Participation in Sustainable Financial Service Systems

Most poor and disadvantaged people have not previously been integrated into the formal financial sector. However, from the standpoint both of financial sector development and poverty alleviation, the participation of low income groups in sustainable financial service systems is warranted. One of the most promising ways to reach these people is by mobilizing and developing their own local self-help groups.

Extending Financial Services to the Poor

Formal financial institutions have long assumed that people without tangible assets can neither pay the real costs of credit, nor save, and in general are poor credit risks. Agricultural loans, particularly in marginal, unirrigated areas, are considered dubious investments. More broadly, for most financial institutions, hardly any of the tiny informal businesses run by poor women and men are seen as attractive investments. The amounts these businesses require are too small and it is too difficult to get information on the clients (they are too far away and it takes too long to visit their farm or their business in the market town). Compounding the problem, there is no real security for the loan. As a result, there is little interaction between most low income people and the formal financial system.

Building sustainable financial service systems for poor people is consistent with the Bank's primary objectives. From the point of view of financial sector development, people who have not been integrated into the formal financial sector because of low incomes, gender, ethnic identity or remote location often represent a large and potentially profitable market for institutions that can develop ways to reduce the costs and risks of serving them. From the perspective of poverty reduction, the case is equally compelling. For the most vulnerable of the working poor who may not be ready to take on debt, accessible savings can help smooth consumption over crisis periods, thus greatly improving their economic security. Once some degree of economic security is attained, access to credit can help them move out of poverty by improving the productivity of their enterprises or creating new sources of livelihoods.

The challenge is to build a system of financial intermediation that offers financial services which are accessible to the poor, while at the same time achieving long-term financial sustainability for the lending institution without continued dependence on subsidies from governments and donors. This is not something that can be fully achieved within the time frame of one or sometimes even a series of Bank lending operations. In some borrowing countries where there are barriers created by remoteness, poor infrastructure, a stagnant or primarily subsistence economy, and by social factors such as illiteracy, caste and gender, self-sustaining financial services may not be attainable for a very long time.

One of the biggest dangers for any microfinance project is that it will be perceived by the end users — and sometimes even by the lending institution — as a one way flow of grant money to beneficiaries rather than a reciprocal contract with clients. The rules which govern these two kinds of relationships are very different. Beneficiaries receive charity and basically must take whatever they are offered; clients buy something that they value enough to pay for. The key to overcoming the vulnerability imposed by continued reliance on subsidies (finance as charity) is establishing a market-based system (finance as business) that can operate on its own when government funds dry up or

donor fashions change. Stakeholder participation is the essential ingredient in fostering a successful group-based financial intermediation process.

**Group-Based Approaches**

To reach poor and marginalized groups, financial intermediation must be combined with social intermediation — the willingness to make a substantial investment in building the human resources and the local institutions needed to help marginalized people become self-reliant. New mechanisms must be created to overcome the gaps created by poverty, illiteracy, gender and remoteness. Local institutions must be built and nurtured, and skills and confidence of low income clients must be developed. Initial subsidies are required to help overcome these and other barriers particular to the poor.

Participation is essential in bridging the gap between financial and social intermediation. In creating sustainable financial service systems, participation is one of the critical links between the Bank’s concern to promote financial sector liberalization and its overarching mandate for poverty reduction.

One of the most promising routes to sustainable financial intermediation with the poor appears to be the one that is most participatory: the use of local self-help groups composed of and representing the poor. Indeed, for very poor clients who have no assets to offer as collateral to formal institutions, such groups may offer the only affordable way of gaining access to financial services.

Group-based social intermediation has two important facets. The first is expanding access for poor men and women to social and production support services such as government health, education or agricultural extension services. This aspect of social intermediation has been the focus of most traditional group-based programs. The second, more difficult aspect of social intermediation is strengthening the human resources and local institutions needed to prepare marginalized groups to manage their own institutions or enter into responsible business relationships with formal institutions. Ultimately it is the cohesion and self-management capacity of groups which enable them to both reduce the costs of financial intermediation, by peer pressure on potential defaulters, and to lower the transaction costs banks incur with many small borrowers and savers. Although there are many local variations, the approach essentially involves identification and organization of local voluntary associations or self help groups among disadvantaged populations.

Two objectives are of particular importance: first, expanding access for the poor to social services and production support services; and second, building the institutional capacity of the groups and the human resources of their members (training members in group dynamics, accounting and basic financial management and auditing practices) so that they can begin to function on their own with less help from outside. The goal is to prepare the groups to enter into solid business relationships with formal financial institutions, or to build up their own institutions.

The development of participatory groups is common to the two main approaches to social intermediation. The first is the linking model, which seeks to integrate disadvantaged clients into the formal financial system through building up self-reliant groups that can reduce the costs and risks to banks in dealing with small savers and borrowers. The most common institutional arrangement for the linking models is for an NGO to mobilize groups and then link them to services from state-owned banks and other government agencies.

The second approach to social intermediation is developing groups into parallel financial institutions focused on the needs of the group members. The development of cooperative banking systems federated from primary cooperative savings and credit groups is a familiar example of this approach. In a few cases such as Grameen Bank in Bangladesh (Box 1) and BancoSol in Bolivia, group-based systems have been able to graduate into formal financial institutions.

**Advantages of Group-Based Services**

Using a group-based approach to financial intermediation has several advantages for the lender. Group liability is an effective collateral substitute: when all members lose borrowing privileges until default by any member is resolved, external enforcement is less important because the group is self-policing. The result is increased repayment rates and reduced lender risk. Savings mobilization is often impressive, proving to be an inexpensive source of loan capital. Group-based services enjoy significant economies of scale since many clients with similar needs can be reached directly through a group. Thus, enforcement costs can be reduced. Group-based financial systems can, in many situations, effectively shift some of the costs and risks from the lending institution to the group.
Box 1
SANASA, Sri Lanka

The SANASA movement, more popularly known as the Thrift and Credit Cooperative Societies (TCCS), was established in 1906 and today has an extensive network of 6,843 rural thrift and credit cooperatives ("primary societies") for low income men and women throughout Sri Lanka. Its mission statement is to "provide (for) basic needs, assurance of equal rights, and the creation of an environment (which supports favorable policies)."

One of the strengths of the SANASA system is the grassroots orientation of the primary societies, which have an impressive financial performance. As demonstrated by rapid growth in members' savings over the past three years, member confidence in the societies is high. Savings have grown at a real rate of 26 percent from 1990 to 1993, reaching Rs. 1.415 billion. The wide range of savings instruments, tailored to different target groups within the primary societies, is a key reason for strong savings mobilization. The average savings account of Rs. 2063, amounting to 8 percent of per capita GNP, Savings support 97 percent of the outstanding loan portfolio, a much higher share than most NGO-supported financial services systems in South Asia.

The estimated 95 percent on-time repayment rate in 1993 reflects the high percentage of the outstanding loan portfolio backed by member savings. On average, SANASA primary societies charge between 6 and 24 percent interest with typical repayment periods ranging from one to six months. Average loan size jumped 73 percent between 1992 and 1993, raising the concern that access may become more difficult for low income village households.

When administrative, monitoring and promotion costs are shifted to a group of clients, very small loans can be provided profitably by a streamlined financial intermediary.

Cohesive groups consisting of members with common interests can also be cost effective delivery mechanisms for training and other enterprise development services. Groups are also effective as channels for social service programs including adult education, nutrition, family planning and health.

From the client's perspective, groups may offer the only affordable way of gaining access to financial services. For landless men and women the substitute for physical or financial collateral provided by group liability is essential; without it, they could not obtain formal credit. Moreover, the savings mobilized by groups are often reloaned to their members for emergencies, consumption and similar purposes for which formal institutions are reluctant to lend. In terms of capacity building, group-based approaches can build solidarity, confidence and financial management skills among members.

For women, one of the most important aspects of a group is that it provides a legitimate "social space" beyond the home and a sense of solidarity that allows them to deal more freely with unfamiliar formal institutions and processes. There is a good deal of anecdotal evidence from Bank and other projects that women's groups perform better than men's groups in terms of repayment and longevity.

Characteristics of Successful Groups

A study of five South Asian group-based services systems identified characteristics related to a successful group's performance. Characteristics of strong groups include:

- self-selection of members
- literacy of at least a few group members
- membership of only one gender.

Group enforcement of sanctions is strongest when there is a readily available system for calling on outside assistance (usually from an NGO) to resolve serious conflicts. The most successful systems are those where a large proportion of the lending capital is raised from members' own savings.

Levels of Participation

Group based systems permit much higher levels of client participation by enabling members to take on group roles according to their capacities. The four major roles of beneficiary, client, shareholder and manager form a kind of "participation continuum" moving from the beneficiary who receives services to the manager who makes strategic and operational decisions about how services are designed and delivered.

One of the premises of a group based approach is that with sufficient training and experience, group members can become effective owners and managers. Projects can be designed to prepare clients to advance along the continuum of in-
Box 2

Mysore Resettlement and Development Agency (MYRADA), India

Established in 1968 and based in Bangalore, MYRADA has become known as one of the leading Indian NGOs in the field of microfinance. Several of MYRADA’s projects involve the development of basic financial service systems for low income rural women and men using a strategy of building up local Credit Management Groups (CMGs) and then linking these to the formal financial sector.

As the first stage of a CMG’s development, MYRADA encourages the group to build its own common fund through admission fees, savings, fines and interest earnings from the group’s internal lending. MYRADA staff help the groups to conduct meetings, keep records and learn basic literacy. When a group is deemed ready, it assumes a financial intermediation role making soft loans (at 3 percent interest) to the CMG’s common fund for on-lending to group members. After a CMG has demonstrated its management capacity, efforts are made to link it to a commercial bank; the bank then provides larger amounts to be on-lent to CMG members requiring larger long-term loans beyond the scope of the common fund. Of MYRADA’s 2,489 CMGs (as of March 1994), 130 had graduated to the status of clients of commercial banks.

It is at the level of actual CMG operations that problems arise — high loan losses, high costs, poor record keeping and underlying trends which move the organization further away from sustainable performance at the group level. An estimated repayment rate of 54 percent and member confusion concerning repayment schedules and obligations illustrate the general lack of CMG financial discipline. Sample village records lead to the conclusion that MYRADA’s portfolio has shifted from 80 percent short-term production loans in 1987 to 80 percent consumption loans in 1993. Since consumption loans do not generate income, the shift could prove dangerous to the financial stability of the group.

Pitfalls of Groups

Using groups as the basis of sustainable financial services is not a guarantee of success. Despite their advantages, groups may also face serious managerial problems. They may be costly to set up, there is potential for corruption or control by powerful groups and minorities, and the most disadvantaged may be excluded. Nevertheless, the resilience and popularity of many locally based financial service organizations indicate that locally managed groups can improve their financial management practices and move toward sustainability through self-help efforts.

Costs of Participation

While financial intermediation and loan transaction costs may be reduced by group cohesion and participation, there may be substantial up-front investments required for capacity building in the skills and systems that permit the target group to eventually take over most of the management of their own financial transactions. In the early years of a financial system’s establishment, these costs can be expected to be a larger part of the lending operation than actual “credit” disbursed to the group members.

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