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BETTER PRACTICES FOR SCALING-UP RURAL MICROFINANCE IN TAJIKISTAN

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Introduction

The question of how to best develop an effective rural financial system has been much debated over the past three decades. A significant evolution in agricultural and rural development strategies has taken place over the last decade. This evolution represents a shift away from supply-led and interventionist policies towards a more liberal, market-oriented approach. Liberalization of the financial sector includes the elimination of regulated interest rates and directed credit programs, and the restructuring or liquidation of state-owned agricultural development banks.

Lack of access to formal credit and to full financial intermediation services impedes agricultural development and hampers the efforts to alleviate rural poverty. However, new initiatives are being undertaken to meet the demand for rural credit. They include the reform of agricultural development banks, enabling them to pursue a market approach in the delivery of credit services to small and medium-sized rural clients.

Two recent developments have influenced these initiatives. The first one has been the adoption of a "financial systems" development approach. This emphasizes the need for an integrated approach to financial market development and the provision of competitive and durable financial services in local financial markets. A clear understanding of both client demand and existing informal financial services providers is required. In fact, over the last decades, development agencies, NGOs, practitioners and researchers have accumulated substantial experience in operating financial services for rural clients.

The second development has been the emergence of specialized microfinance institutions. Microenterprise credit programs were initiated to address the unemployment problems that are associated with the vast rural-urban migration in developing countries. Initially, they targeted the promotion of self-employment and income-generating activities for the urban poor. The evolution in microfinance, like the earlier one in rural finance, has been affected by the principles of financial systems development. Attention is on developing financial institutions that target low-income clients while pursuing commercial viability.

Although today only a few microfinance institutions have achieved full financial independence, many more use innovative credit technologies and have developed organizational structures that produce positive results. These initiatives illustrate the potential to overcome the financial barriers that commercial banks traditionally face when they try to lend to low-income clients.

The goal of this research will be to identify those lending practices that are able to address the challenge of financing small farmer clients. Within the framework of rural financial markets, the text concentrates on the specific issues of lending to agricultural producers. The lessons that can be learned from microfinance will be reviewed and an assessment will be made of the possibility of transferring successful microcredit practices to agricultural lending. In addition, the experiences and the strategies of three micro and rural finance institutions doing agricultural lending will be examined in greater detail.

The research work will be divided into four chapters.

1. The rural microfinance: markets, costs and risks

1.1. Rural financial markets

From directed agricultural credit to rural finance

Until the early 1980s, agricultural planners were primarily concerned with the need to increase food crop production. The adoption of the new green revolution technologies was relatively costly and small farmers were perceived as being too poor to save and to self-finance the required investments in additional farm inputs. As a result, vast amounts of financial resources from governments and donors were poured into agricultural development banks and agricultural credit projects. These programs served as conduits for the provision of subsidized credit to small farmers often for specific production purposes.

The provision of subsidized and easily accessible credit constituted a central theme of the agricultural development strategies in the 1970s and 1980s. It was argued that enhanced access to credit would accelerate technological change, stimulate national agricultural production through increased farm output and improve rural income distribution. However, this approach failed to produce the desired results. The reasons for the failure of these policies were manifold and have been detailed elsewhere.

Many agricultural development banks were created for political purposes and were not meant to operate as viable financial institutions. As they were established to channel subsidized donor and government funds to farmers, they lacked the market discipline and incentives of commercial banks. The provision of credit depended upon political decisions and interests. Moreover, the irregular availability of loan funds, the setting of interest rate ceilings and the periodic write-offs of overdue loans seriously undermined the effectiveness of these agricultural development banks. It is not surprising that many of them have been either restructured or condemned to liquidation.

As the performance of these banks was measured in terms of loan disbursements rather than in the actual number of small farmer-borrowers attended and recovery of outstanding loans, they were tempted to grant sizeable loans predominantly to well established larger farmers. This was reinforced by the rent-seeking behavior of these farmers, who benefited from the subsidized interest rates that were set by the governments (Schmidt and Kropp, 1987, Gonzalez-Vega and Graham, 1995)

To continue many agricultural credit programs were poorly designed and failed to consider the high costs that are associated with agricultural lending. Moreover, as agricultural development banks focused exclusively on agricultural lending, they were exposed to a high concentration of risks. This required frequent rescheduling of overdue loans, thus further undermining the loan recovery efforts and the loan repayment discipline of both bank staff and farmers.

The poor experiences with directed credit programs in the early 1980s have already led to the first changes in policies from channeling supply-led agricultural credit, the system has evolved to meeting the demand for different types of rural financial services. In fact, rural financial market development includes the provision of both farm and non-farm rural lending services as well as essential savings deposit facilities. This implies the creation of commercially viable financial institutions. These act as full-fledged financial intermediaries and compete with informal lenders.

The new policies have led to a shift away from the administration of directed credit programs that rely on continuous government subsidies. Major attention is now given to the performance of financial institutions. When it comes to lending to poorer clients two performance indicators have been developed: outreach and sustainability (Yaron, 1992, Christen *et al.*, 1995). Outreach refers to the extent in which a financial institution provides high quality financial services to a large

number of small clients. It includes both a horizontal dimension of "coverage" that measures the number of clients that are served, as well as a vertical dimension of "depth" that refers to the income level profile of the attended clients. Attempts are also made to evaluate the degree to which a financial institution meets the effective demand for financial services of the targeted clientele. The concept of outreach includes thus a quantitative and a qualitative dimension.

A major feature of sustainability is the financial self-sufficiency or the ability of the financial institution to provide durable services on a cost-covering basis without reliance on external subsidies. Financial sustainability is attained when the return on equity, net of subsidies received, equals or exceeds the opportunity costs of capital (Krahnen and Schmidt, 1994). This means that a financial institution must cover the costs of loanable funds, loan administration costs, provisions for loan losses as well as costs of protection against inflation. Financial institutions are considered commercially viable when they generate profits above and beyond their total financial transaction costs and can finance the development costs that are required to provide new financial products from their retained earnings.

While financial self-sufficiency is a pre-condition to sustainability, other factors have been identified that are necessary to attain full sustainability. These are related to the organizational and the operational effectiveness of financial institutions. They include:

- the development of new financial products to respond to market opportunities;
- the provision of high quality financial services to strengthen the institution's competitiveness. This ensures client trust and loyalty;
- an effective governance and management structure that protects the institution against political interference and distortions that are induced by government and donor interests;
- the ability to access financial markets to fund loan portfolio growth and to strengthen the equity base of the financial institution.

Although the financial systems development approach is now being increasingly accepted and adopted, the debate continues on the nature and the extent of required government interventions in the rural financial sector. For instance, the essential role of governments in establishing an enabling policy environment and laying down an appropriate legal and regulatory framework is generally accepted. But there is much less consensus on the need and the extent to which governments should be involved in the direct provision of financial services in the event of serious market failures. In view of the limited available resources, direct government interventions should be exerted on the basis of operational efficiency and cost-effectiveness. A general rule is that state-owned rural financial institutions should not receive special privileges that create unfair competition.

Credit demand: rural clients

In the financial market and systems development approach, the users of financial services are considered clients rather than beneficiaries. Recent research has revealed that a number of assumptions about small farm households, which formed the rationale for directed agricultural credit programs, were wrong.

Contrary to earlier perceptions, research on rural households has shown that even small farmers save. In fact, their savings are an integral part of farm household livelihood strategies. Savings are crucial to straddle the period between two successive harvests and to meet contingency expenditures. Household savings can be used for a variety of production, investment and deferred consumption purposes. These include conserving seeds, purchasing new farm inputs, storing of crop produce for deferred consumption and/or selling off later in the season at more lucrative market prices. Cash savings are normally kept at home due to the lack of appropriate bank deposit

facilities. Deposits can be mobilized also through informal arrangements such as savings groups and money collectors.

Another misconception is that rural people are unable to pay market interest rates for credit. Widespread use of informal credit suggests that, even farmers with their own savings periodically borrow from informal sources at high effective interest rates. For instance, they prefer to sustain durable relationships with moneylenders who can provide timely access to small loans. Given the risky nature of agricultural production and the incidence of contingency expenditures, farmers are anxious to have access to a range of potential sources of finance even at high cost.

Research has shown that small farmers tend to be risk-adverse and are conservative in their decision-making (Hazell, Pomareda, and Valdes, 1986). They cope with risks by diversifying their household income from farm and non-farm activities. Small farmers save in various forms, accumulate physical assets and participate in networks defined by social relations and mutual aid arrangements. An analysis of the cash flows of low-income rural households indicates that an often complex interdependency exists between the farm and the family household. Non-farm activities may account for a large share of the farm household income in rural areas. Non-farm employment has an important function by generating earnings that are used as working capital, or savings. In the case of poorer households they are an income source for survival during “hungry seasons“.

Agricultural planners used to focus their attention on efforts to increase food production, as they failed to recognize the importance of non-farm income sources for small farm households. Consequently credit programs did not consider the effects of diversified and off-farm income generating activities on the overall farm household net cash flow. Planners underestimated the capability of farmers to self-finance their returning investment requirements and to repay their loans.

The recognition of the existence of rural savings and the need to grant loans for rural off-farm activities has highlighted the prospects for rural financial market development. Appropriate savings deposit facilities and diversified loan products are essential strategies. In fact, their provision would serve to strengthen rural financial intermediation and satisfy the effective demand for different types of financial services. Moreover, the success of rural financial institutions does not depend only on the range of services they are able to provide, but also on their competitiveness with informal lenders.

Informal financial arrangements are important in the rural economy. They have continued to flourish despite the presence of subsidized donor and government credit programs. An analysis of their nature is essential to better understand the economic situation of farm households and their demand for financial services.

Credit supply: typology of rural lenders

The table below presents the types of rural lenders that can be found in developing countries.

Table 1

Typology of rural lenders

1. Formal lenders	Agricultural development banks Rural branches of commercial banks Co-operative banks Rural banks/community banks
2. Semi-formal lenders	Credit unions Co-operatives Village or semi-formal community banks NGOs
3. Informal lenders	Relatives and friends Moneylenders Rotating savings and credit associations
4. Interlinked Credit Arrangements	Input suppliers/Crop buyers Processing industries

The range of rural and agricultural lenders is far more limited than in urban financial markets. This results from the unique features of agricultural production, finance and the history of financial sector development.

Commercial banks are not involved in rural finance. They have not voluntarily established extensive rural branch networks nor have they developed specific financial services for the poorer rural clientele. In some cases, they extended limited services to larger agro-industries in rural areas. This was the background against which governments in many developing countries constituted specialized agricultural development banks. Specialized banks were affected by the structural adjustment programs, financial sector reform and the changed environment of market liberalization and privatization. Many of these banks have been restructured or have ceased their operations.

Beyond formal rural lenders, there are many small, decentralized, semiformal or informal financial intermediaries. Examples of these providers include village banks, community banks, co-operatives and credit unions. Usually their involvement in agricultural lending is constrained as their lending operations are savings-based. They lack sufficient longer-term financial resources for agricultural lending. There is evidence that many small farmers now rely on semiformal and informal arrangements for financing their on-farm production. This shift has emerged following demise of the directed agricultural credit programs and the liquidation or restructuring of the agricultural development banks. Of particular importance are the traditional forms of trade finance and the contemporary agribusiness institutional arrangements like contract farming (Ladman *et al.*, 1992).

In the past informal rural lenders have suffered from a negative reputation, largely due to the lack of competition in local financial markets. The often usurious behavior of moneylenders contributed to this view. While not unfounded, improved understanding of the dynamics of informal financial markets has increased the awareness of the distinct advantages that they offer.

Informal lenders include moneylenders, input suppliers and traders. They lend for distinct purposes and offer credit at different terms and financial conditions. Lending also occurs between family members and friends. These loans are often interest-free. Group-based credit arrangements exist in the form of rotating savings and credit associations (ROSCAs) plus credit co-operatives. Informal savings arrangements include individual money collectors and savings societies that are organized between friends, neighbors and employees (Bouman, 1995).

Informal financial services providers fill the gaps in financial markets. They serve predominantly lower income people who are perceived by formal financial institutions as “unbankable” due to their inability to comply with conventional loan collateral requirements. Informal credit is also used by higher income people when the availability of bank credit is limited. It is used for consumption purposes. Distinct advantages are afforded by informal credit. There are no restrictions imposed on the purpose of its use, provided in very small amounts and it is typically available with a minimum time delay (Adams and Fitchett, 1992; Ghate, *et al.*, 1992).

Informal lenders have overcome the high cost and risk barriers which face institutional lenders when they attempt to serve small clients. Their local presence ensures a convenient and timely access of clients to financial services, increases their familiarity with the borrower’s needs and his/her loan repayment capacity and reduces the costs of loan follow-up. As they are interested in maintaining a good credit reputation to ensure continued access to credit resources, clients have a strong incentive to repay their loans promptly.

Although informal credit and savings services play a crucial role, they also have limitations. In fact, well-functioning banks have institutional advantages for client coverage. They are also able to provide full financial intermediation services and can offer a wide range of financial products through regulated contracts. Formal rural financial institutions need to revitalize their poor public image from the past. They have to build and maintain the confidence of their clientele. This is essential if they intend to compete with informal lenders who can be costly, but are easily accessible and provide opportune services. In particular, formal rural lenders need to demonstrate their viability and sustainability by reducing the high costs and risks that are associated with agricultural lending.

1.2. Costs and risks specific to rural lending

Agricultural lenders who serve small farmers face high financial transaction costs when granting small loans. High lending risks are suggested by the frequent inability of small farmer-borrowers to provide acceptable forms of loan collateral. In this section special attention is given to the challenges that agricultural lenders face in managing their financial transaction costs and risks.

Dispersed clients

Low population density coupled with dispersed location of rural clients make the provision of formal financial services costly. From the lender's perspective, the long distances between communities and the inadequate rural transportation facilities in many developing countries increase the costs of loan appraisal, loan monitoring and enforcement of loan repayments (Gurgand, *et al.* 1996). The use of mobile loan officers and/or branch offices can be effective in lowering transaction costs. But mobile facilities may be subject to security risks if bank staff are required to transport money. The establishment of a rural branch network reduces the security risks, but branches are costly to maintain and to supervise.

Financial transaction costs of institutional credit can also be high for rural borrowers. This results from the high opportunity costs of lost working time. A borrower may have to pay several visits to the bank branch office to conclude cumbersome loan application procedures which require a long time for processing. Clients often have to spend much time and money to obtain the required documents and to find loan guarantors. For very small loans, these costs can significantly increase the effective lending interest rate (Klein, 1996).

While the decentralization of field operations has been effective in reducing the transaction costs in some countries their success depends on the local environment, infrastructure conditions and the management skills of the financial institution.

Seasonality and loan term structure

The seasonal nature of agricultural production and the relative long gestation periods before crops can be harvested and sold have direct implications for the financial transaction costs of the lender. Agricultural loans are normally larger and are required for longer periods. Matching assets and liabilities is more difficult than for non-farm activities. Agricultural credit is also often repaid in "lumpy" installments. These are one or two loan repayments rather than regular weekly or monthly installments common in microcredit. This irregular pattern implies more difficult monitoring of repayment capacity and willingness. Moreover, an uneven distribution of the agricultural lending operations over the year increases the fixed costs of personnel. The earnings from lending may not be sufficient to cover these costs. Liquidity requirements in periods of high seasonal loan demand also increase the price of loanable funds. In times of low demand, excess liquidity needs to be invested in low or non-earning assets. This will increase the opportunity costs of these funds. In summary, lenders face high agricultural lending costs.

The table below presents the unique features of agricultural lending.

Table 2

Unique features of agricultural lending

1. Lending activities in a politically sensitive environment	• Agriculture is a politically sensitive sector. • State interventions often occur in rural financial markets.
2. Risks associated with agricultural lending	• Similar economic activities of borrowers generate covariant risks due to market and price fluctuations, yield uncertainties, changes in domestic and international policies. • State interventions (e.g. waiver of loan overdue). • Low loan repayment discipline in externally-funded credit schemes.
3. High financial transaction costs for lenders and borrowers	• Long distances to serve a dispersed rural clientele. • Poorly developed transportation and communication infrastructure. • Little knowledge about heterogeneous farm households. • Expensive management and supervision of rural bank branch networks. • High additional costs for borrowers: opportunity costs (e.g. lost working time), transport costs, bribes, fees.
4. Specific credit demand	• The provision of long-term credit can lead to matching problems between assets (loans) and liabilities (funding sources). • Reduced turnover of agricultural loan portfolio over the year. • Seasonality in agricultural credit demand.
5. Lack of required loan collateral	• Small farmers have few physical assets (e.g. land). • Farmers and especially poor rural women have difficulties in clearly demonstrating their legal ownership of assets. • Legal contract enforcement problems arise even when collateral is available.
6. Farm households are integrated production and consumption units	• Demand for loans depends on the self-financing potential, access to savings deposit facilities and risk management ability of borrowers. • Due to the fundgibility of money borrowed funds can be used in the farm household for consumption, education, social insurance, production and investment purposes.

The diversity in farm and non-farm income-generating activities of rural households requires better knowledge of the farm household financial situation. Loan officers have more information than may be needed in the case of urban lending. This can extend the bank staff time and expenses needed for loan appraisal. It may also require the setting of individual loan repayment terms. It is likely to increase the costs of training agricultural loan officers.

Risks associated with agricultural lending

Financial institutions face four major risks:

1. Credit or loan default risk - refers borrowers who are unable or unwilling to repay the loan principal and to service the interest rate charges.
2. Liquidity risk – occurs when a bank is not able to meet its cash requirements. Mismatching the term of loan assets and liabilities (sources of loanable funds) exposes banks to high liquidity risks.
3. Interest rate risk – risk that a loan will decline in value as interest rates change.
4. Foreign exchange risk – defines exposure to changes in exchange rates which affect international borrowings denominated in foreign currency.

This research on better practices for rural lending focuses mainly on agricultural credit or loan default risks. Risks impact borrowing farmers and the financial institutions that lend to them. Active management can reduce these risks. Risks and uncertainty are pervasive in agricultural production and are perceived to be more serious than in most non-farm activities. Production losses are also impossible to predict. They can have serious consequences for income generation and for the loan repayment capacity of the borrowing farmer. The type and the severity of risks which farmers face vary with the type of farming system, the physical and economic conditions, the prevailing policies, etc.

Agricultural lending implies high liquidity risks due to the seasonality of farm household income. Surpluses supply increased savings capacity and reduced demand for loans after harvest and deficits reduce savings capacity and increase demand for loans before planting a crop. Also, agricultural lenders face particular challenges when many or all of their borrowers are affected by external factors at the same time. This condition is referred to as covariant risk which can seriously undermine the quality of the agricultural loan portfolio. As a result, the provision of viable, sustainable financial services and the development of a strong rural financial system is contingent on the ability of financial institutions to assess, quantify and appropriately manage various types of risk (Von Pischke, 1994).

Production and yield risks

Yield uncertainty due to natural hazards refers to the unpredictable impact of weather, pests and diseases, and calamities on farm production (Ellis, 1988). Risks severely impact younger, less well-established, but more ambitious farmers. Especially affected are those who embark on farming activities that may generate a high potential income at the price of concentrated risks - e.g. in the case of high input monoculture of maize. Subsequent loan defaults may adversely affect the creditworthiness of farmer borrowers and their ability to secure future loans.

Market and price risks

Price uncertainty due to market fluctuations is particularly severe where information is lacking and where markets are imperfect, features that are prevalent in the agricultural sector in many developing countries (Ellis, 1988). The relatively long time period between the decision to plant a crop or to start a livestock enterprise and the realization of farm output means that market prices are unknown at the moment when a loan is granted. This problem is even more acute for perennial tree crops like cocoa and coffee because of the gap of several years between planting and the first harvest. These economic risks have been particularly noticeable in those countries

where the former single crop buyer was a parastatal body. These organizations announced a buying price before planting time. Many disappeared following structural adjustment reforms and privatization of agricultural support services. Private buyers rarely fix a blanket-buying price prior to the harvest, even though various interlinked transactions for specific crops have become more common today. These arrangements almost always involve the setting of a price or a range of prices, prior to crop planting.

Risk of loan collateral limitations

Problems associated with inadequate loan collateral pose specific problems to rural lenders. Land is the most widely accepted asset for use as collateral, because it is fixed and not easily destroyed. It is also often prized by owners above its market value and it has a high scarcity value in densely populated areas. Smallholder farmers with land that has limited value, or those who have only usufruct rights, are less likely to have access to bank loans. Moveable assets, such as livestock and equipment, are regarded by lenders as higher risk forms of security. The owner must provide proof of purchase and have insurance coverage on these items. This is rarely the case for low-income farm households.

Moreover, there are a number of loan contract enforcement problems, even when borrowers are able to meet the loan collateral requirements. Restrictions on the transfer of land received through land reform programs limits its value as collateral - even where sound entitlement exists. In many developing countries the poor and especially women have most difficulties in clearly demonstrating their legal ownership of assets. Innovative approaches which draw on the practices of informal lenders and provide incentives to low income borrowers to pay back their loans have been developed in microcredit programs.

Moral hazard risks in distorted credit cultures

Potentially serious risk problems have risen from the effects of failed directed credit programs. The impact on the loan repayment discipline is pervasive. Borrowers who have witnessed the emergence and demise of lending institutions, have been discouraged from repaying their loans. Further people have repeatedly received government funds under the guise of “loans”. Loan clients have been conditioned to expect concessional terms for institutional credit.

Under these circumstances, the incidence of moral hazard is high. The local “credit culture” is distorted among farmers and lenders. Borrowers lack the discipline to meet their loan repayment obligations, because loan repayment commitments were not enforced in the past. Lenders, on the other hand, lack the systems, experience and incentives to enforce loan repayment. There is also an urgent need to change bank staff attitudes and the poor public image of financial institutions in rural areas. Another effect of a distorted credit culture on the risk exposure of agricultural lenders is the priority that borrowers give to repaying strictly enforced informal loans. These are settled before they comply with the obligations associated with “concessional” institutional credit. This is explained by the fact that losing the access to informal credit is viewed as more disadvantageous than foregoing future bank loans due to the uncertain future of rural financial institutions. Very often informal lenders have stronger enforcement means than banks.

Risks from changes in domestic and international policies

Policy changes and state interventions can have a damaging impact on both borrowers and lenders. For the latter they can contribute significantly to covariant risks. Many low-income economies under structural adjustment programs have slashed their farming subsidies. This has had, for instance, a serious effect on the costs and the demand for fertilizer. Reducing government expenditures as an essential part of structural adjustment programs may also affect employment opportunities in the public sector. Costs may even reduce agricultural production levels, if extension services are suddenly discontinued.

1.3. Typology of microlenders

A variety of organizations and institutions are active as providers of Microcredit services. They can be broadly divided into three groups: non-governmental organizations (NGOs); credit unions and co-operatives; and banks.

NGOs

The majority of the microcredit programs are operated by NGOs. These include national organizations, many which receive assistance from international donor organizations. The international NGOs operate programs through affiliated local agencies. They have a clear commitment to work with poor people. NGOs have the advantage that they are familiar with the household livelihood strategies and the financial situation of their target population. They are well established in local communities with good access to the population.

However, NGOs have encountered many challenges in the administration of credit programs. As predominantly social assistance organizations, few possess the required professional expertise or the business culture to efficiently execute credit operations. In fact, they will have to undergo a substantial transformation if they intend to become specialized financial services providers. They will have to alter their public image. Instead of serving “beneficiaries”, they must establish contractual relationships with clients. Since the mid-1980s, a number of NGOs have established themselves as specialized microfinance institutions. While some have discontinued their social services, others have created separate affiliated organizations to provide financial services. Specialized NGO microlenders have been at the forefront in the development of appropriate institutional and organizational structures. They have initiated the design of innovative microcredit technologies.

Despite the significant advancements in the field of microfinance, the majority of the NGOs serve only a few hundred or a few thousand clients. Most provide loans and usually have only one or two loan products. Although some require mandatory savings deposits from their clients that form part of their loan collateral, just a few mobilize voluntary savings. There has been interest in operating savings deposit facilities as a means to mobilize loanable funds and to enhance their customer services. However, NGOs are generally restricted from taking deposits. They fall outside the formal banking regulation and supervision system, as they operate without a formal banking license.

This restriction has recently motivated some NGOs to transform themselves into regulated financial institutions. This process, known as up-grading, gives microfinance institutions the freedom to expand their range of financial services. It also enhances the chances of accessing financial markets for additional loanable resources. Bancosol in Bolivia was the first NGO to achieve the status of a regulated financial institution.

Credit unions and co-operatives

Historically, credit unions used to serve people who experienced difficulties in accessing commercial banks. Credit unions tend to be more formal in their structure than NGOs, including the possible establishment of regional and national networks. The constitution of central finance facilities also enables the reallocation of surplus (liquidity) funds between member credit unions. In many countries, credit unions have been included as a special category in the banking law. They are subject to separate regulation and supervision mechanisms.

Most credit unions and co-operatives limit their services to members, whose savings provide the financial basis for their lending operations. This has the advantage that they can better screen prospective borrowers and appraise, monitor and recover loans. As in the case of informal savings and credit groups, members are self-selected, and peer pressure is exerted to attain full and timely

loan repayment. Social pressure and superior information on member clients are effective mechanisms. This functions as long as members know each other and the scope of the financial operations remains manageable.

Despite their advantages, credit unions and co-operatives face notable challenges. The provision of financial services is restricted to members and thus limits their outreach and growth potential. Because loanable funds are generally limited to the mobilized member savings, the credit union is restricted in its efforts to satisfy the total effective credit demand of their members. Loans are often granted for smaller amounts than were applied for. They are only available after outstanding loans have been reimbursed. This restricts borrowing opportunities and therefore the effectiveness of the loans. The lack of professional management, and cronyism among members can undermine the loan portfolio quality. Moreover, where borrowers dominate the co-operatives' policies, there has been a tendency towards setting low lending interest rates. This practice may undermine the financial performance and the potential for loan portfolio growth.

Absent of these difficulties, credit unions and co-operatives have demonstrated potential as a viable institutional model for providing microcredit services. Changes in the regulatory and supervisory framework for credit unions together with technical assistance services from international credit union organizations, have been identified as key factors in strengthening their performance.

Banks

The involvement of commercial banks in microfinance is relatively recent. Banks employ a variety of strategies in serving low-income clients, who are normally perceived as "unbankable". Microcredit may be granted indirectly or directly.

Indirect ways in which commercial banks lend to small clients include the so-called linkage programs with NGOs or other intermediary organizations. In these cases, banks provide loanable resources and the intermediary organizations on-lends the resources to members of self-help groups for microenterprise activities. In these arrangements, banks have limited contacts with the final borrowers. They are not actively involved in the loan product design or credit administration. They rely on the NGO for all aspects of loan appraisal, loan monitoring and loan recovery. While this model has increased the access of low-income clients to bank loans, it has proven to be only moderately successful in the provision of sustainable banking services. The bank has few incentives to develop appropriate and cost effective credit technologies. It relies on a number of organizations, each with different objectives and performance standards.

More interesting has been the recent involvement of some commercial banks in direct lending through the design of new loan products and services for low-income clients. This process is referred to as down-scaling. It implies the creation of a specialized microcredit department in the bank. This development is particularly attractive in view of the outreach and the financial expertise contained in commercial banks. Well established financial institutions enjoy public confidence, as clients recognize and perceive the banks as reliable and stable organizations.

The involvement of banks in microfinance can offer, for example, their amplified intermediation potential. However, if bank operations are inefficient and bank staff are unable to change their traditional banking culture and attitudes, tedious barriers remain to directly serving low-income clients. Indeed, in these cases, it may be preferable to create a new microfinance institution that has a clear corporate mission and set of objectives. This is necessary in cases where banks have a poor reputation due to failed directed credit programs, or when their operations have been undermined by government interference.

1.4. Cost reduction and risk management strategies

Microlenders have developed solutions for the problems of high risks and costs associated with lending to microenterprises and low-income clients. Over the years, a series of best practices and guiding principles have been formulated to enhance the outreach and sustainability of microfinance institutions. In this chapter, an analysis is made of the key lessons that have been learned from microcredit practices. Particular attention goes to procedures that reduce costs and risks. The final objective is to assess if and to what extent these practices can be transferred to rural lending.

Cost reduction

Microlenders face the problem of high costs that are associated with the granting of small loans. In fact, loan administration costs do not vary by loan amount. By definition small loans are less profitable for a lender. Moreover, in many networks there are few branches in formal financial institutions. Generally, setting up and operating branches is very costly. Operation costs should be covered by the profits generated by the branch office. As a result, financial transaction costs are high for borrowers, who may have to travel long distances to the bank branch offices. Microlenders, however, have found ways to reduce the high costs of providing small loans. Various strategies are presented below.

Standardization of loan products and lending procedures

Microlenders simplify their operations by offering only a few highly standardized loan products. They usually provide short-term working capital loans and, only occasionally, grant investment capital loans to established borrowers. Often they have adopted a “credit-only” approach and few microlenders provide technical assistance or business training to their clients. Some have established collaboration agreements with partner agencies for the provision of non-financial support services. Loans are kept small and are extended for only a few weeks or months, especially to first-time clients. Borrowers with good loan repayment records are rewarded almost automatically with repeat loans. Some microlenders increase the size of repeat loans by using pre-determined formulas. Although the provision of small and short-term loans to first time borrowers is costly, the financial transaction costs can be considerably reduced for well-known recurring borrowers.

Microlenders usually charge borrowers interest rates and fees that are much higher than those used by conventional formal lenders. Interest rates need to be positive in real terms to protect the loan portfolio value against the effect of inflation.

Productivity of loan officers

Loan officers are expected to serve a large number of clients. Typically 200-300 borrowers are assigned per loan officer. In order to achieve this, staff performance bonuses are widely used. These incentives are related to the loan volume handled, the quality of the loan portfolio and the number of low income or remote clients that are attended in some cases. While these incentives increase the loan administration costs, well-trained and motivated staff are essential to increase the overall productivity of the financial institution. This lowers the lender operational costs in relative terms.

Group versus individual lending

Microfinance institutions provide loans either through groups or lend directly to individuals. Proponents of the group lending approach highlight the cost-reducing aspect of this methodology. On the other hand, the defenders of individual lending emphasize the advantages of flexibility in meeting the loan demand, achieving a high loan product quality and reducing credit risks.

There are two modalities of group lending. A microlender may lend to a collective entity such as a co-operative or a village bank, which in turn on-lends the funds to its members. More frequently, however, the term is used for joint liability or solidarity group lending, whereby the lender provides loans to individual borrowers who are organized in groups. In both cases, group members are collectively responsible for the full and timely repayment of the loans.

Group lending can have the advantage of increasing the lender's outreach capacity by reducing the loan administration costs. In the first kind of group lending mentioned above only one loan is administered for each group. Moreover, group lending reduces the lender costs by maximizing the use of insider information and by relying on peer borrower screening. Group members perform as well loan monitoring and loan repayment enforcement. However, the costs of group formation are high in most cases. This is especially true for lenders who do not work with existing groups. They have to support the whole group formation process. Also, group maintenance costs are high as group members' needs and circumstances diverge over time, thus weakening cohesion. Loan officers may have to participate in regular group meetings to attempt to strengthen the loan administration responsibilities of the group, the group cohesion and the sense of peer responsibility amongst the group members.

Microlenders use a modified version of the traditional bank lending technology that has been adapted to the characteristics of providing small and short-term loans to low income borrowers. The screening of potential clients is carried out by assessing their individual loan repayment capacity and their willingness to repay. Innovative microlenders examine the enterprise household cash flow and check the credit history of the loan applicant to get a complete picture of his/her loan repayment capacity and creditworthiness. The process of collecting detailed information on individual clients is a costly exercise for microlenders. However, these costs can be lowered by using a standardized checklist of demands. Moreover, once the high start-up costs of establishing a lender-client relationship have been made, the costs of obtaining additional information or updating existing information are much lower.

Some microlenders attempt over time to introduce more individualized lending terms for the members of joint liability groups. These initiatives are interesting since they combine the cost savings of working with groups with the high quality of providing individual lending services to group members. In many cases, loan follow-up and loan repayment enforcement are done by the group and the lender, which may result in relatively high costs to all.

Risk management

Microlenders manage the risks of lending to low income borrowers by selecting a specific target clientele. These clients are normally urban microentrepreneurs who have some experience in the business activity for which a loan application is made. Delegation of lending authority to the branch office level is enabled to specific amounts. This ensures that loan officers who are close to the customers have influence in the lending decision.

Another element in the risk management strategy of some microlenders is the requirement that borrowers contribute a minimum equity share of the total investment costs or down payment. In individual lending the duration of the loan and the loan repayment installments are also adjusted to the repayment capacity of the individual borrower. This reduces the loan default risk. Loan collateral substitutes are normally accepted, as the target clientele will rarely possess conventional bank collateral. First borrowers have to build up a track record of good loan repayment performance before larger loans are granted. Major risk management mechanisms of professional microlenders are adequate liability and asset planning and management, the use of internationally accepted accounting standards, and computerized integrated accounting and management information systems. These improve the basis for timely and cost-effective decision making.

Target clientele

Microlenders mostly serve urban and peri-urban clients. This category calls for easier management of lending costs and risks. The infrastructure and commodity markets in urban settings are normally more developed, providing a better environment for profitable microbusinesses than in rural areas. Urban clients have a higher degree of literacy. More frequent relations between bank staff and clients are likely to decrease the risk of loan default. Microlenders provide small and short-term loans that need to be repaid in frequent installments. This implicitly means that microcredit concentrates on the financing of those activities that have a high turnover and generate regular income flows. Trading and services activities answer these criteria. In fact, they represent a large portion of the loan portfolio of most microlenders.

Microlenders limit the risk of loan default by selecting borrowers with a proven track record. A customer whose business has survived for a minimum time period is more likely to be successful in the future. These borrowers also take their loan repayment obligations seriously and are potential long-term clients for microlenders.

"Bringing the bank to the people" has proved to be a successful component of microcredit strategies. There are many ways to achieve this ranging from loan officers who regularly visit their clients, to the use of mobile bank units in branch offices or agencies. A decentralized delivery structure of financial services decreases information costs and reduces loan default risk. It also allows the growth and the diversification of the loan portfolio. It creates client confidence and promotes a sense of responsibility. For instance, the establishment of branch offices in markets helps to better integrate financial institutions into their local communities. This facilitates the provision of higher quality services and contributes to the long-term sustainability of the microfinance institution.

Group versus individual lending

The problem of risk management differs by group and individual lending approaches. Group lending builds upon the collective responsibility of group members to repay their loans. Proponents of group lending argue that this methodology enables lenders to reach more low-income clients at relatively low costs. However, borrower risk is greater since every group member bears his/her own risk and that of all other group members. The exposure to pay for fellow member loan defaults encourages borrowers to apply for the same loan size rather than fitting loans to the loan repayment capacity of individual group members. This may cause "negative solidarity" in the group, which means that the whole group defaults if one member fails to repay his loan. Usually, group lending offers less flexible terms and loan repayment installments. All group members receive and repay their loans in the same cycle. Even when graduation to individual lending is permitted, the lack of sufficient written records on borrowers hampers individual loan appraisal.

Group information advantages and peer pressure are proportional to the diversity and proximity of the members. The greater the heterogeneity of the group and/or in cases where group members live in dispersed locations the group influence is weaker. On the other hand, homogeneous groups may result in high covariant risks to the lender. There is also the potential for abuse of power and corruption by a powerful group leader. Conversely, if a good group lender leaves, then the group will be severely impaired.

The main differences between the provision of microcredit to individual borrowers and conventional bank lending technologies include the use of collateral substitutes. These comprise co-signers, third-party guarantors, household goods and other proxies. Also the loan repayment capacity of prospective borrowers is appraised.

The personalized nature of individual lending facilitates the granting of loan products that fit the client demand and his/her loan repayment capacity. At the same time, this approach encourages the development of a closer relationship and strengthens the mutual trust between the lender and borrower. It may increase the compliance with contractual loan obligations. Better client knowledge also simplifies the appraisal of repeat loans and reduces the risk of loan default. Accumulated client information may reinforce current financial services and can lead to the development of new loan products.

Adjusting the lending terms and conditions

Loans should never finance the total investment costs requested. Lenders require an equity contribution from the borrower to complement the external resources. This equity participation increases the stake that the borrower has in submitting a realistic loan application thus actively promoting the success of his business. In the case of small working capital loans, it may be difficult or even arbitrary to define investment purposes. As a result the calculation of equity participation may be difficult.

Good microlenders examine the loan repayment capacity and the creditworthiness of new borrowers. In assessing the loan repayment capacity they consider all income sources and expenditures of the microenterprise household unit. The source of funds for repaying the loan does not need to be the income that will be generated by the investment that is financed with the loan. Loan officers who appraise loan applications should be properly trained, as they play a key role in the decentralized decision-making process.

Microlenders often rely on information from local networks to verify the reputation and creditworthiness of prospective borrowers. These networks can be equally useful for enforcing loan repayments. They effectively publicize information on delinquent borrowers. Community networks have proved their value in Indonesia as well as in other Asian countries. There, the system of local organization and the importance of personal reputation make this approach particularly effective.

Frequent loan repayment installments, often weekly or monthly, facilitate a close monitoring of the borrower loan repayment performance. As clients build up a good track record, the loan duration and the loan repayment intervals for repeat loans are often lengthened. Some microlenders grant increasingly individualized loan products, once the borrower has established good creditworthiness. This is often referred to as “graduation” to a next product level or client status.

Loan collateral substitutes and repayment incentives

As most microcredit clients cannot offer conventional bank collateral, loan collateral substitutes are accepted. The personal value that the collateral substitute has for the borrower plays an important role. In view of the practical and legal problems that are associated with the seizure of these assets in cases of loan default, microlenders often place more emphasis on assessing the creditworthiness of a prospective borrower. They prefer to closely monitor his/her loan repayment performance.

Microlenders normally grant small first-time loans to new customers. Only when the first loan is paid back in time can the borrower receive a slightly larger loan. A track record of good loan repayment performance is accumulated. As a result the risk of loan defaults may be reduced. The possible access to new loans is a major loan repayment incentive for microcredit borrowers. Rewards for full and timely loan repayments on the one hand and charging of late payment fees and penalties on the other are effective means of promoting good borrower discipline.

Loan portfolio management

Accurate and timely information systems are crucial for good operational management. Successful microlenders have invested wisely in the acquisition of an adequate banking software to computerize their accounting and management information systems consistent with their specific requirements. The required sophistication of bank automation depends on the volume and the scope of the financial services. It also depends on the organizational and operational structure of the financial institution. Ideally, loan portfolio monitoring and reporting on loan disbursements and reimbursements of branch offices should be integrated with liquidity fund management. This ensures that the necessary information is available to the head office in a timely manner.

Computerized and integrated loan accounting and management information systems that produce frequent reports guarantee that loan officers and bank management can respond promptly to potential loan delinquency problems. It is the responsibility of field staff to examine the reasons for overdue loans. Based on their reports, an immediate decision should be taken on corrective follow-up actions. In cases where legitimate reasons for overdue loan repayments exist, loan rescheduling may be allowed.

Successful microlenders delegate loan authority and decentralize staff responsibilities in the financial institution. At the same time, adequate checks and balances need to be established to monitor decentralized decision-making. In order to encourage the prompt collection of outstanding loans, staff performance bonuses should be based on preset loan recovery rates as well as on the number and the volume of loans that are granted.

1.5. Scaling up microfinance: challenges and progress in microfinance delivery

Clearly, poor households have evolved coping mechanisms for the various risks. However, these tend to be high-cost or inefficient in nature. One of the household responses, in the absence of well-functioning financial markets, is to self-insure and over-diversify activities, which makes it less efficient in generating surpluses for future investments. Another response could be to 'under-invest' which results in sub-optimal returns from the asset so employed.

The dependence on informal mechanisms has been observed to be high among poor households. However, the effectiveness of these mechanisms to cope with risk is dependent on the nature of the risk. Informal mechanisms are more suited to high-frequency idiosyncratic risks than in dealing with low-frequency covariant risks.

Much of the micro finance development has been centred around credit. It must be noted that a credit-led coping mechanism may not be the most effective. An incomplete financial services market may also prove to be inefficient. For instance, out-of-pocket financing to tide over a health/hospitalization event may be less efficient vis-à-vis availing of health insurance that pools risks across households. Similarly, access to savings facilities that permit deposit of small amounts periodically is crucial to building capital for the household over a longer term. Access to futures markets enables price discovery and therefore, informed cropping and investment decisions by the producer household and transfers price risk.

It appears, therefore, that if the question of access to financial services for the poor is being examined from vulnerability and growth perspective, the whole range of financial services (including savings, investments, remittance, credit, insurance and derivatives) will have to be taken into account. This enables income smoothening, building of assets and higher risk taking ability and thereby facilitates participation in the economy.

Broad challenges in microfinance delivery

The key challenge in micro finance has been the costs of servicing accounts that are low in value but large in volume and entailing frequent transactions. This has resulted in very high transaction costs. Further, most of the transactions are cash based which increase the transaction costs associated with cash handling. Low levels of automation in disbursements and collections also contribute to higher costs.

Central to the success of micro finance experiments has been frequent and constant follow-up with the borrowers and flexibility in responses. It could be conjectured that the high recovery rates on the micro credit portfolios reported by MFIs is a direct result of the high costs incurred by way of supervision and monitoring. This would imply a trade-off between supervision cost minimization and default rate minimization.

This phenomenon also provides an insight into the performance of rural microfinacial institutions worldwide. The approach of banks as compared to the current set of MFIs has been less proactive and interaction with the borrower is limited. Therefore, on the one hand, repayment levels were low and the fixed cost incurred in terms of salaries and fixed assets high. Caps on lending rates compounded the problem. The MFI model in contrast has high levels of supervision by field functionaries and pricing that recovers full costs.

The joint liability mechanism has been relied upon to overcome the twin issues of adverse selection and moral hazard. The group lending models are contingent on the availability of skilled resources for group promotion and entail a gestation period of six months to one year. However,

there is not sufficient understanding of the drivers of default and credit risk at the level of the individual. This has constrained the development of individual models of micro finance.

The group model was an innovation to overcome the specific issue of the quality of the portfolio, given the inability of the poor to offer collateral. However, from the perspective of scaling up micro financial services, it is important to proactively discover models that will enable direct finance to individuals. This could entail the development of credit scoring models based on the experience of MFIs and NGOs. Such parameterization will discriminate between clients as regards preparedness for finance. It may be argued that individual lending models may not display the same portfolio characteristics as group lending. However, we cannot rule out the possibility of the right mix of incentive structures and supervision yielding an individual lending model. This is an area that needs more experimentation.

New thinking is required in the direction of individual lending models that will have in-built incentives/disincentives to repay in the absence of a group mechanism. Some of these models could entail progressive increase in lending amounts with consecutive timely repayments or the use of post-dated cheques. As it was outlined, poor households contend with various risks. In a scenario where the access to risk management instruments is low, this poses a challenge to financial service providers, in particular, to lenders. Whereas idiosyncratic risk can be managed by various strategies including private insurance models, systemic risks that result in large losses are more difficult to protect against. This would include events like floods, drought and output price volatility. In the absence of hedging strategies, products like crop loans and livestock loans become extremely risky.

The increase in supply of micro financial services is also constrained by factors such as absence of MFIs in certain areas of the country and the growth of existing MFIs itself constrained by lack of capital and trained human resources. There is a need to aggressively develop entrepreneur models of micro finance that expands the base of micro finance providers. This could particularly be a solution for access in difficult-to-reach areas. The entrepreneur would function practically like a moneylender providing flexible financial services and drawing refinance from banks.

A strategy that enables increase in delivery capabilities is partnerships between the formal financial service providers and NGO/MFIs. This permits combining the capital base and product skills of the former with the ‘last mile’ network of the latter. This has important implications both for credit as well as insurance.

In insurance, the partner-agent model is based on the principle of an insurance company managing the risks and payouts and the NGO managing a large portion of the client relationships, underwriting and extending its field presence to the insurer. Such a partnership also helps overcome the problem of adverse selection because of the close relationships that NGOs typically have with the communities that they work with. MFIs that have identified client demand for insurance products should focus on creating partnerships with regulated insurers through which they can offer clients an insurance product suited to the micro market.

In the area of livelihoods training, the two distinct models currently existing are:

1. the NGO supported livelihood initiatives where the NGO provides the organization and marketing support and
2. training provided by entrepreneurship development institutes in self-employment.

Appropriate models of business development support for enterprises of the poor have to be evolved that have clear linkages to the market, in terms of demand and quality specifications.

A review of progress in microfinance delivery

The progress in outreach and models adopted varies across the classes of micro financial services. We will examine each of the micro financial services, insurance, savings, credit and other risk management instruments, with an emphasis on the prevailing regulatory environment and models of delivery.

Insurance

Insurance reduces the vulnerability of poor households by replacing the uncertain prospect of large losses with the certainty of payout against small, regular premium payments. It is integral to a comprehensive risk management strategy for poor households. This includes life, health, accident and asset (dwelling, crop, livestock) insurance.

The characteristics of the low-income market create certain challenges such as minimising transaction costs, coping with irregular household cash flows and contending with a limited availability of information on potential clients. This results in poor coverage of low-income households. One study (Mesa-Lago, 1994) shows that low coverage is the result of three main factors. These are:

1. heavy contributory burden;
2. high cost of detecting, inspecting and collecting from the large numbers of self-employed and wage earners of micro-enterprises;
3. benefits available for this group are very small and reduce incentives for affiliation.

A basic problem in insurance provision is that of adverse selection. Simply put, this is the likelihood of the most risky clients being insured. Adverse selection occurs when the individuals with a high probability of incurring a loss predominate among policyholders and low-risk individuals fail to join. There have been some innovations attempted to overcome this problem. Mandatory insurance of all clients, say, of an MFI ensures that all clients regardless of risk profiles get covered. Other mechanisms could be third party proof of disability and policy exclusions of certain categories of people. Some additional control mechanisms are photo identity cards as demonstrated in Uganda, sick sheets signed by a third party, training for groups of people and service providers and supplying client lists to service providers (Gineken Van, 1998).

The emergence of MFIs and NGOs willing to facilitate financial intermediation presents an important opportunity for the accelerated delivery of insurance. The joint liability mechanism has effectively countered the information asymmetry in credit delivery and could be harnessed for insurance as well. A significant component of cost has been the expenses incurred on verification of claims. The partner-agent model of micro-insurance where the NGO/MFI provides outreach by means of documentation support, verification and claims administration could significantly enhance the capabilities of mainstream insurers.

Partnership with insurers would be crucial for NGO/MFIs desirous of providing insurance cover to its members. Community managed insurance programmes have remained largely isolated in nature. Unlike credit, insurance cannot be provided to small pockets as it is based on the principle of pooling risk. A large number of policyholders is important because it reduces the potential for adverse selection and increases the likelihood that the variance of actual claims will be closer to the expected average number of claims used in calculating premiums. Insurance provision also necessitates specific skills in pricing and under writing.

For MFIs, the access to insurance for its members could result in the elimination of drivers of credit risk: the death of the earning member and death of livestock. For instance, credit-linked life insurance schemes enable the assignment of the insurance policy in favour of the lender.
The challenges vary across the type of insurance as well. While life insurance is relatively easy to administer, health insurance remains a challenge. The provision of health insurance in a

sustainable manner will have to take into account factors such as cost containment, promotive care, availability of health infrastructure/providers, quality control, filters, checks and controls. Similarly, livestock insurance is constrained by the high costs of verification and moral hazard.

Research on the insurance needs of the poor is very inadequate. An understanding of insurable events that poor households deal with, as well as insights in the ability and willingness to pay for insurance will aid insurers design products that are more suited to the profile of poor households. Factors like flexible and transparent policies in insurance payouts, minimum documentation requirements and education on the concept of insurance need to be thought of while designing products for this segment.

Savings and investment

Access to savings and investment facilities is critical for the poor. This facilitates building capital over a long term as well as to cope with income shocks in the near term. Stuart Rutherford argues that the need for a savings product that enables small frequent deposits largely arises from the multiple claims on it while asserting that the poor can save, do save and want to save money (Stuart, 2000). He identifies deposit collectors and savings clubs as the means by which the poor save.

A study conducted by MicroSave identifies the reasons for the poor saving with the informal sector being willingness to accept small amounts, doorstep services and ease of joining[1]. These characteristics are largely absent in formal sector savings options. Marguerite Robinson further argues that the poor want the 'option' to withdraw whenever they want and that withdrawal itself may not be very frequent (Robinson, 2000). The provision of savings is highly regulated in most countries. Under the regulations, banks are prohibited from employing 'agents' for the mobilization of deposits from the public. On the other hand, institutions other than banks are prohibited from engaging in deposit mobilization. Another regulatory barrier is the stipulation on uniform rates for return for deposit products. Given the savings patterns of poor households (small but frequent deposits), the transaction costs of providing services are likely to be higher. This rationale is similar to charging higher rates of interest on micro loans. This might explain the low penetration of savings bank accounts in rural areas.

Other risk management instruments

The Assessing the Impact of Microenterprise Services (AIMS) baseline studies in Zimbabwe, Uganda, India and Peru found client households to be highly diversified. The household income in most cases was typically a mix of enterprise revenue, daily wage, casual part-time income, remittance income and rental income (cohen, 2000). As mentioned, such diversification makes it difficult for the household to build reserves and break out of poverty. If poor households have to migrate to higher risk-taking, they will need access to instruments that will enable them to manage this risk effectively. Arguments against complete reliance on self-insurance through diversification mechanisms also point out that this strategy is expensive and unreliable in times of extreme events like drought. Idiosyncratic risk can be managed through savings, credit and some forms of insurance. However, in order to cope with risks arising from weather parameters, price volatility and disasters, other instruments are necessary.

Commodity price volatility in developing countries has been traditionally dealt through state provided mechanisms such as the minimum support price and buffer stocks. There is considerable new thinking in the area of market-based approaches such as forwards, futures, options and swaps to enable risk management for poor households.

Index based insurance products provide an opportunity to provide insurance to farmers and the rural poor without incurring the high overheads of loss adjustment and supervision typical of

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[1] www.microsave-africa.com

traditional crop insurance products. Since the index provides a transparent mechanism to compute payouts, claims settlement can be immediate.

An index was created based on an analysis of historical correlation between rainfall and crop (groundnut) yield. The index is created by assigning weightages to critical time periods. The past weather data is then mapped on to this index to arrive at a normal threshold index. The actual weather data is then mapped to the index to arrive at the actual index level. In case there is a material deviation between the normal index and the actual index, compensation is paid out to the insured on the basis of a pre-agreed formula. For the purposes of the contract, the measurements are tracked at a reference weather station. The farmers purchase the insurance contract directly and in the event of the payout, the bank receives the payout as an agent of its clients. This amount may be used by the bank to settle interest or principal payments payable to it in the event of rainfall shortage.

Given the access to an instrument that protects against rainfall volatility risk, it might be possible for several MFIs to build or enhance their crop loan portfolio. Banks should actively seek to combine lending with other risk management instruments. The relationship between risks to the client and risks to the loan portfolio is critical in the micro finance industry. Products, services, and delivery mechanisms that are designed to improve the capacity of clients to deal with the risks in their lives (reduce their vulnerability) and to reduce the risk of taking loans can lead to better payment, fewer dropouts, and accordingly lower operating costs.

A pilot in commodity price risk management has also been attempted in Uganda where members of a coffee growers' cooperative have been provided a put option on their coffee stocks. The broad challenges of participation in commodity derivatives markets have been identified as being problems related to aggregation of risks from smaller entities, basis risk, lack of local reference prices, low levels of liquidity or absence of markets for certain commodities internationally, low levels of know-how and counterparty risk (Larson, Panos, Nanae, 1998).

In India, the biggest issue is that of imperfectly functioning commodity markets. This is characterised by limited price discovery mechanisms, absence of linkages between geographically isolated markets even for the same commodity and no systematic processes and facilities for cleaning, grading, sorting, warehousing and transportation of commodities. This forces lenders to largely ignore the commodity as collateral both pre and post-harvest, significantly increasing the cost of finance and excluding several potential borrowers whose primary collateral base may only be a commodity. Commodity exchanges present a significant opportunity for better price discovery and access to price risk management instruments. Derivative contracts could be a cost-effective route to managing price and weather risks.

A discussion on MFI - specific issues

MFIs have emerged as an important conduit of financial services for the poor in recent years. However, they represent a diverse set of organizations with varying capacities.

In the context of the growing number of MFIs, the challenges to scaling up for MFIs are discussed in this section. The discussion has been structured along two broad themes. These are:

1. Access to capital for increasing micro finance outreach;
2. Capacity building for micro finance.

Access to capital for increasing microfinance outreach

The deficiency of capital is believed to constrain the growth in outreach of MFIs. It appears that even when MFIs become profitable, accumulated profits will not support the kind of growth required to dramatically scale up. Until recently, donor grants and soft loans have been utilised by many of the MFIs to support their operations both in the early years and to scale up. However, such grants, already limited in size and availability, are becoming harder to access as the pool of global MFIs grows. The other sustainable options for MFIs are tapping public debt and equity markets for growth. Regulatory concerns make mobilisation of deposits difficult for MFIs, be they NGOs or registered MFIs.

Diluting the entry norms for deposit mobilisation from the poor will have to be accompanied by an increase in the levels of supervision by the regulator. Other researchers raise similar concerns about diluting the capital entry norms for MFIs and suggests the alternative of permitting NGOs to invest in such for-profit entities, without prejudice to their tax status. The other option for MFIs is to raise equity. The low profitability margins of micro finance operations currently is yet another factor which renders it unattractive for potential equity investors. The profitability of MFIs is not very high because of factors like high initial investment, and high 'cost-to-serve' stemming from the intense supervision requirements, and the time lag between group formation and credit off-take. All this translates into barriers to raise equity capital.

Since mainstream lenders are not familiar with the micro finance industry, it is hard for the MFIs to leverage their existing equity. Commercial lenders are ready to provide only a conservative leverage on this unfamiliar asset class due to the high-risk perception of unsecured lending to the poorest strata of the society. Capital adequacy is going to become increasingly significant in a scenario where the resources that will allow the scaling up of MFIs come from commercial and development banks and through savings mobilisation. Some recent innovations show the way for overcoming the capital constraints discussed above without major regulatory changes.

Strategic partnerships between MFIs and banks with risk sharing

A potential solution to the capital constraint could be to transfer the credit risk from the MFI to the mainstream lender through innovative partnerships. A partnership may be worked out between mainstream banks/financial institutions and MFIs drawing upon the comparative advantages of each. The MFI draws upon its skills to contribute the social intermediation aspects. The bank can carry out the financial intermediation and therefore, bear the credit risk.

This model can be scaled up when embedded with incentives for the partner MFI to maintain collection performance. This would be done by providing collection incentives and review triggers related to portfolio performance. The process of transformation of financial claims into marketable securities is termed securitisation. It is widely employed by firms ranging from housing/ mortgage finance companies to insurance companies as an instrument to access capital markets.

This seems to be an ideal tool for MFIs whereby their cash flows or claims against third parties (borrowers), either existing or future, are identified, consolidated and separated from the originating entity (in this case the MFI), and then transformed into "securities" to be offered to investors. Transforming a claim on a third party as a marketable document affords to the issuer the rare ability to originate an instrument which hinges on the quality of the underlying asset. In other words, as the issuer is essentially marketing claims on others, the quality of his own commitment becomes subsidiary, the credit rating of the issuer becomes less significant, and the intrinsic quality of the asset more critical. This becomes decisive in that MFI portfolios have exhibited stable repayment rates.

2. Microfinance in Tajikistan: Current issues, problems and perspectives

2.1. Economy of Tajikistan: trends after Independence

Macroeconomic performance

The transition toward a market-based economy in Tajikistan and its economic performance after obtaining independence can be divided into two periods: (i) period of deep economic crisis (1992-1996); and (ii) period of initial growth since independence and improving macroeconomic stability (1997- to date).

The main characteristics of *the first period* are a steep fall in GDP, high rate of inflation, substantial unemployment, and a widespread increase in the incidence of poverty. Real GDP declined on average at about 15 percent per annum between 1992 and 1996. In 1996 the total volume of industrial and agricultural output constituted only 34% and 59% of their level in 1991 accordingly. In 1990 Tajikistan's GDP per capita was estimated to be around US$1,050. Two years later, it dropped by half (US$480 in 1992) and 4 years later it was only US$177 (See Table 2).

Hyperinflation had characterized all the FSU economies in the ruble zone after the breakup of the Soviet Union. The evaluation of annual inflation in Tajikistan during 1992-96 reflects the momentum of the broader economic crisis. In 1990, the inflation rate was 5.9 percent. After independence, inflation jumped to 1157 percent in 1992, remaining 418 percent through 1996 (See Table 2). Political instability, price liberalization, monetization of large fiscal deficit and the lax monetary policy were the main causes of high inflation in the country.

Economic decline has also resulted in a dramatic increase in unemployment from negligible levels to a high percentage. Although the official rate of unemployment since independence was not more than 5 percent but the actual unemployment rate was close to 30 percent. The official statistics grossly underestimate actual unemployment for several reasons. The official data do not account substantial unemployment and underemployment in inactive state-owned enterprises and in rural areas. Moreover, many of the unemployed have not registered as such because of the low unemployment benefits, which are often less than the costs incurred in claiming them.

The slowing down of rate of economic development in Tajikistan particularly after independence was due to the following main reasons.

First, the initial conditions of Tajikistan after gaining independence in 1991 were on the whole not very favourable for a sustainable development strategy. During the Soviet era Tajikistan had been one of the least affluent republics – in 1990 its GDP per capita was estimated to be the lowest in the Soviet Union. Besides that, like other Central Asian republics, it had (i) a low degree of industrialization and technological development; (ii) predominantly rural population; (iii) a higher degree of poverty than elsewhere in the FSU; and (iv) rapid population growth rate.

Second, the break-up of the Soviet Union precipitated the collapse of inter-republic trade arrangements, sharply higher prices for imported fuel products, the sharp decline in demand from other FSU states and brought to an end the generous union transfers from Moscow which according to some estimates had been equivalent to 47 percent of the total government revenue.

Third, the political turmoil and civil war (1992-97) had both permanent and temporary effects on output and productive capacity. Besides damaging or destroying much of the economy's infrastructure, the war disrupted industrial and agricultural production, caused widespread dislocation of the population, all but eliminated foreign investment, and diverted the authorities' attention from much needed economic reforms. It resulted in the loss of about 60,000 lives and

the displacement of over 850,000 people. The destruction of physical infrastructure was estimated at US$7 billion. Forth, there was a series of natural disasters, including flooding in 1992 and 1993 and flooding and mud slides in May 1996 that caused damage to infrastructure and productive assets. These shocks, along with other factors including weak economic management, are what contributed the severe economic crisis of the 1990s.

The second period related to the signing of a peace agreement between the Government and the United Tajik Opposition (UTO) in June 1997, which established a basis for normalizing the situation. The process of national reconciliation enabled the Government to focus on an economic reform program, which was originally developed in 1996 with the assistance of the IMF and World Bank. The authorities were successful in controlling inflation, and reforms efforts were renewed, with reasonably significant achievements. After five consecutive years of economic contraction from 1992 to 1996, real GDP grew by 1.7 percent in 1997. GDP growth accelerated further in 1998 until the Russian crisis caused a sharp slowdown of the economy late in the year. Despite this economic downturn, GDP grew by a strong 5.3 percent in 1998.

The effects of the Russian crisis, which were transmitted through trade, international transfers, and the banking system, constrained growth in Tajikistan in 1999. In January –September of 1999 GDP increased by less than 1 percent on the corresponding period of 1998. Higher growth rates resumed only at the end of 1999, due to low base effect and an improvement in world market prices of aluminum, one of the most important export products of the country. As a result, GDP rose by 3.7 percent in 1999.

Tajikistan’s macroeconomic performance has improved significantly since 2000. Economic growth has been strong, particularly in the last four years (9.5 percent growth on average), supported by increased production of key commodities (mainly aluminum and cotton) and strong domestic demand fuelled by increasing remittances from Tajiks working abroad, mainly in Russia. In 2002 the total industrial and agricultural growth rates were 8.2 percent and 15.0 percent respectively.

The relatively tight monetary policy pursued by the National Bank of Tajikistan since 2001 combined with nominal currency stability led to a significant lowering of inflation. End-year inflation fell from over 60 percent in 2000 to about 12.5 percent in 2002, although this was still in excess of the government’s target of 9.5 percent. Moreover, improvements in fiscal management and, in particular, in revenue collection led to a narrowing of budget deficit from 3.8 percent in 1998 to near-balance in 2002 and the surplus of fiscal balance in 2003 (See Table 2).

However, despite five years of relatively strong economic growth in Tajikistan, the effects of this recovery have not trickled down to the majority of population. Tajikistan is in danger of losing one of the important assets it has on which to build its future: its human capital. High levels of poverty (according to the World Bank, more than 80 percent of the population lives below poverty line), an inadequate of social protection, deterioration of health and education services, high rate of unemployment (according to unofficial sources, more than 30 percent) and extremely low level of public sector average wage (US$10) are the country’s top development agenda.

The country’s large external debt (a total of US$1 billion in 2003, which about one third owed to Russian Federation), virtually non-existent at independence, in 2001 was equivalent to 100% of GDP and the recent bilateral debt rescheduling agreements have reduced the debt stock to US$982 million (82 percent of GDP) in 2002 and US$1 billion (65 percent of GDP in 2003). However, even with the rescheduling agreement with Russia, Tajikistan’s debt-service costs remain a substantial burden on the government finances. The large debt complicates economic management and the cost of its servicing threatens fiscal stability. According to the IMF, debt

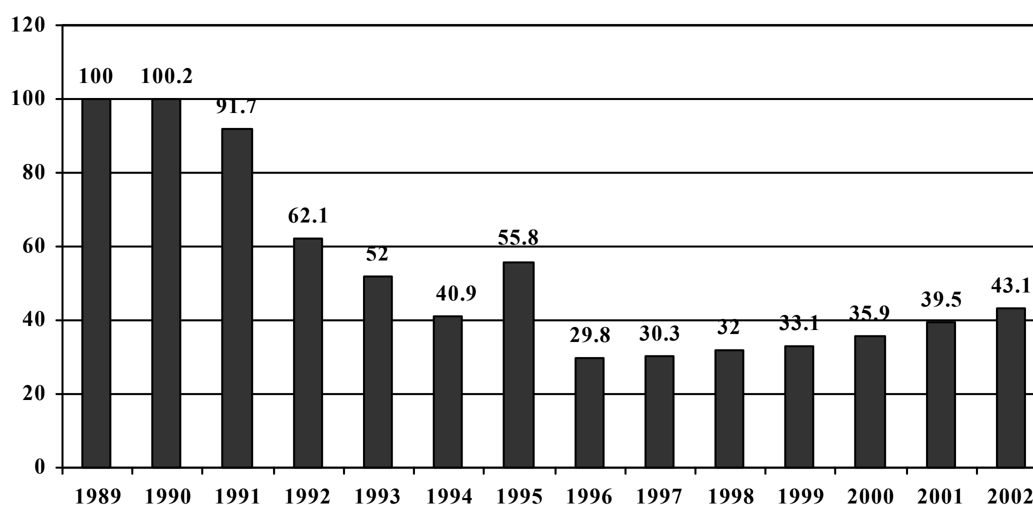
repayments in 2005 alone, when Tajikistan resumes principle repayments on its debt to Russia, will account for about 25% of state budget revenue. Combined with a low domestic savings and investment rates and negligible foreign investment, high debt-service costs severally constrain the government's ability to boost economic growth.

Therefore, Tajikistan's economic performance should be further improved to achieve a higher standard of living for the population. Even with a real overall GDP growth rate of 5 percent, it would require 15 years for Tajikistan to reach pre-independence levels of GDP. According to Figure 1, in 2002 Tajikistan has produced only 43.1 percent of its GDP in 1989. Moreover, population growth, as in the rest of Central Asia, is rapid. Although demographic increase slowed in the 1990s due to emigration and economic hardship, it remained in the range of 1.5 to 2 percent during the latter half of the decade. As a result, real GDP growth in per capita terms during the period was well below the overall GDP growth.

Employment by sectors

Analysis of the sectoral distribution of the labor force in the past decades shows that major part of the population of Tajikistan is involved in the agricultural sector. About 46 per cent of the labor force in 1970 was engaged in the agricultural sector; after 20 years there was no significant difference as it was 43 per cent in 1990, but after independence it increased up to 59.3 percent in 1996 and 63.8 percent in 2001[2]. Agriculture contributes about 25% of GDP and accounts for about 15-20% of export revenues. The main agricultural products of the country are cotton, grain, silk, fruits, vegetables, and tobacco.

Figure 1. Changes in Real GDP in Tajikistan, 1989-2002
(Indices, 1989 = 100)



Source: UNECE (2003), *Economic Survey of Europe*, p.112.

In the opinion of Russian economist, L. Friedman, during the period of 1989-96 the Central Asian states of Kyrgyzstan, Tajikistan, Turkmenistan, and Uzbekistan underwent several main processes. First, this region underwent an "agrarianization" of employment. Friedman's calculations show an increase in agricultural employees in the total labor force in Kyrgyzstan (from 32.0 to 47.3 percent, an increase of 1.46 times), in Tajikistan (from 42.1 percent to 59.3 percent, an increase of 1.4 times), in Turkmenistan (from 32.7 to 43.8 percent, an increase of 1.18

[2] IMF. *Republic of Tajikistan: Recent Economic Development*, March 2000, p.65 and
IMF. *Republic of Tajikistan: Selected Issues and Statistical Appendix*, January 2003, p.71.

times), and in Uzbekistan (from 35.2 to 40.6 percent, or 1.24 times). The exception was Kazakhstan: despite the fact that the GDP fell by more than half, the proportion of people employed in agriculture remained virtually unchanged (22.4 percent in 1989; 22.2 percent in 1996).

Second, Central Asia also experienced “de-industrialization” of employment, as measured by a significant decrease in the proportional share of people employed in industry, construction, and transportation. Friedman's data demonstrate that this decrease was substantial in Kazakhstan (from 41.7 to 27.6 percent, or 1.5 times), Kyrgyzstan (33.3 to 18.7 percent, or 1.8 times), and Tajikistan (29.1 to 15.5 percent, or 1.9 times). By contrast, the pace of de-industrialization was less intense in the case of Uzbekistan and Turkmenistan; here the proportion of the industrial labor force decreased from 31.1 to 23.8 percent (1.26 times).

Third, Central Asia underwent another structural change in the branch structure of employment: the proportion of people working in the trade and service sector increased. Friedman offers the following calculations: "The most significant increase in the number of jobs in this sector, according to official data, occurred in Kazakhstan, where this indicator rose from 35.9 to 50.2 percent (a 1.4 times increase) (Rumer B., Zhukov S., 1998, p. 34).

The Tajikistan economy is primarily agricultural due to several reasons. The slow development of the productive forces is the major reason. Among the other reasons the rich historical background and long association of Central Asian and Tajik people with agricultural sector and the favorable climatic conditions of the region are also important. But, according to some opinions, during the rule of the Soviet Union, the all Central Asian republics, including Tajikistan, was used as the source of agricultural raw material for the industrial regions of the country. For this purpose during the 30's and 50's several times people of mountains region in Tajikistan were forced to come down in the valleys.

In spite of that, the agricultural sector has involved major percentage of the labor force in comparison to other sectors but analysis of the available statistics show that the level of productivity and the contribution of the agriculture sector to GDP have decreased progressively during the independence period. For example the share of agricultural sector in the GDP in 1980 was 34.5 per cent and in 2002 it was only 22.0 per cent (look at Table 3). According to Table 1 (see Appendix), the growth rate of agricultural output during the general economic collapse of 1991-96 has been negative and in 2001 the sector reached only 73.5% its level in 1991. Another example of the decline of agricultural output may be evident in the field of cotton, the major agricultural and export product of the country which its annual production averaged 880,000 tones in 1987-91, but had dropped to 412,000 tones in 1995 and 335,000 tones in 2000. Although the total output of cotton in 2002 and 2003 increased up to 515,000 tones and 533,000 tones respectively, but is still far from the pre-independence level. A combination of unmaintained irrigation and drainage systems due to a shortage of investment and poor management, insufficient agronomic inputs, including quality seeds and fertilizers, and decrepit machinery and insufficient motivation of farmers have resulted in a steady fall of agricultural production.

In our view, in the coming decade, the agricultural sector will remain as a key component of the Tajikistan’s economy in terms of employment, exports and potential for reducing poverty. Hence, not only 70 per cent of the population living in rural areas but also the welfare of the urban people, progress of the industrial sector, increase of employment rate and the development of the whole economy in general is closely associated with the successful implementation of economic reform in agricultural sector and its sustainable development.

Table 3. Sectoral distribution of GDP in Tajikistan, %

	1980	1985	1990	1996	2000	2002
Agriculture	34.5	28.5	33.3	36.0	27.0	22.0
Industry	45.8	38.8	37.6	25.7	23.9	18.7
Services	19.7	32.7	29.1	37.4	49.1	59.3

Sources: IMF *Country Report #04/17,* January 2004, p.4.
The Economist Intelligence Unit, various issues.
UN (1997) Economic and Social Survey of Asia and the Pacific 1997, New York, p.32.

Poverty Reduction Strategy Paper

Despite the progress made during last 4-5 years, Tajikistan's per capita GDP remains lowest among FSU countries. Per capita GDP in 2002 was US$183 at current exchange rates and US$900 at PPP exchange rates. According to the World Bank, 83 per cent of the population lives below the official poverty line. In 2001, the UNDP ranked Tajikistan in the 113th position among 175 countries according to the Human Development Index (HDI). Poverty is highest in rural areas and among those without regular work.

Tajikistan is one of the countries under the CIS-7 initiative, an international initiative to promote poverty reduction, growth and debt sustainability in low-income CIS countries. The Initiative brings together the seven low income and indebted CIS countries, with a support from the four sponsoring organizations (ADB, EBRD, IMF and World Bank) and a group of bilateral creditors/donors.

Poverty is not a new phenomenon in Tajikistan. Before independence, per capita income in the country was one of the lowest among the soviet republics and the percentage of population living in poverty one of the highest. However, suffering a 16 percent average annual decline in real GDP from 1990 through 1996, hyperinflation, end of transfers and subsidies from the union budget which is estimated to be more than 40% of the government budget revenue and followed by the infrastructure damage and population dislocations arising from the civil conflict left the Tajik economy in shambles and caused widespread poverty in the country.

Poverty, however, is primarily due to limited employment opportunities and low wages (average wages of only US$10 per month), particularly in the agricultural sector. Poverty in Tajikistan also shows in decreasing access to such basic public services as education and healthcare. There also exists a big divergence in poverty between urban and rural areas. In addition, the civil war, economic and social imbalances combined with the transition from a centrally planned economy to a market system have weakened the social protection systems, both formal and informal protection mechanisms.

To increase real incomes and living standards and to target better government assistance to the poor, the government has prepared a Poverty Reduction Strategy Paper (PRSP), which was approved in July 2002. The strategy was developed through a broad participatory process that involved a wide range of government officials, civil society, NGOs, representatives of the private sector and the donor community. This strategy forms the basis for future official donor assistance and outlines key policy priorities over the medium term. Particular emphasis is placed on improving the rural economy and the agriculture sector on which the majority of poor people depend.

As indicated in PRSP, the principal objective of the poverty reduction strategy is to increase real incomes in the country, achieve a fair distribution of the benefits of growth and, in particular, ensure a rise in living standards of the poorest groups of the population (PRSP, p. 11).

Rapid growth of real GDP and keeping low inflation rate are recognized as main instruments for implementation of this strategy (on average 5 percent growth of real GDP and 6.3 percent of inflation rate annually during 2002-2006).

In its poverty reduction strategy, the government will rely on the following key principles: encouragement of export-led and labor intensive growth; efficient and fair provision of basic social services; targeted support to the poorest groups of the population; and efficient governance and improvement in security.

Given the level of poverty and limited budget of the government, Tajikistan needs substantial aid, particularly in the form of non-repayable grants. During the fourth Consultative Group meeting in May 2003, multilateral and bilateral donors pledged US$900 million over the next three years, including US$200 million of humanitarian aid. This amount is much greater than that of the last consultative meeting held in Tokyo in 2001 (around US$400 million of commitments, but only US$233 million disbursed by May 2002). The aid programs are based largely on the PRSP, focusing on improving social conditions (health, education, and poverty), infrastructure, governance and public services.

In December 2002, the IMF approved Tajikistan's poverty reduction and growth facility (PRGF) for SDR 65 million (US$87 million) for the next three years, and Tajikistan has so far received about US$22m from the program.

However, one of the most important factors that would affect Tajikistan's economic performance and its poverty reduction program in the near future is the external debt situation, which has reached 1 billion in 2003. Bilateral debt rescheduling agreements in 2002, most importantly with Uzbekistan, Kazakhstan and Russia, have reduced the debt stock to US$985 million (82 percent of GDP), from a peak of US$1,226 million (124 percent of GDP) in 2000 (Table 2 in the Appendix). Debt service due is expected to decline in the next few years (from 25.6 per cent of exports in 2001 to 13.4 percent in 2004) due to the grace periods agreed under the new agreements, but it will increase again from 2005 (a peak of 19 per cent of exports in 2007). Nonetheless, external debt in net present value terms accounted for 129 per cent of exports and 339 per cent of fiscal revenues in 2002. Tajikistan thus remains vulnerable to debt servicing problems and highly dependent on continued access to concessional international financing (EBRD, 2003, p.15).

2.2. The role and importance of microfinance in poverty reduction

Microfinance has proven to be an effective and efficient mechanism in poverty reduction the world over. The 1997 Microcredit Summit declared as its goal to reach “100 million of the world’s poorest families, especially the women of those families, with credit for self-employment and other financial and business services by 2005.” This is a bold objective, since reaching the poorest families through microfinance is still in its infancy, and most microfinance institutions (MFIs) currently reach the poor, not the poorest.

Early in the Campaign, it became clear that it would be difficult to track progress towards the Summit’s goal with the current knowledge in the field. Most microfinance practitioners can report on their numbers of clients, and the percentage that are female, but are unable to document how many of their clients were among the “poorest” when they joined the program. Most practitioners simply do not have a simple, low-cost method for assessing the poverty level of their clients.

But poverty-targeting is more than just knowing who we are reaching, ensuring that we reach who we want to reach, and reporting to our stakeholders on this. Can a microfinance program be designed which will attract only the poorest? Or can we succeed in persuading the wealthier people not to join, and attracting a mixture of the poorest plus the poor? Or will we end up designing a program that does not attract the poorest and serves only the poor and the non-poor?

We argue that unless active poverty-targeting is used then we cannot build microfinance services for the poorest. Many programs exclusively target women, in part because dominance of men can discourage women’s participation. Similarly, experience has shown that if better-off people are included, this may well discourage the poorest from joining! Hence, even if our aim is not to exclusively reach the poorest, unless we use active targeting we may well inadvertently miss the poorest altogether.

It is not a question of cost or sustainability (although this has a major impact on how poverty targeting is done). For us, if we want to reach the poorest through microfinance, we must specifically design a program that caters to their needs.

The micro-finance revolution has changed attitudes towards helping the poor in many countries and in some has provided substantial flows of credit, often to very low-income groups or households, who would normally be excluded by conventional financial institutions. Bangladesh is starkest example of a very poor country, where currently roughly one quarter of rural households are direct beneficiaries of these programs (Khandker 2003). Much has been written on the range of institutional arrangements pursued in different organizations and countries and in turn a vast number studies have attempted to assess the outreach and poverty impact of such schemes. However, amongst the academic development community there is a recognition that perhaps we know much less about the impact of these programs than might be expected given the enthusiasm for these activities in donor and policy-making circles. To quote a recent authoritative volume on micro finance

“MFI field operations have far surpassed the research capacity to analyze them, so excitement about the use of micro-finance for poverty alleviation is not backed up with sound facts derived from rigorous research. Given the current state of knowledge, it is difficult to allocate confidently public resources to micro-finance development.” (Zeller and Meyer 2002).

This is a very strong statement of doubt and in part reflects lack of accurate data, but also in part methodological difficulties associated with assessing exactly what proportion of income and other effects on the beneficiaries of micro credit can actually be attributed to the programs themselves.

This chapter aims to bring together some of the recent evidence that has been accumulating on the impact of micro finance activities on poverty reduction. In particular we ask what is the evidence on three specific issues:

- the extent to which micro finance initiatives have made a lasting difference in pulling households out of poverty on a permanent basis;
- the extent to which micro finance programs reach only the better-off amongst the poor, leaving the 'core poor' unaffected;
- how far micro finance is a cost-effective means of transferring income to the poor.

Some features of micro finance in Asia

"Asia is the most developed continent in the world in terms of volume of MFI (micro finance institution) activities". This conclusion, drawn by Lapeneu and Zeller (2001), is based on analysis of over 1,500 institutions from 85 developing countries. Comparing MFIs in Asia with those in Africa and Latin America, the study found that in the 1990s Asia accounted for the majority of MFIs, retained the highest volume of savings and credit, and served more members than any other continent.

This generalization of course covers up some wide disparities within the region. East Asia is particularly well served by MFIs. The sheer number of members served and the largest distribution of loans and mobilization of savings in terms of GNP is found in Bangladesh, Indonesia, Thailand and Vietnam. In contrast, the two most populated countries in Asia, India and the PRC, have very low outreach, despite a high concentration of the regions poor. Countries such as Afghanistan, Myanmar and Pakistan also have low outreach due to a variety of factors.

Despite these disparities within the region, overall microfinance has flourished in Asia. Compared to other regions, MFIs in Asia exhibit good outreach and high repayment rates. In contrast to their African and Latin American counterparts, Asian MFIs are relatively successful in meeting the needs of rural populations. The largest MFIs operating in Asia: Indonesia's BRI-UD, BAAC in Thailand, the Grameen Bank and BRAC in Bangladesh and the VBSP in Vietnam work in rural areas either exclusively or in combination with urban areas.

Table 4

Table 4: Outreach indicators by regions

	Number of Average Active Borrowers	Loan Balance per Borrower (US$)	Number of Voluntary Savers	Average Saving Balance per Saver (US$)
Africa	21,974 228	27,082	105	
Asia	32,915 195	18,374	39	
Eastern Europe/ Central Asia	6,040	590	0	N/a
Latin America	13,755	581	2,422	741
Middle East/ North Africa	13,463	286	0	N/a

Source: *Microbanking Bulletin* Issue #9, July 2003

Table 4 above presents the most recent data from the *Microbanking Bulletin,* which reports only data on the limited number of MFIs who choose to supply the Bulletin. Those reporting to the Bulletin are thought to be amongst the best and are therefore unlikely to be representative (Meyer, *2002).* Nonetheless amongst these, by various measures, Asian MFIs demonstrate relatively good outreach. Asian MFIs account for the largest number of borrowers (70% of which are women) and are second to African MFIs in terms of number of voluntary savers. In terms of impact size of loans and deposits are often taken as a simple indicator of impact on the poor. By this criteria Asian MFIs have among the lowest Loan and Savings Balance per Borrower, even after adjusting for GNP per capita, suggesting that they are effectively reaching the poor.

The institutions that provide microfinance and the method used to deliver microfinance products take a variety of forms and we see almost all of these varieties within Asia.

The lending methodology of MFIs can be categorized as cooperatives, village banks, and lending to solidarity groups or individuals. Cooperatives and village banks generally focus on savings. Village banks almost always remain small in scale. Cooperatives generally tend to be quite large, although many institutions in Central Asia follow what might be called the "traditional model" and are quite small. Institutions that focus on solidarity group lending, as made famous by the original Grameen Bank in Bangladesh, also generally have trouble growing to large scale. Asia is the exception. The BAAC in Thailand, the Grameen Bank, BRAC, PROSHIKA and ASA in Bangladesh, Friends of Women's World Banking in India, the Vietnam Bank for Social Policies in Vietnam and P4K in Indonesia all have more than 300,000 members. Institutions engaged in individual lending, which can be difficult in countries with low income and low population densities, also tend to be small. But again, Asia is the exception. Indonesia's BRI-UD in Indonesia has 18 million members and Vietnam's Bank for Social Policies has 4 million members. Both are engaged in individual lending.

As there can be a variety of lending approaches, a range of institutional models are also found for MFIs. These include unregulated NGOs, credit unions or co-operatives (which are often regulated), registered banking institutions (either banks or non-bank financial institutions) and government organizations. In some cases the institutional forms blur into one another with government banks operating micro finance services in collaboration with NGOs or credit co-operatives. NGOs are very active in Bangladesh, Nepal, Sri Lanka and the Philippines. Government organizations are particularly important in India, Indonesia, Vietnam and PRC.

Poverty and micro-finance

Here we define poverty as an income (or more broadly welfare) level below a socially acceptable minimum and micro-finance as one of a range of innovative financial arrangements designed attract the poor as either borrowers or savers. In terms of understanding poverty a simple distinction can be drawn within the group 'the poor' between the long-term or 'chronic poor' and those who temporarily fall into poverty as a result of adverse shocks, the 'transitory poor'. Within the chronic poor one can further distinguish between those who are either so physically or socially disadvantaged that without welfare support they will always remain in poverty (the 'destitute') and the larger group who are poor because of their lack of assets and opportunities. Furthermore within the non-destitute category one may distinguish by the depth of poverty (that is how far households are below the poverty line) with those significantly below it representing the 'core poor', sometimes categorized by the irregularity of their income.

In principle, micro finance can relate to the chronic (non-destitute) poor and to the transitory poor in different ways. The condition of poverty has been interpreted conventionally as one of lack of access by poor households to the assets necessary for a higher standard of income or welfare, whether assets are thought of as human (access to education), natural (access to land), physical

(access to infrastructure), social (access to networks of obligations) or financial (access to credit) (World Bank 2000:34). Lack of access to credit is readily understandable in terms of the absence of collateral that the poor can offer conventional financial institutions, in addition to the various complexities and high costs involved in dealing with large numbers of small, often illiterate, borrowers. The poor have thus to rely on loans from either money-lenders at high interest rates or friends and family, whose supply of funds will be limited. Micro finance institutions attempt to overcome these barriers through innovative measures such as group lending and regular savings schemes, as well as the establishment of close links between poor clients and staff of the institutions concerned. As noted above the range of possible relationships and the mechanisms employed are very wide.

The case for micro-finance as a mechanism for poverty reduction is simple. If access to credit can be improved, it is argued, the poor can finance productive activities that will allow income growth, provided there are no other binding constraints. This is a route out of poverty for the non-destitute chronic poor. For the transitory poor, who are vulnerable to fluctuations in income that bring them close to or below the poverty line, micro-finance provides the possibility of credit at times of need and in some schemes the opportunity of regular savings by a household itself that can be drawn on. The avoidance of sharp declines in family expenditures by drawing on such credit or savings allows 'consumption smoothing.' In practice this distinction between the needs of the chronic and transitory poor for credit for 'promotional' (that is income creating) and 'protectional' (consumption smoothing) purposes, respectively, is over-simplified since the chronic poor will also have short term needs that have to be met, whether it is due to income shortfalls or unexpected expenditures like medical bills or social events like weddings or funerals. In fact, it is one of the most interesting generalizations to emerge from the micro finance and poverty literature that the poorest of the chronic poor (the core poor) will borrow essentially for protectional purposes given both the low and irregular nature of their income. This group it is suggested will be too risk averse to borrow for promotional measures (that is for investment in the future) and will therefore be only a very limited beneficiary of micro-finance schemes (Hulme and Mosley, 1996).

The view that it is the less badly-off poor, who benefit principally from micro-finance has become highly influential and, for example, was repeated in the World Development Report on poverty (World Bank, 2000). Apart from the risk aversion argument noted above a number of other explanations for this outcome have been put forward. A related issue refers to the interest rates charged to poor borrowers. Most micro finance schemes charge close to market-clearing interest rates (although these will often not be enough to ensure full cost-recovery given the high cost per loan of small-scale lending). It may be that, even setting aside risk-aversion argument, such high rates are unaffordable to the core poor given their lack of complementary inputs; in other words, despite having a smaller amount of capital marginal returns to the core poor may be lower than for the better-off poor. If the core poor cannot afford high interest rates they will either not take up the service or take it up and get into financial difficulties. Also where group lending is used, the very poor may be excluded by other members of the group, because they are seen as a bad credit risk, jeopardizing the position of the group as a whole. Alternatively, where professional staff operate as loan officers, they may exclude the very poor from borrowing, again on grounds of repayment risk. In combination these factors, it is felt by many, explain the weakness of micro-finance in reaching the core poor.

Even where micro-finance does reach the core poor, when (as in many instances) donor or government funds are required to subsidize the micro-finance institutions involved, it is not inevitably the case that this is an efficient strategy. As funds are fungible within households the use of the loan is not the issue and what matters is the cost of transferring the funds through a micro credit institution per dollar received by the target group, as compared with the benefit-cost ratio for alternative schemes for reaching the core poor, such as food subsidies, workfare,

integrated regional development initiatives and so forth. Such comparisons must take account of not just the administrative costs involved, but also the leakage rate (that is the benefits to the non-poor).

Assessing the true relationship between micro-finance services and poverty reduction is not straightforward. It is not simply a case of looking at a group of borrowers, observing their income change after they took out micro-credits and establishing who has risen above the poverty line. Accurate assessment requires a rigorous test of the counterfactual – that is how income (or whatever measure is used) with a micro credit compares with what it would be without it, with the only difference in both cases being the availability of credit. This requires empirically a control group identical in characteristics to the recipients of credit and engaged in the same productive activities, who have not received credit, and whose income (or other measure) can be traced through time to compare with that of the credit recipients. Furthermore to allow for changes over time, in principle assessments should allow for the possibility of reversals with households slipping back below the poverty line, if the productive activities financed by the credits are unsustainable. Studies based on a rigorous counterfactual find much smaller gains from micro-finance than simple unadjusted before and after type comparisons, which erroneously attribute all gains to micro credit.

2.3. Main obstacles to development of microfinance

Given the unquestionable importance of viable and stable target group-oriented financial institutions and the empirical evidence that banking for the poor can be economically viable and that successful financial institutions can be built with moderate financial investment and in a short time, one might wonder why many more successful institution building projects are not started and implemented. In fact, the vast majority of would-be institution building projects are unqualified failures. In this chapter we will discuss the three main reasons why institution building projects fail, or – to put it another way – the three most important challenges which institution building projects must face.

Expecting too much and too little at the same time

All too often, the difficulties involved in building or transforming an institution are vastly underestimated by those who manage and advise the institutions and even more so by those who provide the funds on which the institutions have to rely for a certain time, i.e. by the international donor community. The underestimation of the problems of starting or expanding and transforming a microfinance institution shows up most clearly in the tendency of donor institutions to expect institution building projects to achieve many things at the same time: In addition to creating a viable institution, project partners and implementers are expected to distribute certain quantities of loans to specific segments of the target population, such as self-employed women in a remote region of a country; to provide various kinds of financial, and in many cases even non-financial services irrespective of what strains providing these services puts on the emerging institution; to train not only the people working in the institution, but also the target group; and last but not least, to meet excessive reporting requirements. These burdens are put on the institutions as if the creation of a viable institution working in a difficult environment and with a difficult clientele were not enough of a challenge on its own.

But this is not all; in many cases emerging microfinance institutions are also expected, tempted and sometimes even put under a certain pressure to "absorb" donations and cheap funds from some donors who follow a "soft" policy approach, or, as the case may be, to pay "market rates" for external funds from "tough" donors – and this again largely irrespective of the situation in which the institution finds itself (Schmidt/Zeitinger, 1994). All too often, the kind of support which is provided is mainly a reflection of the policies and the internal needs of various donor agencies. The tendency to overburden an institution and to provide support of a kind which is inappropriate at the given stage of the institution's development is fostered by the fact that in many cases a promising institution is "supported" by many donor institutions which have to follow their own, often quite different, policies; which fail to coordinate their efforts sufficiently; or which sometimes simply compete to be involved in a possible success story. Most partner institutions do not have the experience or the strength to refuse requests when the supply of funding is made contingent on their fulfillment, or to reject ostensible "favors", even if they might feel that the measures to be adopted are not good for them.

There is also the opposite tendency of the donor community as a whole, and even of certain individual donor institutions, to ask and expect too little from a partner in an institution building project, or to be too "understanding" if a local partner institution fails to meet certain targets which have been agreed beforehand and which are essential for the envisioned process of institutional transformation and development.

It seems to be difficult for donors to make the continuation of their support conditional on progress at the level of the partner institution. There are several reasons for this: One of them is that many people in the donor administration simply do not care enough about genuine success in terms of institution building; having achieved a certain amount of success and possibly also some

positive economic and social impact is enough for them, and they may be content with a limited improvement at an institution which they support, even if this falls short of the envisioned objective of creating a strong institution. Another reason is that pushing for the kind of change and development which institution building necessarily requires invariably meets with resistance from important decision makers within the partner institution as there are always individuals who lose influence, privileges or status when the transformation proceeds along the planned path. This resistance is almost a natural consequence of success at early stages of an institution building project, as such success improves the institution and thus makes the positions of such individuals more valuable and strengthens the bargaining power of these individuals, who now have a strong motive to slow the process down. Finally, discontinuing a project "merely" because the partner institution does not change as much and as fast as it could suggests that the relevant decision makers might have bet on the wrong horse in the first place. In technical terms, a strategy of institution building is very hard to make renegotiation-proof.

Experience confirms that both mistakes, i.e. demanding too much and demanding too little, often go hand in hand: Having demanded too much at one stage is a perfect excuse for not demanding enough at a later stage when demanding more would involve serious conflicts. In addition, all of these problems are exacerbated when a local microfinance institution interacts with several donors and investors at the same time, which is typically the case. In order to make an institution building project a success, and to create a vibrant and dynamic target group-oriented financial institution, it is imperative to avoid both mistakes. This requires that donors – possibly several of them at the same time – and local partners find ways of committing themselves to the institution building objective, i.e. that they voluntarily establish mechanisms that will effectively prevent them from changing their strategies over time even though their current interests are most likely to change. A prerequisite for the establishment of such mechanisms is a detailed and explicit strategy or development plan which is formally agreed between the parties involved. But this is not enough. What is also needed is the awareness in the donor community that institution building is a worthwhile endeavor in its own right and that a long-term perspective is required in order to make it succeed.

Neglect of corporate governance and ownership

A key problem is how to allocate decision-making and control rights and, ultimately, ownership so as to ensure that everyone who has a say in important decisions is guided by both incentives and constraints to act in such a way as to help the institution to grow, become stronger, more profitable and also more socially relevant. Unfortunately, there is no easy solution as to how to best allocate these rights. There is no one optimal legal form and no ownership structure which covers all cases, or even all cases of a given type. Too strong a role for profit-oriented owners might jeopardize the target group-orientation, while too little influence for owners who really have their own capital at risk might undermine financial soundness and limit the growth of the institution and its longer-term impact.

Designing and implementing an appropriate governance and ownership structure is difficult even under stable conditions. In the case of an institution building project, it is even more difficult, and even more important. It is more important because if change and development are to take place, there must be someone with the power to drive change. It is more difficult because the governance system must enable and encourage change. In this case, the ideal owners, directors and senior managers – from an economic standpoint, not necessarily in legal terms – would be those who have a strong interest in *not* maintaining the status quo which is achieved at any given time, and who also can provide leadership and monitor other members of the institution. But people who have no particular incentive to maintain the status quo at any given time often also have no real stake in the institution at all, and therefore do not add value.

Even though all of this may appear to be fairly obvious, experience suggests that these points are often not given due consideration in practice: Even though it seems impossible to define the best governance and ownership structures, when one looks at a specific institution one can easily see whether certain weaknesses exist in this area. Indeed, many institutions and many projects have suffered greatly, and are still suffering, from inattention to the problems of aligning incentives, restricting the scope of decisions and actions and of ensuring accountability. Disregarding governance and ownership issues is a deadly sin in the case of institution building projects. In practice, it is often quite obvious where the deficiencies lie. What is then needed is a concept to bring about improvement, and the determination and the willingness to push for its implementation; all too often, these are lacking. What may appear to be respect for the autonomy of the key players in the partner institution typically turns out to be a clear violation of the interests of the other people at the partner institution and, most of all, of the members of the target population, who will not benefit from the supply of financial services if the institution does not continue to grow and improve.

Institution building projects thus face many hazards: fruitless internal conflicts or inappropriate actions; inaction on the part of management where action is needed; a lack of commitment on the part of the board and the donors. The practical problem for those who want to make the institution building project a success is to make sure that none of these potential problems are allowed to frustrate the institution building effort.

Lack of a conducive regulatory framework for MFIs

The third main reason why institution building projects fail or are not even initiated is the lack of appropriate regulation for microfinance institutions. In general, it is important that financial institutions are subject to regulation and supervision, as, at least in principle, appropriate regulation and supervision tend to contribute to financial and institutional stability. However, in many cases regulation for microfinance institutions is not in place or is not appropriate. One kind of deficient regulation is overly lenient regulation, which is often combined with a total lack of supervision. Another kind is one which fails to take into account the peculiarities of microfinance, e.g. by forcing financial institutions to request forms of collateral which the target group typically does not have, or by preventing financial institutions from charging interest rates which are high enough to cover the considerable administrative costs incurred in making very small loans.

A specific problem in this area is that, under the guidance of, and even under pressure from, the World Bank and the IMF, many countries have recently raised capital requirements for microfinance institutions considerably. It is important to distinguish between capital requirements in the form of solvency ratios, which should in fact be high in the case of microfinance institutions, and minimum capital requirements. The latter should not be high, because high minimum equity requirements make it very difficult to create and later on to formalize such an institution. The reason is that it is typically very difficult to find professional investors who are willing and able to put up a sum of, say, USD 5 million – to take a minimum equity requirement which is now in effect in many countries – and who are also committed to the goal of building up a commercially viable target group-oriented financial institution.

The set of potential investors who can be called upon these days to invest in emerging microfinance institutions is very limited, and each of them individually is rarely willing to invest more than USD 1 million. In addition, these investors have recently come to require that a consulting firm or other private institution which implements an institution building project also contribute equity. This requirement is indeed quite reasonable, as it strengthens the commitment to succeed. However, for tax reasons, the share of the implementing organization has to be at least 10 percent to be economically feasible, and the number of eligible organizations which have the staff and the know-how necessary for "serious" institution building in the area of small and micro

finance is even more limited than that of potential investors. There are at present not even a handful of candidates, and none of them is a large and wealthy corporation which could put up the required equity easily. In addition, given such high capital requirements, a microfinance institution would have to attain quite a large size in order to be financially viable, and thus would have to develop a correspondingly large market; this might not even be possible for an institution operating in a small country.

All of this has a clear implication: Raising minimum equity requirements to the high levels they are currently reaching worldwide is stifling promising efforts to build up the target group-oriented institutions which are so urgently needed to improve the economic and social situation of a target population which is still grossly underprivileged and lacks access to credit. High minimum equity requirements tend to prevent microfinance from breaking out of the confines of informality and the NGO world, leaving it in the hands of those players in the national and international donor community who are still not interested in serious financial institution building.

2.4. Legal framework for Microfinance

Concept of microfinance

Microfinance is widely recognized as an effective tool in fighting poverty. Establishment and development of private small and medium businesses may not be possible without functional microfinancing system.

Microfinance has emerged as a growing industry to provide financial services to very poor people. Until recently, microfinance focused primarily on providing microcredit (small loans of about $50-$500) for microenterprises. Now, however, there is a recognition that poor people need a variety of financial services, not just credit. Current microfinance has therefore moved towards providing a range of financial services, including credit, savings and insurance, to poor enterprises and households.

The field of microfinance was pioneered by specialized non-governmental organizations (NGOs) and banks such as Bank Rakyat Indonesia (BRI) Unit Desa (Indonesia), Grameen Bank (Bangladesh), Kenyan Rural Enterprise Programme (K-Rep) (Kenya), Fundación para la Promoción y Desarrollo de la Microempresa (PRODEM), Banco Solidario (BancoSol) (Bolivia), and others. They challenged the conventional wisdom of the 1970s and discovered that with new lending methods, the rural poor repaid loans on time. These new methods included providing very small loans without collateral at full-cost interest rates that were repayable in frequent installments. They demonstrated that the poor majority, who is generally excluded from the formal financial sector, can, in fact, be a market niche for innovative banking services that are commercially sustainable.

As a result, current microfinance has made a major shift from subsidized microfinance projects of the past, which ended up serving few people, to the development of sustainable financial institutions specialized in serving the low-income market.

Today there are a growing number of successful microfinance institutions (MFIs) worldwide. These are primarily local institutions that are reaching a significant number of poor people and that are becoming commercially viable.

It is important to note that microfinance is not just about microcredit, it is a combination of social mobilisation, training/consultation, and permanent contact between client and MFI.

Background of microfinance in Tajikistan

The microcredit industry in Tajikistan is currently in a state of development. New MFIs are being established, some MFIs that were providing credit last years are no longer lending, and existing MFIs are expanding, offering new products, opening new offices and changing their registration.

Micro-credit has so far been proved successful in rural areas with the experience of the Development Fund and Oriyon in partnership with Mercy Corps. This success can be attributed to the following factors, which should be carefully considered in introducing new rural credit programmes or expanding existing ones. Rural microcredit programmes must be implemented within the context of social mobilization to ensure repayment, build sustainable capacity and promote self reliance amongst clients.

Credit to small farmers and poor should be free of physical collateral – substituted by social collateral which can be effectively developed only through social mobilization.

Introducing microfinance programs within existing formal financial institutions would substantially increase coverage of the poor and small farmers to the desired level, particularly in view of the limited availability of donors' and government funds and work towards sustainability. There are formal financial institutions, which are already disbursing small credits but microfinance systems need to be well developed which could in turn enable them to increase outreach, cut costs for small loans and achieve sustainability. Such institutions should, however, build appropriate microfinancing technologies and expertise within their institutions in order to operate effectively. Convenience and quick availability of credit to the poor and small farmers are essential for success of such programs.

Measures to build capacity and ensure an appropriate legal framework for community based groups/associations to link up directly with formal financial institutions, and as they develop further, establish their own financial networks, either through credit unions, cooperatives, etc.

Appropriate interest rates should be charged to ensure that funds allocated for micro-finance are not depleted.

Mobilization of local finances can also make a significant contribution to development of the rural financial sector. Savings, combined with micro-credit within the same institution can offer more opportunities for increasing outreach, ensuring repayment, encouraging local ownership and moving towards financial sustainability.

The lack of formal savings facilities is limiting the growth of the financial sector in rural areas. The motivation to save is initially based on programme requirements, the need to establish risk funds in case of repayment difficulties, group member crisis or internal credit to members for short-term income generating activities. As the groups develop, however, they begin to recognize the value of savings and the need to build up the savings fund for larger business ventures, including investment in machinery. This process is, however, hampered by lack of safe and easily accessible formal savings facilities with reasonable earnings.

It is unfortunate that commercial banks which have such facilities do not run microfinance programs, whilst such formal financial institutions such as Development Fund and Oriyon which are so far running successful microcredit programmes do not have savings facilities. Future policies and programmes should therefore focus on developing financial packages which combine credit with savings, both within the banking and non-banking financial institutions. Opportunities to build upon existing mechanisms, which are working successfully, should not be missed.

The Current Legal Framework for Microfinance in Tajikistan
The main normative act for micro-crediting activities is based on the Civil Code of the Republic of Tajikistan.

In accordance with the Civil Code, a bank or any other credit organization may issue credit. The main normative act regulating the order of establishment and activity of banks, is the Law of the Republic of Tajikistan "On Banks and Banking in the Republic of Tajikistan". In accordance with this law, a bank in the Republic of Tajikistan is a financial institution created to attract deposits from individuals, legal entities and other funds, and allocate them on its behalf, based on terms of returnability and payability within the restricted period of time, as well as to conduct settlements in accordance with the clients' instructions.Along with legal norms directly relating to micro-crediting, legislation of the Republic of Tajikistan contains norms, which regulate the procedure of granting financial and property support. These norms may be used along with micro-credit.

Obstacles

- One of the major obstacles in running a successful microcredit programme in the Republic of Tajikistan is the attitude of dependency, particularly among the poor population, who still expect financial and material support from the government and international institutions to help them through the current economic crisis. Until poor people have a clear understanding that microcredit is not a compensation from the government, but it is a first step in self employment and starting their own enterprises, microcredit programmes targeting the poor will not succeed.
- In many cases poor people and small farmers simply lack knowledge about microcredit, marketing, business planning and many other private business related issues.

Tajikistan's president signed the new Law on Microfinance Organizations on May 27, 2004 to promote the growth of the microfinance sector in the country. The law was developed with support from the International Finance Corporation (IFC), the private sector development arm of the World Bank, and the United States Agency for International Development (USAID.) The legislation creates a progressive legal and regulatory framework to allow existing and new microfinance organizations in Tajikistan to expand their activities and, importantly, to attract additional capital from both donor organizations and private investors.

Throughout the world microfinance, broadly defined as financial services for low income and rural populations without access to formal financial markets, has proven an effective tool in reducing poverty, especially for women. Since the early 1990s microfinance organizations have been active in Tajikistan providing small loans to individual entrepreneurs and small businesses to help them expand their activities. IFC has provided advisory help to individual microfinance institutions in Tajikistan through grants from Government of Canada and from IFC, through IFC's Technical Assistance Trust Funds program. However, the growth of the microfinance sector has been restricted by limited access to commercial funds and the inability to take deposits from the general population. The new law now opens the door to new, more sustainable sources of funds.

Further, the new law will allow microfinance institutions to operate within a clear legal framework and, over time, have the opportunity to transform into deposit-taking institutions. The law also provides for risk-based regulation by the National Bank of Tajikistan to promote safety for depositors and increased public confidence in the financial sector in Tajikistan. Experts from IFC's Microfinance Legislation Development Project in Dushanbe, Tajikistan with assistance from the Day, Berry Howard Foundation based in Connecticut, USA, worked closely with the National Bank of Tajikistan to draft the law and support it through the legislative process. The project will continue this successful collaboration in developing the detailed regulations under the new law.

Formal credit and savings for the poor are not recent inventions: for decades, some customers neglected by commercial banks have been served by credit cooperatives and development finance institutions. These organizations have legal charters that govern their financial operations and allow them access to savings or other public funding. But the past two decades have seen the emergence of powerful new methodologies for delivering microfinance services, especially microcredit. Much of this innovation has been pioneered by non-governmental organizations (NGOs), who typically do not have a legal charter authorizing them to engage in financial intermediation. Governments, donors, and practitioners are now talking about new legal structures for microfinance in dozens of countries. Microfinance regulation and supervision has suddenly become a hot topic, with conferences, publications, committees, and projects appearing everywhere. Much of the attention is focused on NGO microfinance.

Regulation of microfinance is being discussed in one country after another. But the people doing the discussing are often motivated by differing objectives, which tends to confuse the dialogue:

- Looking to fund themselves, NGOs with microcredit operations often want to be licensed (and thus regulated) in order to access deposits from the public, or credit lines from donors or governments.
- Sometimes microfinance institutions (MFIs), especially NGOs, believe that regulation will promote their business and improve their operations.
- Some NGOs, governments, and donors want financial licenses to be more widely (and easily) available in order to expand savings services for the poor.
- Donors and governments may expect that setting up a special regulatory window for microfinance will speed the emergence of sustainable MFIs.
- Occasionally, where unlicensed MFIs are already taking deposits, the central bank's motivation in pushing to license them is to protect depositors.
- Many MFIs charge surprisingly high interest rates. Government may view these rates as exploitative and want to protect small borrowers from them.
- Local authorities are sometimes troubled by the weakness of many MFIs, and unimpressed with the coordination and supervision being exercised by the donors who fund them.

They want someone to step in and clean up a situation that they think is hurting the development of microfinance in their country. In this research paper microfinance means formal banking services for poor people (definitions of "poor" in this context vary widely). Governments or others regulate financial service providers when they make rules for them, controlling for instance the safety standards they must meet. Supervision is systematic oversight of such providers to make sure that they comply with the rules, or close down if they don't. In order to limit the cumbersome repetition of "regulation and supervision," this paper will sometimes used "regulation" as a shorthand for that phrase. It is worth noting that even today, most of the world's microfinance clients are served by banks, credit unions, and other licensed institutions.

- Occasionally governments look to regulation as a means of clamping down on bothersome foreign-funded NGOs or other groups that it would like to control more tightly.
- In some countries there is simply no legal structure under which a socially motivated group can lawfully provide loans to poor clients. Unless such a structure is developed, loans may be legally uncollectable, and microfinance providers may even be at risk of prosecution.
- Finally, microfinance is getting a high political profile in many countries, especially since the 1997 Microcredit Summit and its aftermath. Occasionally, attention to regulation springs from a government's sense that it has to do something about microfinance, for reasons that may combine concern for the poor and the demands of practical politics.

For all these reasons, microfinance today seems to find itself in the midst of a rush to regulate. There is no shortage of people willing to offer views on when and how to do it. But all of them suffer from the same handicap: experimentation with microfinance supervision is so recent that we can not rely much on its historical results to guide us.

2.5. Microfinance institutions operating in Tajikistan

3. International experience of microfinance institutions

3.1. Case study of FINCA Kyrgyzstan

Microfinance in the Kyrgyz Republic

There are nineteen government or donor supported credit programs currently in the Kyrgyz Republic. To achieve greater and deep outreach and financial viability, a number of institutional forms for providing microfinance services can be pursued in the Kyrgyz Republic. Each option has advantages and poses challenges to on-going institutional viability. A brief analysis of these options is considered:

- Specialized financial institutions. Specialized financial institutions in the Kyrgyz Republic are the KAFC which is limited to providing agricultural credit and SSC which provides savings, not credit.
- Specialized services within commercial financial institutions. Two commercial institutions are analyzed –Promstroibank and AKB Kyrgyzstan.
- Nongovernmental organizations. FINCA, the largest NGO microcredit organization operating in Krygyzstan is briefly described.
- Credit unions or other member-owned financial institutions.

Savings Settlement Company (SSC)

Savings Settlement Company (SSC) is one of the very few operating financial organizations in Kyrgyzstan with nationwide coverage. It is designed to attract savings from the public and can expedite payments through its network of 48 affiliates. The liquidation of two of the biggest state banks, Agromprombank and Elbank, resulted in inadequate geographical coverage of banking services. Partly to overcome this, SSC was established by the decision of the National Bank of Kyrgyz Republic in 1996. SSC was converted into a Joint Stock Company in the end of 1997. The Central bank owns 100% of shares. The functions of SSC include the following: to provide payment services to the Social Fund and Central Treasury and to provide bank services with full geographic coverage. The company's license includes all bank services except business and consumer credits, which were excluded by NBK to reduce risk in operations. SSC has the widest coverage of the country through its 48 branches. Branches are well organized and have a broad client base.

Kyrgyz Agricultural Finance Corporation (KAFC)

The World Bank launched the Rural Finance Project which resulted in the establishment of Kyrgyz Agriculture Finance Corporation (KAFC) in 1997 with a license for agricultural credit business only. KAFC is a joint stock company with the Government as the sole shareholder. It has a commercial credit window (IDA credit of US$ 13 million) and a Small Farmers Outreach Component (IDA credit of US$ 3 million), both with collateral requirements. In addition, IFAD has provided a credit Sub-Component of US$ 1.5 million enabling poor farmer groups to get no collateral loans of up to US$140 per member. KAFC charges 28% yearly interest rate to farmers and 30% to small businesses. The UNDP and KAFC have agreed that IFAD loan funds will be channeled to the groups of rural poor that UNDP Poverty Alleviation Project II and UN Volunteers organize. The IFAD credit line is the source of credit currently tapped by the UNDP organized Self-Help Groups (SHGs). In the second phase of the Rural Finance Project the World Bank and KAFC intend to support the development of group lending so that the project would achieve its original goal of reaching out to small-scale farmers and micro entrepreneurs and providing financing without traditional collateral. Regarding microfinance, KAFC plans to offer a wide network of offices, 46 offices, one in each rayon.

Promstroi-bank

Promstroi-bank was privatised in 1996. It used to be the state construction bank during the Soviet era. Promstroi-bank has 26 branches throughout the country. By the number of branches it is

second biggest after SSC. By the volume of total assets (336 million som) it belongs to the group of six large banks. On the volume of funds raised in deposits and contributions it belonged to 6 the first group , that raised more than 200 million som. In 1997 it had the second highest return on equity of all the banks, 65.9%.

AKB Kyrgyzstan
AKB was established in 1989 as a state-owned bank and has been gradually privatized. Before privatization it used to be the social bank. AKB has the third largest branch network in the country with 23 branches and 450 employees. By the volume of total assets (300 million som) it belongs to the group of six large banks. Active portfolio of AKB is 145 million som. In terms of the volume of raising funds through deposits and contribution, AKB belongs to the lowest group of banks that raised less than 100 million som(1997). In 1997 it had the highest return on equity of all the banks, 71,2%. According to the management, the bank has a broad social mission to serve the people, including those who require small savings and loans. AKB has recently gone through a restructuring and decentralization process with assistance from TACIS experts which analyzed work load and number of personnel. As a result, branches have been restructured, staff reduced and other staff trained. AKBs new growth strategy is to increase clients and work more closely with clients to provide better services.

Credit Unions
The ADB supported "Rural Financial Institutions Project" aims at establishing a Credit Union (CU) system comprising a network of about 280 individual CUs across the country over a seven year period ending May 2005. CUs are community level co-operative financial institutions that provide savings and credit services to individual members, expected at about 100 people per group. The system is expected to mobilize about US$11 million by way of share capital and retained earnings by the end of the project period. The FCSCU (Financial Company for the Support and Development of Credit Unions), established in 1997, will promote, develop, monitor and supervise the CUs and NBK will be responsible for overall supervision and regulation of the system. The project includes a credit line of US$12.5 million to equally match the total contributions of CU members shares, which is lent to the credit union at a 24% annual rate. The loan portfolio is expected to reach US$19 million by end of period.

FINCA International, Inc . (FINCA)
FINCA International, Inc . ("FINCA") is a US based not-for-profit organization. The purpose of FINCA is to "Help the poor to help themselves". FINCA believes that world hunger and poverty cannot be cured simply by food handouts and grants, but can be permanently affected by self-help and self-sufficiency of the poor. FINCA Micro Credit Company (FMCC) is a closed joint-stock company incorporated in the Kyrgyz Republic on June 2003. The FMCC is a not-for-profit organization.

The FMCC is a micro-finance organization regulated by the National Bank of the Kyrgyz Republic and conducts its business under certificate issued by the National Bank of the Kyrgyz Republic. By the end of October 2003 FINCA Kyrgyzstan, which is an affiliate of FINCA International, Inc., stopped granting loans and all its functions were taken over by the FMCC. Within the next few months, loans issued by FINCA Kyrgyzstan and operating expenses were gradually transferred to the FMCC.

The FMCC provides self-help opportunities by establishing community revolving loan funds in impoverished communities. Small loans support individual or community productive micro enterprise investment. The FMCC's mission is to support the economic and human development of Kyrgyz families trapped in severe poverty. This is to be accomplished through granting individual collateralized loans (SEL) and the creation of associations of 5 to 20 individual

members who receive working capital loans to finance self-employment activities and a mutual support system that encourages self-worth and personal development. The Organization has 6 regional offices in the Kyrgyz Republic located in Bishkek, Batken, Osh, Jalal-Abad, Issyk-Kul and Talas.

In recent years, the Kyrgyz Republic has undergone substantial political, economic and social change. As an emerging market, the Kyrgyz Republic does not possess the well-developed business and regulatory infrastructure that generally exists in more developed market economies. As a result, operations carried out in the Kyrgyz Republic involve significant risks that are not typically associated with those in developed markets. The Kyrgyz financial market operations reflect uncertainty surrounding the future direction of economic and regulatory policy in the Kyrgyz Republic. Interest rates in the Kyrgyz Republic are therefore relatively high by international standards, reflecting these risks. As a microcredit company, FMCC will not be allowed to mobilize deposits for a two-year period, during which time supervision will be mainly off-site, with FINCA sending reports to the National Bank of the Kyrgyz Republic. After that two-year period is complete, it is expected that FINCA Kyrgyzstan will transform into a microfinance company, which will allow it to mobilize savings from the public.

FINCA International's mission is to "provide financial services to the world's poorest families so they can create their own jobs, raise household incomes, and improve their standard of living." Traditionally, FINCA International programs work with the village banking methodology, in which groups of up to thirty clients co-guarantee each other's loans. FINCA Kyrgyzstan, however, has taken the innovative approach of working with smaller groups and individual clients, evaluating the creditworthiness of individuals and their businesses. Other changes in methodology have included changing the payment schedules to monthly payments, in most cases, and the recent elimination of the savings requirement for borrowers.

FINCA Micro Credit Company data as of April 30, 2005

Table 5

Village Banking Groups	3,106
Total Clients	24,319
Percentage Women Clients	83%
Average Loan Size	$454
Total Loans Outstanding	$9,864,800
Total Client Savings	$3,140
On-Time Repayment	99.1%

Now in its ninth year of operation, FINCA Kyrgyzstan offers full service in all of the oblasts (provinces), setting the stage for its targeted transformation to a legally registered commercial enterprise by 2005. FINCA Kyrgyzstan is one of FINCA International's three pilot transformation programs. A leader in the microfinance movement, FINCA Kyrgyzstan and FINCA International played a prominent role in helping shape microfinance legislation and in organizing a seminar on the specifics of microfinance operations and regulations for the National Bank of Kyrgyzstan.

3.2. Case study of Grameen Bank of Bangladesh

Grameen Bank (GB) has reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. GB provides credit to the poorest of the poor in rural Bangladesh, without any collateral. At GB, credit is a cost effective weapon to fight poverty and it serves as a catalyst in the over all development of socio-economic conditions of the poor who have been kept outside the banking orbit on the ground that they are poor and hence not bankable. Professor Muhammad Yunus, the founder of "Grameen Bank" and its Managing Director, reasoned that if financial resources can be made available to the poor people on terms and conditions that are appropriate and reasonable, "these millions of small people with their millions of small pursuits can add up to create the biggest development wonder."

Today, in April, 2005, it has 4.48 million borrowers, 95.5 percent of whom are women. With 1,456 branches, GB provides services in 51,687 villages, covering more than 75 percent of the total villages in Bangladesh. Grameen Bank's positive impact on its poor and formerly poor borrowers has been documented in many independent studies carried out by external agencies including the World Bank, the International Food Research Policy Institute (IFPRI) and the Bangladesh Institute of Development Studies (BIDS).

A short history of Grameen Bank

The origin of Grameen Bank can be traced back to 1976 when Professor Muhammad Yunus, Head of the Rural Economics Program at the University of Chittagong, launched an action research project to examine the possibility of designing a credit delivery system to provide banking services targeted at the rural poor. The Grameen Bank Project (Grameen means "rural" or "village" in Bangla language) came into operation with the following objectives:

- extend banking facilities to poor men and women;
- eliminate the exploitation of the poor by money lenders;
- create opportunities for self-employment for the vast multitude of unemployed people in rural Bangladesh;
- bring the disadvantaged, mostly the women from the poorest households, within the fold of an organizational format which they can understand and manage by themselves; and
- reverse the age-old vicious circle of "low income, low saving & low investment", into virtuous circle of "low income, injection of credit, investment, more income, more savings, more investment, more income".

The action research demonstrated its strength in Jobra (a village adjacent to Chittagong University) and some of the neighbouring villages during 1976-1979. With the sponsorship of the central bank of the country and support of the nationalized commercial banks, the project was extended to Tangail district (a district north of Dhaka, the capital city of Bangladesh) in 1979. With the success in Tangail, the project was extended to several other districts in the country. In October 1983, the Grameen Bank Project was transformed into an independent bank by government legislation. Today Grameen Bank is owned by the rural poor whom it serves. Borrowers of the Bank own 90% of its shares, while the remaining 10% is owned by the government.

Credit delivery system

Grameen Bank credit delivery system has the following features:

1. **There is an exclusive focus on the poorest of the poor.**

Exclusivity is ensured by:

i. establishing clearly the eligibility criteria for selection of targeted clientele and adopting practical measures to screen out those who do not meet them;

ii. in delivering credit, priority has been increasingly assigned to women;
iii. the delivery system is geared to meet the diverse socio-economic development needs of the poor.

2. **Borrowers are organized into small homogeneous groups.**

Such characteristics facilitate group solidarity as well as participatory interaction. Organizing the primary groups of five members and federating them into centres has been the foundation of Grameen Bank's system. The emphasis from the very outset is to organisationally strengthen the Grameen clientele, so that they can acquire the capacity for planning and implementing micro level development decisions. The Centres are functionally linked to the Grameen Bank, whose field workers have to attend Centre meetings every week.

3. **Special loan conditionalities which are particularly suitable for the poor.**

These include:

i. very small loans given without any collateral;
ii. loans repayable in weekly instalments spread over a year;
iii. eligibility for a subsequent loan depends upon repayment of first loan
iv. individual, self chosen, quick income generating activities which employ the skills that borrowers already posses;
v. close supervision of credit by the group as well as the bank staff;
vi. stress on credit discipline and collective borrower responsibility or peer pressure;
vii. special safeguards through compulsory and voluntary savings to minimise the risks that the poor confront;
viii. transparency in all bank transactions most of which take place at centre meetings.

4. **Simultaneous undertaking of a social development agenda addressing basic needs of the clientele.**

This is reflected in the "sixteen decisions" adopted by Grameen borrowers. This helps to:

i. raise the social and political consciousness of the newly organized groups;
ii. focus increasingly on women from the poorest households, whose urge for survival has a far greater bearing on the development of the family;
iii. encourage their monitoring of social and physical infrastructure projects - housing, sanitation, drinking water, education, family planning, etc.

5. **Design and development of organization and management systems capable of delivering programme resources to targeted clientele.**

The system has evolved gradually through a structured learning process, that involves trials, errors and continuous adjustments. A major requirement to operationalize the system is the special training needed for development of a highly motivated staff, so that the decision making and operational authority is gradually decentralized and administrative functions are delegated at the zone levels downwards.

6. **Expansion of loan portfolio to meet diverse development needs of the poor.**

As the general credit programme gathers momentum and the borrowers become familiar with credit discipline, other loan programmes are introduced to meet growing social and economic development needs of the clientele. Besides housing, such programmes include:

i. credit for building sanitary latrines;
ii. credit for installation of tube-wells that supply drinking water and irrigation for kitchen gardens;
iii. credit for seasonal cultivation to buy agricultural inputs;
iv. loan for leasing equipment / machinery, i.e., cell phones purchased by Grameen Bank members;
v. finance projects undertaken by the entire family of a seasoned borrower.

The underlying premise of Grameen is that, in order to emerge from poverty and remove themselves from the clutches of usurers and middlemen, landless peasants need access to credit, without which they cannot be expected to launch their own enterprises, however small these may be. In defiance of the traditional rural banking postulate whereby "no collateral (in this case, land) means no credit", the Grameen Bank experiment set out to prove - successfully - that lending to the poor is not an impossible proposition; on the contrary, it gives landless peasants the opportunity to purchase their own tools, equipment, or other necessary means of production and embark on income-generating ventures which will allow them escape from the vicious cycle of "low income, low savings, low investment, low income". In other words, the banker's confidence rests upon the will and capacity of the borrowers to succeed in their undertakings.

The mode of operation of Grameen Bank is as follows. A bank branch is set up with a branch manager and a number of center managers and covers an area of about 15 to 22 villages. The manager and the workers start by visiting villages to familiarize themselves with the local milieu in which they will be operating and identify the prospective clientele, as well as explain the purpose, the functions, and the mode of operation of the bank to the local population. Groups of five prospective borrowers are formed; in the first stage, only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to the rules of the bank. Only if the first two borrowers begin to repay the principal plus interest over a period of six weeks, do the other members of the group become eligible themselves for a loan. Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense, the collective responsibility of the group serves as the collateral on the loan.

Loans are small, but sufficient to finance the micro-enterprises undertaken by borrowers: rice-husking, machine repairing, purchase of rickshaws, buying of milk cows, goats, cloth, pottery etc. The interest rate on all loans is 16 percent. The repayment rate on loans is currently - 95 per cent - due to group pressure and self-interest, as well as the motivation of borrowers.

Although mobilization of savings is also being pursued alongside the lending activities of the Grameen Bank, most of the latter's loanable funds are increasingly obtained on commercial terms from the central bank, other financial institutions, the money market, and from bilateral and multilateral aid organizations.

Breaking the vicious cycle of poverty through microcredit

The Grameen Bank is based on the voluntary formation of small groups of five people to provide mutual, morally binding group guarantees in lieu of the collateral required by conventional banks. At first only two members of a group are allowed to apply for a loan. Depending on their performance in repayment the next two borrowers can then apply and, subsequently, the fifth member as well.

The assumption is that if individual borrowers are given access to credit, they will be able to identify and engage in viable income-generating activities - simple processing such as paddy husking, lime-making, manufacturing such as pottery, weaving, and garment sewing, storage and marketing and transport services. Women were initially given equal access to the schemes, and proved not only reliable borrowers but astute entrepreneurs. As a result, they have raised their status, lessened their dependency on their husbands and improved their homes and the nutritional standards of their children. Today over 90 percent of borrowers are women. Intensive discipline, supervision, and servicing characterize the operations of the Grameen Bank, which are carried out by "Bicycle bankers" in branch units with considerable delegated authority. The rigorous selection of borrowers and their projects by these bank workers, the powerful peer pressure exerted on these individuals by the groups, and the repayment scheme based on 50 weekly installments, contribute to operational viability to the rural banking system designed for the poor.

Savings have also been encouraged. Under the scheme, there is provision for 5 percent of loans to be credited to a group find and Tk 5 is credited every week to the fund.

The success of this approach shows that a number of objections to lending to the poor can be overcome if careful supervision and management are provided. For example, it had earlier been thought that the poor would not be able to find remunerative occupations. In fact, Grameen borrowers have successfully done so. It was thought that the poor would not be able to repay; in fact, repayment rates reached 97 percent. It was thought that poor rural women in particular were not bankable; in fact, they accounted for 94 percent of borrowers in early 1992. It was also thought that the poor cannot save; in fact, group savings have proven as successful as group lending. It was thought that rural power structures would make sure that such a bank failed; but the Grameen Bank has been able to expand rapidly. Indeed, from fewer than 15,000 borrowers in 1980, the membership had grown to nearly 100,000 by mid-1984. By the end of 1998, the number of branches in operation was 1128, with 2.34 million members (2.24 million of them women) in 38,957 villages. There are 66,581 centre of groups, of which 33,126 are women. Group savings have reached 7,853 million taka (approximately USD 162 million), out of which 7300 million taka (approximately USD 152 million) are saved by women.

It is estimated that the average household income of Grameen Bank members is about 50 percent higher than the target group in the control village, and 25 percent higher than the target group non-members in Grameen Bank villages. The landless have benefited most, followed by marginal landowners. This has resulted in a sharp reduction in the number of Grameen Bank members living below the poverty line, 20 percent compared to 56 percent for comparable non-Grameen Bank members. There has also been a shift from agricultural wage labor (considered to be socially inferior) to self-employment in petty trading. Such a shift in occupational patterns has an indirect positive effect on the employment and wages of other agricultural waged laborers. What started as an innovative local initiative, "a small bubble of hope", has thus grown to the point where it has made an impact on poverty alleviation at the national level ".

Method of action

The Grameen Bank's Method of action can be illustrated by the following principles:

1. Start with the problem rather than the solution: a credit system must be based on a survey of the social background rather than on a pre-established banking technique.
2. Adopt a progressive attitude: development is a long-term process which depends on the aspirations and commitment of the economic operators.
3. Make sure that the credit system serves the poor, and not vice-versa: credit officers visit the villages, enabling them to get to know the borrowers.
4. Establish priorities for action vis-à-vis to the target population: serve the most poverty-stricken people needing investment resources, who have no access to credit.
5. At the beginning, restrict credit to income-generating production operations, freely selected by the borrower. Make it possible for the borrower to be able to repay the loan.
6. Lean on solidarity groups: small informal groups consisting of co-opted members coming from the same background and trusting each other.
7. Associate savings with credit without it being necessarily a prerequisite.
8. Combine close monitoring of borrowers with procedures which are simple and standardised as possible.
9. Do everything possible to ensure the system's financial balance.
10. Invest in human resources: training leaders will provide them with real development ethics based on rigour, creativity, understanding and respect for the rural environment.

Grameen Bank now operates through fifteen zonal, three sub-zonal, 123 area, and 1456 branch level offices.

A basic principle of Grameen Bank is that the *bank goes to the poor people*, since it is difficult for the poor people to come to the bank. All banking transactions are done in the centre meetings at the village level, attended by borrowers and the centre manager who is a bank staff. The branch borrows from the head office whenever it needs funds, at the rate of 4 percent for housing loans (on-lending at the rate of 8 percent) and at the rate of 12 percent for income-generating loans (on-lending at the rate of 20 percent).

At the end of April 2005, the bank, through its 1,456 branches located in 389 sub-districts and 60 districts of Bangladesh, was serving 4.48 million members. It had disbursed, by the end of April, 2005, Tk. 296,980.00 million (US$4,790.27 million) as basic loans. Grameen Bank members also deposit in various savings accounts and the balance of their savings stood at about Tk.14,900.00 million. The bank's services reached 51,687 villages, out of a total of about 68,000 villages in the country.

The Generalized Grameen System

There was a long period of preparation by the bank staff and management to develop a new flexible loan system that was introduced at the end of 2000. The new system is a more simplified, more customer friendly system that can work equally well both in normal and disaster situations. The Grameen Generalized System**,** basically has two types of loans, *Basic Loan and Flexible Loan*. Unlike the old system where all income-generating loans were for one year, in the new system income generating loans can be of any duration mutually agreed between the bank and the borrower. Besides the size of weekly repayments can be also varied according to the pre-negotiated agreements. Eighty five per cent of the borrowers of Grameen Bank have moved from the old system of multiple loans, to the new generalized single loan system by December, 2002.

Basic Loan means hundred per cent repayment and *Flexible loan* means loans at risk. At the end of 2002, only fifteen per cent of the borrowers were on flexible loans. A borrower facing repayment difficulties can convert her overdue amount into a flexible loan. Flexible loan is not an independent loan. It is only a temporary detour from the basic loan. A borrower will always make efforts to go back to the basic loan. If a borrower fails to repay the basic loan and is unwilling to go into flexible loan, she becomes a willing defaulter. But if she tries and does not succeed, then she becomes an unwilling defaulter. Flexible loan not paid back in two years becomes overdue; 100 per cent provision is made in such a case and in three years, it becomes bad debt and written off.

Grameen also provides housing and higher education loans. A durable shelter is one of the basic requirements to enable people to organize and manage business activities and undertake plans for creative pursuits in the future. The ownership of a house infuses people with a sense of confidence, security and self-respect, to begin dreaming for a better life for herself and her family. A member can borrow up to Tk. 25,000 for constructing a simple tin-roof house at an interest rate of 8 percent to be paid back over a period of ten years. More than 558,000 such houses had been constructed by December 2002. By that time, Tk. 7,687.53 million has been disbursed as housing loan, the average loan size being Tk. 13,775. Our experience shows that, given the opportunity, the poor can provide and pay for decent housing for themselves, when they can generate income through Grameen credit.

In 1997, Grameen Bank introduced the *Higher Education Loan* programme, in an effort to provide new opportunities for talented children of its borrowers to receive higher education. Children of borrowers who enrol in medical schools, engineering, honours and masters degree programmes, agricultural colleges, textile engineering and other higher education programmes, are eligible to receive financing from this loan window. The loans are intended to cover all expenses incurred by students from the beginning of their respective courses until completion,

including admission fees, course fees, required stationery, food and accommodation and other necessary expenses. Until the end of the year, 395 students from various disciplines have so far received loans under this programme.

The new system requires all borrowers with loans above Tk. 8,000 to contribute a minimum of Tk. 50 each month to a pension deposit account and after ten years they receive almost double the amount. Many are coming forward to save under the Grameen Pension Scheme and the balance of savings came to Tk. 7,305.08 million at the end of 2002. Grameen bank is now on a strong financial footing to expand its lending operation without further borrowings from outside.

The new Generalized system is supported by a program to computerize all branch level accounting and the MIS. New computerized Information Management Centre has been set up in the area office. Now that computer does all the routine paper work, the staff can concentrate more on improving the quality of lives of the borrowers. About 80 per cent of the branches are now computerized. By the end of 2003, it is expected that almost all the branches would be served by the Information Management Centers.

Since many branches are connected by GSM mobile phones, the bank is planning to take the next logical step to integrate the entire information system through the Internet. Already, most of the zones are connected with each other and the head office through an Intranet system.

Conclusions and recommendations

This research has examined the challenges that rural lenders face in designing and operating demand-oriented lending services. These systems should be widely accessible to small farm households and durable. Based on the preliminary guiding principles for rural lending a summary is presented of the main lending strategies. These methods are used to reduce the high costs and risks of lending to small farmers and rural entrepreneurs.

Cost Reduction and Risk Management Strategies

Cost Reduction

To secure a satisfactory out-reach and sustainability, rural agricultural lending institutions should be actively engaged in adopting cost-effective credit delivery strategies. Further they should develop appropriate loan products and lending technologies. Most of the cost-reduction strategies, outlined below involve heavy initial overhead costs. This means that they do not pay off immediately. In fact, a careful assessment should be made of their long-term cost effectiveness.

Strategies to reduce rural lending costs

- Use a decentralized operational structure and employ mobile loan officers and/or mobile branch offices;
- Delegate loan authority to field staff;
- Recruit staff with a solid background in agronomy, farm management and rural economics;
- Provide adequate staff training and use performance-based staff incentives;
- Simplify lending procedures;
- Screen potential clients and appraise loans by collaborating with local organizations and networks (agricultural extension staff, NGO and communities);
- Install an integrated banking software to produce accurate and timely accounts and constitute an effective management information system;
- Diversify the loan portfolio in order to balance uneven staff work load due to agricultural seasonality.

Selected annotations

- Rural and agricultural lending institutions require an adequate operational structure to meet their client demand. This includes well-trained and motivated staff and appropriate loan products. The effective operation of a decentralized rural branch network depends on the delegation of loan authority to field staff, the existence of proper checks and balances plus the use of an adequate management information system. Performance-based staff incentives enhance the motivation and the productivity of loan officers. Collection of essential market information facilitates the identification of potential clients.
- Classification of farmers by farming systems, description of on farm production inputs and major agricultural commodities helps to define their effective demand for loan products. The high costs of collecting specific information on the creditworthiness and the loan repayment capacity of prospective clients can be reduced significantly by collaborating with local organizations. It is important to set the lending interest rates at market terms to cover the full agricultural lending transaction costs.
- The adoption of integrated banking software for the computerization of an accounting and management information system is highly recommended. Accurate and timely information is indispensable for decision making in a financial institution. With appropriate banking software systems, a comprehensive and consolidated data base may be built from the files of branches. It contains fully integrated information on customers, different types of accounts and a general ledger. Such banking software is able to produce

required financial accounts for separate branches as well as a consolidated account for the entire financial institution. Based on the integrated database it is possible to generate a variety of user-defined reports.

Risk Management

Active management on the part of the farmer-borrower and rural entrepreneur-borrower as well as the financial institution is required to reduce the high risks associated with rural agricultural lending. Different factors affect exposure in rural agricultural lending. The kind and severity of risks that face farmers and rural entrepreneurs vary according to the type of farming system, agricultural production, weather conditions and the prevailing economic and agricultural policies. Rural agricultural lenders are confronted with high covariant rural agricultural credit risks and liquidity risks.

Strategies to reduce agricultural lending risks

Enhance the required information base of rural agricultural lenders by:

- identifying the risks of specific types of agricultural production activities;
- collecting information on the credit history and creditworthiness of potential farmer clients;
- appraising the loan repayment capacity of loan applicants;
- monitoring policies and agricultural commodity markets that are relevant for farmers.
- Start rural agricultural lending in agroecological zones that present low credit risks and expand operations gradually to more risky areas;
- Commence with small and short-term rural agricultural loans and increase the loan size and term with repeat loans;
- Individualize rural agricultural loan products and loan repayment modalities in accordance with the loan repayment capacity and borrowing performance of farmer and rural entrepreneur clients;
- Adjust, in case of group lending, the size and the composition of joint liability farmer groups in accordance with local conditions;
- Reduce rural agricultural credit risks through adequate asset and loan portfolio diversification;
- Manage external credit risks through prudential loan rescheduling; if feasible use commercially viable insurance mechanisms; mobilize, in cases of serious natural disasters, emergency aid to fund rehabilitation grants to affected farmer clients;
- Use staff remuneration incentives to encourage a high lending productivity and to reward good portfolio quality;
- Promote a good credit culture and discipline through client education and moral persuasion;
- Develop mutual trust between lender and borrower by establishing and maintaining close contacts between loan officers and farmers;
- Use appropriate loan collateral substitutes and provide borrowers with incentives that encourage good loan repayment behavior.

Selected annotations

- The basis for good risk management is quality information. For instance, rural agricultural lenders should collect information on the incidence of drought, flood, plant and animal diseases and other risks that affect farm production. Lenders should know what risk-reducing mechanisms are available such as irrigation and insurance. They need to collect data on markets and prices of relevant farm inputs and agricultural commodities. They should monitor current economic and agricultural policies as well as policy changes. On the other hand, lenders have to build up specific client information on the creditworthiness and the loan repayment capacity of prospective farmer-borrowers. The lending operations

and conditions of other financial intermediaries and the current and past experiences of agricultural credit programs should be monitored.

- Once lenders have a rough idea of the effective demand for rural agricultural loans and the lending risks, they should choose the loan products and lending technologies to serve specific types of farmer-borrowers. It is recommended to set fairly standardized lending conditions and loan terms. Flexibility can be increased as the lender learns more about new small farmer clients. First-time borrowers should be granted small loans, even though the per unit costs of these loans are high. Similarly, interest rates should be kept simple and uniform for borrowers at the outset. Later differential rates can be set by type and size of loans. The frequency of loan repayment installments depends on the loan repayment capacity of the farmer-borrower. Overdue loans should be dealt with promptly. Both individual and group lending technologies can be utilized. They differ with regard to their method of client screening, loan appraisal, loan collateral requirements, loan monitoring and loan recovery. In general, lenders should be willing and able to adjust their lending technologies over time.
- Diversification of the loan portfolio serves to protect agricultural lenders against a concentration of covariant risks among farmer-borrowers. It is attained by granting loans to different types of farmers for distinct lending purposes at different loan terms. In addition, farmers in various agroecological zones should be served. Still, lenders need to set ceilings on the volume and the share of agricultural loans. Limits should be defined by zone and in their overall loan portfolio, to restrict the incidence of concentrated risks due to unfavorable weather conditions, pests, diseases and natural disasters.
- Often rural agricultural lending institutions are faced with a subsidy mentality on the part of small farmer-borrowers who were accustomed to receive agricultural loans at concessioal terms from state-owned agricultural development banks, donor agencies, and NGOs. For this reason, rural financial institutions need to emphasize client education by informing prospective borrowers on loan application procedures and lending conditions. In particular, farmers have to be reminded of their loan repayment obligations and the various loan repayment enforcement mechanisms. Specific incentives that reward good loan repayment behavior should also be explained to them. The overall aim of client education is to promote a positive credit culture in which mutual trust and respect is built up between the lender and the borrower.

Remaining Challenges in Rural Agricultural Lending

The granting of loans to small farm households and rural entrepreneurs remains a tricky business. Costs and risks are high and diverse. The dispersed location of rural clients, the difficulties and high costs of transportation and communication, the heterogeneity in farming activities and management skills make small farm lending a costly endeavor. The high agricultural production risks further complicated by the sensitive political nature of agriculture and domestic food production, explain why lending to agriculture is risky. There is limited availability of risk-mitigating mechanisms. Many challenges still remain to constitute an agenda for future research.

Need for an Adequate Agricultural Finance Policy Framework

Structural Adjustment Programs have been successful in generating a more favorable macroeconomic environment in developing countries.

Still ongoing market reform and privatization have not yet produced appreciable improvements in the provision of agricultural support services. Nor have they increased farming profitability. If anything, small farmers often have less access to rural banking and institutional agricultural lending facilities than before. A major reason is the absence of an adequate rural and agricultural finance policy framework. The generation of agricultural finance policies is also complicated because agriculture is a politically sensitive sector. Rural people and farmers are affected by three different policy-making areas: macroeconomic policy, financial sector policy and agricultural

sector policy. The essence of a successful agricultural finance policy is skillfully integrating these three policy areas. The regulation must capture the views of all stakeholders involved in policy formulation, delivery, monitoring and feedback.

Heterogeneity of Farming

The variety in farming activities and farm management poses challenges and opportunities to agricultural and rural lenders. As the use of standardized agricultural lending products and lending conditions is unrealistic, the design of individualized loan products will increase the transaction costs of the lender. The availability of viable farm and non-farm investment provides opportunities to meet the effective demand of farmers and rural clients for a wide range of loan products and other financial services. This diversifies the loan portfolio and thus reduces the concentration of agricultural lending risks. Lenders need to be willing and able to develop new loan products. They need to adopt lending technologies that respond to the demand and the loan repayment capacity of potential farmer-borrowers. To attain this, lenders must have good knowledge of farming systems, agricultural commodity markets, and rural and farm household economy. Initially, those farmer clients should be served who present low risks.

Loan Appraisal and Loan Follow-up

An innovative use of loan appraisal techniques and close loan follow-up can contribute to reduce agricultural lending risks. Yet, the problem of high agricultural lending costs persists. This is due to a dispersed rural client location, high transportation costs, high overhead costs to startup a decentralized rural branch network, and high information costs. Collaboration with local organizations can be extremely useful to reduce client information costs. Farmer-borrowers can be provided with essential non-financial support services such as agricultural extension, and business and financial management training.

Lending Technologies

The choice between the options of individual or group lending is closely related with the type of clients that will be served, the operational structure and outreach of the financial institution and the relative importance of cost or risk-reducing strategies. For instance, agricultural lenders which work with joint liability groups should be aware that group size and group homogeneity have a direct impact on the effectiveness of peer group member solidarity and pressure. In general, rural borrower groups need to be smaller than urban ones. There are high potential costs for group formation, organization, intra-group information and loan monitoring by fellow group members. High covariant risks of farm and rural incomes suggest that heterogeneous rural groups may be more effective in reducing lending risks. However, too much group heterogeneity can give rise to the problem of demand for different loan products, loan sizes and loan terms between group members. In any case, lenders must be willing to change their lending technologies over time. Individual borrower graduation should be made possible for group members who progress more rapidly than others and who are capable of servicing larger loans.

Potential for the Use of Electronic Banking Products

New information technologies provide significant scope for the adoption of innovations in bank automation, electronic data processing and development of new agricultural loan products. For instance, launch a credit card scheme in rural areas. Farmers who are credit card clients may get advances up to a certain limit per acre of land without additional formalities. Another example is the use of smart cards that allow farmers to draw loans on retailers of fertilizers and other agricultural inputs. For the lender, significant cost efficiency can be effected by using this form of loan disbursement.

Term Lending Facilities

Agricultural loans are required for relatively long terms, which makes matching of assets (loans) and liabilities (sources of funds) a key issue to be addressed. The difficulty of mobilizing

sufficient longer-term loanable resources at reasonable financial conditions limits the capacity of agricultural and rural lenders to meet demand for medium- and long-term loans. Ways of securing longer-term loanable funds are the increase of equity of a financial institution by retaining earnings, the negotiation of long-term borrowings from development organizations and multilateral development finance institutions. This may also happen through the issuing of medium and long-term debentures or bonds and the creation of a subsidiary merchant bank

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Liquidity Management

Mismatching the term of loan assets and liabilities exposes a financial institution to high liquidity risks. Good liquidity management requires priority attention in agricultural lending. The liquidity position of agricultural lenders is affected, in particular, by agricultural seasonality. Careful liquidity management is also needed in the event of large changes in agricultural commodity prices, or natural disasters. Under these circumstances withdrawals of rural savings and new loan demand of farmers occur at the same time. Agricultural lenders need reliable information on the timing of required loan disbursements and scheduled loan repayments to properly plan and manage their cash requirements. Sufficient funds should be available at the beginning of the planting season, while the high costs of keeping loanable funds idle should be minimized as much as possible.

Interlinked Agricultural Credit Arrangements

Today, with the breakdown or restructuring of agricultural development banks and the withdrawal of the state and donor and development agencies from agricultural and rural finance, interlinked credit arrangements provided by non-financial institutions often offer the only way to finance the on-farm production of small farmers in developing countries. For instance, both traditional trade finance as well as more sophisticated forms of agribusiness arrangements like out grower schemes and contract farming have (re-) emerged recently in many countries. Interlinking the supply of agricultural inputs with credit and output marketing, presents farmers with the advantage of market orientation and better outlets for farm products. Small farmers, with weak bargaining positions, may be paid unfair low prices for their produce. Essential support services will be required in developing appropriate market intelligence systems and providing farmers with better market information and business advisory services. At the same time, they may be assisted in proper farmer organization. Much more research on this subject is needed.