



**Paving the Way Forward for Rural Finance
An International Conference on Best Practices**

Discussant Reaction Paper

Comments on

**“Models of Rural Financial Institutions”
by Manfred Zeller**

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All views, interpretations, recommendations, and conclusions expressed in this paper are those of the author (s) and not necessarily those of the supporting or collaborating institutions.

Professor Zeller's paper provides a valuable description of various types of financial institutions that comprise the rural finance sector. Specifically, he makes an important point that I would like to focus on in my response: "Institutional diversity is desired to enhance competition, depth and breadth of outreach, and welfare impact."¹ Specifically, I would like to talk about my experience in El Salvador over the past four years where we work with a diversity of institutional approaches, credit technologies and products within the same competitive environment.

In section four and table 1 of the paper, Professor Zeller describes a continuum of institutional types according to a variety of criteria. I found this categorization interesting, yet a bit confusing, as it seems to equate institutions with specific credit technologies while this may not be the case. I believe it is important to understand the diversity of legal institutions as separate and distinct from the diversity of products and credit technologies and not try to meld the two very distinct concepts into a single continuum. For example, commercial banks and specialized microfinance banks offer solidarity group products and NGOs offer village banking. For my own organizational framework, I think of several different matrices. For example, I place on one axis the institutional types, based on legal and ownership structures, and the product mix on another axis. When examining credit products, I consider different products on one axis and the diverse credit technologies used on the other. (See these simpler frameworks at end of this document.)

As Professor Zeller points out, a downfall of early rural credit schemes was they assumed people needed credit. Rural households need a variety of financial services – credit yes, but also deposit, payment, transfer and insurance services, etc. Moreover, while just about anyone can legally make loans, the legal, regulatory, infrastructure and other requirements for these other services tend to raise the bar on entrance or limit the institutions eligible. So, if we are interested in rural finance, rather than just microcredit, we need to think in terms of the various target groups, the full potential demand for the diverse services and hence the institutions that can and do provide the full gamut of such financial services.

In El Salvador, DAI manages a USAID "rural microfinance project" known as FOMIR/DAI. For USAID in El Salvador, and hence for our project, rural is defined as outside the greater San Salvador metropolitan area. Hence, for us, rural includes several primary and secondary cities and towns and, to a lesser degree, what most of us would agree is rural and mainly agricultural. However, few of the institutions we work with serve, much less target, farmers or agricultural enterprises in a significant way and most concentrate on commerce in towns and cities.

The attached tables indicate geographically where microenterprise credit clients and branches (defined as those with a microenterprise loan officer), from 11 project institutions, are located around the country based on department capitals and non-capitals (a closer proxy for rural/non-rural than our project definition). As demonstrated in these tables, about 56% of all clients with outstanding loans are from departmental capitals, while 44% are from rural municipalities. If we group the clients by institutional type, then the NGOs, which represent 49% of all clients have 38.6% in rural municipalities, the credit unions, with 10.89% of all clients, have 33.89% in rural municipalities, and the banks, with 39.94% of all clients, have 53% in rural municipalities.

The individual loans, which represent about 64% of all borrowers in our sample, are distributed almost evenly between rural and urban clients, while the 36% of clients with group loans are

¹ Page 1, Zeller, M. 2003. Models of Rural Finance Institutions, International Conference on Best Practices in Rural Finance, June 2-4, 2003 in Washington, D.C.

predominantly urban (66.47% versus 33.53%) based on the department capital definitions. Unfortunately, to date, I do not have geographic data on clients of other services.

The geographic distributions may be more a result of individual institutional strategies rather than the legal type of institution or its preferred credit technology. Nonetheless, the results are important to consider when establishing expectations and making generalizations about the reach of rural financial services by diverse types of institutions and credit technology. In my opinion, it is not surprising that the individual credit technologies reach a higher percentage of rural clients than the group technologies as these loans are more customized to the unique needs of clients, which vary more in rural areas than in urban areas where clients tend to be clustered in similar types of enterprises.

Among the 11 institutions in our project, during the past four years and using donor incentives, we have seen total growth in rural credit clients (project definition of outside San Salvador) outpace total client growth, meaning rural credit clients grew more rapidly than urban clients during this period. During the same period, profitability for each institution has fluctuated up and down and overall arrears have decreased.

What the growth, portfolio quality, client outreach and profitability trends and my observations of institutional development have shown me over the past four years is that the starting point and rate of change varies by institutional type, in part. However, the most important difference is management, not institutional type. Management's vision, leadership and administrative capacity is what shapes the depth and breadth of outreach, portfolio quality and level of profitability. It is true that management is determined, in part, by the institutional type, as certain types of institutions tend to attract certain types of individuals and tend to set certain types of objectives. Moreover, the priority placed on the types of outreach and profitability of different product lines and client segments varies within institutional types.

For example, we have found the start-up and rollout costs of microfinance lending technology or new savings products in existing banks and credit unions are much lower than the start-up costs for an NGO or specialized microfinance bank. The former can take advantage of existing systems, infrastructure, funding and management while the latter must start everything from scratch. This is important to consider in lowering transaction costs for institutions and clients. However, the credit unions and commercial banks (that donor supported projects usually require, correctly, to invest their own resources to cover operational and financial expenses and investments) tend to be more conscious and conservative when it comes to risk management and profitability. Hence, these institutions have been more cautious about rapid investment and expansion.

Even more limiting to growth and innovation in these multi-service financial institutions is the list of priorities these established institutions struggle to attend each day. Rural finance or microfinance will by definition be the priority in a specialized institution. However, these product lines or client segments must compete with other priorities – defined by business or other objectives – for resources in a multi-service, multi-segment institution. This struggle makes working with credit unions, banks or other institutions that are not specialized, or where you do not control management, more frustrating.

So, while we have seen costs contained and profitability more rapidly achieved with banks and credit unions, their growth in outreach is slower than specialized banks or NGOs. However, I

would argue that these multi-service institutions are our best bet in many countries for greater outreach, profitability and sustainability in the medium-term. Likewise, if the management in control of a state-owned bank is skilled and incentivized to focus on profitable rural and microfinance and the governance structure is such that political interference is prevented, then these entities also demonstrate high potential for both outreach and profitability.²

However, if all types of institutions hold potential, how do donors, policy makers, investors, managers or others interested in expanding and improving rural and microfinance pick partners and make choices? First, evaluate the existing institutional landscape to see what does and can exist. Second, determine client preferences for institutional types, products and services. Third, determine if institutions exist that already provide quality services profitably to similar client groups (and hence just need help in expanding more quickly) or others with potential but demonstrated weaknesses that are willing to change (e.g. owners, directors and managers have capacity and willingness to change) and if you will be able to establish a position to influence that change. This point is most important as management is what makes the most difference in outreach and profitability as it is not the type of institution but rather who is running it. Fourth, determine resources available, time frame and objectives.

In a nutshell, what we have seen as the strengths and weaknesses of different institutional types can be summarized as:

Credit Unions

- Strengths – client/member focused, diversity of products and services, profitable and self-sufficient, located in rural areas, know and are dedicated to these regions, can attract and reach diverse segments (poor and non-poor)
- Weaknesses – leadership and management skills vary greatly, need to build-up management structures and staff skills significantly, weak credit technology (traditionally, changing in some with TA), difficult to capitalize and justify investments (not impossible, depends on leadership and management to justify)

Commercial Banks

- Strengths – diversity of products, services, and client segments, profitable and self-sufficient, meet own funding requirements, branch network, skilled managers in diverse technical areas, tend to be larger and hence can diversify risk better than smaller, local institutions
- Weaknesses – how to keep micro and rural finance a priority and to garner support from throughout bank for success, objectives and profitability may be measured by volume rather than margins making smaller operations less attractive, slower growth curve for micro or rural finance based on cautious expansion plans and implementation

Public Banks

- Strengths – diversity of products, services, and client segments, branch network, management structures in diverse technical areas, tend to be larger and hence can diversify risk better than smaller, local institutions
- Weaknesses – if run for political reasons, then likely that management is weak, funding scarce and profitability low, changes in leadership and strategy dependent upon political rather than market forces, as with commercial banks, it may be a struggle to keep micro and rural finance a priority in large, multi-service institution

NGOs

² For more detailed discussion on successful management lead turn around of state-owned banks, see case study on the Ag Bank of Mongolia that Jim Boomgard will present in the session on restructuring and post-restructuring results.

- Strengths – focus on target group
- Weaknesses – difficult to capitalize, difficult to make investments to scale-up operations, limited service offering based on legal/regulatory constraints, governance and ownership undefined and hence accountability and legal constraints arise

Specialized Banks or Finance Companies

- Strengths – these may combine the best of banks (product diversity, capitalization and funding capacity, quality management) and NGOs (client or target group focus) for rural and microfinance.
- Weaknesses – however, if the specialized formal institutions do not yet exist, start-up costs may be significantly higher than working through existing institutions. Focus on supporting these in competitive environments may crowd out private investment or other players. Support as demonstration effect in markets without existing players may entice others to enter.

As we have not worked with pawn brokers or money-lenders, I cannot comment on their strengths or weaknesses. However, I would like to mention that loan officers at specific branches in rural El Salvador have cited these institutions as their main competitors, despite a competitive microfinance industry in this country.

In conclusion, I agree with Professor Zeller that we need diversity of financial services and attention to diverse clients. However, based on my experience in El Salvador, client access and service diversity is not as dependent on institutional types, or even credit technologies, as it is on the vision and leadership provided by an institution's management and the resulting efficiency and diversity of services delivered.

Data on 11 Financial Institutions in El Salvador as of March 31, 2003

Type of Institution	Dept. Capitals		Other Municipalities		Total	
	# Clients	% Clients	# Clients	% Clients	# Clients	% Clients
NGOs	30,258	61.38%	19,041	38.62%	49,299	49.16%
Credit Unions	7,223	66.11%	3,702	33.89%	10,925	10.89%
Banks	18,765	46.85%	21,289	53.15%	40,054	39.94%
TOTAL	56,246	56.09%	44,032	43.91%	100,278	100.00%

Type of Institution	Dept. Capitals		Other Municipalities		Total	
	# Branches	% Branches	# Branches	% Branches	# Branches	% Branches
NGOs	32	86.49%	5	13.51%	37	35.58%
Credit Unions	7	77.78%	2	22.22%	9	8.65%
Banks	44	75.86%	14	24.14%	58	55.77%
TOTAL	83	79.81%	21	20.19%	104	100.00%

NGOs: Includes two specialized companies established and owned primarily by NGOs (AMC & Integral) as well as CAM, ASEI and FJND, all non-regulated

Credit Unions: Includes all credit clients of ACACU, ACCOVI and ACASEMERSA, including salaried workers as well as MSEs

Banks: includes microfinance portfolio of two commercial banks (Banco Agricola & Banco Salvadoreño) and entire portfolio of Financiera Calpia. Branches for banks include only those with a MSE loan officer, although product available through all branches

Type of Loans	Dept. Capitals		Other Municipalities		Total	
	# Clients	% Clients	# Clients	% Clients	# Clients	% Clients
Individual	32150	50.21%	31,878	49.79%	64,028	63.85%
Group	24096	66.47%	12,154	33.53%	36,250	36.15%
TOTAL	56,246	56.09%	44,032	43.91%	100,278	100.00%

Group loans include those to village banks and solidarity groups

Client geographic area determined by municipality of residence in institutional databases.

Institutional and Product Matrices

INSTITUTIONS	PRODUCTS				
	Credit	Savings	Remittances/ Transfers	Payroll	Payment Services
Non-profit/Non-government Organizations					
Credit & Savings Cooperatives					
State Owned Banks					
“Private” Commercial Banks					
Pawn/Money Lenders					
Specialized Finance Companies					
Money Lenders & Pawn Brokers					
Etc.					

CREDIT PRODUCT	CREDIT TECHNOLOGY		
	Village Bank	Solidarity Group	Individual
Working Capital			
Capital Investment			
Housing			
Consumption			
Etc.			