) with the aim of transferring ownership, management, and control of resources to the target group. CARD MRI is composed of Card NGO, Card Bank and Card MBA (Mutual Benefit Association).

Card NGO began in 1986, as a small organisation whose main mission was to assist and help landless rural women to have regular income. In 1997 CARD was the first MFI in the Philippines to establish a bank. In 1998 CARD MBA was set up, a separate micro-insurance institution to provide for the need for greater security of its clients including life insurance, provident savings, retirement savings, and no-redemption insurance. Recently the CARD training centre has been established that provides training for human resources for CARD as well as for other microfinance institutions in the Philippines and abroad.

Although CARD has fully integrated into the formal sector and it has a strong corporate image, it has always kept its original values. CARD aims to serve the poorest section of society, people living in dilapidated houses and in poor living conditions, with per capita incomes at or below USD 1 per day. While the need for financial sustainability generates a strong pressure to change the client profile and some clients have indeed loans ranging from USD 1,000 to 3,000, the average is still USD 120. By December 2004, CARD had almost 1,000 employees, 132,249 clients and a loan portfolio of USD 10 million.

The same was the case of *CARD* in the Philippines. *CARD* was the first MFI to get the legal status of a bank in 1997. To safeguard its mission, *CARD* made sure that it had sufficient investors as board members that would uphold the vision and mission of the institution. Among them were two board members representing the client-members guarantying their participation in policy formulation and governance.

Although few MFIs have become part of the formal sector, globalisation in the financial world has advantages and creates opportunities for international co-operation. Smaller entities can enter into the financial world and MFIs can lobby for financial development in the rural areas. The *Red de Microfinanzas Regionales* in Peru has entered into a special alliance with Cordaid in order to stimulate innovative practices and development of new and flexible financial instruments and to tap expertise and capital from the financial sector. This has initiated a series of important exchanges and negotiations with banks in the Netherlands and in Spain with the objective of entering into a special partnership on the basis of mutual interests.

General Santos, the Philippines - A credit officer of KPS Seeds is writing in the personal credit books of women in the slums of General Santos.

The main difference between microfinance institutions and commercial banks is in the type of clients they serve and the type of collateral their services are based on. Generally, commercial banks target people with assets and/or regular incomes, whereas microfinance institutions specialise in offering small credits to the poor. Depending where the line is drawn, defining the poorest section of society (income below either USD 1 or USD 2 per day), 1.2 to 2.0 billion people world-wide are living in poverty. The majority of them make a living from subsistence farming or from self-employed activities in the informal sector. As most clients of MFIs come from the last group, microfinance is often referred to as the banker of the informal sector.

Microfinance is a unique development tool using commercial approaches to serve the poor and reduce poverty. Given their specific nature, microfinance institutions have developed credit methodologies of their own, based on the concept of social collateral. This social collateral is participative in nature: solidarity groups and group meetings are often part and parcel of the arrangements, even in the case of individual lending. Driven by their social commitment MFIs have devised ingenious products such as obligatory savings and financial service products that are suited to the specific social and economic conditions of the poor, with simplicity and flexibility of procedures.

Microfinance institutions were the first to realise that besides providing financial services, they needed to offer protection from unforeseen setbacks. As a result, they began developing the instrument of micro-insurance that provides coverage for eventualities of accident, sickness and death; the instrument of micro-warrants that provides post-harvest insurance cover for products that are subject to price fluctuations; and coverage for veterinary costs and death of livestock. In fact, most MFIs that have been pioneering the instrument of micro-insurance are realising that it is a separate ball-game that has to be conducted on the basis of its own separate logic. Some have become staunch lobbyists and advocates of access to micro-insurance for the poor from the main stream insurance providers, as is the case in India.

Since 1997, the microcredit sector world-wide has been able to increase its outreach from 20 million people to 80 million, the majority of whom are women. It needs to be mentioned though that in the case of Africa, microcredit serves only a small percentage of total poor population, in some African countries as low as 2% of the poor. Further, not only has access to credit increased income and employment figures, there are also important social effects. A number of studies indicate that microfinance institutions have contributed to the improvement of living conditions of the poor, in terms of the quality of their nutritional patterns, quality of housing and sanitation, access to consumptive durable goods and access to education. As a result of their economic activities, the poor have proven to have increased their skills, self-confidence and self-respect. Their earnings have added to a better risk mitigation. Microfinance also has been reported to have a mitigating effect on the interest rates charged by local moneylenders.

However, there is still much that needs to be done. Analyses and studies on the performance of microfinance institutions point out that the outreach to the poorest of the poor, also called the ultra poor, is limited. To reach these most vulnerable groups special programmes have been initiated. Recent efforts by well known MFIs like *Grameen*, BRAC and ASA in Bangladesh indicate that a combination of financial and in-kind instruments is an effective and promising approach.

Guntur, India - this woman used to be a rag picker. With a loan of Spandana she was able to set up a thriving business in the collection of 'fallen hair'. Fallen hair is used for making wigs for the European and American market. Hair from specifically Indian women is very popular. This lady was able to set up a distribution network in hundreds of villages to collect the hair. She is standing in front of the hut where she used to live. Now she is living further down the road in a well maintained brick house.

However, this way of working is time consuming and costly. It calls for higher capital investments by the funders and it slows down the transformation process of an MFI on its way to sustainability.

Other obstacles are the onerous legal environments MFIs are operating in, often prohibiting them to collect savings. Where possible, MFIs use different legal organisational forms to mobilise savings in innovative ways. Elsewhere platforms of MFIs have battled with their respective governments and central banks for rules and regulations that fit the needs of the sector[2].

Finally, it needs to be noted that eighty million poor form only 10% of the total population that could benefit from microfinance. Seven hundred million people in Africa, Asia, Latin America and Eastern Europe are still waiting for opportunities to increase their incomes and improve their lives. Providing access to financial services for these people will not only improve their livelihoods but will also enhance the well-being of their societies.

Cagavan d'Oro, the Philippines - The Credit Officer of Milamdec is counting money and administrating the funds received of group leaders.

[2] This need was emphasised by all three microfinance platforms that were participating in the Cordaid conference: AMFIU (Association of Microfinance Institutions of Uganda), COPEME (Consorcio de Organizaciones Privadas de Promoción al Desarrollo de la Pequeña y Microempresa) from Peru and Sa-Dhan from India.

Debate on the different roles of CFOs, banks and social investors 5

The microfinance sector, although expanding fast, is still too small to serve the millions of poor people that do not have access to financial services. It is clear that in order to satisfy the demand - which is estimated to amount to hundreds of billions of dollars - the sector cannot rely only on investments from the international development organisations but has to attract capital from private and commercial sources. The financial investments from development organisations need to provide the basis for further investments from private investors, social investors and the banking sector.

Recently, there have been quite some specific views in the Netherlands regarding the roles various actors can play, in particular, on the role of the Co-Financing Organisations (CFOs) and the private sector. In this debate, questions have been raised concerning effectiveness, efficacy and the importance of southern ownership.

5.1 Views of banks and government

It is the view of the NFX (*Netherlands Financial Sector Development Exchange*, a platform comprising various ministries and banks in The Netherlands[3]) that the battle against poverty needs primarily to be driven by the private sector, wherein the banks play an important role. In this view vulnerable groups in developing countries will have great difficulty to come out of their poverty situations if they are not reached by banks. Savings are seen as important and sustainable assets that need to be mobilised locally to support entrepreneurial activities.

The NFX maintains that, though microcredit has done much to provide access to credit to poor sections of the population, solutions need also to be sought by encouraging commercial banks in developing countries to serve the lower side of the market, meaning middle and small enterprises. These local commercial banks must increase their capacity to identify the market potential of new clients, develop tailor-made financial products and thereby learn to manage risks. Very often, they lack the necessary expertise to reach out, for example, to the rural markets. The Dutch banks and the Dutch government see it as their responsibility to support the counterpart banking community in developing countries to overcome these barriers.
The views of the Ministry of Foreign Affairs (Development Cooperation) seem to depart from a Dutch perspective in terms of what the different organisations in The Netherlands have to offer to the microfinance sector, irrespective of the contextual situations in which the poor clients find themselves. The Ministry embraces the views expressed in the *CGAP (Consultative Group to Assist the Poor) Peer Review* in May 2003 that CFOs working with public funds should basically be working with grants and technical assistance and not with the financial instruments of loans, guarantees and share capital. In the speech by Agnes van Ardenne, Minister for Development Cooperation[4], the following was commented with regard to the role of the different players, viz. the Co-Financing Organisations, the social investors (like *Oikocredit and Triodos*, which typically use private funds and sometimes share risks with some CFOs) and the commercial banks (which use deposits as a basis for investments):

"When considering the different kinds of assistance that microfinance institutions need, I believe it makes sense to establish a clear division of labour between the different players. For example, one would expect CFOs to focus on microfinance start-ups until they attain operational self-sufficiency. Beyond this stage, social investors should become the main partners, while commercial banks can take over once microfinance institutions are completely financially viable. Such a transparent division of labour would mean that the typical relationship between a CFO and a start-up would have a clear-cut beginning but also a well-defined end. Not only would this result in more start-ups getting access to funding, but it would also create specialised expertise for microfinance institutions in their different stages".

There is certainly some clarity and further nuances in this speech regarding the role of the CFOs and implicit in the position on the division of labour is the recognition that CFOs work with start-ups till they reach the stage when they are financially viable. While this clarity needs to be appreciated, it needs to be noted that the Ministry still holds on to a linear view of transformation, in which the ultimate aim of the development and growth process of MFIs is seen to be integration into the formal financial sector.

[3] Members of the platform are the Ministry of Economic Affairs, the Ministry of Foreign Affairs, ABN-AMRO Bank, Rabobank, Fortis Bank, ING Bank, Triodos Bank and the Development Bank FMO
[4] Delivered by Rob de Vos, Director-General for Development Cooperation on behalf of Minister Agnes van Ardenne, Minister for Development Cooperation, at the Cordaid Congress, International Year of Microcredit 2005: "Investing in the Poor" on 10 June 2005.

5.2 Rethinking the discourse

Although Cordaid recognises and strongly endorses the need for private capital to support further growth of the microfinance sector, it makes a strong plea to rethink the current position held by banks and government that want to see MFIs on a linear road of integration into the formal sector, commercial banks in developing countries as the suppliers of loans, and CFOs solely as facilitators of the integration of microfinance institutions into the financial system. This discourse needs more thought and must be spelled out more accurately in terms of its contents.

MFIs do not seek to be integrated into the formal sector as is at the moment being perceived by commercial banks wanting to do business in microfinance or by prestigious entities like CGAP. The integration objective fails to see the role that bigger and consolidated MFIs can and do offer to start-ups and MFIs in lower grades of transformation that do not have the opportunities to grow to the higher stages of transformation. The integration objective also misses out on the special nature of the MFIs and their value systems, and fails to understand their functioning and the types of supports they need.

Microfinance institutions have been established primarily with the purpose to assist the poor to get out of their poverty situations and, as such, they see themselves as developmental instruments in the fight against poverty. MFIs do realise that practising microfinance is a separate ball game from that of developmental organisations. They are run not on the basis of philanthropy but on the logic of financial sustainability. Yet, while all efforts are made to function as responsible microfinance institutions with the accent on the financial, it is a serious issue to remain true to their original mission to work primarily for the poor, including the lower segments or the ultra poor. From this perspective, MFIs are special creatures of their

Nairobi, Kenya - Overview of a local market in Eastland, the working area for many micro entrepreneurs. Some of them were able to start their small business with the help of MPL, a micro finance institution.

own kind and not "baby banks" that will some day have to be integrated into the formal financial sector. Their major concern on their road to professionalism and sustainability is to maintain a healthy balance between the two tension poles emanating from their mission: their developmental roots and their exigency of working with the economic logic. This essential notion is crucial to Cordaid's discourse on microfinance.

As stated above, it is the ambition of the commercial banks to serve the lower side of the market, being the middle and small enterprises. It is crystal clear, however, that this part of the market in general does not coincide with the lower segments of the poor. Besides, whatever their ambitions may be, except for some special sections of banks, so far the commercial banks have not done much to support the microfinance sector by on-lending, because of lack of collateral, lack of assets and loan portfolios that consist of thousands of small, uninsured loans.
The (presumed) high risks, costs and investments, in combination with a lack of incentives, small profits and high transaction costs deter banks from investing on a broad scale in MFIs.

Microfinance institutions see collaboration with the formal financial sector as healthy and necessary provided they have their own legitimate space while interfacing with the banks and have some in-built guarantees that a meaningful proportion of their investments will be allocated to the very poor. MFIs need to work with simple and flexible financial instruments, procedures and systems since they work with the poor. They need different types of supports and financial resources at different stages of their growth and development. Investors need to understand that the risks they need to take together with the MFIs are based on the collateral of trust and confidence which is a collateral that many banks and other investors fail to understand.

In the short run therefore, the system will predominantly be financed by public funds and social investors. For them the development value is most important, and it balances the small profits or even small losses incurred.
Special measures, such as tax advantages and a system of certification of young MFIs on the right track can help to encourage private investors in the developed countries to divert more capital to the microfinance sector. Yet in the long run development organisations and social investors are not able to meet the needs of MFIs in terms of capital. Eventually banks will also have to come with their investments to meet these needs.

Yet, although banks are showing an increasing urge to be active in the microfinance sector, the MFIs present in the seminar indicated that it was not in their interest to live by the prevailing conditions. If commercial banks really want to support MFIs, they must start re-thinking the relationship from a southern perspective. MFIs do see the need for private capital from the private sector, but on their own terms. They do not strive to become part of the formal financial establishment and they struggle to live by the existing rules and regulations, which are not so conducive to the fulfilment of their mission. Instead of adapting to the legal restrictions imposed on them by governments, banks and central banks, MFIs call to restructure the prevailing legal environment, by recognizing for instance the value of social collateral and allowing mobilization of savings by MFIs for on-lending.

Jakarta, Indonesia - Woman preparing an order of wide range home made food items. She has prefinanced her productive activities with a loan provided by Bina Swadaya.

Being the second largest investor in the Netherlands in microfinance institutions, Cordaid is well aware of its responsibility for the further development of the sector and for the position of the microfinance sector within the Dutch development policy. It sees the support to microfinance as an integral part of its approach to poverty reduction and is benefiting from its ability to respond in an integrated way to requests of partners with grants and technical assistance as well as guarantees, loans and equity participation.

Cordaid subscribes to the fact that it has a specific role within the framework of the *Dutch Microfinance Offer*. This role is seen as supporting a mix of mature and emerging MFIs, especially new initiatives. This view of its role is based on its wide experience in strengthening organisations and capacity building, and on its ability to use the wide range of instruments that are at its disposal. As growth processes are country, region and case specific, this ability gives Cordaid a unique position to offer integrated, tailor-made support to MFIs, the kind of support that is needed given the various circumstances and the complexity of the issues they are dealing with.

Cordaid made a strong plea at the Cordaid Congress on the occasion of the International Year of Microcredit 2005 for social investors and banks to come in and assist with their investments and expertise in supporting microfinance institutions as partners that are willing to take on higher risks, provide funding at reasonable rates, look to ways and means to provide funding in local currencies, play a tactical role in explicitly leveraging private domestic capital, function as an important bridge to commercial capital and support the development of innovative financial products aimed at reaching out to the lower segments of the poor.

Cordaid has also actively promoted corporate social responsibility by seeking cooperation with a number of banks. Through the *Red de Microfinanzas de Perú*, Cordaid facilitates the linking of the rural banks in Peru with the aim of creating a second tier rural banking institution run and managed by the autonomous *Cajas Rurales*. Cordaid also works closely with the *Rabobank Development Foundation* and the *Rabobank Leiden-Oegstgeest*. In the Philippines, Cordaid has initiated a working relationship with the Bank of the Philippine Islands. Further, Cordaid has built friendly and business relations with the Deutsche Bank in New York to work together on start-up MFIs in Africa.

Although being critical of some of the findings of the CGAP Peer Review, Cordaid subscribes to the words in the Joint Memorandum that was published following a High Level Meeting entitled “Leveraging our Comparative Advantage to Improve Aid Effectiveness” that was held in Paris in February 2004:

> “We recognize that microfinance contributes to achieving the MDGs, in particular the overarching aim of halving extreme poverty and hunger by 2015. But addressing market failures that prevent poor people from accessing the financial services they need is a massive and daunting task. Microfinance is a very dynamic field that has moved from ‘microcredit’ to ‘microfinance’ to ‘building financial systems for the poor’. This changing landscape makes microfinance a particularly challenging area for the development community. It means that we must engage with a diversity of players, from central banks to self-help groups, from commercial banks to community savings and loans cooperatives to auditors and credit rating firms, recognizing that there is great scope for a diversity of approaches. When possible, we should support the national plans of governments to develop the overall financial sector. Each of us should contribute in a way that leverages our respective strengths and promotes mutual learning. At the very least, we should avoid actions that distort local financial markets”.

One might add that an unquestioning emphasis on a linear growth model, and putting one’s eggs only in the basket of commercial banks reaching down to the microfinance sector, could not only at times distort local markets but

Mindanao, the Philippines - Woman receiving a first disbursement for her sweet banana growing activities in the Davao highlands.

also hinder the open access to the poorest populations. This line of thinking fails to take into account the basic mission of MFIs, and is more likely to take them away from the poor, than to help them reach their goals. This is the very reason why the various microfinance platforms that have sprung up in several developing countries are pleading for a special regulatory space within the financial sector, allowing MFIs to adapt not to the exigencies of the system but to the limited possibilities of their clients. Supporting MFIs, therefore, is not about integration in the existing formal financial sector but about re-thinking existing limiting structures, opening up new possibilities of mobilizing funds, and creating legal environments that are friendly to the special creatures that MFIs are and thereby to the needs for financial services of the poor.

List of abbreviations

ABN-AMRO	Commercial bank in The Netherlands
ADOPEM	Asociación Dominicana para el Desarrollo de la Mujer
AMFIU	Association of Microfinance Institutions of Uganda
ASA	Association for Social Advancement
BRAC	Bangladesh Rural Advancement Committee
CARD	Center for Agriculture and Rural Development
CFO	Co-Financing Organisation
CGAP	Consultative Group to Assist the Poor
CIPCA	Centro de Investigación y Promoción del Campesinado
COPEME	Consorcio de Organizaciones Privadas de Promoción al Desarrollo de la Pequeña y Microempresa
DEC	Development Education Centre
FDL	Fondo de Desarrollo Local
FIE	Centro de Fomento a Iniciativas Economicas
FMO	Netherlands Development Finance Company
FONDECO	Fondo de Desarrollo Comunal
G8	Group of eight, a group of eight leading industrial nations
HR	Human resources
ING	Commercial bank in The Netherlands
KWFT	Kenya Women's Finance Trust
MBA	Mutual Benefit Association
MFI	Microfinance Institution
MIS	Management Information System
MPL	Microfinance Partners Ltd.
MRI	Mutually Reinforcing Institution
NABARD	National Bank for Agriculture and Rural Development
NFX	Netherlands Financial Sector Development Exchange
NGO	Non-governmental organisation
PRIDE	Promotion of Rural Initiatives and Development Enterprises
SHG	Self-help group
TA	Technical Assistance
USD	United States Dollar
WADEP	Women and Development Project
WVI	World Vision International

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Cordaid

Cordaid is one of the leading development organisations in the Netherlands with an annual budget of around 150 million euros, of which non-grants financing amounts to around 15 million euros a year.

Cordaid is committed to serving the poor and those that are deprived of their rights from a perspective of economic and social justice.
We support the poor and their organisations, regardless of age, sex, race, religion or political conviction.
Cordaid strongly believes that everyone has the right to a decent human life free from the shackles of poverty.

Cordaid is a non-governmental organisation with a Catholic tradition. Our inspiration is based on Catholic Social Teaching. For Cordaid, every single person counts. Cordaid's vision on development cooperation envisages building on the poor people's own strength to improve their livelihoods. Non-grant financing is an integral part of Cordaid's approach and strategy to development financing.

Cordaid Finance Business Unit

Cordaid Finance Business Unit is a specialised unit that offers financial services to the vulnerable poor engaged in economic activities in developing countries.
Finance Business Unit started in 2000 from a perspective that non-grants financing is a powerful tool in the support of programmes in developing countries that improve the economic livelihoods and perspectives of the poor.

Finance Business Unit has approved a total of 60 million euros in loans and guarantees in some 25 countries over the period 2000 - 2004. This portfolio is to a large extent financed from the "co-finance development programme" of the Government of the Netherlands.

Finance Business Unit is active in the following areas:
• emerging microfinance institutions
• trade finance
• cooperation with private companies
• innovative approaches

Cordaid
Visiting address:
Lutherse Burgwal 10
2512 CB The Hague
The Netherlands

Postal address:
PO box 16440
2500 BK The Hague
The Netherlands

t + 31 70 3136 300
f + 31 70 3136 301

cordaid@cordaid.nl
www.cordaid.com
www.cordaid.nl