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Microfinance Strategies: Strategies for developing viable microfinance institutions and sustainable microfinancial services in Asia

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University of Cologne
Development Research Center

Working Paper No. 1996-2

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MICROFINANCE STRATEGIES:
Strategies for developing viable microfinance institutions and sustainable microfinancial services in Asia

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Abstract[*]

In most Asian countries including Vietnam, **inadequate access** of small farmers and microentepreneurs including women and the poor to effective financial services presents a major challenge. Such services must include facilities to deposit microsavings, access to microcredit for production, consumption and emergencies, and the provision of some basic insurance. Only **viable financial institutions with sound practices** will be able to respond to the evergrowing demand of the microeconomy for such services and to contribute to its growth.

There are three principal approaches to the **development of the system of microfinance:**
- a regulatory reform approach to improve the policy environment of microfinance;
- an institutional transformation approach to improve the financial infrastructure and the microeconomy's access to it; and
- a sound practices approach to improve the effectiveness of microfinancial services.

(**1) Regulatory reform** comprises:
- interest rate deregulation,
- a revised banking law to facilitate the establishment of local financial institutions, and
- effective supervision over local institutions by an appropriate regulatory authority.

(2) Institutional transformation pertains to competing formal and nonformal institutions. There are four major strategies:

(2.1) Adapting banks to the needs of the microeconomy,
- which is of particular relevancy to institutions like VBA. This strategy comprises changes in:
- the delivery system, bringing the bank to the people;
- the bank's corporate culture, making it customer-oriented;
- its business and product policy towards profitable, savings- and demand-driven banking;
- bank procedures, which must be convenient and effective;
- terms and conditions, to be differentiated according to transaction costs and loan sizes, maturities and instalments adjusted to the capacities of types of customers;
- risk management, to prevent arrears through appropriate loan terms, reliance on track record, proper collateral substitutes and repayment incentives;
- the training system to foster skills and behaviors geared at microfinance and the microeconomy; and
- the organizational structure, which may encompass the transformation of bank operations into autonomous small institutions owned by the local people.

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(2.2) Upgrading nonformal financial institutions,

- including self-help groups, governmental and nongovernmental development organizations,
- by improving their financial practices or
- by assisting them in acquiring legal status up to the level of a local bank.

(2.3) Linking formal and nonformal financial institutions,

- respecting the autonomy of participating banks, self-help groups and development organizations as business partners, and promoting a variety of viable schemes of cooperation with appropriate flexible terms.

(2.4) Establishing new microfinance institutions,

- provided the existing ones cannot be transformed through the institutional adaptation, upgrading or linkage strategies. They must be demand- and savings-driven and cover their costs from the margin. They may be initated by banks, governmental or nongovernmental development organizations. They may start with any appropriate legal form, be it informal or semiformal, and might eventually be upgraded to the status of a local bank.

(3) Sound practices are crucial to the sustainability of microfinancial services. They may comprise:

- the mobilization of internal resources for institutional self-reliance through savings collecton, higher interest rates on loans, share capital, profits and insurance premiums;
- the promotion of microsavings as a source of microenterprise self-financing, including voluntary withdrawable savings, time deposits, compulsory savings, lottery savings, and daily savings collection at doorsteps;
- appropriate microcredit products with small loan sizes growing according to repayment performance and absorptive capacity, mostly short maturities and instalments according to customer capacity, insistence on timely repayment, and market rates of interest covering the costs of each product;
- microinsurance products contributing to loan security, such as life and health insurance;
- product reciprocity, tying credit to savings and insurance to enhance financial discipline and bankability;
- collection reciprocity as a means of arrears prevention, combining savings and loan installment collection or financial and commodity transactions;
- customer-oriented microfinance procedures and services set by financial institutions rather than government, including sound financial management, convenient collection and deposit facilities, appropriate loan processing, adequate risk management, timely repayment collection, monitoring and effective information gathering;
- terms and conditions which benefit from the experience of formal and nonformal institutions and satisfy both the institutions' and the customers' interests.

1. Introduction

The quest for equitable growth and development in Asia:

In most Asian countries, access to financial services has been a matter of growing concern to large numbers of people. Many governments have responded positively to this concern by embarking on financial system reform. They have attempted to match the demand of the people for adequate financial services with the government's responsibility for financial stability and economic growth.

In this endeavor, they have begun to deregulate the interest rate regime, to adjust the legal environment including the banking law, to transform financial institutions into effective intermediaries between savers and investors, to provide opportunities to local people to establish and own their own financial institutions, and to encourage sound banking practices.

Many bridges have been built in the process: over the gap between financial institutions and clients, the gap between formal and nonformal finance, the gap between government and people, the gap between savings and credit. By building these bridges and gradually increasing the outreach of their banking system, some developing countries have substantially alleviated poverty.

It is now being recognized that only a harmonious balance between the interests of governments, financial institutions and the people including the poor will guarantee stability and lead to equitable growth. At the same time it is being realized in many Asian countries including Vietnam that special care must be taken not to leave out the poorer sections of the population from economic and financial development; for they account for up to 80 percent of the population and represent each country's greatest resource for development. It is this part of the population which has not been adequately served by conventional banks with conventional savings and credit products. APRACA has therefore proposed to its member institutions to evaluate their experience and prepare for innovations in a field that is presently being brought under a new heading: microfinance.

Objective of the paper:

The core issue to be addressed in this workshop is how best to develop the financial system in Vietnam in the interest of all segments of the population including the poorer sections, pertaining to the policy environment, the institutional infrastructure and sound financial practices. Workshop participants will work out strategies of sustainable financial development which are most appropriate to the social and economic requirements of the country and its people. Based on the Asian experience, this paper is to provide a general overview over the various strategies that can be applied to make a full range of financial services accessible to all segments of the population, particularly its poorer sections in the rural areas.

2. The role of microfinance in development

Microfinance:

Microfinance is that part of the financial system which provides financial services to the microeconomy.

Microfinancial services:

Such financial services encompass at least savings, credit and insurance, or more concretely:
- facilities to deposit microsavings,
- access to microcredit for production, consumption and emergencies, and
- the provision of some basic insurance[1].

A sole emphasis on *credit only* is almost always mistaken!

Target population:

The microeconomy comprises small farmers and microentrepreneurs, including women and the poor, which may account for as much as 80 % of the populace.

Core challenge:

In most developing countries, inadequate access of people in the microeconomy to sustainable financial services is a core problem and major challenge.

Goal of intervention in the financial sector:

To solve this problem on a national basis and in the long run and improve access to finance, a country needs viable financial institutions with effective microfinancial services. Any intervention must thus be geared to the viability of financial institutions and the sustainability of their services to the microeconomy.[2]

Development goal:

This in turn will then benefit the small farmers and microentrepreneurs, contributing to their employment, production and income. It has been recognized that creating access to viable financial institutions is the most efficient way (efficient in terms of costs incurred and impact achieved) of making the microeconomy grow.

The harmonious balance prerequisite:

Effective interventions must thus strike a balance between the supply side and the demand side of finance. On the one hand, they must improve the effectiveness of financial institutions and their supply of financial services to the microeconomy. On the other hand, such services must be appropriate to the actual demand of small farmers and microentrepreneurs

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1 Particularly life and health insurance and, in the rural economy, perhaps cattle insurance, but, for economic reasons, rarely crop insurance.

2 Institutions are viable if they cover their costs from the margin and make a profit. Their services are sustainable if they mobilize their own resources and utilize them profitably.

and the requirements of their microenterprise activities. Only those interventions will be successful in the long run which satisfy both requirements.

3. Strategic approaches to the development of the system of microfinance

Strategic approaches:

There are three principal approaches for enhancing the effectiveness of the financial system and its services to the microeconomy:

(1) **a regulatory reform approach:**
to improve the policy environment in which financial institutions with microfinancial services operate;

(2) **an institutional transformation approach:**
to improve the financial infrastructure and the microeconomy's access to it;

(3) **a sound practices (or: *best practices*) approach:**
to improve the effectiveness of financial institutions with microfinancial services.

While they are interrelated within an overall financial systems context, each approach can be chosen as a separate entry point of development interventions. Even in a repressive regulatory environment, sound practices such as appropriate loan sizes and instalment periods or positive incentives to repay on time can be feasible. However, the ultimate effectiveness of interventions focussing on institutional transformation and sound banking practices will greatly vary depending on the appropriateness of the policy environment.

4. The regulatory reform approach: strategies for creating an appropriate policy framework

Regulatory strategies:

Microfinance is part of a country's wider financial system. Three reform measures are of crucial importance to the development of viable institutions with sustainable microfinancial services:

(1) **the deregulation of interest rates on deposits and loans:**
permitting each institution to adjust its interest rate structure to its costs, particularly the costs of serving marginal clients in remote areas, of collecting microsavings and microinstallments, and of doorstep services

(2) a revision of the banking law:
facilitating the establishment of a wide branch network of banks and permitting local people to establish their own small financial institutions with moderate capital requirements.

In addition, the legal system should provide for alienable private land use rights or land ownership titles as a basis of collateral and for the efficient processing of claims arising from bad debts.

(3) the provision of effective bank supervision:
providing guidance and supervision to institutions with microfinancial services in the interest of both the banks and their clients. In the case of a multitude of small local microfinance institutions, such supervision my be provided by a separate second-tier regulatory authority.

5. The institutional transformation approach: Strategies for developing vible microfinance institutions

The financial infrastructure:
In many countries there is a variety of financial institutions of national and local outreach, each with its own comparative advantages for microfinancial services at the local level:
- formal institutions which fall under the banking law, including agricultural banks, development banks, commercial banks, private shareholding banks and sometimes village banks;
- semiformal institutions authorized by some government agency, including savings and credit cooperatives, NGOs and various projects and programs; and
- informal institutions beyond the purview of government agencies, including rotating and nonrotating savings and credit associations, community-owned fund-raising and credit arrangements and other types of self-help groups.

Institutional transformation strategies:
Depending on the existence and vigor of such institutions in a given area, four major institutional transformation strategies have emerged that offer strategic entry points for the development of microfinance:

(1) Adapting formal financial institutions to the needs of the microeconomy
(2) Upgrading nonformal (comprising semiformal and informal) financial institutions
(3) Linking formal and nonformal financial institutions
(4) Establishing new local financial institutions with microfinancial services.

Interest rate fexibility as a policy prerequisite:
The prime prerequisite and at the same time crucial policy incentive for institutional

transformation is an interest rate regime which allows for market oriented interest rates. Banks must be permitted to offer attractive and differentiated interest rates to savers and to charge interest rates on loans which cover their fixed and variable costs, and include an adequate profit margin. If banks are to serve customers which differ widely in terms of service costs and risks, the only viable inducement for them is an adequate margin, lest they exclude the small farmers, microentrepreneurs and people in remote areas.

In the absence of this prime prerequisite banks may pursue one of the following three courses: they may request an exemption from the central bank; they may externalize part of their costs by working through intermediaries with separate funding (e.g. NGOs); or they mey set up a non-bank organization with a separate legal personality (e.g., a limited liability company) which does not fall under the interest rate regulations of the banking law. However, these approaches should only be transitory; they are no long-term substitute for interest rate deregulation.

5.1 Formal finance and the institutional adaptation strategy

Relevancy for institutons like VBA:

Existing agricultural, development and commercial banks frequently have a potential for adjustment to the financial requirements of the microeconomy. Tapping this vast potential is a major challenge for institutions like the Vietnam Bank for Agriculture.

Areas of adaptation:

Institutional adaptation of banks to the microfinance market concerns the following areas: (1) their delivery system; (2) their corporate culture; (3) their internal business and product policy; (4) bank procedures; (5) terms and conditions; (6) risk management; and (7) the manpower and training system.

(1) Delivery system:

Adapting the delivery system of a bank may comprise four major avenues towards microfinance, all geared at one tenet, ***bringing the bank to the people:***

■ extending the branch and sub-branch network;
■ the establishment of part-time offices in villages, markets or small industry sites;
■ mobile services through cars, motorcycles, bicycles, or on foot;
■ full-time or part-time agents providing doorstep or other decentralized services.

(2) Corporate culture:

Adapting the corporate culture at the local level requires:

■ an adjustment of the bank's material culture (such as the appearance of the bank building and its offices, types of vehicles, facilities such as air-conditioning);
■ social culture (such as social background, dress code, language and behavior of staff as well as quality of staff-customer relations); and

■ the bank's value orientation system (comprising values such as honesty and reliability, diligence and hard work, innovativeness, being of service to the customer, making the bank grow).
This customer-oriented corporate culture must be internalized through staff training and propagated as the bank's image through public relations.

(3) Business and product policy:
Adapting the banks' business and product policy requires a reorientation towards savings- and demand-driven sound banking. This comprises in particular:
■ an orientation of a bank towards cost coverage and institutional viability,
■ market and customer-oriented banking and
■ self-reliance through mobilization of its own funds of which **savings** are the most important source in the field of microfinance.

This reorientation is to be operationalized through:
■ appropriate savings and credit products; and
■ reciprocal savings-cum-credit schemes,
which are all designed to bring the mutual business interests of the banks and their customers into balance.

(4) Bank procedures:
Adapting procedures requires:
■ a simplification of forms and procedures,
■ convenient facilities and banking hours,
■ customer-oriented services of high quality and reliability, including
  ■ timely delivery and collection services,
  ■ doorstep services,
  ■ daily savings collection,
■ creditworthiness examination and collateral requirements adjusted to the needs of small customers.

(5) Terms and conditions:
Adapting terms and conditions to the requirements of microentrepreneurs and informal sector households comprises:
■ a differentiation of terms according to area or customer groups with different risk and cost structures;
■ a differentiation of terms according to the length and quality of the business relationship, including a difference in terms between initial and subsequent repeat loans;
■ an emphasis on small sizes of savings, loans and installments;
■ variable but short maturities;
■ frequent instalments;
■ no or short grace-periods.

(6) Risk management:

Adapting risk management comprises a comprehensive strategy for arrears prevention, including:

■ appropriate loan terms,

■ reliance on a borrower's track record based on savings and previous loan repayment behavior,

■ appropriate forms of collateral, if any, including nonformal collateral substitutes,

■ personal guarantees, and

■ various forms of joint liability, possibly in cooperation with self-help groups including joint liability groups formed by customers.

(7) Manpower development and training system:

Adapting the manpower and training system requires:

■ a selection of staff with particular language and social skills, which may be more important than formal certification, and

■ inclusion of customer-oriented social behavior, microloan appraisal and arrears prevention in the training curriculum.

This may further include:

■ exposure training programs for bank executives and management in other banks, perhaps in neighboring countries, which can serve as examples of successful adaptation.

(8) Transformation into separate local institutions:

Development banks or national agricultural bank activities which are plagued by a lack of dynamism, high costs and low repayment rates can be salvaged through privatization of their small farmer and microenterprise lending operations, e.g.:

■ as member-owned local banks or semiformal financial institutions;

■ as community-owned local banks or semiformal financial institutions;

■ as private shareholding banks.

Experience shows that this can greatly enhance local resource mobilization, repayment behavior, institutional viability, volume and quality of services, outreach, and people's participation.

Limitations:

Formal financial institutions serve but a fraction of the population which typically lies within the upper quartile of the social hierarchy. Through adaptation to the microfinance market requirements, they may gradually expand into the second-highest quartile and into segments of the lower quartiles. Within the foreseeable future they will normally not be able to fully serve that market. To reach the whole market, the institutional adaptation strategy for formal financial institutions must be complemented by an *upgrading* strategy for nonformal financial institutions. The former is a top down approach, the latter bottom up.

5.2. Nonformal finance and the institutional upgrading strategy

Approaches with or without legal status:

Nonformal finance mostly rests on local institutions which are directly accessible to all segments of the population. There are two principal approaches: (1) organizational development without the adoption of legal status; (2) transition of an institution to a higher-order legal form, such as a credit cooperative or bank.

These two approaches may be directed at enhancing the capacity of (1) grassroots financial institutions including self-help groups and *people's organizations;* (2) self-help promoting institutions like NGDOs, non-governmental development organizations; or GDOs, governmental development organizations.

(1) Self-help groups (SHGs):

SHGs are member-owned and member-controlled local institutions. They may either be financial groups, with financial intermediation as their primary purpose, such as savings and credit assocations; or nonfinancial groups, with financial intermediation as a secondary purpose, such as vendors' associations, craft guilds, family planning groups and numerous other types of voluntary associations.

Functions of SHGs:

Functions that may be enhanced through development assistance may include:

- providing guidance to members
- collecting savings from members
- building up an internal loan fund
- loan appraisal and creditworthiness examination
- financial consultancy services to members
- arranging for nonformal collateral or guarantees including joint liability
- granting loans to members
- size and term transformation
- collecting installments
- applying social control mechanisms to enforce repayment
- granting emergency loans
- granting nonfinancial emergency assistance
- providing insurance services
- communication and exchange of experience
- providing linkages with banks, NGOs or donors
- supporting the loan applications of individual members to banks through recommendations.

Weaknesses:

While the activities of SHGs are usually well-adapted to local conditions, they frequently lack technical skills, networking capacities and access to sources of refinance.

The feasibility of bank status for SHGs:
The possibility and appropriateness of acquiring bank status by SHGs depends on the legal framework and on their financial and organizational maturity. In countries with an appropriate legal framework financial SHGs may be assisted in establishing a bank owned and controlled by members. In countries without such a framework, SHGs may be assisted in establishing a non-bank institution until the law is changed. In cases where an SHG cannot immediately fulfil the conditions of the banking law, acquisition of a non-bank legal status, e.g. under cooperative law, association law, etc., may provide an interim solution which permits a SHG to undergo a process of upgrading until it is mature enough for bank status. In countries with effective savings and credit cooperatives, the feasibility of converting them into cooperative banks must be carefully examined. In countries where cooperatives have failed to mature into viable financial institutions (e.g., as a result of credit conduiting on behalf of the government), rehabilitation with the objective of transforming them into viable institutions under the supervision of the central bank may provide a feasible alternative. This would in turn require massive technical assistance.

(2) Governmental and non-governmental development organizations:
GDOs and NGDOs may be established and supported by government or humanitarian organizations, relying on donor support and working for the benefit of others such as self-help groups and microentrepreneurs or small farmers. Or they may be apex or umbrella organizations of financial self-help groups, business associations and the like working for the benefit of their own members. The latter are, or may be, member-owned and member-directed, the former are not. Examples of the latter are regional and national federations of credit cooperatives, craft unions or market vendors associations. While their start-up phase may be donor-supported, they are to be financially self-reliant in the long run, drawing on their own resources or those of their members.

Functions of development organizations as financial intermediaries:
GDOs and NGDOs acting directly as financial intermediaries or working through financial self-help groups may have two basic functions: (i) guidance, training and consultancy in financial and nonfinancial matters; (ii) acting as a financial intermediary between microentrepreneurs or their self-help groups and donors or banks.

The activities of GDOs and NGDOs as financial intermediaries may include any of the following:

- financial extension services
- bookkeeping training
- financial management training
- proof innovative savings schemes, e.g. daily or doorstep savings collection in the informal sector, withdrawable voluntary savings as well as time deposits in self-help groups (SHGs), etc.
- mediating contacts with a bank or donor

- collecting and safekeeping savings
- depositing savings of microentrepreneurs of SHGs in a bank
- examining the creditworthiness of microentrepreneurs or SHGs
- negotiating bank loans for microentrepreneurs or SHGs
- onlending to microentrepreneurs or SHGs
- collecting installments from microentrepreneurs or SHGs
- bearing the credit risk
- repaying bank loans

Functions of development organizations as nonfinancial intermediaries:
GDOs and NGDOs not acting as financial intermediaries may still carry out several of these functions, except concluding loan contracts and bearing the credit risk. For NGDOs acting directly or indirectly as financial intermediaries it is mandatory to possess an adequate accounting system, financial management skills and financial reserves to absorb arrears and bear the risk. For DOs which strengthen financial capacities of microentrepreneurs or SHGs it is mandatory to possess adequate training and consultancy capacities. This in turn requires major institutional enhancement inputs from donors, as most DOs lack the required skills and capacities.

Bank status for development organizations acting as financial intermediaries:
DOs acting as financial intermediaries are very strongly encouraged to opt for banking status or otherwise formalize their financial operations. In actual fact, they may:
(1) contribute to the bankability of their target group (individuals or SHGs) and turn their financial operations over to suitable banks;
(2) establish their own bank operating along sound banking principles;
(3) establish a bank jointly with the SHGs or microentrepreneurs under their guidance. In the latter case the DO may either consider its engagement in banking permanent or transitory, with the intention of eventually turning ownership and management over to the SHGs or microentrepreneurs.

Upgrading assistance:
The upgrading of nonformal financial institutions or operations of DOs and SHGs into member-based banks of microentrepreneurs, small farmers, women and the poor, which operate along sound banking criteria, may be a major field of financial or technical assistance. The operational details of SHG upgrading are presented in a manual of training modules.

5.3. Formal and Nonformal Finance and the Linkage Strategy

Reducing transaction costs through linkages:
Departing from the transaction cost problem the linkage strategy focusses on self-help groups as grassroots financial intermediaries between banks and the vast numbers of

microentrepreneurs and small farmers to cut down on transaction costs for both banks and customers. The linkage strategy usually encompasses measures of upgrading nonformal financial institutions and the institutional adaptation of banks as well as the adoption of sound practices.

Guiding principles:

The following guiding principles have emerged:

- Working through existing formal and nonformal institutions
- Respecting the autonomy of participating institutions
- Promoting savings mobilization
- Promoting credit delivery at market rates
- Linking savings and credit
- Repeat loans growing in size with each successful repayment cycle
- Substituting group liability or nonformal collateral for conventional collateral
- Ensuring institutional viability
- Covering the risk from the margin
- Promoting sound banking practices ("best practices")

Participative process resulting invariable schemes:

The linkage strategy is designed to participatively initiate linkage processes, rather than prescribe specific models. Any specific schemes are to be the outcome of participative processes among the respective participants. Each bank, GO and self-help group is free to negotiate their own scheme with its business partners. This may result in a multitude of schemes in a given country.

The evolution of linkage schemes:

Institutional linkages between banks and SHGs may proceed in an evolutionary sequence of three steps: from indirect linkages to direct linkages and ultimately to direct access of microentrepreneurs to banking services. Between these stages, there may be intermediate steps, with NGOs or SHGs, respectively, in a consultative role.

World Bank assessment:

In the 1989 World Development Report linkage banking was recommended as a promising strategy of financial system development: *Informal financial institutions have proved able to serve the household, agricultural, and microenterprise sectors on a sustained basis. Measures that link informal institutions to the formal financial system will improve that service and ensure a competitive environment* (p. iv; cf. p. 119). Through APRACA, the approach is now spreading to many countries in Asia and, through AFRACA, in Africa.

5.4. The strategy of establishing new institutions

Infrastructural innovation as a residual strategy:

Infrastructural innovation, i.e. the establishment of new local financial institutions, can be an appropriate approach where no suitable institutions exist or existing institutions cannot be upgraded or adjusted to local requirements. If approaches of adaptation, upgrading or linkage banking are found inadequate in coping with local demands, infrastructural innovation can also serve as a complementary or competitive strategy and contribute to institutional differentiation.

Requirements:

There are three basic requirements for viable and sustainable institutional innovations in microfinance on a competitive market:

- they must be demand-driven, i.e. respond to felt needs and articulated demands for financial services by microentrepreneurs, small farmers, women and the poor;
- they must be savings-driven, both in the interest of institutions and their customers as savers;
- they must cover their costs from the margin.

There are three types of institutions which are likely to meet these requirements: (1) community-based financial institutions which are owned and controlled by a local community; (2) member-based financial institutions which are cooperatively owned and controlled by their members; and (3) privately financial institutions, such as local shareholding banks. Mixed ownership is also possible.

Initiatives:

Depending on national and local circumstances new institutions may be established in the formal, semiformal or informal financial sectors. New formal financial institutions may be initiated by the central bank or by major national, regional or provincial banks, including development banks and banks with a rural mandate, as facilitators or intermediaries. They may be seconded by well-prepared NGOs in their capacity as training and consultancy agencies. New semiformal financial institutions which include cooperatives and GO and NGO-supported financial programs, may be established through cooperative or NGO networks and apex organizations which need to be adequately qualified for that task. Group-based informal financial institutions may be set up in cooperation with NGOs and cooperatives, usually through their respective networks and apexes, which in turn have to provide adequate training and facilities to their member institutions. Under favorable conditions government institutions may also succeed in establishing financial self-help groups. Private financial institutions may be set up by any number of private local people with variable share capital contributions; among their co-owners may also be self-help groups.

Phasing:

In any of these cases, infrastructural innovation should be planned and implemented with a view towards the other three institutional strategies as complementary or successive strategies:
(1) In countries with an inappropriate policy environment and deplete of adaptable institutions intervention may start with infrastructural innovations at the informal or semiformal level;
(2) to be followed in another phase by upgrading within the nonformal framework;
(3) next by infrastructural upgrading of the most successful institutions to semiformal institutions or banks;
(4) then by linkages between nonformal and formal institutions;
(5) and eventually by a transition to formal institutions.

6. The sound practices[3] strategy: Strategies for providing sustainable microfinancial services

Scope and applicability:

The sustainability of microfinancial services hinges on two factors: (1) the mobilization of internal resources and (2) the soundness of financial practices.

To some extent, sound practices can be applied in any policy environment and by any type of financial institution, be it formal or nonformal. A successful institutional adjustment strategy must encompass a sound practices strategy. This comprises improved or new financial products, good procedures and effective contractual terms and conditions. Certain, but not all sound practices such as cost coverage from the margin, will depend on the policy environment; but in government-approved niches or in the nonformal sector virtually *any* practice can be implemented regardless of the regulatory environment.

Internal resource mobilization:

Own internal resource mobilization makes microfinance institutions independent of government and donor funding. It provides a solid basis for the sustainability of microfinancial services. Major resources include share capital, savings deposits and profits. For microfinancial institutions operating in the microeconomy, high interest rates on loans may be far more effective an instrument of internal resource mobilization than the collection of voluntary savings; this is a form of self-imposed compulsory savings mobilization frequently chosen by small institutions in the informal financial sector.

Microsavings:

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[3]The World Bank has introduced the term *best practices.* This term evokes the notion of optimal practices applicable anywhere. In contract, experience has shown that sound practices vary by environment and must be adjusted to a given situation. What is sound in one situation may be unsound in another.

Savings products and innovations to be promoted may comprise convenient deposit facilities for the accumulation and safeguarding of savings for microenterprise self-financing, consumption and emergencies; positive real returns to prevent erosion by inflation; savings products that differ in yield, maturity and incentive structure, such as voluntary savings withdrawable at any time or fixed deposits vs. regular compulsory savings that are non-withdrawable, lottery savings, raffles, etc.; and collection services organized by institutions or customers, such as doorstep daily savings collection, which differentially distribute transaction costs. In small local microfiance institutions, high interest rates on loans may serve as a major mechanism of self-imposed compulsory savings mobilization.

In subsistence agriculture and marginal informal sector activities, where virtually any type of credit may be inappropriate, savings promotion that strengthens the self-financing capacity of small farmers and microentrereneurs may be the only responsible financial strategy.

Microcredit:

Microcredit products are more appropriately differentiated in terms of maturities, instalments, services and collateral requirements (ranging from joint liability and personal guarantees to tangible collateral and pawning) than in terms of loan use, which is costly to appraise and, for fungibility reasons, difficult to control. Viable and sustainable microcredit schemes require: prudent adjustment to household savings, investment and repayment capacities; small loan sizes, with ceilings growing over a cycle of repeat loans up to a level determined by the absorptive capacity of the microenterprise and household economy; dynamically growing savings-to-credit ratios; market rates of interest autonomously determined by financial institutions and differentiated according to costs and services provided; loan maturities and repayment modalities according to customer needs and differentiated, in case of wholesaling, according for each level of intermediation; short maturities, no grace periods and short instalment periods in case of initial loans; insistence on, and incentives for, timely repayment; and the development and provision of cost-effective monitoring systems.

Microinsurance:

Microinsurance is the most underdeveloped part of microfinance. Yet various schemes exist that are viable, benefiting both the institutions and their clients. Such schemes have generally served two major purposes: (1) They have contributed to loan security; and (2) they have served as instruments of resource mobilization.

On a modest scale, various forms of life and health insurance have been successfully practiced by different institutions in different countries. There are also successful examples of accident insurance and cattle insurance. There are virtually no cases of viable crop insurance schemes.

Product reciprocity:

Product reciprocity ties credit to savings and insurance. It avoids moral hazard and improves financial discipline. For otherwise unbankable customers, it establishes a track record. To banks, it offers a cost-effective solution to the information problem.

Collection reciprocity:

Through collection reciprocity an institution may combine the collection of savings with the collection of instalments, which can be crucial to arrears prevention in the informal sector where incomes are daily or irregular, but not monthly, and are likely to escape collection without appropriate timing and collection techniques. Recovery rates can be further improved by tied lending, which interlinks credit with commodity transactions, which are widespread in the nonformal sector but may also be successfully applied by formal institutions.

Microfinance procedures and services:

They should be set by financial institutions rather than government; be customer-oriented, i.e. simple, fast and on time; be market-oriented and in competition with those by other formal or nonformal institutions; and cover their cost. Appropriate procedures and services should be applied to attain (1) sound financial management, (2) convenient and safe savings collection and deposit facilities, (3) appropriate loan appraisal and processing procedures, (4) adequate risk management (including collateral substitutes, nonformal collateral, loan protection schemes and prudent loan disbursement), (5) timely repayment collection, (6) monitoring and (7) effective information gathering, all of which may include cooperation between different formal and nonformal intermediaries in fields where each is most effective.

Terms and conditions:

Financial contracts must be sound from both an institution's and its customers' viewpoints. To arrive at balanced loan contracts, an exchange of experience and mutual learning may be required between between the various types of nonformal and formal institutions including: (1) informal financial institutions with their wide range of contractual terms concerning interest rates, loan sizes, maturities, grace periods, loan purposes, reciprocities, collateral requirements, services, transaction cost sharing arrangements and unbounded innovations; (2) semiformal financial institutions including projects and programs, which tend to be influenced by governmental or non-governmental donors and may combine comprehensive services with a lack of commercial orientation; (3) formal institutions on tightly regulated markets, with a narrow and usually inflexible range of contractual terms; and (4) formal institutions on deregulated markets with their much wider range of terms, transaction cost sharing arrangements and innovations.

Ultimately savers and borrowers must be regarded as a market for financial institutions: with the institutions as intermediaries, and savers and borrowers as customers rather than

beneficiaries. Contractual terms and conditions on that market are the result of negotiation and competition rather than administrative imposition and convenience.

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