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Policy Recommendations
for Sida's programs

Rural Microfinance

MAKING FINANCIAL MARKETS WORK FOR THE POOR

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Executive Summary:
Policy and practice in rural microfinance

A. Background

This study is a contribution to the development of Sida's policy and practice in rural finance within Sida's overall poverty-oriented microfinance policy. Based on the experience that only sustainable institutions are capable of responding to the financial needs of Sida's target group on a long-term basis, its specific objective is to render Sida's support to rural microfinance more efficient in terms of both sustainable institution-building and sustainable outreach to Sida's target group. Sida now needs:

- a comprehensive development finance policy, which comprises the overall financial sector, microfinance and rural finance;
- the political will to apply that policy;
- professional staff to implement the policy in its projects; and
- a knowledge management system to effectively supervise the implementation of the policy in its projects.

B. Conceptual framework

1. Conceptual perspectives, and where does Sida stand?

Due to the overall failure of donor-driven directed credit, the emphasis in development policy has shifted to (rural) financial systems development and the building of self-reliant, sustainable institutions. Regardless of ownership, type of institution, rural or urban sphere of operation and target group, financial institutions ultimately all have to accomplish the following:

- mobilize their own resources through savings;
- have their loans repaid;
- cover their costs from their operational income;
- earn enough profits to offset the effects of inflation;
- finance their expansion from their profits and savings mobilized.

The role of Sida and other donors must be temporary and instrumental for the attainment of these objectives.

Two paradigms – needs-driven vs. institution-building approach: Policymakers at Sida must be familiar with the two worlds of finance as discussed below and then decide where Sida wants to stand and what it wants to accomplish:

(1) *The old school of the needs-driven approach and agricultural credit as an input* dates back to the 1950s and 60s and was followed by credit NGOs in the 1970s and 80s. It stressed the unique features of agricultural finance in theory and practice, ignored the existence of rural savings, identified a perennial need for credit, and provided detailed administrative prescriptions for credit by crop, loan size, geographical area and target group. Institutions did not accept deposits; only the politically chosen few received loans; and poverty was aggravated. This school of thought has resulted in a disaster of rural finance into the 21st century. Much of the support given during half a century has not only failed to create a healthy and dynamic system of rural finance, but has in fact undermined its very emergence.

(2) *The new school of institution-building and sustainable financial services* gained worldwide recognition during the 1990s. It has analysed the rural economy as complex, comprising a multitude of agricultural and non-agricultural activities, and has identified a need for continual access to reliable financial institutions with a wide range of financial services, foremost among them keeping savings in a safe place. This has led to an overall shift from agricultural credit to rural finance, encompassing credit and savings as well as finance for agricultural and non-agricultural purposes. This school recognizes that rural finance is no panacea and cannot solve all rural development problems, but it stubbornly insists that no matter what, rural people need access to financial services on a sustainable basis from financial institutions. These must be part of a well-regulated and effectively supervised financial system, comprising a conducive policy environment, a differentiated financial infrastructure, and effective strategies and instruments in a competitive market environment.

Rural finance: project components or stand-alone projects? The paradigm shift has generally implied a shift from project components (e.g. supplying credit to needy farmers) to stand-alone projects (e.g. promoting networks of sustainable financial institutions). However, this does not necessarily imply abandoning rural finance as a project component; in fact, in some cases it might even lead to a strengthening of the latter. For example, in an integrated rural development project, the paradigm shift might imply moving from agricultural credit, the supply of which is limited to the project period, to building a number of rural banks or savings & credit cooperatives with a wider range of services for an unlimited period.

Where does Sweden stand? During the 1960s and into the 80s, Sweden, together with other Nordic countries, practised the new-school approach and supported financial institution-building in a number of countries. In the 1990s however, it fell back to the needs-driven approach, treating credit as an input and as a project component without regard for institutional sustainability. With its ongoing rural and microfinance policy and competence development project, Sida is now in the process of reviewing and revising its position.

2. What are the unique features of rural finance?
Financial systems development and rural finance: The new school of institution builders focused on the building of sustainable financial institutions, re-

gardless of where they were located. The time may have come to revisit rural finance and agricultural credit and take a fresh look at their particularities. There are usually wide differences between rural and urban areas, but there are also vast rural-rural differentials within and between countries.

Quite different institutions have been involved in quite different innovative approaches to rural and marginal areas; there is too much variation, too small a number of institutions, and not enough knowledge to present this in a typology matrix. For many problems, there are no solutions yet. Before the search for sustainable solutions can continue through sector studies and specific feasibility studies, *a definite policy decision will be required from Sida* whether or not it wants to move in that direction: building sustainable financial systems and institutions which do not collapse once donor assistance comes to an end.

C. Lessons taught by international experience: What matters in development finance, microfinance, rural finance?

A wealth of lessons have been taught by international experience, but not always learned by donors and governments. The lessons are complex and are presented in more detail in the background paper, but for actual implementation, further reading of the reference literature and selected exposure visits are required.

1. What matters to the poor:

- *First of all, client experience matters.* Clients have experienced in projects that credit can make them poorer or richer.
- *The poor themselves matter … and so do the non-poor.* Their autonomy in self-selection, instead of targeting, should be respected, also on separate vs. mixed institutions of women and men.
- *Access to savings and credit matters* – far more than interest rates.
- *Rural enterprise viability matters* and is mutually reinforcing with R/MFI viability.
- *Household portfolio diversification matters,* but group enterprises have usually failed.

2. What matters in terms of origin, history and culture:

- *Informal finance matters,* particularly in the form of self-help groups (SHGs). Upgrading and mainstreaming through networking and linking them to banks are two ways in which donors can support expansion of outreach and financial deepening.
- *History matters.* Since 1720, MFIs in Europe have started from informal beginnings and evolved, through appropriate regulation and supervision, to cooperative banks and savings banks. Microfinance is not a poor solution for poor countries!
- *Crisis matters.* Financial innovations typically emerge in response to crisis.
- *Development matters:* Microfinance is no panacea; it requires a climate of broader development to be fully effective.

- *Culture matters.* Development from above, through the established authorities, is more effective in hierarchical or closed societies; development from below, through participatory processes, is more effective in segmented or open societies.

3. What matters at the level of financial systems:

- *Financial systems matter.* Donors can contribute to that evolution, but only in a long-range perspective and in a donor-coordinated and goal-oriented manner.
- *Financial sector policy matters,* particularly interest rate deregulation.
- *The legal framework matters.* Appropriate legal forms allow people to establish their own financial institutions in private, cooperative or community ownership.
- *Capital matters,* but should be mainly used for bridging temporary shortages in funds.
- *Savings matter,* as a service to the poor and as a source of loanable funds.
- *Financial intermediation matters,* savings-first for low-yielding activities; and credit-first for high-yielding activities – depending on the rate of return.
- *Interest rates on deposits matter,* preventing the erosion of capital.
- *Interest rates on loans matter,* covering all costs.
- *Institutions matter* (projects do not), providing continuity and efficiency. Donors must abstain from perverse incentives which enable institutions to maintain unviable operations.
- *Competition matters,* entailing institutional diversity and pressures to perform.
- *Prudential regulation and supervision matter,* requiring the political will and institutional capacity to enforce standards in rural banks, SACCOs, AgDBs, other R/MFIs.
- *Knowledge matters.* Effective knowledge management is urgently needed.

4. What matters at the level of institutions:

- *Institutional reform matters.* There are striking cases of reform of very different types of institutions, with great benefit to the poor, leaving no excuse for continual support to unviable institutions.
- *Ownership and institutional autonomy matter,* but management autonomy in terms of customer selection and loan decisions may be more important than ownership.
- *Viability, efficiency, sustainability and self-reliance matter.* Sida should support domestic resource mobilization, cost-effectiveness, and profitability.
- *Saver and borrower outreach matter,* which is compatible with sustainability.
- **Sustainable outreach to marginal rural areas** requires support for the primacy of savings and self-financing, and of member-owned SHGs operating at low costs.
- *Lending technology matters* – and should not be a matter of ideology: group technologies for the very poor; individual technologies for graduating to larger loans.

- *MFI portfolio diversification matters* as a risk management strategy.
- *Good practices matter,* not best practices, which lead to inappropriate replications.
- *Institutional size matters.* There is no best practice in terms of size, both small and large institutions can be feasible.
- *Profits matter,* as a source of capital and a major determinant of growth of outreach.
- *Incentives matter,* as a major determinant of quality of performance and profits.
- *Repayment matters.* Many institutions now know how to reach repayment close to 100%.
- *Financial products and delivery systems matter,* demand-oriented and cost-effective.
- *Loan protection matters.* Insurance is a service, but also part of loan protection.

D. Sida's experience

Sida's microfinance portfolio comprises 30 contributions with a total portfolio of SEK 343m as of mid-2002. The rural finance portfolio comprises SEK 123m in 11 contributions. Sida's experience in five regions is summarized in the main report and presented in more detail in the background paper. There is ambiguity and lack of adherence to sound practices, with recent, albeit unsystematic, shifts towards:

- an increase in the number of projects focusing on building sustainable MFIs;
- a stronger emphasis on the regulatory framework for MF in several countries;
- improvements in project appraisal and assessment of R/MFIs;
- the use of performance based agreements;
- an increased use of technical expertise;
- support to networks and training service providers;
- innovative ways of providing equity to risk capital funds like AFRICAP.

Lessons taught by actual experience in the field have not always been transformed into *lessons learned.* This may change with the ongoing *Rural and Micro Finance Policy and Competence Development Project.*

E. Comparative analysis

1. The two worlds of rural and microfinance revisited

There is an overall move from the old world of *supply-driven development finance to the new world of demand-driven commercial finance.* Sida is among those donors where this move is not consistent. In a number of instances, Sida's projects appeared to be driven by a pressure to disburse, which has led to *disbursement without development.*

The matrix below summarizes the findings and lessons learned from international experience. To a large extent, many of Sida's projects outside the Balkans fall into the left column of the *old world* of the needs-driven approach. The resulting message is unequivocal: To adhere to its mandate given by the Swedish Parliament, Sida must decide on a definite move towards the new world of institution-building as described in the right column.

Typology matrix: The *old world* of the needs-driven approach vs. the *new world* of institution-building in R/MF: the Do's and the Don'ts of R/MF

	Sida, don't support: *The old world of the needs-driven approach*	**Sida, do support:** *The new world of institution-building*
Policy environment	Financial repression	Prudential deregulation, fin. system dev
Legal framework	Lack of private local R/MFIs	New legal forms for local R/MFs
Develop't approach	Supply-driven	Demand-driven
Institutional focus	Monopoly institutions	Various competing financial institutions
Clients perceived as:	Beneficiaries	Customers
Selection of clients	Targeting by donors and governments	Self-selection
Outreach	Limited outreach to groups	Potentially all segments of the economy
Incentives	Perverse: leading to fund misallocation	Efficient allocation of funds
Non-formal FIs	Millions of informal MFIs ignored	Opportunities for mainstreaming
Semiformal FIs/NGO	No standards, no deposit mobilization	Conversion to deposit-taking formal FIs
Financial coops	Unsupervised, ruined by governments	Self-reliance; low costs, expansion
AgDBs	Lack of viability and outreach	Reforms towards autonomy, viability
Rural banks (RBs)	Lack of opportunities for private RBs	Legal framework for private RBs
Regulation and supervision (R&S)	Coops, MFIs, AgDBs unsupervised; donors keep distressed institutions alive	MF units in CBs; regulation of RBs/MFIs; closing of distressed FIs
Commercial banks	Unable to lend to a variety of sectors	Some outreach to micro-entrepreneurs
Agricultural finance	Lack of self-financing and credit	Self-financing thru savings and profits
Remote and marginal areas	Futile attempts of donors to drive ill-suited MFIs into remote areas	Self-managed savings-based SHGs and cooperatives operating at low cost
Individual and group technologies:	Rigid replications without growth of outreach and sustainability	Both can be profitable and reach micro-entrepreneurs and the poor
Non-financial services	Maximalist approach without cost coverage undermines FIs	Provided by SHGs, other agencies, FI subsidiaries; balance of objectives
Targeting	Undermines outreach and viability	Differentiated financial products
Linking banks and SHGs/MFIs (LBS)	Lack of healthy banks with a mandate to be of service	Spectacular increase in outreach to the poor; profitable if interest rates are free
Interlinked schemes	Lack of institutional sustainability	Ltd.success under controlled conditions
Self-reliance	NGOs, AgDBs barred from deposit-taking; donor and gov. dependency	Self-financing through deposits and profits; institutional autonomy
Sustainability	Donors, gov. fail to insist on performance standards and sustainability	Increasing numbers of self-sustaining institutions of any type and ownership
Access to financial services	No access of many poor and non-poor to savings, credit, insurance	Sustainable access of the poor as users and owners of R/MF institutions

2. Strengths and weaknesses of Sida

Among Sida's strengths and comparative advantages are its flexibility, presence in the field through the Swedish embassies and, despite setbacks, its experience with long-term institution-building in the cooperative and savings banking sectors at home and abroad. Weaknesses to be remedied include a lack of knowledge management *(lessons taught* do not lead to *lessons learned);* a lack of consistent financial institution building along the lines of its financial sector policy of 1997; a lack of project performance monitoring & supervision; supply of easy money, which discourages R/MFIs to mobilize resources domestically; and continued support for failing projects and distressed institutions. Sida needs performance standards just like the financial institutions it supports.
This requires the political will to introduce self-regulation and effective instruments of control.

3. A special role for Sida in marginal areas?

Sida has put a major emphasis on remote areas on which little systematic work has been done. There it faces a number of challenges: intermingled budgets of diversified households; strong demand for safe-keeping of savings; weak overall effective demand for credit; wide variation of risks; lack of physical collateral; and high institutional transaction costs.

Appropriate institutional responses to these challenges include

- self-help and self-reliance as basic principles in the design of local financial systems;
- self-financing, savings-based or local capital-based institutions;
- creditworthiness examinations based on the household as a whole;
- informal collateral and peer pressure as a collateral substitute;
- small and variable loan sizes, repeat loans starting very small and very short-term.
- zero-cash principle, recycling savings and loan repayments immediately;
- member-owned and member-managed institutions with low transaction costs;
- deposit rates above the inflation rate and lending rates which cover all costs; and
- linkages of local institutions to formal institutions for liquidity exchange.

If Sida sticks to its focus on marginal areas and the poor, it may want some more concrete advice on inappropriate and appropriate institutional vehicles for its support – but with the proviso that in different countries, very different institutions have responded to the particular challenges of remote areas:

- Mostly inappropriate for marginal areas are commercial banks and credit NGOs.
- Mostly appropriate are indigenous and new autonomous self-help groups (SHGs).

Projects of promoting SHGs, networks of SHGs and linkages with banks in marginal areas have proven successful in a number of African and Asian countries. There are two basic strategies:

(1) through networks or federations of SHGs; and

(2) through linkages of SHGs with regulated financial institutions.

F. Conclusions and recommendations to the management of Sida

1. Fundamentals of sustainable development and rural finance: adopt, modify or reject

Decide on fundamentals in a participatory process: *The following fundamentals are objectives to be attained in the long-term perspective and through a variety of interventions. It is of crucial importance that the management of Sida identifies with the fundamentals of sustainable development. In a participatory process of decision-making, any of the tenets l below may be adopted, modified, reformulated, complemented or rejected.*

1.1 Sustainable development requires:

- continual growth and diversification of the rural economy;
- access of all segments of the population to sustainable financial services;
- provided by self-reliant, sustainable financial institutions;
- adjusted to the cultural and socio-economic conditions in their area of operation;
- in a conducive macroeconomic policy environment;
- with coordinated donor support, including cooperation and co-financing.

1.2 Sustainable R/MF requires local initiatives and careful donor support for the development of institutions, enabling them to:

- offer both savings and credit services;
- mobilize their own resources;
- have their loans repaid and cover their costs from their operational income;
- finance their expansion to the poor and non-poor from deposits and profits.

1.3 Governments, with careful donor assistance, have to provide,

- a conducive policy framework with deregulated interested rates;
- a legal framework for private, cooperative, community and government institutions;
- a system of prudential regulation and effective supervision.

2. Options for Sida: select, decide and implement

Decide on options in three steps, again in a participatory process: *There is a wide array of options available for Sida as a bilateral donor of technical and financial assistance on a grant basis. The following recommendations are made on the basis of discussions with Sida staff, documents, and field visits. The management of Sida* *has to take decisions (i) on their adoption; (ii) their relevant weight in Sida's intervention; and (iii) their application in specific projects. Transmitting policy to operations will remain a continual challenge:*

2.1 Sweden may contribute to the development of rural financial systems through:

- experts for R/MF units in central banks, R/MF networks and leading R/MFIs;
- regional R/MF experts for consultancy, training and supervision of projects and MFIs;
- policy dialogue;
- social and human capacity building in financial authorities, R/MFIs and networks;
- equity investments with leverage for deposit-taking institutions;
- no credit lines, cooperating instead with FA donors to bridge temporary liquidity gaps;
- assistance for the transformation of MFIs into regulated financial institutions;
- assistance for the promotion of ownership of financial institutions by the poor;
- donor coordination, cooperation and co-financing;
- Sweden's social capital, embedded in its own financial and other institutions.

2.2 Specific major options for interventions:

a) Interventions in partnership with other donors:

- *With financial assistance agencies:* building a rural financial infrastructure.
- *With technical assistance agencies:* developing a legal framework for R/MFs; capacity enhancement for networks; establishing systems of effective supervision.

b) Interventions in partnership with Swedish agencies:

- *With the Swedish central bank:* capacity enhancement of banking supervision and establishing a R/MF supervision unit in the central bank.
- *With representative bodies of Swedish financial institutions:* establishing networks of financial institutions including savings & credit cooperatives and savings banks; establishing systems of regulation and effective supervision.

c) Direct interventions:

- Transformation of AgDBs and credit NGOs into sustainable deposit-taking institutions with a diversified portfolio;
- Supporting selected R/MFIs as lead agencies with training and consulting services for institutional reform and transformation;
- Development of self-regulation and self-supervision in networks of MFIs.

d) Innovative lighthouse projects:

- Upgrading of member-based informal financial institutions;
- Promoting networks of informal financial institutions and SHGs in marginal areas;

- Linking SHGs and non-formal MFIs to regulated financial institutions;
- Pilot-testing insurance products (e.g. in areas with a high incidence of HIV/AIDS).

Once Sida decides on particular options, detailed strategies will have to be worked out and adjusted to an area of implementation through feasibility studies.

2.3 Supporting self-help groups as autonomous local financial institutions in marginal areas: a preferred strategy for Sida?

Two basic strategies are suggested, both directed at indigenous or new SHGs as autonomous local financial institutions:

- Through networks or federations of SHGs, implying that both SHGs and their networks are being promoted in the framework of a project;
- Through linkages of SHGs with regulated financial institutions like AgDBs, rural banks or other types of deposit-taking financial institutions.

This option would require a thorough feasibility study in each case, a long-term perspective of support, long-term experts, the willingness to work, in the long-term perspective, towards a legal status for the SHGs or their networks or federations, and cooperation with other donors and regional organizations. Manuals exist, but would have to be adjusted. Appropriate partners for Sida for the first approach may comprise AgDBs and development NGOs, which will eventually transfer their institution-building and –maintenance functions to networks of SHGs. Partners for the second approach may include AgDBs, rural banks or other types of deposit-taking financial institutions.

3. A proposal beyond M/RF: opening up markets

The total effect of development assistance is small compared to the importance of opening up markets in the EU and elsewhere for products from developing countries. Sida should make every effort in Sweden and the EU for abolishing agricultural subsidies and opening up markets for developing countries.

1. Background

Objective of the study: This study is a contribution to the development of Sida's policy and practice in rural finance within Sida's overall poverty-oriented microfinance policy. Based on the experience that only sustainable institutions are capable of responding to the financial needs of Sida's target group on a long-term basis, its specific objective is to render Sida's support to rural microfinance more efficient in terms of both sustainable institution-building and sustainable outreach to Sida's target group.

Sida's perspective: Sida's support to rural microfinance is based on the Swedish Parliament's development policy statement of 1962 and on Sida's financial sector policy of 1997. Among Sida's main achievements in rural finance are the establishment of financial cooperatives in East Africa since the 1960s and the expansion on a national scale of the Grameen Bank in Bangladesh in the 1980s. Sida joined the new consensus of the early 1990s on financial systems development and sustainable institution-building. In the absence of effective knowledge management, Sida faces, like other donors, the challenge of implementing policy in its projects. It now needs:

- a comprehensive financial sector and R/MF policy;
- the political will to apply that policy;
- professional staff to implement the policy in its projects; and
- a system to effectively supervise the projects.

A single development finance policy for Sida? Given the wide overlaps between financial sector and R/MF policies and between urban and rural markets among many MFIs, it is recommended that Sida:

- prepares a comprehensive Sida development finance policy, which comprises the overall financial sector, microfinance and rural finance.

2. Conceptual framework

2.1 Conceptual perspectives, and where does Sida stand?

Due to the overall failure of donor-driven subsidized directed credit administered by government-owned development finance institutions, the emphasis in development policy has shifted to (rural) financial systems development and the building of self-reliant, sustainable institutions. While savings-based self-help groups and member-managed small cooperatives are more appropriate to remote and marginal areas, most donors and experts see little need in the present situation to further differentiate rural and urban microfinance. Regardless of ownership, type of institution, rural or urban sphere of operation and target group, financial institutions ultimately all have to accomplish the following:

- mobilize their own resources through savings;
- have their loans repaid;
- cover their costs from their operational income;
- earn enough profits to offset the effects of inflation;
- finance their expansion from their profits and savings mobilized.

The role of Sida and other donors must be temporary and instrumental for the attainment of these objectives.

Two worlds of finance continue to exist, in which donors may intervene in very different ways: the old world of donor-driven development finance, which needs to be transformed into sustainable institutions; and a new world of development finance, comprising viable formal and semiformal institutions with a commercial orientation, which do not, or not fully, rely on donor support for expansion. To these, a third world of finance may be added, which is the oldest and most widespread yet most ignored: the world of informal financial institutions of ancient or recent origin, based on principles of self-reliance and viability with their potential for innovation and mainstreaming, to which donors may contribute. Policymakers at Sida must be familiar with the first two worlds of finance as discussed below and then decide where Sida wants to stand and what it wants to accomplish.

Two paradigms – needs-driven vs. institution-building approach: Of the three worlds of finance which continue to exist, two are backed by their own school of thought:

- *The old school of the needs-driven approach and agricultural credit as an input* to be provided by specialized credit institutions (AgDBs), dating back to the 1950s and 60s, followed by credit NGOs in the 1970s and 80s. This school equated the rural economy with agriculture, ignored the existence of rural savings and consequently the demand for deposit services, and identified a perennial need for credit. This school stressed the unique features of agricultural finance in theory and practice, elaborating dozens and more credit products and documenting them in voluminous agricultural credit handbooks, with detailed descriptions for credit by crop, loan size, geographical area and target group. This school of thought has resulted in a disaster of rural finance which has continued into the 21st century. Much of the support given during half a century has not only failed to create a lasting system of rural finance, but has in fact undermined its very emergence. In the process, donor credit provided by multilateral and bilateral agencies frequently, particularly in Africa, has not only failed to reach the target population, but has also made the countries poorer: these countries are now stuck with huge amounts of external debts which cannot be repaid from failed investments in agriculture.
- *The new school of institution-building and sustainable financial services,* which has gained worldwide recognition, at least in theory, during the 1990s. This school has analysed the rural economy as complex, comprising a multitude of agricultural and non-agricultural activities with widely differing profit margins, and has identified a need for continual access to reliable financial institutions with a wide range of financial services, foremost among them keeping the savings of the poor and the non-poor in a safe place. This has led to an overall shift from agricultural credit to rural finance, in which the term finance encompasses, as a minimum, credit and savings as well as finance for agricultural and non-agricultural purposes and for consumer and emergency purposes. This school recognizes that rural finance is no panacea, cannot respond to all needs which are overwhelmingly many, and is far from solving all rural development problems; but it stubbornly insists that no matter what, rural people need access to financial services on a sustainable basis, and that such services can only be provided in a lasting manner by sustainable financial institutions as part of an orderly, well-regulated and effectively supervised financial system. Conducive macroeconomic conditions include a low inflation rate, exchange rate liberalization, and deregulation of prices and the trade regime.

Financial systems perspective: At the centre of the new paradigm stands the financial systems perspective based on pioneering work during the 1960s by Shaw and McKinnon and propagated in 1989 through the World Development Report on *Financial Systems and Development.* Ten functional subsystems have been identified as shown in the table below, which are ideally integrated into a single functioning system: for example, institutions *(subsystem v)* will not develop and provide adequate savings and credit products *(subsystem vi)* if the government sets interest rates on deposits above the level of lending rates *(subsystem ii)* and forces institutions to lend to beneficiaries *(subsystem ix)* who are not going to repay their loans. The result will be that institutions do not accept deposits; that only the politically chosen few will receive loans; and that poverty will be aggravated.

The financial system and its subsystems

Financial system spheres	**Subsystems**	
Policy environment	(i) (ii) (iii) (iv)	The total system The policy framework The legal framework The supervisory framework
Institutional infrastructure	(v)	Institutions: – formal financial sector – semi-formal financial sector – informal financial sector
Instruments	(vi) (vii) (viii)	Financial products Procedures and services Terms & conditions of contracts
Market environment	(ix)	Customers vs. beneficiaries
Intervention entry points	(x)	Financial system strategies

Source: Seibel 1996a: 86; 85–121

Rural finance: project components or stand-alone projects? The paradigm shift is thus from the old school of *agricultural credit as an input* to the new school of complex *financial systems* to be promoted as a whole and in their component parts. Among major donors, this has generally implied a shift from project components (e.g. supplying credit to needy farmers in an irrigation project) to stand-alone projects (e.g. promoting a nationwide M/RF legal framework or building networks of sustainable financial institutions). However, this paradigm shift does not necessarily imply abandoning rural finance as a project component; in fact, in some cases it might even lead to a strengthening of the latter. For example, in an integrated rural development project, the paradigm shift might imply moving from agricultural credit, the supply of which is limited to the project period, to building a number of rural banks or savings & credit cooperatives These will not only provide a wider range of services, but will also be there for an unlimited period of time, possess a far larger capacity for absorbing development assistance during the project period, and generate new resources far beyond the project period.

A note on charity: There is a pronounced need for charity in developing countries. Charity is not part of this study; but this does not imply that there is no need for the transfer of resources from rich to poor countries for charitable purposes. This, however, is not normally the mandate of development organizations (though relief is frequently regarded as a special case, for example as a first step before institution-building can start). Other organizations such as religious and other non-governmental organizations are usually more qualified to provide charitable assistance, though many of them, including many churches, have shifted their emphasis using charity funds the building of sustainable institutions and strengthening the self-help capacity of the poor.

Where does Sida stand? During the 1960s and into the 80s, Sweden, together with other Nordic countries, practised the new-school approach and supported financial institution-building in a number of countries. In the 1990s however, when other countries and donors awoke to the new school approach, it miraculously fell back to the needs-driven approach, treating credit as an input and as a project component without regard for institutional sustainability in many cases. With its ongoing rural and microfinance policy and competence development project, Sida is now in the process of reviewing and revising its position.

2.2 What are the unique features of rural finance?

Financial systems development and rural finance: The new school of institution builders with its shift in emphasis from agricultural credit to rural finance does not deny that there are substantial differences between the rural and urban economy. However, its focus has been on the overall financial system, the fundamentals of sustainable financial services, and the building of sustainable financial institutions, regardless of where they were located. The transition from the old world of supply-leading credit to the new world of demand-leading financial services is far from complete. Yet, given the success of this transition in an increasing number of countries, the time may have come to revisit rural finance and agricultural credit and take a fresh look at their particularities.

Rural-urban differentials: So, let us start with some of the differentials. There are usually wide differences between rural and urban areas: readers are invited to contribute to the list and turn this into a living document. In rural areas:

- population densities tend to be lower;
- paradoxically paralleled by larger family sizes and higher population growth rates;
- educational levels tend to be lower, particularly among women;
- physical, institutional and IT infrastructures are poorly developed;
- access to markets and integration of producers and organizations into national markets is limited;
- the range of income-generating activities and the degree of economic diversification is limited;
- the profitability of economic activities is lower;
- agriculture predominates, with its low profitability and its exposure to co-variant physical and economic risks.

Rural-rural differentials: Yet, there are also vast rural-rural differentials within and between countries. For example, population densities vary from less than 1/km² in the Sahel to several hundreds in tropical West Africa and up to more than 1000/km² in rural Java; educational levels in rural areas vary greatly between the Balkans and most other developing countries; the rural economy may be based on subsistence crops or cash crops with vastly different profitability rates; risks vary greatly according to the degree of diversification (e.g. vegetable production), irrigation and market proximity. At the same time, absolute poverty may be more severe in cities, as in parts of India.

A typology matrix? This subject, including the issue of suitable and unsuitable financial institutions in terms of particular strategies will be further discussed in chapter E 4. Quite different institutions have been involved in quite different innovative approaches to rural and marginal areas; there is too much variation, too few institutions, and not enough knowledge to present this in a typology matrix.

Search for sustainable solutions for rural finance…: Here, we are just at the beginning! Asking for answers does not produce them. It will take many years to arrive at answers. For the time being, within mostly underdeveloped financial systems, there are no solutions yet to many problems. The problems of rural finance in remote areas cannot be solved before the basics of a functioning national financial sector including the microfinancial sector (i.e. a sector which provides services to low-income groups and the poor) have been established. Thus, access to sustainable financial services for the vast numbers of the rural (and urban!) poor is a goal for the decades to come. It will not be attained by good intentions and the mere transfer of resources from rich to poor countries. However, this does not preclude well guided and goal-oriented action, as will be indicated in our specific recommendations.

… but take a policy-decision first: However, before the search for sustainable solutions can continue through sector studies and specific feasibility studies, a definite policy decision will be required from Sida that it wants to move in that direction: building *sustainable* financial systems and institutions which service low-income-groups and the poor in rural areas, and providing assistance to institutions and approaches which do not collapse once donor assistance comes to an end.

3. Lessons taught by international experience: What matters in development finance, microfinance, rural finance?

3.1 What matters to the poor?

First of all, client experience matters: Clients have experienced in donor projects that credit can make them poorer or richer:

- Starting with large loans and long-term finance, as has been common among donor-supported AgDBs, is a guarantee for failure.
- Only small short-term loans allow them to experiment with investments at a reasonable risk; test their ability to borrow, invest, repay and save, and to change to more profitable investments as opportunities emerge; and to grow rapidly with growing internal and external resources.
- Once they are successful, they need a banking partner which responds to their increasing financial needs. This allows them not only to move beyond the poverty threshold, but also to create employment for the poor and the very poor.

The poor themselves matter … and so do the non-poor: In exploitative cultures, the poor may prefer access to financial services as a separate group. This depends on culture and the financial infrastructure. Banking with both the poor and non-poor may increase outreach to the poor.

- Respect the autonomy of the poor, women, local institutions and their owners.
- Support self-selection through particular financial products; abstain from targeting.
- Promote financial services to the poor and non-poor in separate or mixed MFIs depending on culture.
- Instead of targeting, promote financial products for different market segments.

Access to savings and credit matters – far more than interest rates.

- Support institutions which offer both savings and credit.
- Insist on the transformation of credit NGOs into institutions collecting voluntary savings.

Rural enterprise viability matters: The viability of R/MFIs and rural farm and non-farm enterprises are mutually reinforcing.

- Promote linkages with agencies providing BDS in rural areas and to enterprising poor.

Household portfolio diversification matters:

- Refrain from restricting small loans to single (productive) purposes.
- Encourage loans to IGA with high rates of return, including petty trading.
- Stay away from financing group enterprises – they have usually failed.

Culture of labour division matters: Depending on culture, women and men may opt for separate or mixed institutions:

- Refrain from targeting women for the sake of targeting women.
- Respect the autonomy of women and men and let them decide on separate vs. mixed institutions.

However, in areas where women have evolved as eminent savers, borrowers and investors, it is of course appropriate to support their efforts and strengthen their role in society.

3.2 What matters in terms of origin, history and culture?

Informal finance matters: Informal financial institutions in various forms of ownership – particularly in the form of self-help groups (SHGs) – have been based, some for centuries, on the very principles that many credit NGOs and AgDBs find difficult to adopt: self-reliance, viability, outreach to the poor as owners or users, competition, market-driven innovations, demand-oriented financial products and appropriate risk management. Yet, they are usually limited in size, services and duration.

- Upgrading and mainstreaming through networking, driven by incentives, is one of many ways in which donors can support expansion of outreach and the deepening of informal financial institutions.
- Linking SHGs to banks and thereby integrating them into the national financial system has been very effective in a number of countries in Asia and Africa.

History matters: MFIs in Ireland, 1720–1950, demonstrated how regulation makes and breaks savings-driven R/MF. MFIs in Germany, 1778–2002, started from informal beginnings and evolved, through appropriate regulation and supervision, to cooperative banks and savings banks *(Sparkassen)* with outreach to the majority of the German population in rural and urban areas, accounting for 51% of all banking assets. In Sweden, *Sparbanken* and *Föreningsbanken* evolved later. Among the lessons are:

- Microfinance is not a poor solution for poor countries.
- Savings-driven microfinance institutions, in cooperative or community ownership, are equally feasible in rural and urban areas.
- If properly regulated and supervised, they have great potential in poverty alleviation and development, both in rural and urban areas.

Crisis matters: Financial innovations typically emerge as a response to crisis, which must be taken as a positive force:

- Learning from experience means responding to crisis with innovations.
- Many MFIs in crisis are kept alive, and prevented from reform, through donor support.
- MFIs which fail to respond to crises constructively must be allowed to falter: *close them or reform them!*

Development matters: Microfinance is no panacea. It contributes to development, but requires a climate of broader development to be fully effective, both macro-economically and at the local level, which may only be attained in the long run:

- Promote M/RF in a long-term perspective.
- Participate with other donors in the development of a conducive policy environment.
- Contribute to the development of a village economy, comprising poor and non-poor.

Culture matters: The enthusiasm over the new consensus in R/MF has led to the neglect of cultural factors, which may be of crucial importance to the clients and corporate culture. For example, a culturally sensitive approach may arrive at two fundamentally different approaches to development:

- *Development from above,* through the established authorities, is more effective in hierarchical or closed societies, which are oriented towards status, tradition and the preservation of stability
- *Development from below,* through participatory processes, is more effective in segmented or open societies, which are oriented towards competition, experimentation, individual achievement and social change

3.3 What matters at the level of financial systems?

Financial systems matter: Well functioning financial systems must be in place if sustainable development and poverty alleviation are to occur. Governments and donors have to realize that financial systems and functioning networks of MFIs evolve over long periods of time:

- Donors can contribute to that evolution, but only in a long-range perspective and in a coordinated and goal-oriented manner.

Financial sector policy matters:

- Interest rate deregulation, with interest rate autonomy on deposits and loans.
- Institutional deregulation, to freely establish financial institutions and branches.

The legal framework matters: Appropriate legal forms allow people to establish their own financial institutions in private, cooperative or community ownership:

- Donors should support the financial authorities in providing an appropriate framework.

- The most important legal forms are privately owned rural banks and financial cooperatives, to which reformed AgDBs may be added in some regions.

Capital matters, but capital transfer has undermined rural finance and development: Reliance on external resources, interest rate subsidization and outside administrative control led to misallocation of scarce resources, corruption and external debts not matched by productivity increases.
Under disbursement pressure, donors have provided credit lines in substitution of domestic savings, undermining the growth of self-reliant financial institutions. The main functions of capital transfer from abroad should be:

- bridging temporary shortages in loan capital through credit lines;
- investing in deposit-taking institutions, providing leverage for savings mobilization;
- strengthening the capacity of R/MFIs to generate their own resources: savings and retained earnings.

Savings matter, with interest rates above the inflation rate (to prevent the erosion of value):

- as a service to the poor, to deposit and accumulate their savings in a safe place, and as a safety net;
- as a source of self-reliance and self-esteem among the poor;
- as a motor of group dynamics and social cohesiveness;
- as a source of loanable funds and self-reliance for (rural) financial institutions;
- as the main source of domestic capital in the national economy.

Two strategies for coping with high inflation are recommended: insisting on deposit interest rates above the inflation rate and matching savings with credit.

Financial intermediation matters:

- it generates loanable funds on a sustainable basis at a low cost and creates economies of scale with lower transaction costs for each additional service.
- savings-first for subsistence and low-yielding activities, credit-first for high-yielding activities – depending on the rate of return.

Interest rates on deposits matter:

- Interest rates above the inflation rate on deposits prevent the erosion of capital.
- Interest rates below the inflation rate make the poor poorer.

Interest rates on loans matter: They must cover all costs; subsidized interest rates deepen poverty:

- They encourage investments that will prove unviable when the subsidy ceases, thereby making people poorer.

- They undermine the health of financial institutions, thereby making institutions poorer.
- They channel scarce financial resources to areas and investments with low returns, thereby making the country poorer.
- Caps on interest rates curtail viability and outreach, rob savers and investors of the value of their resources, and ruin MFIs.

Institutions matter (projects do not): Institutions are the social capital of a society, providing continuity and efficiency. Donors may:

- support a differentiated financial infrastructure with competitive formal, semiformal and informal institutions organized in networks;
- support the expansion of sustainable rural financial institutions and their outreach;
- provide opportunities and incentives for upgrading non-formal to formal institutions;
- support the transformation of unregulated credit institutions to regulated deposit-taking institutions;
- **abstain from perverse incentives** which enable NGOs, AgDBs and others to maintain unviable operations.

Competition matters: An emphasis on the creation of a competitive environment entails:

- institutional diversity (e.g. financial cooperatives, rural banks, AgDB branches);
- pressure to perform, through effective supervision and enforcement of standards;
- procedures of bankruptcy for non-performing institutions.

Prudential regulation and supervision matter: Regulation is a prerequisite for financial market development and must be enforced by effective supervision. Sida should strengthen:

- the political will and institutional capacity to enforce standards of performance.
- the restructuring or closing of non-performing financial institutions, instead of bailing out terminally ill institutions – *bankruptcy matters too!*
- bank supervisory authorities or central banks and, under delegated supervision, networks and auditing apexes of rural banks, SACCOs, and other R/MFIs.

Knowledge matters: The wealth of highly variegated institutional experience has largely escaped knowledge management at the level of donor organizations, countries and regions:

- Sida will have to take up the challenge of establishing a system of knowledge management, perhaps in cooperation with other donors.
- Knowledge and experience may be transmitted to staff through professional development training and exposure visits.

3.4 What matters at the level of institutions?

Institutional reform matters: There are striking cases of reform of different types of institutions, leaving no excuse for continual support to unviable institutions. Lessons include:

- Financial sector policies such as deregulation of interest rates and the provision of legal forms for regulated financial institutions are conducive to financial innovations.
- Any type of financial institution can be reformed, including credit NGOs, SACCOS and AgDBs.
- The transformation of unregulated credit institutions into regulated deposit-taking institutions deserves high priority.
- With attractive savings and credit products, appropriate staff incentives, and an effective system of internal control, rural microfinance can be profitable.
- The poor can save; rural financial institutions can mobilize savings cost-effectively.
- If financial services are offered without a credit bias, demand for savings deposit services exceeds the demand for credit by a wide margin.
- Incentives for timely repayment work.
- Outreach to vast numbers of low-income people and sustainability are compatible.
- Transaction costs can be lowered, profitability and outreach to the poor increased, by including the non-poor and their demands for widely differing deposit and loan sizes.

Ownership and institutional autonomy matter: Credit NGOs lack ownership; private ownership is most effective, but:

- depending on culture, institutions can be sustainable and reach vast numbers of the rural poor under any type of ownership, also by government as in BRI/Indonesia, BNDA/Mali and BK/Iran;
- individual or cooperative ownership by the poor as shareholders of MFIs, including transformed NGOs, deserve special support;
- management autonomy in terms of customer selection and loan decisions is more important than ownership. Sida should strengthen this and refrain from targeting.

Viability, efficiency, sustainability and self-reliance matter: Sida should support the enhancement of:

- the mobilization of domestic resources, such as savings, equity and borrowings;
- profitability, requiring adequate repayment and coverage of all costs from the margin;
- cost-effective microfinance products and services:
- an adequate regulatory framework.

Saver and borrower outreach matter: In contrast to a ubiquitous credit bias of donors and governments, both saver and borrower outreach matter, of small as of large institutions. There is strong evidence of the compatibility of outreach and sustainability, except under conditions of fixed interest rates:

- Support both saver and borrower outreach.
- Insist on mutually reinforcing growth of sustainability and outreach, allowing for adequate interest rates above the inflation rate and profits.

Sustainable outreach to marginal rural areas requires recognition of, and support for:

- The primacy of savings and self-financing, due to the scarcity of markets.
- Member-owned SHGs and cooperatives, operating at low costs.

Lending technology matters – and should not be a matter of ideology:

- The poor can be reached by either individual or group technologies, if properly applied.
- Group technologies with joint liability are more effective for small loans to the very poor.
- Individual technologies offer opportunities for graduating to larger loans and sustainable movements out of poverty.

MFI portfolio diversification matters as a risk management strategy:

- Support portfolio diversification of both clients and MFIs.
- Abstain from imposing loan purposes, which create undue risks and costs.

Good practices, not best practices, matter: The term best practices evokes notions of optimal solutions and leads to inappropriate replications:

- Support satisfactory culturally appropriate solutions.
- Support financial innovations and adjustments to local culture and avoid rigid replication of success stories.

Institutional size matters, but not absolutely; there is no best practice in terms of size:

- Support both, small numbers of large, and large numbers of small, institutions; there is no minimum size of sustainable institutions, as in the case of SHGs and cooperatives.

Profits matter: Profits are a source of capital and a major determinant of growth of outreach.

- Support studies of profitability of different credit and savings products.
- Support organizational efficiency, bringing down interest rates or increasing profits.

Incentives matter: While profits are a source of incentive payments, incentives are at the same time a major determinant of profits. Sida may support:

- the transformation of branches into profit centres;
- the introduction of systems of staff performance incentives;
- client incentives (rather than penalties) for timely repayment.

Repayment matters: There are many institutions of different types with repayment rates near 100%; however, enforcing perfect repayment may not be cost-effective and curtail outreach. Sida may support measures to attain adequate repayment based on:

- appropriate terms like size, instalments, grace periods, purpose, timely disbursement;
- sound practices of loan enforcement, insisting on timely repayment;
- joint liability, peer pressure and informal collateral;
- support adequate Management Information Systems with provide timely information

Financial products and delivery systems matter:

- Support the development of demand-oriented and cost-effective savings and credit products.
- Support measures to bring the MFI to the people (e.g. doorstep services, balancing transaction costs between clients and institutions.

Loan protection matters: Life (also health, cattle) insurance is a service to clients, but also part of loan protection:

- Support the development of cost-effective insurance services by MFI, particularly to cover the default risks arising from HIV/AIDS.

4. Sida's experience

4.1 Overview

Sida's microfinance portfolio comprises 30 contributions with a total portfolio of SEK 343m as of mid-2002. The rural finance portfolio comprises SEK 123m in 11 contributions. There is ambiguity and lack of adherence to sound practices, with recent, albeit unsystematic, shifts towards:

- an increase in the number of projects focusing on building sustainable MFIs;
- a stronger emphasis on the regulatory framework for MF in several countries;
- improvements in project appraisal and assessment of R/MFIs;
- the use of performance-based agreements;
- an increased use of technical expertise;
- support to networks and training service providers;
- innovative ways of providing equity to risk capital funds like AFRICAP.

Lessons taught by actual experience in the field have not always turned into *lessons learned*. This may change with the ongoing *Rural and Micro Finance Policy and Competence Development Project*.

4.2 Ethiopia: Amhara Credit and Savings Institution (ACSI)

4.2.1 Project background:

Sida's support to rural finance in Ethiopia is part of the Sida Amhara Rural Development Program (SARDP), in response to requests by the government and the ruling party. Rural credit is one of 19 project components.

4.2.2 Policy and regulatory framework:

In 1996, a microfinance law was passed which had both liberalizing elements, such as the authorization to mobilize savings, and repressive elements, such as restrictions on interest rates, loan terms and lending technology. The latter has prevented profit-making and thus private ownership. These restrictions are now being gradually removed.

4.2.3 The microfinance sector:

Ethiopia has large numbers of flourishing informal financial institutions. SACCOs were destroyed during the Marxist regime. The microfinance law has laid the foundation for registered MFIs with a borrower outreach of 510,200. Major sources of funds are savings, government equity and limited donor funds. MFIs are organized in a network, AEMFI. MFIs face a number of issues:

- *Absence of private ownership.* The six largest MFIs, accounting for 92% of borrower outreach, are owned by party-affiliated associations. Shareholding is nominal; there is no insistence on profitability. MFIs need to be "totally restructured" (DBE).
- *Transparency* on the basis of audited accounts is largely absent. Few board members are professionals.
- *Risk management* is inadequate. Off-balance sheet input credit poses a threat to the credit culture.
- *Access to large amounts of funds* through IFAD/AfDB is feared to work as a disincentive to mobilize private capital and savings.
- *Capacity building* needs concern all operational aspects. The MFIs are largely unprepared for the massive influx of resources from IFAD/AfDB.
- *Repressive microfinance policies,* which have been slowly changing, have reduced the viability of MFIs and the usefulness of their services.
- *Donor coordination* is a big challenge.
- *Market distortion:* In DBE's and AEMFI's view, equity grants by donors distort the market, except as seed money for start-ups. Expansion should be predominantly financed by savings, profits and commercial borrowings. Donors should support MFIs and SACCOs with capacity building only.
- *The indigenous base* in terms of informal financial institutions and their upgrading potential to SACCOs or "MFIs" has been largely, but not completely, ignored.

4.2.4 ACSI:

Despite its government origin, its dependency on government and donor funding, its rudimentary MIS and its lack of profitability due to repressive financial policies, ACSI has attained, within five years and against all odds:

- an effective saver outreach to over 300,00 clients, half of them also active borrowers;
- near self-reliance, where loans outstanding are matched by net savings (89%);
- loans almost fully repaid (98.9%);
- and with interest rate freedom, it should soon move into full cost coverage and profitability, financing its further expansion from its profits. There is thus little justification for pouring additional equity into ACSI.

ACSI is thus one of those institutions which defy generalization and are on the way sustainable outreach to larger numbers of the rural poor against all expectations. Sida has contributed to this.

4.2.5 Sida's marginal and contradictory role:

Yet, despite the impressive performance of ACSI, Sida has missed two opportunities by ignoring the fundamental contradictions of microfinance in Ethiopia between liberalization and repression:

- Through policy dialogue on liberalizing interest rates and other loan terms, Sida could have helped to promote institutional autonomy, growth and expansion of outreach through self-financing from profits.
- Through a more flexible use of its funds, Sida could have contributed to institutional innovations, helping to establish large numbers of privately or cooperatively owned small MFIs.

Sweden has made some of the poor richer; it could have made many more richer.

4.3 Zambia: Economic Expansion in Outer Areas

Sida's support: In Zambia, Sida supports the central bank in preparing microfinance legislation, the association of MFIs (AMIZ), a benchmark MFI (Pride Zambia) and a rural finance component in EEOA.

4.3.1 Policy and macroeconomic background, a difficult environment:

Neglect of agriculture, financial repression and high inflation rates have ruined the financial sector and undermined development. This has been slowly changing since the onset of liberalization in 1992, though the legal and police systems continue to be highly deficient, particularly concerning loan enforcement

4.3.2 The rural and microfinance sector: emerging from the ashes of directed credit?

The R/MF sector is poorly developed, with little if any transparency and very low rates of sustainability. Pride Zambia is a notable exception. Zambia might greatly benefit from an extension of services by the joint GTZ-Sida regional project located in the Bank of Uganda.

4.3.3 The case of Micro BankersTrust, EEOA's credit partner – will it recover from its fatal illness?

Poor donor inputs have led to the rise and fall of MBT between 1996 and 99. Its wholesale credit has completely failed. At the point of doom, it was revived by a contract with EEOA. It is doubtful whether can be turned around and continued donor dependency will probably not be helpful.

4.3.4 Economic Expansion in Outer Areas: EEOA uses facilitation

as an instrument of development. There are major deficiencies according to a recent evaluation: lack of a clear project objective, lack of proven credit system, weak and unsustainable local organizations, lack of a multiplier effect. The EEOA credit component, introduced in response to pressures from the Ministry of Agriculture, has undergone a process of trial and error, with no clear learning of lessons:

- a credit guarantee fund with commercial banks, 1996–98, failed utterly;
- only one MFI applied to channel left-over funds, MBT, which was technically defunct;
- MBT's attempt at wholesale lending through an MFI led to the collapse of that retailer;
- MBT's new retail lending through 34 interest groups lacks a financial technology; initial loan sizes are excessive, there are no incentives for repayment;
- There is no guidance, training and supervision of the groups;
- Savings deposited in banks by some groups have made people poorer, with an erosion in the value of saving of >25% p.a. In a highly inflationary environment, groups should adhere to the zero-cash principle, transforming savings immediately into loans at interest rates which compensate savers for inflation losses.

4.3.5 Suggestions to Sida

- SCC in Lusaka has spare human resources for guiding and training coops; EEOA groups and MBT need guidance and training; and the feasibility of cooperation between SCC and MBT may be further examined (views to the contrary at Sida notwithstanding). Examine the feasibility of cooperative loan protection schemes based on life-insurance, covering the default risks due to HIV/AIDS.

The Swedish Embassy is vigorously involved in development cooperation; its effectiveness may be further improved:

- Coordinate regular communication and cooperation between Swedish projects.

4.4 Mozambique: Fundo de Crédito Comunitário Norte

4.4.1 Unsustainable financial services vs. sustainable financial institutions:

There is consensus among NGOs in Mozambique that the time has come for consolidation and for taking steps towards sustainable institution building, requiring:

- A long term strategy coordinated among all stakeholders.
- Agreement on damage control by not intervening with directed credit.

4.4.2 FCCN, good intentions for viability and outreach:

FCC reports a national outreach of 7,000 and sustainability ratios above 100%. Yet, the expansion of FCCN into Nampula and, with Sida assistance, into Niassa, a sparsely populated area without access to markets, faces serious problems in attaining the dual goal of profitable operations and access to sustainable financial services. Nearly 3000 clients have been reached with microloans; one might be impressed by the detailed project documents, were it not for…:

4.4.3 An eye-opening evaluation:

A joint donor evaluation team found that, while staff commitment at field level was high, there were serious problems at head office level: the business plan was unacceptable, and FCC failed to submit consolidated financial statements and projections. It concluded that there is no basis for negotiating future support; and it "questions FCC's capacity to develop and/or implement a credible plan for building a sustainable microfinance institution." Meanwhile, there seem to have been some changes (including a new business plan), resulting in a more positive assessment by Sida (in contrast to UNCDF).

4.4.4 Donor pressure for institutional sustainability: will it work?

The donors insist that continuing donor support will require:

- Establishment of FCC as an independent legal entity and eventually, once legislation is in place, as a regulated institution.
- Mixed ownership, reflecting the investments and risks of the shareholders.
- Creative strategies of ownership and governance to facilitate institutional viability.
- Hiring a competent senior manager who has the confidence of the donors/investors.
- Close monitoring of performance benchmarks.
- Adherence to CGAP disclosure guidelines.

4.4.5 Lessons for Sida:

The donors intend to monitor compliance. Sida should:

- take an active role in the process of monitoring and enforcement of performance;
- learn from the experience; and
- apply the lessons learned to its projects elsewhere – i.e. how to insist on institutional sustainability and self-reliance, and to withdraw otherwise.

4.5 Eastern Europe and the case of Bosnia & Herzegovina (BiH)

During recent years Sida has initiated support in the Balkans with an emphasis on building financial institutions with services to a broad range of target groups in rural areas.

4.5.1 A foundation for a solid system of rural finance?

In its RF Portfolio Overview 2001, two stand-alone projects are listed with a focus on rural micro credit, in Serbia/Montenegro and Kosovo; yet,

- Sida's past and current project support to BiH is not included in the review, raising questions of knowledge management of Sida's experience of institution-building.

4.5.2 Building credit NGOs with equity – in cooperation with other donors:

Through its support to EKI and AI (also its partner in Serbia/ Montenegro) in BiH, Sida has demonstrated under comparatively favourable conditions:

- the feasibility of sustainable rural credit, with individual and group technologies;
- the compatibility of institutional sustainability and efficiency with outreach to increasing numbers of rural clients including the poor.

4.5.3 From a credit NGO to a savings-based financial intermediary?

With assistance and pressure from USAID and EU, two legal forms have been created in BiH:

- Microcredit organizations (MKO) under the supervision of the Ministry of Social Welfare, which are not authorized to mobilize savings, with a minimum capital requirement of $5,000 and similar reporting requirements to those of banks;
- Commercial banks under central bank supervision, authorized to mobilize savings, with a minimum capital requirement of $7m.

EKI and AI are MKOs dependent on the supply of loanable funds on donors. Sida has contributed large amounts of capital, but has failed to insist on transformation into a commercial bank. This has created two constraints:

- A weakening of the self-financing capacity of farmers who lack deposit facilities.
- A lack of growth of loanable funds from deposits.

In contrast to EKI and AI, CHF MKO in BiH, which is also supported by Sida, is expected to turn into a bank within 3–5 years: as a result of pressure from CHF, not Sida.

4.5.4 The experience of regulated financial intermediaries in BiH: a model for MFIs?

The number of commercial banks is rapidly increasing in BiH. Raiffeisen Bank has demonstrated the feasibility of savings mobilization and self-reliant financial intermediation through branches in rural areas: Micro Enterprise Bank, established by consulting firm IPC (Frankfurt) and its international capital fund IMI, the feasibility of small enterprise and agricultural lending – at zero loan losses. Both might serve as benchmark institutions, which have attained viability at branch level within less than a year. There is thus no excuse among MFIs:

- for not lending to agriculture and small enterprises;
- for a lack of self-reliance and sustainability;
- for not converting, if equity is sufficient, into a commercial bank.

4.5.5 From donor-dependency to self-reliance: a challenge to Sida and the donor community:

In BiH, donors including Sida have created viable financial institutions with a social mandate and a commercial orientation; but they lack dynamic growth from savings, while their clients lack opportunities of self-financing from savings and are forced into barter. Sida should:

- support new MFIs only with the expectation of transformation within a specified timeframe into deposit-taking commercial banks;
- stop supporting the expansion of outreach of mature MFIs with equity and support instead their transformation into deposit-taking institutions;
- work toward a joint donor strategy on the transformation of MFIs.

Sida may further support *innovative options for ownership* of credit NGOs/MKOs when transformed into banks:

- Promote private or cooperative ownership of MFIs, MKOs or commercial banks by clients as shareholders.

4.6 Nicaragua: FondeAgro

4.6.1 Project background:

Sweden has been cooperating with Nicaragua since the early 1980s. Currently, Sida supports:

- *The Nicaraguan Association of MFIs (ASOMIF):* Sida supported ASOMIF's creation (1998) and has played a supportive role without interfering in the Association's business. ASOMIF has developed as an independent, leading apex, playing a crucial role as an advocate and lobbying representative of 16 Nicaraguan MFIs, with almost 130,000 clients and US$51.8 million outstanding loan portfolio. ASOMIF also plays a dynamic role within the Central American MFIs Network, REDCAMIF, whose consolidated MFIs report 362,600 clients and an outstanding loan portfolio of US$141 million, 67% invested in rural areas. Through ASOMIF, Sida is contributing to the advancement of microfinance in Nicaragua and Central America. ASOMIF has played a leading role in disseminating and establishing industry performance standard among its members, publishing industry data, and playing an advocacy role with government
- *The Agricultural Development Fund Project, FondeAgro (2001–2011):*
  This is an agricultural development project with several components (technical assistance for agricultural production, credit, homestead economy, land property and institutional strengthening of municipalities). The credit component consists of funds for credit lines and institutional strengthening. In 2002, FondeAgro selected a competitive bid from three MFIs that met the criteria of: (1) financial specialization, experience and commitment to rural clients with presence in the project target areas; (2) proposed strategy to serve the target group, outreach and financial performance indicators; (3) portfolio growth and quality; (4) operating capacity and procedures, MIS and available infrastructure; and (5) managerial capacity as demonstrated by qualifications and experience of technical and administrative staff.
  The major challenge for the project is how to contribute to sustainability of MFIs with agricultural loan products to clients targeted by the project.

4.6.2 Policy and regulatory framework:

Nicaragua's private financial system is the youngest in Latin America. In the past decade, the government has undertaken a series of reforms: the latest Bank Law was passed in 1997. The Superintendence of Banks, created in early 1990s, is still in a process of strengthening its own capabilities to regulate banks and other financial institutions. Despite major expansion, the geographic coverage of Nicaraguan banks is still poor compared to other Central American countries. Banks are characterized by operational inefficiencies as measured by their high interest spreads. The liquidation of the National Development Bank (BANADES) in 1997 resulted in an increase in the number of micro-lending NGOs. Two credit NGOs, operating mainly in urban areas, have converted in the past 3 years into regulated financial companies. The government controls the interest rates charged by non-regulated private institutions (e.g. NGOs) at some points over the average rate of banks' interest rates. NGOs compensate the interest rate ceiling by charging clients commission charges. Interest rate controls contribute to the MFIs' lack of transparency as they need to disguise ways of recuperating their costs through commissions.

4.6.3 The microfinance sector:

There is a very competitive and dynamic MF market with many credit NGOs competing for donor funding which is abundant. Recent assessments by the World Bank (2002) identified the following issues and suggested public policy issues for strengthening the Nicaraguan financial sector and deepening the financial markets:

- A consistent and appropriate regulatory framework for providers of financial services, basic financial sector infrastructure and a consistent approach for targeting donor and government support to the financial services industry based on achieving unsubsidized private sector competition.
- Reforming legal norms and regulatory standards (e.g., micro-loan classification and provision, hours of operation) that discourage banks and finance companies from serving small-scale and rural markets.
- Reviewing current practices of government and donor-financed credit programmes that distort credit markets.
- Encouraging sustainability-oriented microfinance NGOs to work toward conversion into formal commercial finance companies. Subsidies are targeted to microfinance NGOs without any uniform, accounting or performance standards. Competition on a level regulatory playing field is the most effective way to encourage increased efficiency among financial service providers.

4.6.4 Did FondeAgro select the right partner institutions?

Out of 7 proposals, FondeAgro selected three institutions, FDL, FIDESA and Hermandad Campesina which are at different levels of operational and financial sustainability[1]:

- *FDL, at the most advanced level:* As one of the top Nicaraguan MFIs, FDL is reaching financial sustainability (covering operational and financial expenses from its own revenues), has an outstanding loan portfolio of US$8 million and 15,680 clients. Sixty per cent of FDL's operations are in rural areas where it has a solid institutional experience in reaching poor clients. FDS is the right partner for Sida to develop rural microfinance in Nicaragua (and perhaps later in Central America). FondeAgro should support FDL's own strategy rather than FDL reaching project targets.

- *FIDESA, at an intermediate level:* With a US$2.6 million outstanding loan portfolio and close to 2,000 clients (60% to 70% rural), this NGO is in the process of consolidating its financial services (separately from its parent NGO) and has the mission of serving rural population.
- *Hermandad Campesina, at a beginner's level:* With 450 members,100% rural and a loan portfolio of US$0.77 million, this credit and savings cooperative is still dependent on subsidies and other institutional support to carry out its operations. Hermandad Campesina is the result of the completion of an international rural development project with a credit component.

These three institutions operate in the geographic areas targeted by the agricultural development project and are already reaching target project participants. The project's target has been estimated to be 3,200 participants. While FDL can be a strong partner and a counterpart for rural microfinance, the other two institutions need more monitoring and technical support. Can FondeAgro provide this type of support to the less developed MFIs? Since FondeAgro is an agricultural development project, the credit component activities might be necessary but not sufficient to support the type of inputs FIDESA and Hermandad Campesina require to become sustainable MFIs.

4.6.5 Issues for Sida's approach to rural financial services at a general/strategic level in Nicaragua:

The experience of Sida's involvement in Nicaragua is at two levels:

1. At the microfinance industry level: Sida's support for ASOMIF is contributing to advance the industry and providing for:

- An enabling policy and regulatory environment for MF: Sida's support for ASOMIF is contributing to building private sector capacity to advocate and present a solid case for microfinance. Furthermore, microfinance needs to be linked to the financial sector. ASOMIF can be a broker in developing links and sustainable relationships for the nascent MF industry.
- MF industry standards: ASOMIF is already pushing for MIF's to adopt and perform according to internationally accepted standards. This is critical to MF viability since sound and prudential practices should be followed by the MFIs independent of government regulation.
- Building finance infrastructure: The MF industry needs to develop an infrastructure of services that support MFIs' sustainability. This infrastructure includes industry services such as credit bureaux and rating agencies.
- Donor coordination: needed in Nicaragua in order to avoid a situation in which donors undermine each other.

2. At the project level – FondeAgro:

- *Credit component as part of an agricultural development project:* Since FondeAgro is an agricultural development project, Sida should be careful to avoid raising the expectations of the potential of its credit component (for targeted agricultural activities and clients) to deal with a variety of rural microfinance issues. It is valid for an agricultural development project to include issues dealing with the financing of agricultural activities such as credit – one of the key inputs (technical assistance is another) for increasing productivity and market competitiveness.
- *Institutional viability vs. project related-targets:* The FondeAgro project deals with a specific product, agricultural loans. Developing agricultural loans can be an appropriate objective if these loans contribute to long-term institutional sustainability.
- *MFIs institutional sustainability vs. project target objectives:* Careful consideration should be given to each MFI's institutional development strategy and how the FondeAgro programme supports their strategy and not the reverse (MFIs change their strategy to meet project objectives).
- *Product innovation:* FondeAgro's credit component provides an opportunity to identify good practices in agricultural lending (directly supported by the programme) as well as non-agricultural loans (other rural-related activities) based on a performance analysis of the institutions involved in the programme.
- *Lending methodology:* FDL is playing a key role in the advancement of rural microfinance in Nicaragua. For example, FDL has already demonstrated that it is possible to: (1) reach rural clients whose main activity is agriculture, although their debt-paying capacity is not based merely on agricultural activities; and (2) lend for agricultural and non-agricultural activities with a credit methodology that responds to poor rural borrowers in terms of: collateral requirements (e.g. legal registered title not required, alternative guarantees such as group guarantees); loan size (ranges vary from very small to larger amounts); loan repayment (e.g. a variety of options based on cash flows of borrowers).
- *The pilot phase:* The component includes an evaluation at the end of phase I (2003). This is an opportunity for Sida to assess: (1) on the basis of the performance of selected MFIs during pilot phase, the best performer to continue developing good practices in agricultural lending as part of the partner MFIs' overall institutional strategy; and (2) support the institutional development of other MFIs if it feasible as part of a Sida's overall strategy to build rural microfinance capacity in Nicaragua in the long-term without focusing specific on short-term project objectives (delivering a target number of agricultural loans by a specific date).
- *The exit phase:* FondeAgro's design contemplates the option for selected MFIs to have their capital strengthened subject to satisfactory performance in managing lending portfolio. Institutional support contributes to strengthen their operational and financial capabilities.

Sida's role in donor coordination: Sida has a long commitment to Nicaragua's development. Its leverage among international, governmental and private institutions can contribute to donor coordination to advance microfinance. Donor collaboration is needed in every aspect of microfinance: setting priorities in policy dialogue, apex support, attracting private equity investments and initiatives to support MFIs (in upgrading, expanding, downscaling), developing new financial products (e.g. housing finance, agricultural loans, rural savings products, remittances). The microfinance experts at the Swedish embassy in Nicaragua and at the FondeAgro project can contribute to donor coordination and collaboration.

5. Comparative analysis

5.1. The two worlds of rural and microfinance revisited

There are numerous notable new developments in R/MF but, in the majority of countries, there are still major shortcomings that call for country-driven, coordinated interventions. Donors with their projects are found in both worlds; but there is an overall move from the *old world of supply-driven development finance to the new world of demand-driven commercial finance.* Sida is among those donors where this move is not consistent. In areas like the Balkans, Sida has moved into the new world of institution-building. In the three African countries examined, it has adhered to what it calls a *needs-driven approach,* responding to an imputed need for credit – rather than a need for reliable financial institutions and sustainable financial services comprising not only credit but also savings.

Disbursement without development: In a number of instances, Sida's projects appeared to be characterized by disbursement without supervision:

- driven by a pressure to disburse,
- rather than by a pressure to attain objectives of development and poverty alleviation.

This has led to *disbursement without development.*

The matrix below summarizes the findings and lessons learned from international experience. To a large extent, many of Sida's projects outside the Balkans fall into the left-hand column of the *old world* of the needs-driven approach. The resulting message is unequivocal: To adhere to its mandate given by the Swedish Parliament, Sida must decide on a definite move towards the new world of institution-building as described in the right-hand column.

Typology matrix: The *old world* of the needs-driven approach vs. the *new world* of institution-building in R/MF: the Do's and the Don'ts of R/MF

	Sida, don't support: *The old world of the needs-driven approach*	**Sida, do support:** *The new world of institution-building*
Policy environment	Financial repression	Prudential deregulation, fin. system dev
Legal framework	Lack of private local R/MFIs	New legal forms for local R/MFs
Develop't approach	Supply-driven	Demand-driven
Institutional focus	Monopoly institutions	Various competing financial institutions
Clients perceived as:	Beneficiaries	Customers
Selection of clients	Targeting by donors and governments	Self-selection
Outreach	Limited outreach to groups	Potentially all segments of the economy
Incentives	Perverse: leading to fund misallocation	Efficient allocation of funds
Non-formal FIs	Millions of informal MFIs ignored	Opportunities for mainstreaming
Semiformal FIs/NGO	No standards, no deposit mobilization	Conversion to deposit-taking formal FIs
Financial coops	Unsupervised, ruined by governments	Self-reliance; low costs, expansion
AgDBs	Lack of viability and outreach	Reforms towards autonomy, viability
Rural banks (RBs)	Lack of opportunities for private RBs	Legal framework for private RBs
Regulation and supervision (R&S)	Coops, MFIs, AgDBs unsupervised; donors keep distressed institutions alive	MF units in CBs; regulation of RBs/MFIs; closing of distressed FIs
Commercial banks	Unable to lend to a variety of sectors	Some outreach to micro-entrepreneurs
Agricultural finance	Lack of self-financing and credit	Self-financing thru savings and profits
Remote and marginal areas	Futile attempts of donors to drive ill-suited MFIs into remote areas	Self-managed savings-based SHGs and cooperatives operating at low cost
Individual and group technologies:	Rigid replications without growth of outreach and sustainability	Both can be profitable and reach micro-entrepreneurs and the poor
Non-financial services	Maximalist approach without cost coverage undermines FIs	Provided by SHGs, other agencies, FI subsidiaries; balance of objectives
Targeting	Undermines outreach and viability	Differentiated financial products
Linking banks and SHGs/MFIs (LBS)	Lack of healthy banks with a mandate to be of service	Spectacular increase in outreach to the poor; profitable if interest rates are free
Interlinked schemes	Lack of institutional sustainability	Ltd.success under controlled conditions
Self-reliance	NGOs, AgDBs barred from deposit-taking; donor and gov. dependency	Self-financing through deposits and profits; institutional autonomy
Sustainability	Donors, gov. fail to insist on performance standards and sustainability	Increasing numbers of self-sustaining institutions of any type and ownership
Access to financial services	No access of many poor and non-poor to savings, credit, insurance	Sustainable access of the poor as users and owners of R/MF institutions

5.2 Strengths and weaknesses of Sida

Sida has the following strengths and comparative advantages:

- Swedish social capital through a history of savings-based microfinance, comprising *Sparbanken* and *Föreningsbanken*.
- Experience with long-term institution-building in the cooperative and savings banking sectors, particularly in East Africa.
- Assistance through grants, without increasing indebtedness of recipient countries.

- Freedom in the selection of countries, projects, partners and types of institutions.
- Flexible use of funds as equity, grants for onlending, experts, capacity building, operational support.
- Presence in the partner countries through the Swedish embassies.

Weaknesses to be remedied include:
- Lack of institutional memory (e.g. of cooperative institution building).
- Lack of systematic use of Swedish social capital and experience.
- Lack of knowledge management; *lessons taught* do not lead to *lessons learned.*
- Lack of application of rural finance guidelines and financial sector policy of 1997.
- Lack of consistent financial sector development and R/MF institution building.
- Lack of project performance monitoring & supervision.
- Supply of easy money discourages R/MFIs to mobilize resources domestically.
- Continued support of failing projects and distressed institutions.
- Lack of insistence on upgrading NGOs/MFIs into deposit-taking institutions.
- Lack of impact, due to faulty project designs and lack of effective project supervision.
- Lack of systematic use of experts at project, national and regional level.
- Lack of participation in policy dialogue.
- Lack of insistence on policy and macroeconomic conditionalities in R/MF projects.
- Lack of systematic donor cooperation and co-financing (e.g. with IFAD).
- Lack of facilitation of information exchange between projects by Swedish embassies.

Donor organizations like Sida need performance standards, effective supervision and the enforcement of standards as much as the financial institutions they support. This requires:
- The political will to introduce self-regulation.
- Organs of internal and external control.

5.3 A special role for Sida in marginal areas?

Characteristics of rural finance in marginal areas: So far, Sida has put a major emphasis on remote areas. To these, most of the characteristics given above (B 2) apply. These are areas which have not been at the centre of attention during the recent microfinance revolution. Little systematic work has been done on finance in remote and marginal areas, either by Sida or by major donors who focus on agriculture and the very poor. Rural finance in such marginal areas faces a number of *challenges,* mostly on the demand-side, many of which are not unique but shared with the urban informal sector:

- The customer is the household as a complex of diverse economic activities rather than the individual farmer or micro-entrepreneur.
- Farm and micro-enterprise budgets are intermingled with household budgets.
- Strong demand for safe-keeping of savings.
- Comparatively weak overall effective demand for credit.
- Demand for small loan sizes and short loan terms.
- Demand by a few for additional term credit.
- Wide variation of risks according to agro-ecological zone and high co-variant risks.
- Lack of enforceable physical collateral.
- Demand for appropriate risk management through portfolio diversification, appropriate loan terms and joint liability.
- High institutional transaction costs.

Appropriate institutional responses to these challenges include:

- Self-help and self-reliance as basic principles in the design of local financial systems.
- Self-financing, savings-based or local capital-based institutions.
- Flexible financial services responsive to actual demand.
- Creditworthiness examinations based on the household as a whole with all its activities, sources of income and total repayment capacity.
- Informal collateral and peer pressure as a collateral substitute.
- Small and variable loan sizes, repeat loans starting very small and very short-term.
- Zero-cash principle, recycling savings and loan repayments upon receipt.
- Member-owned and member-managed institutions, based on institutional autonomy and independent of political influence.
- Balanced interest-rate structure, based on deposit rates above the inflation rate and lending rates which cover costs, risks and erosion losses due to inflation.
- Transaction costs lowered by self-management and effective risk management.
- Linkages of local institutions to formal institutions for liquidity (surplus and deficit) exchange.

Alternative strategies for Sida – for or against marginal areas:
Several alternatives are open to Sida:

- Given its present policy of minimal involvement of foreign experts in the field, to focus on such areas as building R/MF units in central banks or transforming credit NGOs into regulated financial intermediaries, staying out of remote areas.

- To support in-depth field studies of financial innovations in selected marginal areas in preparation of future support.
- To support institutional innovations in selected marginal areas through support which includes foreign experts on a substantial scale and over an extended period of time.

There are no generally applicable best practices that could be cast into recommendations for Sida. In fact, there are considerable variations in what works and what does not work in different countries and geographical areas. Thus, in every particular case, detailed feasibility studies are required to work out an appropriate approach, which subsequently requires careful monitoring and re-planning based on actual experience, including terminating projects or closing institutions if found unworkable or unsustainable.

How Sida may support rural finance in marginal areas – through SHGs: Sida may want to stick to its focus on marginal areas and the poor, and it may want some more concrete advice, which it will have to take with due caution, first on inappropriate and appropriate institutional vehicles for its support:

- Mostly inappropriate institutional vehicles for marginal areas are commercial banks and credit NGOs.
- Mostly appropriate vehicles are indigenous informal financial institutions on a self-help group basis, and newly established autonomous self-help groups (SHGs).

However, these are gross generalizations. In different countries, very different types of institutions have shown the willingness and ability to respond to the particular challenges of remote areas. In each individual case, much depends on political will, individual moral commitment, and innovative capacity – which may, or may not, be open to external influence.

Projects of promoting SHGs, networks of SHGs and linkages with banks in marginal areas have proven successful in recent years in African Sahel countries such as Mali and Burkina Faso,[2] in Asian countries like India[3], Indonesia[4] and Nepal[5], and in Syria[6]. The regional agricultural credit organizations, APRACA and AFRACA, have played prominent roles in a number of Asian and African countries.

There are *two basic strategies* for supporting indigenous or new SHGs as autonomous local financial institutions in marginal areas:

- Through networks or federations of SHGs, implying that both SHGs and their networks are being promoted in the framework of a project.
- Through linkages of SHGs with regulated financial institutions like AgDBs, rural banks or other types of deposit-taking financial institutions.

In either case, support for new (rather than ongoing) projects requires a thorough feasibility study, a long-term perspective of support, long-term experts, the willingness to work, in the long-term perspective, towards a legal status for the SHGs or their networks or federations, and possibly cooperation with other donors and with regional organizations.

Appropriate partners for Sida for the first approach may comprise AgDBs and development NGOs, which will eventually transfer their institution-building and –maintenance functions to networks of SHGs[7]. Partners for the second approach may include AgDBs, rural banks or other types of deposit-taking financial institutions. Manuals for institution-building and training exist, but would have to be adjusted.

6. Conclusions and recommendations to the management of Sida

6.1 Fundamentals of sustainable development and rural finance: adopt, modify or reject them

Decide on fundamentals…: The following fundamentals of sustainable development and rural finance are generally accepted in the development community; but gaps might exist between their general acceptance at the level of senior management and advisory units and their actual adoption at the level of operational departments. At all levels, the staff of Sida has to realize that these fundamentals are objectives to be attained, with due support, in the long-term perspective and through a variety of interventions. While the actual contribution of a particular project to any of these objectives might be quite limited due to external or internal factors, great care is to be taken, through damage control, that their attainment is not undermined by any part of the intervention. For example, the generous supply of credit must not undermine existing efforts of local institutions to mobilize savings, recycle them through loans and cover their costs.

… in a participatory process: It is of crucial importance that the management of Sida identifies with the fundamentals of sustainable development. This may require a participatory process of clarification and decision-making in which any of the tenets listed below may be *adopted, modified, reformulated, complemented or rejected.* It is essential for Sida as for any other development organization to critically examine the fundamentals and recast them as seen fit.

6.1.1 Sustainable development requires:

- continual growth and diversification of the rural economy;
- access of all segments of the population including rural microentrepreneurs, farmers and the poor to sustainable financial services such as savings, credit and insurance;
- provided by self-reliant, sustainable financial institutions,
- adjusted to the cultural and socio-economic conditions in their area of operation;
- in a conducive macroeconomic policy environment;
- with coordinated donor support, including cooperation and co-financing.

6.1.2 Sustainable rural microfinance requires local initiatives and careful donor support for the development of institutions, enabling them to:

- offer both savings and credit services;
- mobilize their own resources;
- have their loans repaid;
- cover their costs from their operational income;
- finance their expansion to the poor and non-poor from their profits.

6.1.3 Governments, with careful donor assistance, have to provide,

- a conducive policy framework with deregulated interested rates;
- an appropriate legal framework for competitive local and national financial institutions with different forms of ownership, including private, cooperative, community and also government ownership;
- a system of prudential regulation and effective direct or delegated supervision.

6.2 Options for Sida: select, decide and implement

Decide on options…: There is a wide array of options available to Sida as a bilateral donor of technical and financial assistance on a grant basis. The following recommendations are made on the basis of discussions with Sida staff, documents, and field visits. As these are options, the management of Sida has to take decisions (i) on their adoption, (ii) their relevant weight in Sida's intervention, and
(iii) their application in specific projects. For example, whether or not Sida decides on providing more experts requires first a general decision by management, followed by specific decisions in every single project.

… in three steps…: Recommendations are made in three steps: first at a general level, which includes tools and instruments; then at a more specific level, where Sida may chose between interventions with other donors, other Swedish agencies, direct interventions in established fields of development cooperation, and more experimental and innovative projects; and finally at the level of a type of intervention specific to the rural poor in marginal areas. The latter is the option which this consultant would select if the decision were put into his hands.

… again in a participatory process: At every one of these three levels, it is recommended that management reaches its decisions through a participatory process. Again, these decisions will have to be made in two steps: first for Sida as a development agency, then for each particular project. In the case of innovative options, management may greatly benefit from exposure visits to selected programmes before reaching a final decision. Transmitting policy decisions to operational departments will remain a continual challenge:

- Examine the feasibility of a matrix structure, with operational responsibility in the operational units and responsibility for project design and performance in the financial sector & microfinance unit
- Create a mechanism for monitoring the effective implementation of policy.

6.2.1 Sweden may contribute to the development of rural financial systems through:

- experts for R/MF units in central banks, R/MF networks and leading R/MFIs;
- regional R/MF experts for consultancy, training, information exchange and supervision of Sida-supported projects and MFIs;
- policy dialogue;
- social and human capacity building in financial authorities, R/MFI networks and R/MFIs;
- equity investments with leverage through deposit-taking, clear ownership and an exit option;
- no credit lines, cooperating instead with FA donors to bridge temporary liquidity gaps of (emerging) sustainable R/MFIs;
- financial and technical assistance for the transformation of MFIs into regulated financial institutions such as rural banks, community banks, thrift banks, commercial banks, finance companies or similar institutions;
- technical and financial assistance for the promotion of ownership of financial institutions by the poor as shareholders, particularly in the process of transforming credit NGOs into regulated institutions;
- donor coordination of financial and technical assistance, cooperation and co-financing, making good use of the comparative advantages of multilateral donors and Sida as a flexible bilateral donor;
- Sweden's social capital, embedded in its own financial and other institutions.

6.2.2 Specific major options for interventions:

a)Interventions in partnership with other donors:

- *With financial assistance agencies:* Building a rural financial infrastructure, including networks of R/MFIs and apexes.
- *With technical assistance agencies:* Developing a legal framework for rural banks and other regulated MFIs; capacity enhancement of networks of R/MFIs; establishing systems of effective (delegated) self-regulation and self-supervision through auditing federations.

b)Interventions in partnership with Swedish agencies:

- *With the Swedish central bank:* Capacity enhancement of banking supervision and establishing a R/MF supervision unit in the central bank.
- *With representative bodies of Swedish financial institutions:* Establishing networks of financial institutions including savings & credit cooperatives and savings banks; establishing systems of regulation and effective supervision, including auditing federations at network level and supervisory organs at central bank or government agency level.

c)Direct interventions:

- Transformation of AgDBs and major R/MFIs into sustainable deposit-taking institutions with a diversified portfolio.
- Supporting the establishment of transformed R/MFIs as lead agencies with training and consulting services for institutional reform.
- Development of self-regulation and (delegated) self-supervision in networks of MFIs.

d)Innovative lighthouse projects:

- Upgrading of member-based informal financial institutions.
- Promoting networks of informal financial institutions, SHGs and small co-operatives in marginal areas.
- Linking SHGs and non-formal MFIs to regulated financial institutions.
- Pilot-testing insurance products (e.g. in areas with a high incidence of HIV/AIDS)

Once Sida decides on particular options, in a first step, more detailed general recommendations and strategies will have to be worked out. In a second step, particular projects have to be prepared through detailed feasibility studies. There is no way of implementing a particular paradigm or approach without adjustment to a selected area.

6.2.3 Supporting self-help groups as autonomous local financial institutions in marginal areas: a preferred strategy for Sida?

If Sida, within the existing approach of area-based development programmes, decides to continue promoting rural finance in marginal areas with a focus on the poor, two basic strategies are suggested, both directed at indigenous or new SHGs as autonomous local financial institutions:

- Through networks or federations of SHGs, implying that both SHGs and their networks are being promoted in the framework of a project.
- Through linkages of SHGs with regulated financial institutions like AgDBs, rural banks or other types of deposit-taking financial institutions.

This option would require a thorough feasibility study in each case, a long-term perspective of support, long-term experts, the willingness to work, in the long-term perspective, towards a legal status for the SHGs or their networks or federations, and cooperation with other donors and regional organizations. Manuals exist, but would have to be adjusted.

Appropriate partners for Sida for the first approach may comprise AgDBs and development NGOs, which will eventually transfer their institution-building and –maintenance functions to networks of SHGs[8]. Partners for the second approach may include AgDBs, rural banks or other types of deposit-taking financial institutions.

6.3 A proposal beyond R/MF: opening up markets

The total effect of development assistance is small compared to the importance of opening up markets in the EU and elsewhere for products from developing countries. This would increase incomes of local producers and substantially increase the role of effective rural financial institutions.

- Sida should make every effort in Sweden and the EU to abolish agricultural subsidies and open up markets for developing countries.

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Endnotes

[1] A previous microfinance consultancy (IPC) had recommended working with one or two of the most advanced MFIs, which were NGOs in the process of becoming formal financial institutions. By the time FondeAgro was approved, the most advanced MIF had been converted to a regulated institution with an urban clientele. A second consultancy (SAS) recommended working with a variety of MIFs. This is what FondeAgro is doing.

[2] Cf. Transforming Rural Finance in Africa: The Role of AFRACA in Linkage Banking and Financial Systems Development. Internationales Afrikaforum vol. 32 no. 3, 1996: 185–190

[3] Seibel & Khadka 3/2001; Seibel & Dave 11/2002.

[4] Kropp & Clar de Jesus 4/1996

[5] Staschen 2001; Wehnert U. & R. Shakya, 2001

[6] Seibel 2002

[7] One example is the federations of SHGs (promoted by Nabard) in India with the legal status of MACS, a new type of cooperative status. As of end-2002, Nabard has established 500,000 autonomous SHGs with access to bank services, comprising some 40 million family members of very poor rural population segments.

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Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.

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