BEST PRACTICES IN SAVINGS MOBILIZATION

NOVEMBER 5–6, 2002
WASHINGTON, DC

WOCCU extends appreciation & gratitude to

The US Agency for International Development (USAID),

The German Confederation of Cooperatives (DGRV),

The National Credit Union Foundation (NCUF),

The DC Government Employees Federal Credit Union &

The OAS Federal Credit Union

for their generous contributions to this event.

AGENDA

TUESDAY, NOVEMBER 5

8:30 am **REGISTRATION**

9:30 am **Welcome**

Adolfo Franco, Assistant Administrator for Latin America and the Caribbean, U.S. Agency for International Development (USAID)

H.E. Dr. Speciosa Wandera Kazibwe, Vice President of the Republic of Uganda

Paul Armbruster, Director of International Relations, German Confederation of Cooperatives (DGRV)

Arthur Arnold, President and CEO, World Council of Credit Unions, Inc. (WOCCU)

10:00 am **Introduction: Conceptual Framework**

Brian Branch, Vice President, WOCCU

10:30 am **Discussion**

10:45 am **COFFEE BREAK**

11:15 am **Savings Patterns of the Poor**

Moderator: ***Anna Cora Evans***, Development Finance Analyst, WOCCU

Mark Staehle, Interim Director, SafeSave

Graham Wright, Program Director, MicroSave-Africa

Lucy Ito, Vice President, WOCCU

12:45 pm **Discussion**

1:15 pm **LUNCH**

2:45 pm **Making the Transition to Savings-based Financial Intermediaries**

Moderator: ***Madeline Hirschland***, Independent Consultant

Marguerite S. Robinson, Institute Fellow Emeritus HIID, Harvard University

Mark Cifuentes, Regional Manager for Latin America, the Caribbean and Africa, WOCCU

Dale Adams, Professor Emeritus, The Ohio State University

4:15 pm **Discussion**

5:00 pm **RECEPTION**

WEDNESDAY, NOVEMBER 6

9:00 am **Assessing the Costs of Savings Mobilization**

Moderator: ***Liza Valenzuela***, Deputy Director, Office of Microenterprise Development, USAID

Brigit Helms, Senior Microfinance Specialist, Consultative Group to Assist the Poorest (CGAP)

David Richardson, Senior Manager of Technical Development, WOCCU

Commentators: ***Elisabeth Rhyne***, Senior VP, Research, Development and Policy, ACCION International

John Owens, Chemonics Chief of Party, Microenterprise Access to Banking Services (MABS), Philippines

10:30 am **Discussion**

11:00 am **COFFEE BREAK**

11:30 am **Designing, Managing and Marketing Innovative Savings Products**

Moderator: ***William Brands***, Acting Team Leader, Broad-based Economic Growth Group, LAC Bureau, USAID

Brian Branch, Vice President, WOCCU

José Linares, Independent Consultant

David Grace, Financial and Regulatory Affairs Manager, WOCCU

1:00 pm **Discussion**

1:30 pm **LUNCH**

3:00 pm **Effective Supervision of Savings**

Moderator: ***Robert Christen***, Senior Advisor, CGAP

Glenn Westley, Senior Advisor, Inter-American Development Bank

Matthias Arzbach, Director of Latin America and the Caribbean, DGRV

Carlos Cuevas, Principal Financial Economist, World Bank

4:30 pm **Discussion**

5:00 pm **Conclusion: Striking the Balance**

Paul Armbruster, Director of International Relations, DGRV

David Richardson, Senior Manager of Technical Development, WOCCU

INTRODUCTION: CONCEPTUAL FRAMEWORK

Brian Branch

SAVINGS MOBILIZATION: CONCEPTUAL FRAMEWORK

Brian Branch
World Council of Credit Unions
Washington, DC
November 2002

OBJECTIVE

- Review Lessons, Best Practices of Mobilizing Savings … Micro Savings
  - From Credit Union Experience
  - Share / Exchange / Debate with other Institutions

VOLUNTARY SAVINGS

- 1. Liquid, Withdrawable
- 2. Not Forced Savings
- 3. Not Required as Part of Loan Leverage

BEST PRACTICES IN SAVINGS MOBILIZATION

FRAMEWORK

1. Savings Patterns of the Poor
2. Making the Transition to Savings Based Financial Intermediaries
3. Assessing the Costs of Savings Mobilization
4. Designing, Managing and Marketing Innovative Savings Products
5. Effective Supervision of Savings

SAVINGS PATTERNS OF THE POOR

- Why the Poor Save
- How the Poor Save
  - Real Goods vs. Financial Savings
- Service Demands
  - Long term vs. Short term
  - Liquidity
  - Returns

MAKING THE TRANSITION

- What Institutions can make the Transition?
- What are the Requirements for making the Transition?
  - External
  - Institutional

MAKING THE TRANSITION

- Is there a "Business Culture" of Market Based Vision and Savings Protection Disciplines that is a Pre-Requisite?
- Must an Institution be Supervised first before it can Accept Savings?

COSTS OF SAVINGS MOBILIZATION

- Is Providing Savings Services to the Poor Feasible?
- Functional Costing Studies and Methodologies
- How does the Cost of Savings Mobilization Compare to the Cost of Borrowing?

COSTS OF SAVINGS MOBILIZATION

- Are there Economies of Scale?
- What does the Structure of Savings as a Source of Funds Look Like?
- What does this Tell us about Mixing Service to the Poor and non-Poor?

SAVINGS PRODUCTS

- Voluntary Savings Products
- Savings Behavior
- Variety of Products
  - Key Characteristics
  - Tradeoffs Liquidity and Return
  - Pricing

SAVINGS PRODUCTS

- Marketing / Product Development:
- What is the Target Market?
- Competition through Product Characteristics, Models, Branding
- Strategies for Promotion as Applied to Different Niches in our Savings Market
- Remittances: How linked to Savings

SUPERVISION OF SAVINGS

- What are Criteria for Deciding to Supervise?
- Who to Supervise Savings Takers?
- Direct Supervision or Delegated Supervision?
- When to Supervise Savings Takers?
- How to Supervise Savings Takers?
  - Costs of many Small Savings Takers

SAVINGS MOBILIZATION: SUCCESS FACTORS

- Management.
- Savings Protection.
- Public Image.
- Voluntary Savings.
- Range of Services and Products.
- Market Rates of Return.
- Diversity in Savings Capacity of Clientele.

SAVINGS MOBILIZATION: CONCEPTUAL FRAMEWORK

SAVINGS PATTERNS OF THE POOR

Moderator: Anna Cora Evans

Graham Wright
Mark Staehle
Lucy Ito

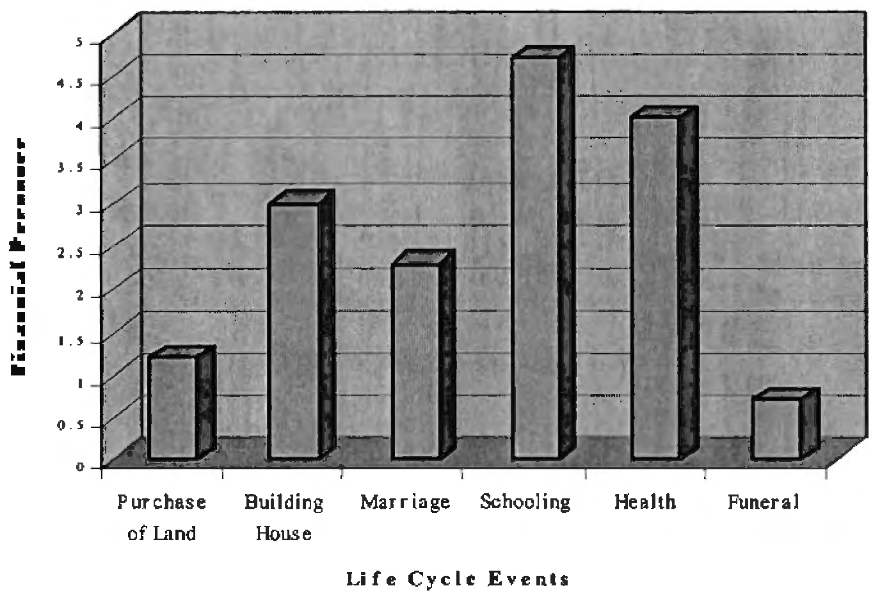
Between a Rock and a Hard Place
Savings Patterns of the Poor

WOCCU Conference on
"Best Practices in Savings Mobilization"
Graham A.N. Wright

The Risks Facing The Poor (1)
Rahman and Hossain (1995)

- ***Lifecycle Risks*** are related to such events as marriage and birth, education, healthcare, home-making, widowhood, old age, death and the need for an inheritance for one's heirs.
- They tend to have a certain degree of *predictability* that makes planning and managing them more feasible.

Life Cycle Risks

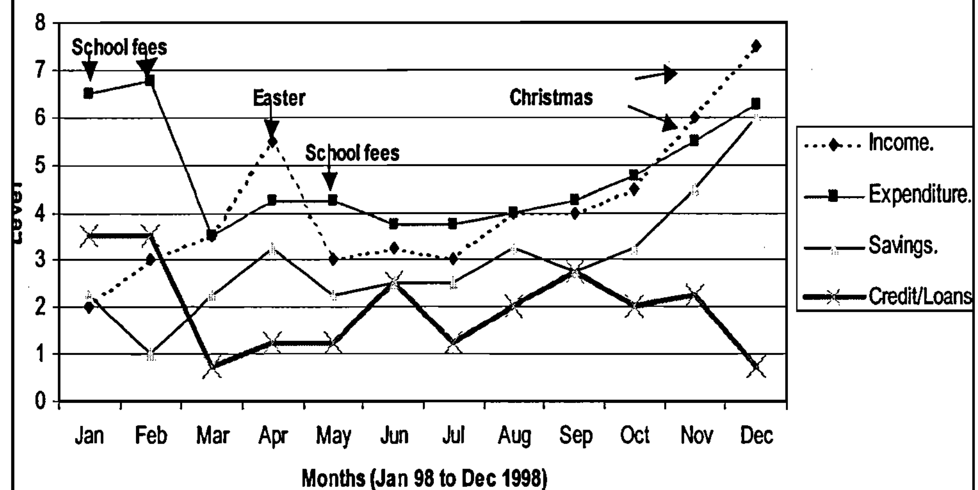


The Risks Facing The Poor (2)

Rahman and Hossain (1995)

- ***Structural Risks*** tend to be long-term or permanent changes in the national or international economy.
- In East Africa, as in many other developing countries, the most conspicuous structural factors are linked to the implementation of *structural adjustment programmes*, and *seasonal factors* that affect income and expenditure.

Structural Risk: Seasonality

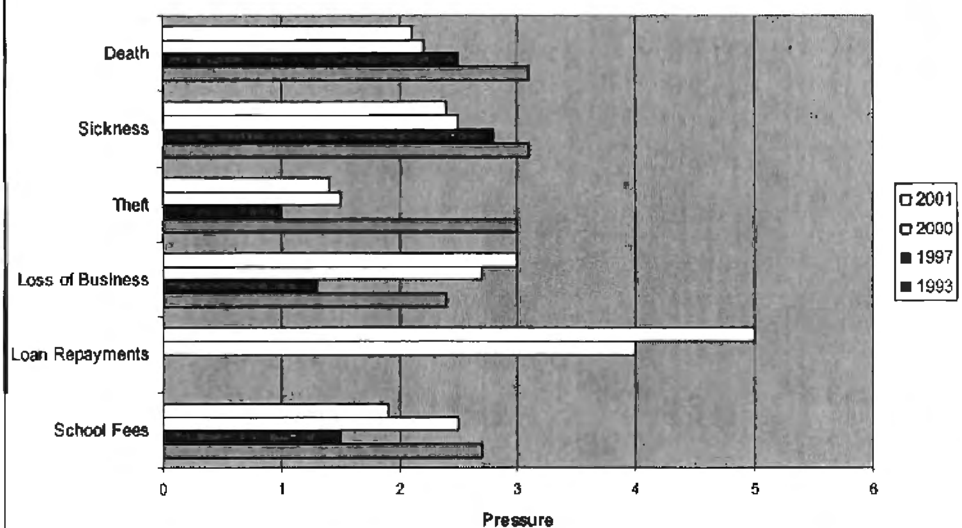


The Risks Facing The Poor (3)

Rahman and Hossain (1995)

- ***Crisis Risks*** are sudden, unexpected shocks to the household that disrupt its ability to generate income.
- Typically theft/cheating, fire, accident and illness/death of close relative (note overlap with lifecycle) … also school fees.
- Are particularly difficult to manage without access to insurance and/or savings.

Crisis Risks in Uganda



In Summary

- Poor people face a wide variety of risks/needs
- Some of these risks/needs are predictable, others less so
- These risks/needs dictate that poor must and do save
- The nature/predictability of these risks/needs have significant implications for the design of savings services/products

Balancing Convenience, Risk and Returns: Access

- Most poor people do not have *access* to formal sector banks :
  - physical proximity of the financial institution;
  - conditions governing the financial services;
  - the opening hours of the institution;
  - how long it takes to transact;
  - how the staff treat poor clients;
  - the appearance of the financial institution; and
  - the complexity of the paper work and the process necessary to make a transaction.

Balancing Convenience, Risk and Returns: Security and Discipline

- The poor look for some form of system or other to provide the *security* and accessibility necessary to save.
- This security is only relative, but the accessibility of a regular *opportunity* to save in a *disciplined* manner is what makes deposit collectors and RoSCAs so popular worldwide.

Balancing Convenience, Risk and Returns: Liquidity

- Access is markedly different from *liquidity*, and often considered more important by poor people who have little time to make their transactions.
- While many authors have stressed that "liquidity is the key to local savings mobilization", it is important to note that in many circumstances the poor have a strong "*illiquidity preference*".

Balancing Convenience, Risk and Returns: Returns

- With the exception of successful Accumulating Savings and Credit Associations (ASCAs) and auction RoSCAs, the *return* on savings in the informal sector is rarely above zero (real rate of return negative).
- Indeed often the poor pay to save through a conveniently accessible system such a deposit collector who visits daily to collect savings.

In Summary ...

- Poor people look for an appropriate mixture of:
  - Access
  - Security/discipline
  - Liquidity
  - Returns
- Typically in that order
- These too have significant implications for the design of savings services/products

No Where to Run to ...

- Given these risks/needs
- Given these requirements for savings services
- Given that they do not (typically) have access to the formal sector ...
- What are poor people actually doing?

Diversified and Informal Prudence

Prudence from Karatina saves using the following:

- 2 RoSCAs
- 1 ASCA
- Informal Insurance
- Cash at home
- In-kind

Diversified and Informal Prudence (1)

- RoSCA 1: 4 members daily contribution of $0.29. From this $26.57 is paid out each month to each member in turn
  - Use: School fees for grandchildren
- RoSCA 2: 4 members weekly contribution of $2.90. From this $11.57 is paid out each week to each member in turn
  - Use: Re-stocking business (small market stall selling basic commodities: salt, rice, biscuits, soap etc.)

Diversified and Informal Prudence (2)

- ASCA: 40 members save $1 a week, can borrow. The ASCA is liquidated annually in December
  - Use: Celebrating Christmas (savings) and emergencies (loan)
- Informal Funeral Insurance Fund: 100 members contribute $11.40 per month – covers immediate family
  - Use: Risk pooling for "repatriation" to village

Diversified and Informal Prudence (3)

- Emergency cash in the home: $3-$5
  - Use: Emergencies requiring immediate cash
- A cow back in the village: looked after by Prudence's brother
  - Use: Provision for old age/social capital maintenance

In Summary ...

- Poor people need a diversified range of savings products that meet a diversified set of needs:
  - Different terms
  - Different liquidity
  - Different schedules for saving
  - Options to save different amounts (small/regular and larger/irregular lump sums)
- Many poor people have diversified savings to meet these needs

It's A Wild World ...

- With all these diversified savings mechanisms, do the poor need access to formal/semi-formal sector savings services?

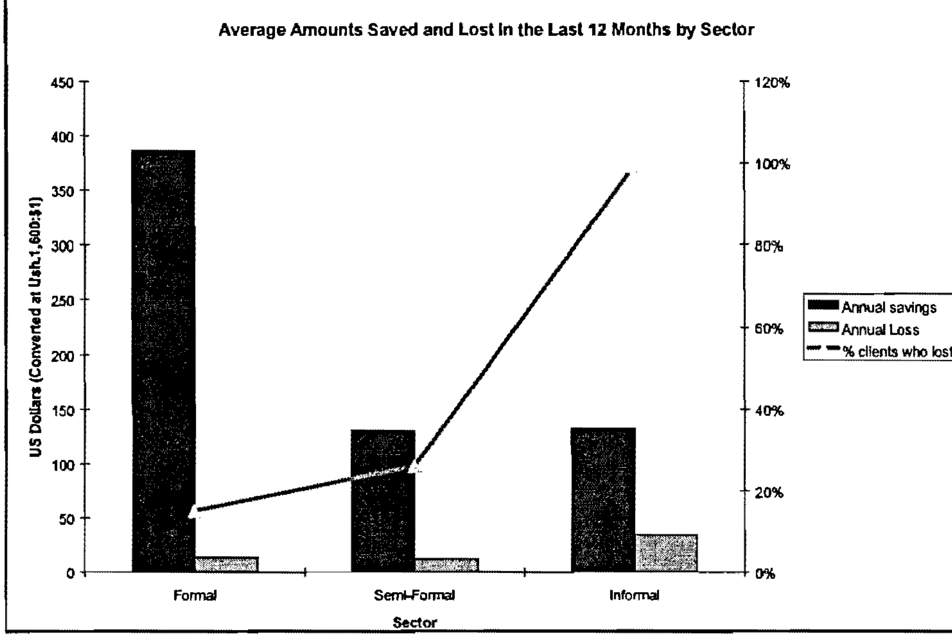
Savings and Losses Study: Methodology

- *Qualitative data set:*
  - Existing ***MicroSave-Africa*** data from over 500 group interviews [with groups averaging 6-8 people] and another 200 plus individual in-depth interviews)
  - an additional 19 focus group discussions and participatory rapid appraisal exercises explicitly designed for this study.
  - Research International hired to carry out the quantitative study of 1,500 face-to-face interviews among adults in Central, Eastern and Western Uganda.

Losses – the Big Picture

Sector	Average Amount Saved Last Year	Average Amount Lost Last Year	% who had Lost Some Savings	Av. Amount Lost/ Av. Amount Saved
Formal	$386	$13.50	15%	3.5%
Semi-Formal	$130	$11.82	26%	9.1%
Informal	$132	$34.38	99%	22%

The Relative Risk to Savings



Why?

- Poor people have limited access to formal or semi-formal financial services (indeed this is the basic rationale for the development of the microfinance industry).
- Poor people therefore lack formal financial service alternatives to the MFIs.
- If MFIs are prohibited from offering savings services to poor people, those poor people are forced to resort to the informal sector in order to save.
- The informal sector is an ***extremely*** risky environment.

Relative Risk

- It is clear that when discussing the risk to poor people's savings, this has to been evaluated on a relative basis.
- Very often all the alternative savings systems available to poor people are risky … thus poor people are left facing decisions on the ***relative risk*** (or relative security/safety) of the various semi- and informal savings systems open to them.
- And that's another reason they diversify …

Risks of Savings In Kind

- Examples of savings in kind: coffee, maize, livestock
- Risks:
  - fluctuation of commodity prices

    e.g. coffee 1997: Ush. 3,000/kilo

    1999: Ush. 1,000/kilo
  - destruction through insects/fire etc.
  - thieves (particularly livestock)
  - feeding/tending (specifically for livestock)

Risks of Savings At Home

- Risks/problems:
  - relatives with pressing "needs" and demands,
  - thieves breaking into the house in search of the money,
  - insects eating it,
  - fire,
  - trivial spending prompted by visitors or small-scale celebrations

Risks of Merry-Go-Rounds

- Risks/problems:
  - Uncompleted rounds
  - Limited level of trust within the community, so merry-go-rounds are usually small in scope: both in terms of the number of participants and the amounts of money rotated
  - They are poorly equipped to respond to:
    - unpredicted emergency needs, or
    - the need build-up larger lump sums over time, or
    - changes in the ability to the member save

So Establishing CBOs is Easy …

- The risk to poor people's savings under each of these traditional options is high.
- When the "Elgon Village Bank" was established, the people jumped at the opportunity.
- 18 months after it formally opened, EVB has 1,700 members who have:
  - bought $12,000 shares
  - deposited $321,875 and
  - withdrawn $313,750 savings

It's Not Good Enough …

- It is not good enough to say, "We cannot guarantee the security of your deposits at unsupervised institutions, so you cannot save with them"
- This simply drives people into (or strands them in) the highly risky informal sector.
- To depend on Central Banks to supervise every financial institution – they struggle with their main commercial banks
- Time to think outside the box!!

The Two Strategies (1)

- **Outside agencies**: strategy of "permanence and growth" and look to create sustainable institutions that deliver financial services to an ever-increasing number of clients
- **Poor people**: strategy of "replication and multiplication" and look to create many small self-contained, often self-liquidating, schemes - ROSCAs, Christmas clubs etc.

The Two Strategies (2)

- The permanence and growth institutions tend to encourage the long-term build-up of funds through relatively slow, but steady, saving (and are therefore extremely well suited for addressing longer-term savings needs).
- The replication and multiplication schemes tend to encourage the rapid accumulation and disbursement of funds (and are therefore better suited to meeting shorter-term savings needs).

A penny saved…

"If you would be wealthy, think of saving as well as getting."

Benjamin Franklin, 1706 to 1790

What will I talk about?

- *Saving:* the verb
- *Savings:* the noun
- Lessons for institution-building

Saving: the verb

The act of saving

Saving: the verb

- "Saving" is holding back from today's consumption.

*When we talk about designing institutions that facilitate savings, **facilitating the act of saving is what we should focus on***

Everyone saves

- To repay debt when yesterday's consumption was more than yesterday's income
- To save up for tomorrow, if today's consumption is less than today's income

Saving can be even more critical when you are poor

- The poor are less likely to have excess income each day for the non-essentials. So they are more likely to need to savings and credit
- Unfortunately for the poor, saving in cash – the most versatile asset – can be inconvenient and risky

Savings habits of the poor in Bangladesh

- Reciprocal lending, money guards, rotating savings and credit groups, consumer credit and NGO *micro-credit* obligations are all popular ways to put what is not consumed today into productive use.

Savings habits of the poor in Bangladesh

- NGO MFIs, despite their outreach, *don't attract much* *savings*.
  - Withdrawal rules can be inflexible
  - Savings can be looked upon as an expense of borrowing, since the aren't always accessible, and they can be absorbed by the group guarantee

Savings: the noun

(One) result of saving

Savings: the noun

- Cash savings is the most versatile asset, especially if it is accessible
- Cash savings is so important that poor people are often willing to pay for it:
  - Money guards
  - Risky informal savings groups

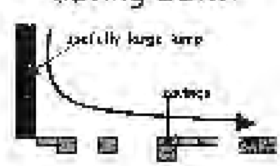
What if I don't have the option to build up savings (the noun)?

- I "save" in other ways:
  - I participate in a savings club with others
  - I take supplies or groceries on credit, then pay it back by saving out of tomorrow's income
  - I take a <u>loan from an MFI and pay it back</u>

But how can taking a loan and paying it back be "saving"?

"Saving Up"

"Saving Down"



Stuart Rutherford teaches us that accumulating savings and taking loans are similar, as they are both facilitated by the *act* of saving. The act of saving is what produces the strings of small sums that add up to a useful large sum - *the order in which the act of saving occurs is less important than the act of saving itself*

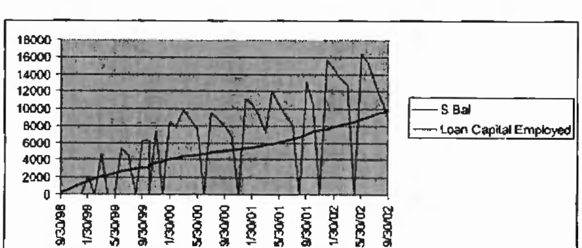
So what's the difference?

- Accessibility
- Versatility
- Cost

- Credit is a useful, widely available means to 'save.' Loan repayments are more readily respected by your family than cash in hand (discipline). But *credit is an expensive way to 'save,'* and it is not always accessible, nor particularly versatile.

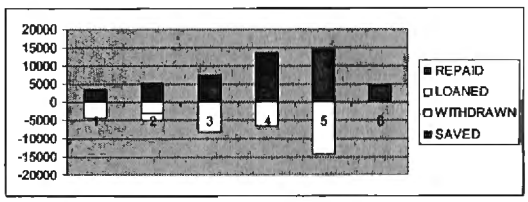
Md. Shahid: 2.5 years

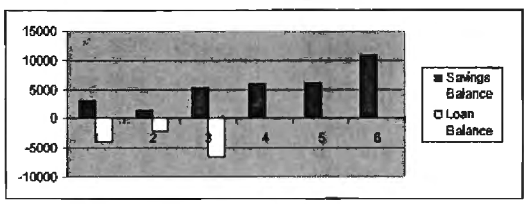
Shahid has taken 15 loans in 30 months, repaying them daily. His most recent loan is for 17,500 taka ($300), toward which he is repaying at 100 taka per day. He has used his loans to finance land and a house in the village. Shahid is "saving down."



Shahid has paid more than 13,000 taka in fees ($230) for this service.

Nasima Begum: Six years





Nasima was always a good saver, but she stopped borrowing in her fourth year with SafeSave. She says there are two simple reasons: If she saves up and withdraws, she doesn't lose money to interest. Further, withdrawals can be accessed at any time (as compared to loans taken one at a time)

Institution-building

How do I use this information?

Savings is created constantly

- Rutherford et. Al. found that a sum equivalent to 2/3 of all income within poor households was subjected to some form of money management – meaning that it was 'saved' rather then consumed that same day. This adds up to *$10 billion per year,* and is all the result of the act of "saving."

But relatively little gets stocked up as "savings" in the formal or semi-formal financial system.

How does that realization help?

- Savings institution designers need to concentrate on facilitating the <u>act</u> of saving, not on the savings itself – there is massive demand for the products that result
- This is best done by making pay-ins (both saving up and saving down) *flexible* and *frequent* - helping households to hold back from today's consumption in a convenient manner

Frequent opportunity

If *SafeSave* gives a rickshaw puller the chance to save 5 taka per month, he'll save 5 taka in a month.

If it gives him the chance to save 5 taka per week, he'll save 20 taka per month.

If it gives him the chance to save 5 taka per day, he may save 150 taka per month, and *he probably won't notice the difference.*

Facilitating flows vs. stock (the verb, not the noun)

- If we emphasize the stock of savings in the microfinance market, we'll miss the point: *poor people save every day.* They just don't have much opportunity to stock up their savings reliably and flexibly <u>in cash</u>.

SafeSave's formula:

A frequent and convenient opportunity to save (up or down)

Loans with flexible timing and repayment strategies

A reliable and accessible place to store savings

SafeSave in September

- 6,300 clients, 5 branches and 60 branch staff
- 51,595 transactions totaling $55,000
- 36,018 transactions (70%) were savings deposits averaging $0.30
- 14,175 transactions (27.5%) were loan repayments averaging $1.20
- 97.5% of all transactions in September were acts of 'saving,' whether to save-up or save-down

Frequency of transactions

SafeSave in September

		Per transaction
Pay-ins		
Deposits	6 per client	$ 0.30
Repayments	3.5 per loan client	$ 1.20
Pay-outs		
Withdrawals	1 per 6 clients	$ 8.00
Loans	1 per 20 clients	$ 61.00

Stocks and flows again

Saved per client	$	1.80
Withdrawn per client	$	1.33
Borrowed per client	$	3.05
Repaid per client	$	2.63
Change to assets per client	**$**	**0.78**
Total transaction flow per client	**$**	**8.81**

Transaction flow per client was 11 times the increase in average client assets during September

Review

- Poor people need banking services that allow them a frequent, convenient opportunity to save what they don't consume, as well as control over the amount
- They need a choice between saving up and saving down, and control over the timing of loans and withdrawals
- They need a reliable, accessible place to store their savings when they are able to accumulate them

SafeSave

www.safesave.org

MAKING THE TRANSITION TO SAVINGS-BASED FINANCIAL INTERMEDIARIES

Moderator: Madeline Hirschland

Marguerite S. Robinson
Mark Cifuentes
Dale Adams

Eight Principles of Savings Mobilization for Commercial Microfinance

Marguerite S. Robinson

World Council of Credit Unions
Washington, D.C.
5 November 2002

1. Poor People Save

- Poor people in developing countries save in a variety of forms.
- The job of the MFI is not to teach them to save.
- It is to develop products and services appropriate for savers' needs.

The Value of People's Savings

"The value of savings among the poor is, in fact, immense—forty times all the foreign aid received throughout the world since 1945. But they hold these resources in defective forms...Because the rights to these possessions are not adequately documented, these assets cannot be readily turned into capital."

-- Hernando de Soto

Capital – Dead and Alive

- De Soto calls the legally unrecognized assets of the poor "dead capital" – capital that cannot create capital.
- Savings accounts are often the first legally recognized assets that poor people can acquire. These are live capital – which can create capital.

2. *Preconditions for Mobilizing Savings from the Public -1*

Country Environment

- Reasonably enabling macroeconomy and some degree of political stability
- Adequate regulatory environment
- Capacity for public supervision of MFIs that take deposits from the public

Preconditions for Mobilizing Savings from the Public -2

Institutional Performance

- Accountable ownership
- Effective governance
- Strong, committed management
- Track record of financial self-sufficiency
- Transparency
- Well-trained and motivated staff

3.Change in Attitude Required

- For credit the MFI selects, and must trust, the client.
- But for savings it is the client who selects, and must trust, the MFI.
- Potential savers need to know about the institution and why they should trust it.
- No more yellow pajamas!

What Savers Want -1

- Security
- Convenient locations and opening hours
- Access to an appropriate product mix, including an account with unlimited transactions
- Confidentiality
- Helpful, friendly service

What Savers Want -2

- Returns
- Potential access to loans

- **These are components of a package needed for large-scale savings mobilization from the public.**
- **They are not a menu from which the MFI can choose!**

4. To Serve the Poor, Savings is Collected from the Public -1

- Can financial institutions mobilize large-scale voluntary savings from the poor profitably?
- Not if they confine their savings services to the poor. The transaction costs for large numbers of tiny accounts are too high for profitability.

4. To Serve the Poor, Savings is Collected from the Public -2

Public savings mobilization:

- Raises the average account size so MFIs can mobilize savings profitably
- Provides a diversified deposit base
- Staggers the timing of withdrawals
- Can finance an expanding microloan portfolio

5. Savers Cannot be Turned Away - 1

- More low-income people typically want to save at any one time than to borrow.
- Mature MFI intermediaries tend to have more savings accounts than loans.
- MFIs entering savings must prepare for a substantial, rapid – and largely uncontrollable -- increase in the number of their clients.

5. Savers Cannot be Turned Away - 2

Accommodating a large increase in clients usually requires significant improvements and additions in:

- Management – of a larger institution, now a financial intermediary
- Staff, space, training, transportation
- MIS, reporting, accounting, internal audit
- Computers, furniture, supplies

6. Savings is not only a source of funds – it is also a liability - 1

- MFIs need to pay careful attention to protecting savers' funds from:
- Poor management
- Internal corruption
- Loan defaults
- Theft

6. Savings is not only a source of funds; it is also a liability - 2

Accessing public savings requires:

- A corporate culture of accountability
- New security measures
- Constant attention to loan portfolio quality
- Effective and timely internal supervision

7. An Appropriate Product Mix

MFIs should offer *a few* well-designed products that savers can customize for their own use.

- A current account, a fixed deposit account, and 1-2 others to start.
- Too many products make branch management too complex and expensive.
- A few products designed for use in different combinations for different purposes are essential.

Products Tend to be Overemphasized

An unfortunate recent trend is a "Have products, will roll" approach to savings mobilization.

Appropriate products are crucial. But so is the ability to deliver them, which includes:

- High quality, well-trained, accountable personnel
- Appropriate, well administered MIS
- Effective asset-liability management, liquidity management, cash management, transfer pricing
- Helpful, friendly attitude toward clients
- Efficiency (no long lines)

8. Sequencing is Crucial - 1

MFIs beginning savings mobilization from the public must sequence their introduction appropriately

1. Learn international experiences
2. Appropriate macroeconomic conditions, regulatory environment and supervision capacity

8. Sequencing is Crucial - 2

3. Institutions must be financially sound
   - clear ownership
   - good governance
   - a record of high repayment
   - profitable
   - appropriate capital adequacy

Sequencing is Crucial - 3

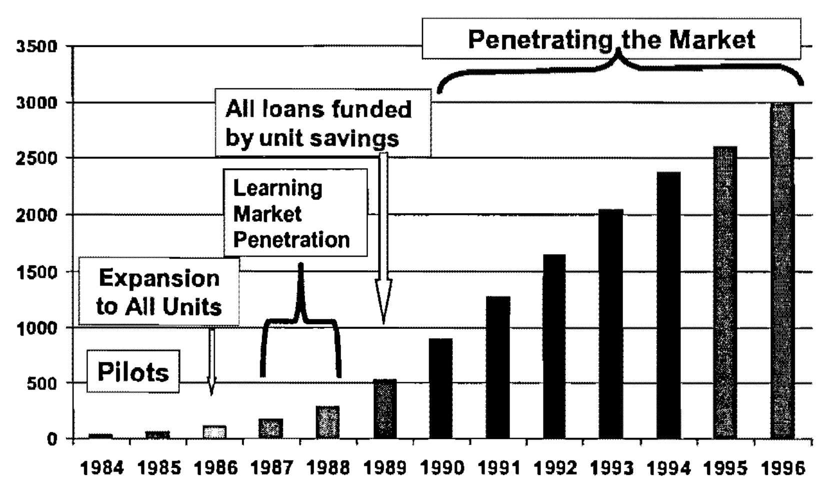
4. Full-time high-level management resources made available
5. Conduct demand research
6. First pilot project
7. Pilot project assessment and revisions
8. Second pilot project if necessary

Sequencing is Crucial - 4

9. Monitor pilots and train trainers for expansion
10. Expand gradually to all branches, training staff in each location
11. Systematic approach to savings mobilization and staff incentives for performance
12. Market penetration

Stages of Development and Performance in BRI's Unit Desa Savings Mobilization Program

1984 - 1996 (in millions of US Dollars)



BRI Unit Desa Savings and Deposits, 1996-2001

Indicator	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*
Value of savings and deposits (billions of rupiah)	**7,092**	**8,837**	**16,146**	**17,061**	**19,115**	**21,991**
Number of savings accounts (thousands)	***16,147***	***18,143***	***21,699***	***24,236***	***25,823***	***27,045***

2

Conclusions

- Savings mobilization from the public should be undertaken only by well governed and managed, financially self-sufficient institutions.
- Large-scale microfinance intermediaries are complex organizations, requiring high-level, financially experienced, dedicated managers.
- Successful savings mobilization from the public is not a matter of adding a few products.*It changes the institution fundamentally.*

INSTITUTIONAL PRECONDITIONS FOR SAVINGS MOBILIZATION

November 2002

Mark Cifuentes
Regional Director for Latin America, the Caribbean and Africa

What is our responsibility?

- What do savers need from our institutions?
  - Security
  - Transparency
  - Information
  - Flexibility of withdrawals and deposits
  - To generate earnings?

INSTITUTIONAL PRECONDITIONS FOR SAVINGS MOBILIZATION

- Legal Issues
- Financial Issues
- Market Viability
- External Influences
- Internal Influences
- Marketing

LEGAL ISSUES

- Legal Authority/Power to Mobilize Savings
- Legal capacity to set interest rates
- Legal Restrictions
  - The institution does not have the authority to mobilize savings
    - » What can we do?
      - Transform your institution, if you can
      - Become a branch of an institution that has authorization to mobilize savings
  - Laws are very restrictive
    - » I can mobilize savings, but I cannot set rates
    - » I can only mobilize savings from one segment of the market

LEGAL ISSUES

- Transparent accounting procedures that are precise and appropriate for the financial institution
- Updated accounting reports
- Financial information that is sufficiently flexible to allow for management of the match between assets and liabilities
- Low delinquency

FINANCIAL ISSUES

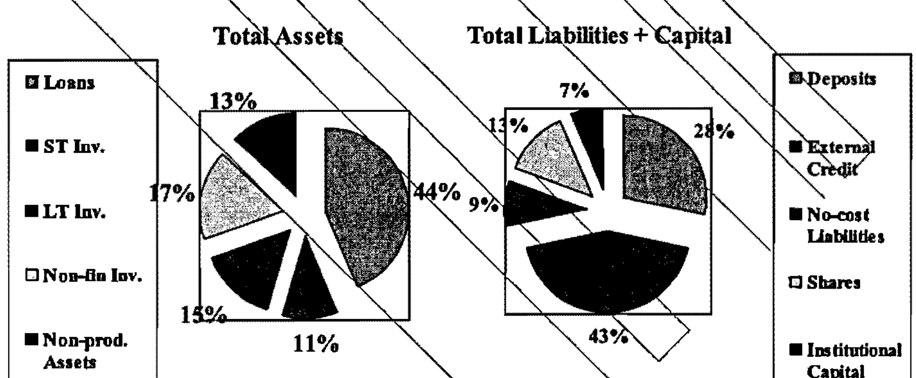
- Updated credit policies and procedures
- Based on the five "Cs" of credit:
  - » Conditions of the loan
  - » Capacity to pay
  - » Collateral that guarantees the loan
  - » Credit History (Payment History)
  - » Co-Signer (Guarantor)
  - – Do not use savings to determine credit
  - – Do not restrict savings withdrawals based on credit
  - – Protect the loan portfolio through provisions for loan losses and adequate institutional capital

FINANCIAL ISSUES

- Liquidity Management
  - Policies and procedures for managing liquidity
    - » Liquidity (minimum of 15% of total deposits)
    - » Liquidity Reserves (minimum of 10% of total deposits)
    - » Short-term Investment Liquidity (no more than 20% of assets)
    - » Long-term Investment Liquidity (no more than 10% of assets)
    - » Money Management
    - » Cash-flow Analysis
    - » Internal Control

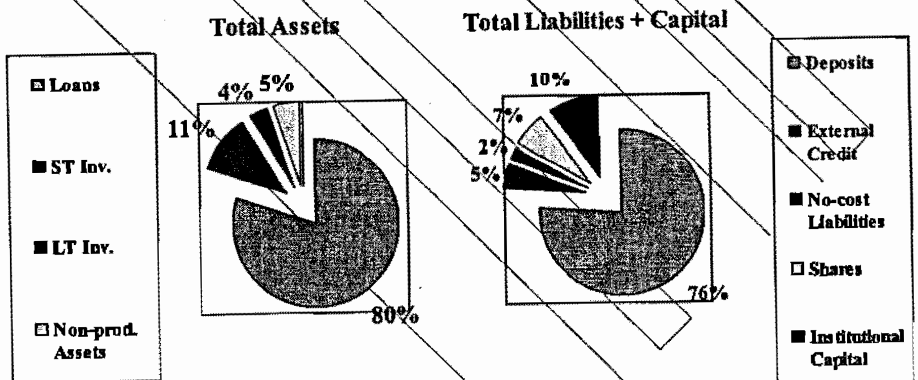
FINANCIAL ISSUES

- Unbalanced Financial Statement



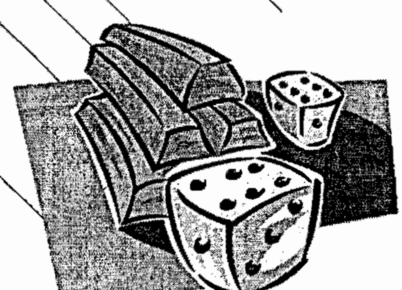
FINANCIAL ISSUES

- Balanced Financial Statement



FINANCIAL ISSUES

- Limit non-earning assets (no more than 5% of assets)
- Control operating costs (keep costs low – as low as possible without compromising service or security) (No more than 10% of average assets)



MARKET VIABILITY

- Need to perform market studies:
  - Surveys
    - » Understand what the community thinks about our institutions
    - » Understand the needs of the market
    - » Understand what the community thinks about savings
    - » Understand the patterns of financial behavior of the market
    - » Know where and how the community saves and why they do so with that institution

MARKET VIABILITY

- Market Studies
  - Need to know where professionals, laborers, clerical workers, doctors, pharmacists and small business owners live and work
  - Need to know about the competition: Banks, NGOs, Mutuals, Savings and Credit Cooperatives, etc.
  - Develop instruments to measure market penetration (distinguishing by gender, age, profession, education and health)

EXTERNAL INFLUENCES

- Market Competition
  - Security
  - Image
  - Market Penetration
  - Perception of the organization in the market
  - Employee turnover rate
  - Flexibility of products and services
  - Flexibility and ease of savings deposits and withdrawals

EXTERNAL INFLUENCES

Would you save here?

Or would you save here?

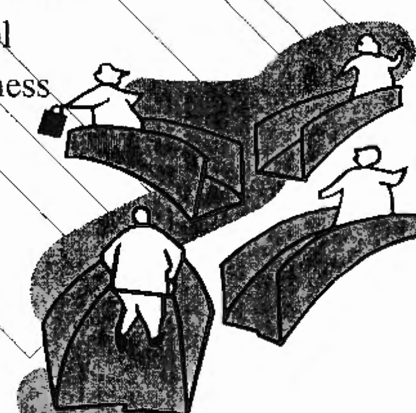
INTERNAL INFLUENCES

Would you save here?

Or would you save here?

INTERNAL INFLUENCES

- Inadequate laws, rules and regulations
- Inadequate policies and procedures
- Inadequate accounting procedures
- Lack of management control
- Lack of security and soundness
- Lack of an effective business philosophy
- Inadequate marketing
- Lack of competitive spirit
- Lack of leadership



MARKETING

- Adequate marketing plan
- Understanding marketing vs. simply distributing brochures or pamphlets
- Understanding that mobilizing savings is expensive and requires work and effort
  - The cost of mobilizing savings decreases as the volume and amounts of savings increases
  - Savings products are valuable for the institution inasmuch as they are used by clients, balancing the needs of the institution (cost of money, liquidity, etc.) and the needs of clients (security, soundness, profitability, convenience, etc.)

MARKETING

- Understanding how to set rates
  - By product
  - By term
  - By degree of liquidity
  - According to volume of accounts (through business and marketing plans)
- Promotions
- The use of various means of communication
- Branding (distinguishing oneself from the competition)

CONCLUSION

- Legal Issues
- Financial Issues
- Market Viability
- External Influences
- Internal Influences
- Marketing

Filling the Deposit Gap in Microfinance

Dale W Adams
Park City, Utah
October 12, 2002

The core of the microfinance industry is comprised of thousands of organizations that provide loans to people of modest means. These organizations typically rely on subsidies and on outside sources for funds. Some former core organizations, especially in Latin America, have matured to the point where they obtained bank charters, or bank-like supervision, that includes permission to accept deposits. On the fringe of this core, additional institutions such as financial cooperatives, postal savings systems, and some traditional banks do microfinance.[1] Most of the remaining core organizations do not mobilize voluntary deposits, although they might collect forced savings. This results in a large deposit gap in microfinance that is only partially filled by organizations that have matured out of the core, organization on the fringe, and by informal finance. As a whole, the microfinance industry has been highly successful in providing loans to millions of new borrowers, but it has been far less successful in expanding deposit services for poor people, particularly in rural areas.

I'm pleased to see that an increasing number of policy makers recognize the need to fill the deposit gap.[2] If I'm not mistaken, a major supposition behind this conference is that this gap should be filled primarily by organization in the core of the industry. For reasons I'll describe more fully later, I'm uncomfortable with this approach. I'll also argue that before trying to fill the gap we must understand why it occurred. I'll then go on to argue that most of the deposit mobilization ought to be done by organizations on the fringe of the industry: officially recognized banks, financial cooperatives (a.k.a. credit unions), and postal savings systems. Before exploring these topics I share several of my assumptions.

- First, I believe that more poor people could benefit from access to quality deposit services than can benefit from subsidized lending programs.
- Second, I also believe that large amounts of deposits can be mobilized from poor people, more than enough in most cases to cover prudent lending opportunities.
- Third, I further believe there is a conflict between deposit mobilization and altruistic lending. Both are useful activities, but they must be separated.
-

Explaining the Deposit-Gap

Clarifying the reasons for the deposit gap might assist in designing methods to fill it. Over the years I've heard at least six overlapping explanations for the paucity of deposit mobilization. The traditional excuse has been that most people lack the capacity to save because of their poverty. More recently a few observers have argued that many poor people do not save in financial form because they lack opportunities to do so. Some of these same observers also argue that poor people make few deposits because the interest paid is too low or the quality of services too unsatisfactory to provide positive incentives. I've heard a few key people further argue that small deposits are just too expensive to mobilize and manage. I've also heard some government and donor employees murmur -- under their breath -- that deposit mobilization projects are not a way to further their career. Finally, many people in the industry say the gap is due to lack of government permission to accept deposits.

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[1] In addition, an even larger number of poor people regularly use informal finance, both to obtain loans and to manage their deposits. This includes many individuals who borrow from semi-formal or formal lenders and, at the same time, participate in informal finance.
[2] Recent efforts by CGAP, Microsave, and WOOCU have stimulated this awareness.

Capacity to save

Compared to a decade ago, fewer policy makers now argue that poor people lack the capacity to save. Those who continue to make this argument ignore a good deal of history. A large number of studies and experiences over the past 150 years, especially in Asia, strongly suggest that most poor people will save a surprising amount if they have opportunities and incentives to do so. For example, the financial cooperatives that were spawned in Germany in the mid-1800s, and later grafted into the farmers associations in Korea, Japan, and Taiwan, were built on voluntary deposits (Hyun; Kato; Lee and others; Ong and others). A few major banks such as the Bank of America, the French Caisse Nationale de Credit Agricole, and the Japanese Norinchukin Bank were initially erected on small deposits. More recently, postal savings systems in Japan, Taiwan, and China have mobilized huge amounts of deposits from people of modest means (Leong, Scher, The Taiwan Economic News). The experience of the Units Division of the Bank Rakyat Indonesia (BRI) the past twenty years is also a well-known example of a successful deposit mobilization effort (Robinson).

Additional insights on savings capacities in other regions have been provided by research on informal finance. Numerous studies, for example, have shown that people of modest means often deposit substantial amounts of money in self-help financial groups (Bouman). Researchers estimated that the float in these informal groups in Cameroon exceeds the volume of formal deposits in the country (Schrieder and Cuevas). Other research showed that most employees of a large agricultural bank in Egypt maintained a substantial part of their financial savings in these informal groups (Baydas and others). Additional investigation in Bolivia and the Philippines showed similar savings patterns among poor households (Adams and Canavesi; Adams and Nazarea-Sandoval).

In some countries such as Bangladesh, Egypt, El Salvador, Mexico, Pakistan, and the Philippines large amounts of remittances are sent to households of modest means. Remittances from the United States to Mexico amount to about $10 billion per year, an amount many multiples the volume of lending done by the microfinance industry in the country. These funds have undoubtedly augmented the savings capacity of receiving households and thereby expanded the potential for deposit mobilization in areas that receive these remittances.

Compared to several decades ago, fewer policy makers now maintain that poor people lack the capacity to save. As a result, limited savings capacity is likely not a primary explanation for the current deposit gap in the microfinance industry.

Opportunities to deposit

Deposit mobilization is affected by self-fulfilling prophecies. If policy makers assume certain people are too poor to save, and then implements policies that severely limit their access to deposit facilities, one should not be surprised when few deposit are mobilized. It goes without saying that individuals must have easy access to deposit services to facilitate deposit mobilization. Potential depositors are highly sensitive to the transaction costs that are imposed on them by deposit takers, especially the time and distance involved in making small deposits. Despite the rapid multiplication of organization doing microlending, many of these lenders lack permission to accept deposits and have, therefore, provided few additional voluntary savings opportunities for poor people. The decay of some postal savings systems, the contraction of some financial cooperatives, and the collapse of numerous government owned banks have reduced the opportunities for poor people in may countries to access deposit facilities, especially in rural areas.

In some cases, the rapid expansion of subsidized microfinance lending has crowded out banks that might, otherwise, have provided more deposit services to poverty-niches in financial markets.[3] Also, in some cases, various banking regulations limit the ability of banks to open branches that might fill the deposit gap. Hefty legal reserve requirements in a few countries similarly discourage banks from vigorously capturing deposits. Furthermore, in some countries bouts of inflation and economic uncertainty or wars continue to restrict deposit mobilization.[4]

The results of a handful of pilot projects in Latin America funded by the Agency for International Development (AID) that substantially expanded deposit services show that access is highly important in influencing deposit mobilization (Arbuckle and Adams; Gonzalez-Vega; Richardson; Vogel). Although other factors are likely also involved, the lack of convenient financial institutions that accept financial deposits explains part of the deposit-gap. A fundamental question is why have various organizations moved so slowly in filling this gap?

Incentives to save

Compared to a decade or so ago, there are far fewer restrictions in most countries on what deposit takers can pay on deposits. For many years in most low-income countries interest rate restrictions, hefty amounts of subsidized lending, and inflation resulted in most depositors receiving negative real returns on their financial deposits. While depositors will maintain part of their savings in deposit even when they receive negative real rates of interest – because of liquidity requirements – they do so with little enthusiasm and are unwilling to add substantially to their deposits.

Fortunately, most institutions that are authorized to accept deposits now have wide latitude in the incentives they can offer to depositors. As a result, the incentives issue is likely less of an explanation for the deposit gap than was true several decades ago.

Deposits are too costly

As the late Frits Bouman often pointed out, poor people deal in transactions that are measured in cents not dollars. This is especially true regarding their deposits. They typically have only small amounts to deposit, they often make a number of deposits and withdrawals, and the total amount in their accounts may be small. If the institution accepting deposits does not have an efficient information management system the costs of handling these transactions and accounts can discourage them from seeking this business.

Adding deposit taking to lending activities allows economies of scope, but it also augments management problems and increases workloads for employees. It likewise involves keeping more cash on hand, thus increasing security costs. Managers are also forced to make more liquidity management decisions. Clearly, adding deposit services can substantially increase costs and make financial intermediaries less sustainable unless cost reducing technologies are adopted. A hallmark of the microfinance industry has been cost reducing innovations in lending, but not in deposit taking. Why?

To adequately understand the costs-are-too-great argument, one must ask the comparative question. Deposit taking is too costly, but compared to what? If an organization can obtain concessionary funds from government or donors it is logical for lenders to look at deposits

[3] I vividly remember talking to commercial bankers in Bangladesh who said they avoided doing business in rural areas because of the many subsidized elements of the microfinance industry that had colonized the countryside.

[4] Nonetheless, in the early 1970s I was surprised by the amount of deposits an agricultural development bank in Vietnam mobilized in the midst of a war. In some cases, uncertainty prompts saving.

as a more costly source of funding. Even when so-called market rates of interest are charged on loans provided by donors or governments, these sources of funds may be less expensive than paying similar rates of interest on deposits plus incurring the transaction costs of mobilizing and managing small accounts.

I remember several conversations with a manager of a German consulting firm who was involved in the development of the Cajas Municipales in Peru during the 1980s. He came away from that experience convinced deposits were too expensive to mobilize. His opinion later strongly influenced the design of microfinance projects in other countries. I question, however, the appropriateness of generalizing from the Peru experience in the 1980s. This was a period in Peru of hyperinflation, extreme depression, and availability of funds from donors for microlending on highly concessionary terms. These conditions certainly limited the capacity of people to save and severely crimped the incentives that could be offered. Despite this harsh economic environment, nonetheless, an AID-sponsored pilot project was highly successful in mobilizing deposits at about the same time in Peru (Vogel). It is especially noteworthy that AID did not provide concessionary funds for lending in this project. As a result, the managers of the bank and financial cooperatives involved in the project did not view deposits as a more costly source of funds than other sources, because they had no other source, unlike the managers of the Cajas Municipales.

Clearly, perceptions about costs have contributed to the deposit gap. This same cost problem, however, faced those who earlier wished to make small loans, but techniques were then designed to lower costs. Do managers of the microfinance industry have incentives to discover and implement similar cost-reducing techniques in deposit mobilization?

Furthering careers

Like depositors, government and donor employees respond to incentives. The paucity of deposit promoting projects suggests that few of these employees see deposits as a fast track for career advancement. In the 1960s and 1970s I saw a number of AID employees who fomented subsidized lending projects in Latin America and later rise to positions of leadership in the Agency, even though most of their credit projects eventually imploded. In the late 1970s and early 1980s, I saw a handful of innovative Agency employees develop small deposit mobilization projects that, in my opinion, were highly successful.[5] As far as I know, however, these risk-taking employees were never rewarded for their innovations and the Agency quickly lost interest in deposits in the stampede to fund microlending programs.

I don't wish to criticize AID. It at least experimented with deposit mobilization. I've looked in vain for similar efforts within the project portfolios of the World Bank, the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, the Food and Agricultural Organization, the International Fund for Agricultural Development, European donors, the Japanese development agency, and foundations that support development. The lack of interest in deposit mobilization among donors is reflected in their employees' expertise. There are hundreds of these employees who are comfortable designing credit projects. Specialists in deposit mobilization, however, are as scarce as hens' teeth.[6] The paucity of this expertise among employees of agencies in the core of the microfinance industry and among the consulting firms that feed off the industry suggests it will be difficult to mount a substantial deposit mobilization effort in the near future. This staffing problem is unlikely to change until deposit mobilization has a much higher priority in development strategies.

[5] Barry Lennon, Doug Tinsler, Roberto Casto, Clliff Barton, and Charles Blankstein were among those innovators.
[6] By specialists, I mean people who have had hands-on experience in fostering successful deposit mobilization projects such as Richard Patten, Robert Vogel, David Richardson, Lee Arbuckle, John Gadway, and Jeffrey Poyo.

In retrospect, deposit mobilization does not fit with donor priorities: moving relatively large amounts of money quickly into countries through development projects. In most respects, deposit mobilization is the antithesis of this. From my point of view, this systemic problem explains most of the deposit gap.

Institutions lack authorization

Most countries prohibit organizations from mobilizing voluntary deposits unless they have official permission from banking authorities to do so. Still, one has to wonder why more organizations in the core of the microfinance industry didn't start much early to push for permission to accept deposits. Was it because participants were too pessimistic about capacities to save, could provide too few incentives, or thought it was too costly? Overtime, I suspect that all of these factors help explain some of the slow movement toward seeking permission to accept deposits. Still, I believe that something more fundamental is involved. Perhaps that something could be called Shaw's Law.[7]

Shaw's Law

Shaw's Law states that the availability of inexpensive outside funding discourages deposit mobilization. Its corollary is that deposits will only be mobilized when there is little or no outside funding available to potential deposit takers. Verifications for this law can be gleaned from a review of successful deposit mobilization efforts as well as from the experience with subsidized and targeted lending efforts. Could anyone imagine, for example, that the farmers associations in Korea, Japan, and Taiwan would have had much interest in mobilizing voluntary deposits if the Japanese government had offered these associations access to subsidized funds? Similarly, would the BRI have encouraged their units division to mobilize deposits if the Central Bank of Indonesia had continued to allow BRI ample access to concessionary discount lines? In the same vain, would the financial cooperatives in the Dominican Republic, Guatemala, Honduras, and Peru that were prompted to mobilize more deposits by AID-funded technical assistance projects have turned their backs on deposits if AID or other donors had offered them subsidized funds?[8]

Recommendations for Donors

AID's experience with small farmer credit programs, the World Bank's funding of development banks, and the Inter-American Bank's efforts to channel funds into financial cooperatives through a regional organization all discouraged deposit mobilization efforts. I wonder if all of the donor and government money given to the microlending industry hasn't had the same result?

What can donors and governments do to avoid Shaw's Law? My suggestions follow:

1. Donors should avoid providing funds for lending to organizations that might promote deposit mobilization.
2. They should confine their subsidized lending to altruistic lenders.

[7] Named after Edward Shaw whose 1973 book first drew attention to the importance of deposit mobilization in national development.

[8] In the early 1990s I saw a dramatic example of this in Egypt where AID spent a good deal of money trying to reform a traditional agricultural bank, including stimulating more deposit mobilization. These efforts were later undercut by a large World Bank loan that provided funds to the bank more cheaply than the bank could obtain them from depositors. The agricultural bank quickly lost interest in the difficult task of mobilizing voluntary deposits.

3. They should strengthen prudential regulation and supervision.
4. More donors ought to provide small technical assistance grants to reform and strengthen financial cooperatives and postal savings systems.
5. The larger donors should promote changes in bank branching restrictions, encourage lower legal reserve requirements, and eliminate other regulations that discourage banks from seeking more deposits, especially in rural areas.
6. All donors should discourage access to second tier banks by microlenders who have deposit-taking authority.
7. All donors should stimulate cost-reducing innovations in deposit taking.
8. Donors should also reward employees for designing creative and effective deposit mobilization projects.
9.

Conclusions

Substantially reducing the flow of funds into the microfinance industry is likely politically impossible. Advocates for the industry have sold too many politicians on the merits of debt in resolving poverty. Furthermore, there are too many organizations, employees, and consultants who benefit from this system to expect it to shrink or disappear. In fairness, one might argue there is a role for specialized lenders who receive outside funds and subsidies, what I call altruistic lending. The question is how to quarantine these funds and build firewalls between altruistic lending and deposit taking. In my value system, it is appropriate to assist poor people with lending that is subsidized and often managed by those with social objectives. I'm quite uneasy, however, in entrusting poor peoples' deposits to these types of systems. I'd feel more comfortable if these two important activities were segregated. If this were done, I suspect there would be far more innovation and outreach in deposit taking.

None of this, however, resolves the incentive problem within donor and government agencies. Unless much higher priority is assigned to deposit mobilization in poverty alleviation programs this incentive problem will throttle efforts to move to deposit-based financial intermediation in the microfinance industry.[9]

[9] Where microfinance conferences are held is a metaphor for the priority given to deposits. Most of these conferences, including this one, are located in the centers of governments or near donors, instead of being located in the hinterland near depositors.

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ASSESSING THE COSTS OF SAVINGS MOBILIZATION

Moderator: Liza Valenzuela

David Richardson
Brigit Helms

Commentators: Elisabeth Rhyne
John Owens

Counting the Costs of Savings Mobilization

David C. Richardson
Washington, D.C.
November 6, 2002

The Purpose of the Costing Study

Provide Answers to the following:

- Is Savings Mobilization a Viable Alternative to Borrowing from External Credit sources?
- Is Microsavings Mobilization feasible?

WOCCU

Cost Study Definitions

<u>Size</u>

- Large: >$5 million Assets
- Medium: $1-$5 million Assets
- Small <$1 million Assets

<u>Experience</u>

- Advanced >10 years
- Intermediate 3-10 years
- Beginner <3 years

WOCCU

Credit Union Costing Study

	Guatemala	Nicaragua	Ecuador	Bolivia	Total
Number	5	4	3	3	15
Size					
Large	4		1	1	6
Medium			2	2	4
Small	1	4			5
Experience					
Beginning		4			4
Intermediate			2	2	4
Advanced	5		1	1	7
Location					
Urban	1		1	2	4
Rural	4	4	2	1	11

Credit Union Costing Study

- 3 Groups of Costs
  - Financial Costs
  - Direct Administrative Costs
  - Indirect Administrative Costs

Financial Costs

- Financial Costs are Variable Costs that are directly related to the price that is paid to the depositors in order to entice them to deposit their savings with the financial institution. The financial costs increase in proportion to the volume of savings mobilized. They include three key components:
  - Interest
  - Life Insurance
  - Taxes

Direct Administrative Costs

- Direct Administrative Costs are directly related to the administration and management of the savings deposit program. These costs would tend to disappear without savings. There are three main areas:
  - Human Resources (Marketing Staff, Tellers, & Security Guards)
  - Marketing (Publicity, & Promotional Activities, and Feasibility Studies)
  - Commissions

Indirect Administrative Costs

- Indirect Administrative Costs are those costs that must allocated across all departments because they cannot be directly related to any one activity. They would exist with or without savings. There are four main areas:
  - Human Resources (Management, Back Office, Support Services)
  - Adminstrative Services (Utilities, Telecommunications, Vehicles, Supplies etc.)
  - Depreciation (Buildings, Vehicles, Equipment, Furniture)
  - Protection (Insurance, Auditing, Supervision)

Allocation Criteria for Indirect Costs

- Time-Based
  - % of time spent on Savings Activities
- Physical Space-Based
  - % of square footage used for savings services
- Transaction-Based
  - % of transactions linked to savings products or services

Direct Administrative Costs

Area	Sample	Large CU's	Medium CU's	Small CU's
Human Resources	**1.27%**	**1.33%**	**0.77%**	**2.93%**
Marketing	0.34%	0.36%	0.21%	0.64%
Tellers	0.50%	0.53%	0.29%	1.23%
Security Guards	0.43%	0.44%	0.27%	1.06%
Marketing	**0.55%**	**0.55%**	**0.44%**	**1.28%**
Publicity	0.22%	0.17%	0.42%	0.50%
Promotional Activities	0.29%	0.39%	0.02%	0.71%
Feasibility Studies	0.04%	0.05%	0.00%	0.07%
Savings Commissions	**0.12%**	**0.15%**	**0.00%**	**0.02%**
Total Direct Costs	**1.94%**	**2.03%**	**1.21%**	**4.23%**

Indirect Administrative Costs

Area	Sample	Large CU's	Medium CU's	Small CU's
Human Resources	**0.52%**	**0.45%**	**0.63%**	**2.43%**
Management	0.24%	0.22%	0.22%	1.32%
Back Office	0.26%	0.21%	0.41%	1.03%
Support Services	0.02%	0.02%	0.00%	0.08%
Administrative Services	**0.47%**	**0.47%**	**0.41%**	**1.14%**
Utilities	0.05%	0.05%	0.05%	0.24%
Telecommunications	0.09%	0.09%	0.07%	0.05%
Maintenance	0.13%	0.13%	0.12%	0.15%
Materials & Supplies	0.13%	0.12%	0.16%	0.07%
Vehicles	0.07%	0.08%	0.00%	0.63%
Taxes	0.00%	0.00%	0.01%	0.00%
Depreciation	**0.61%**	**0.57%**	**0.85%**	**0.53%**
Buildings	0.07%	0.05%	0.09%	0.11%
Vehicles	0.01%	0.02%	0.00%	0.02%
Furniture	0.08%	0.08%	0.12%	0.09%
Computers	0.41%	0.37%	0.63%	0.19%
Leasehold Improvements	0.04%	0.05%	0.01%	0.12%
Protection	**0.11%**	**0.10%**	**0.15%**	**0.11%**
Insurance Premiums	0.03%	0.02%	0.04%	0.06%
Audits & Supervision	0.08%	0.08%	0.11%	0.05%
Total Indirect Costs	**1.71%**	**1.59%**	**2.04%**	**4.21%**

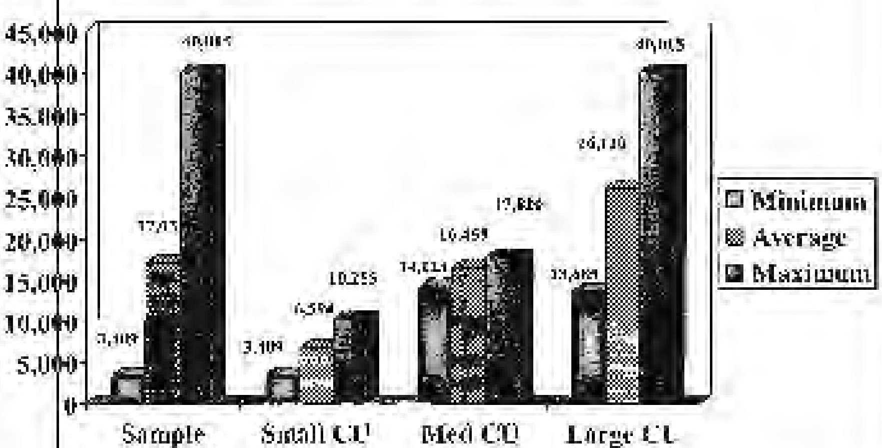
Total Administrative Costs

Line Items	Large CU's		Medium CU's		Small CU's		Consolidated	
	Cost	%	Cost	%	Cost	%	Cost	%
Number of Credit Unions	6		4		5		15	
Total Savings Deposit Volume	55,255,795		11,373,026		1,346,156		67,974,977	
Average Savings Volume per CU	9,209,299		2,843,257		269,231		4,531,665	
Direct Administrative Costs	1,120,665	2.03%	138,063	1.21%	56,923	4.23%	1,315,651	1.94%
Human Resources	734,969	1.33%	87,922	0.77%	39,463	2.93%	862,355	1.27%
Marketing	305,646	0.55%	50,141	0.44%	17,215	1.28%	373,002	0.55%
Commissions	80,049	0.14%	0	0.00%	245	0.02%	80,294	0.12%
Indirect Administrative Costs	875,844	1.59%	232,531	2.04%	56,614	4.21%	1,164,989	1.71%
Human Resources	246,268	0.45%	71,800	0.63%	32,714	2.43%	350,782	0.52%
Administrative Services	259,520	0.47%	46,977	0.41%	15,304	1.14%	321,801	0.47%
Depreciation	312,263	0.57%	96,591	0.85%	7,126	0.53%	415,980	0.61%
Protection	57,793	0.10%	17,163	0.15%	1,470	0.11%	76,426	0.11%
Total Administrative Costs Related to Savings Mobilization	1,996,509	3.61%	370,594	3.26%	113,537	8.43%	2,480,640	3.65%
Total Administrative Costs	5,150,344		1,249,146		249,985		6,649,475	
% of Total Administrative Cost	38.76%		29.67%		45.42%		37.31%	

The Key to Managing Costs?

Salary Expenses equate to 49% of all administrative costs

CU Manager's Annual Salary US$



WOCCU

The Key to Managing Volume?

Diversify Clientele and Attract Net Savers

WOCCU

Savings & Share Mobilization

December 31, 2000

85 Credit Unions

Range	# Accts.	%	Volume ($US)	%	Avg.
$0-$300	2,300,414	94.2%	75,006,221	26.0%	33
$301-$1000	98,473	4.0%	53,613,432	18.6%	544
>$1000	44,365	1.8%	160,325,772	55.5%	3,614
Totals	2,443,252	100.0%	$288,945,425	100.0%	118

5 Countries: Guatemala, Ecuador, Bolivia, Romania, Philippines

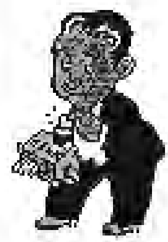
Is Savings Mobilization a Viable Alternative to Borrowing External Credit?

Economic Advantages of Savings Mobilization

December 31, 2001

Country	Weighted Average in Sample Financial Costs	Administrative Direct Costs	Administrative Indirect Costs	Total	Borrowing Costs from Commercial Banks	Difference
Bolivia	15.54%	0.79%	1.31%	17.64%	19.50%	1.86%
Ecuador	4.54%	1.62%	2.16%	8.32%	17.71%	9.39%
Guatemala	9.12%	2.33%	1.64%	13.09%	18.80%	5.71%
Nicaragua	17.02%	5.12%	6.29%	28.43%	29.65%	1.22%

Is Micro Savings Mobilization Feasible?



Total Administrative Costs 4 Guatemalan Credit Unions

Credit Union	Administrative Expense Ratio
1	10.01%
2	8.12%
3	7.79%
4	6.98%
Consolidated	7.96%

Structure of Savings Deposits

Four Guatemalan Credit Unions

December 31, 2001

Range	# Accounts	%	Volume	%	Avg.
<$300	103,112	89.0%	$2,966,672	8.0%	$29
$301 - $,1000	6,285	5.4%	$3,567,178	10.0%	$568
$1,000 - $6,250	5,430	4.7%	$13,601,235	38.0%	$2,505
$6,251 - $12,500	750	0.6%	$6,766,009	19.0%	$9,021
$12,501 - $37,500	296	0.3%	$5,790,712	16.0%	$19,563
>$37,500	45	0.0%	$2,927,819	8.0%	$65,063
Grand Total	115,919	100%	$35,619,675	100%	$307

Summary of Deposit-Oriented Transactions

Four Guatemalan Credit Unions

December 31, 2001

Transaction Amount	%	%	Volume	%	Average
< $100	334,369	70.1%	$9,414,641	6.3%	$28
Between $100 - $400	95,253	20.0%	$22,298,740	14.8%	$234
Between $400 - $800	20,547	4.3%	$13,817,770	9.2%	$672
>$800	26,764	5.6%	$104,856,222	69.7%	$3,918
Total	476,933	100%	$150,387,373	100%	$315

Conclusions of the Study

- Savings Deposit Mobilization is a viable alternative to borrowing external credit, IF properly designed and managed.
- MicroSavings is feasible, IF balanced with larger savings accounts.
- Savings Products are highly demanded by poor and low-income people, and are equally as important as credit products. They are the missing link of MICROFINANCE!

Thank-you

Quality Credit Unions for Everyone

CGAP

MICROFINANCE PRODUCT COSTING

Why Product Costing?

Early discussions of sustainability and profitability of microfinance focused mainly on the revenue side: how to set interest rates on microloans that cover all costs and allow for growth. Everyone seemed to accept that microfinance costs would always be higher than commercial bank costs, but many practitioners and experts have begun to wonder whether microfinance costs remain too high. Is it ethical, or does it make good business sense, to pass along the high costs of operational inefficiencies to microfinance clients?

Microfinance managers, especially those working in more competitive markets, increasingly recognize the importance of streamlining operations and cost management for long-term viability. Product costing offers a key tool to better understand their operations and cost structure as a first step toward increasing efficiencies, lowering costs, and ultimately providing better services to their clients.

What is ABC?

Activity-based costing (ABC) traces costs to specific activities undertaken by the MFI, like processing a loan application or opening a savings account. The costs of these activities are then "driven" to products or other cost objects, such as branches, using estimates of usage of these activities by the cost objects.

Inserting activities into the costing process distinguishes ABC from other costing methods, and provides much richer information because it answers the questions: HOW and WHY are costs incurred? This information leads directly to specific adjustments or modifications in an MFI's activities to streamline costs.

How can ABC help me?

The ability to quantify the costs of an MFI's activities provides a powerful tool for understanding and managing costs. For instance, an MFI manager may find that loan processing for housing loans takes much longer and consumes a lot of the institution's resources because of onerous inspection and verification procedures that might or might not be necessary. Unit costs of each activity (i.e. loan processing per application, opening a savings account per client account) can be traced over time to monitor the effectiveness of streamlining measures.

ABC also allows MFIs to cost their individual products to determine whether they are viable. Better management information on products helps managers make key decisions about product design, delivery mechanisms, and pricing. The costing exercise can also raise awareness of the cost components of different products, reveal hidden costs, instill cost-consciousness in staff, and can uncover excess capacity and other operational problems.

What does an ABC report look like?

The simplified ABC report below shows some of an MFI's administrative costs broken down into several (but not all) activities, by product type.

Quarter 1, 2000		Microloan		Housing	
Processes/Activities	Unit Cost	Total Cost	Cost/ Avg. Balance	Total Cost	Cost/ Avg. Balance
Making Loans		**1,656**	**9.4%**	**192**	**3.3%**
Answer client questions/advise	0.82	333	1.9%	42	0.7%
Accept loan application	0.33	133	0.8%	17	0.3%
Review and approve loan application	1.46	596	3.4%	76	1.3%
Perform general loan disbursement administration	1.63	595	3.4%	57	1.0%
Servicing Existing Loans		**748**	**4.2%**	**533**	**9.1%**
Follow up with delinquent clients	1.88	94	0.5%	281	4.8%
Track repayments	1.24	62	0.4%	186	3.2%
Perform portfolio analysis	0.19	342	1.9%	38	0.6%
Perform general loan administration	0.14	251	1.4%	28	0.5%

After a year of quarterly costing exercises, a unit cost trend analysis might look something like this:

Loan products --- Unit Costs	Q1/00	Q2/00	Q3/00	Q4/00	Q1/01	Q1/Q1(%)
Making Loans						
Answer client questions/advise	0.82	0.84	0.83	0.73	0.77	-6.5
Accept loan application	0.33	0.32	0.33	0.28	0.32	-3.1
Review and approve loan application	1.46	1.45	1.41	1.28	1.40	-4.3
Perform general loan disbursement administration	1.63	1.66	1.60	1.55	1.65	+1.1
Servicing Existing Loans						
Follow up with delinquent clients	1.88	1.84	1.77	1.45	1.50	-25.3
Track repayments	1.24	1.24	1.22	1.20	1.22	-1.6
Perform portfolio analysis	0.19	0.18	0.18	0.17	0.18	-5.5
Perform general loan administration	0.14	0.14	0.14	0.13	0.14	0.0

The sample reports show that in the first quarter of 2000 the cost of making microloans (as a percentage of the average microloan portfolio) is very high – 9.4%, especially when compared to the same process for housing loans. The loan application review and approval process seems to be relatively expensive for microloans, indicating the possibility of inefficiency in that activity.

On the other hand, the housing loan product is very expensive to service, apparently reflecting the high cost of delinquency, given the costs of the activities "follow up with delinquent clients" and "track repayments".

Over time, however, it looks like the MFI's efforts to reduce unit costs has worked, especially for reducing costs of the "follow up with delinquent clients" activity. This means that it costs 25% less on average for following up with each delinquent client.

What is entailed in completing an ABC exercise?

MFI managers should know that embarking on a product costing exercise is a very involved and complex project that delves into nearly every aspect of an MFI's operations.

However, the level of effort required depends on many MFI-specific factors, like: the size and complexity of the organization, including the quality of the information system, the number of distinct activities and processes, uniformity of operations within the organization, and the number of staff levels.

Most of all, the dedication and commitment of management and staff is essential to the completion of an ABC exercise and its ongoing usefulness to the organization.

Experience to date has shown that an MFI's first costing exercise entails the following steps:

Stage 1	
1.	Plan the costing exercise
2.	Select a costing team
3.	Develop an activities dictionary
4.	Select the period for data and representative test sites/sample
5.	Select drivers
6.	Develop questionnaire/timesheet for staff interviews or survey
Stage 2	
7.	Gather and organize costing data from the MIS into the preferred format
8.	Test and validate the questionnaire/timesheet
9.	Gather staff time data – interviews, timesheet, observation, etc.
10.	Develop/modify spreadsheet for analysis
11.	Enter data
12.	Analysis and reporting

Stage 1 can take up to two days for everyone on the costing team (usually composed of 4-6 members of middle management, including operational staff). Stage 2 will take a few weeks, but is highly dependent on the quality of the MIS and size of the MFI. Step 7 and Steps 8/9 can be done in a parallel manner by members of the team. Step 7 can take one to two days depending on whether the information system contains cost "drivers" (like the number of transactions) separated out by product. Step 9 can take several days depending on the resources allocated to collecting the data. Steps 10 through 12 can be completed in 2-3 days. Subsequent costing exercises would demand less of a time commitment, as much of the work will have already been completed during the initial exercise.

What assistance is available to help me implement an ABC exercise?

CGAP has limited funding of up to $5,000 per MFI to promote further testing of the ABC costing tool. The funding is meant to partially defray the costs of the exercise, with the MFI contributing its own resources as well. In return for the funding, the MFI is expected to provide feedback on the usefulness of the tool, the process of conducting the ABC exercise, including problems encountered, and (within reasonable confidentiality constraints) the costing results. For more information on this opportunity, please contact Brigit Helms: Bhelms@Worldbank.org.

CGAP

Activity Based Costing

Streamlining and Sustainability

WOCCU Saving Conference
November 6, 2002

CGAP

Why Product Costing?

- Costs = the forgotten half of sustainability
- Costs can be cut: look at competitive markets
- Strategic planning relies on detailed understanding of costs
- Savings: are they really low cost?

2

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The Benefits of Activity-based Costing (ABC)

- Determines the full costs of delivering products
- Improves delivery mechanisms and customer service
- Assists in decisions regarding selection of products
- Improves delivery mechanisms and customer service
- Reveals hidden costs and excess capacity
- Contributes to better product design
- Provides a basis for business planning and investment decisions

3

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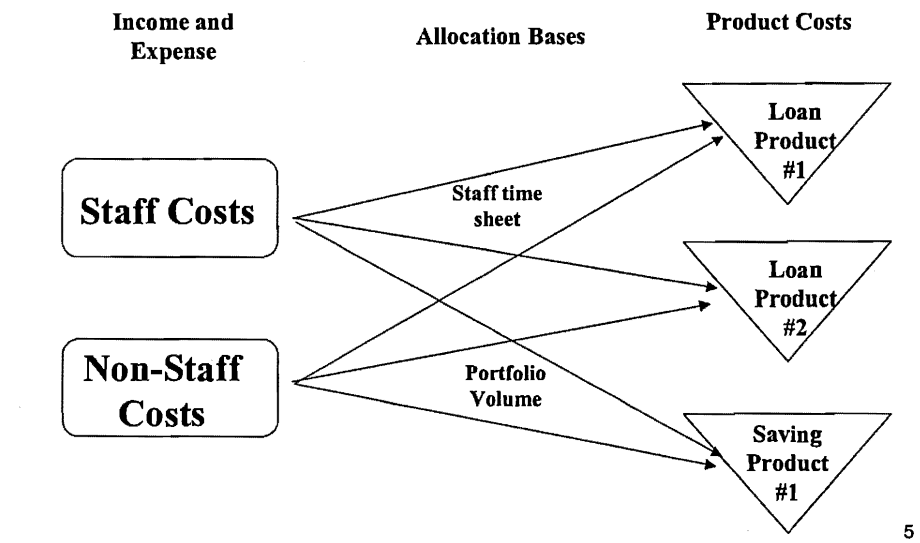
Characteristics of Costs in Financial Services

- Most costs are fixed
- Many if not all costs are indirect: few staff members specialize in just one product
- Don't take indirect, overhead, or fixed costs for granted

4

Traditional Cost Allocation



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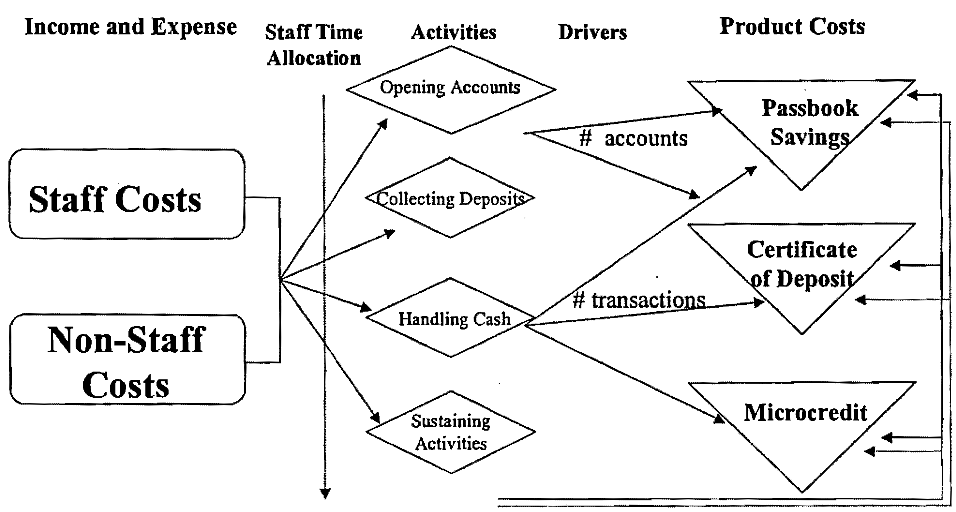
Activity Based Costing (ABC)



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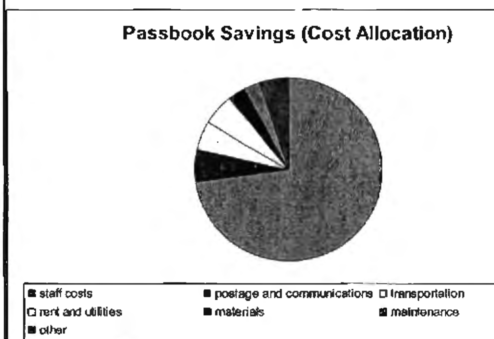
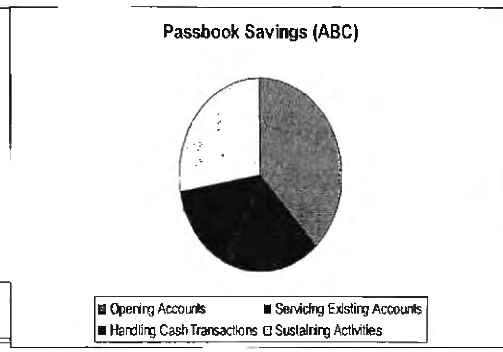
Traditional Costing vs. ABC





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What Is Involved in Activity Based Costing?

1. Plan for the costing exercise
2. Identify products for costing
3. Ascertain core processes and activities
4. Conduct staff time estimates for each activity
5. Calculate costs per activity
6. Assign cost drivers and determine unit activity costs
7. Drive activity costs to products

8

Planning!

- Steps:
  - ✓Communicate the purpose
  - ✓Choose a team leader
  - ✓Assemble the costing team
  - ✓Choose the period
  - ✓Choose representative branches
  - ✓Assemble information (incl. timesheets)
  - ✓Identify products for costing
  - ✓Prepare the workplan

9

SKS Activity Dictionary

1. Group Formation
Village Survey
Projection Meetings
Motivation of members
CGT (Continuous Group Training)
GRT (Group Recognition Test)
Housing Survey
Traveling

2. Centre Meetings
Preparation for centre meetings
Traveling
Late start of meetings
Admin tasks (Padam, Attendance etc)
Writing loan and savings cards

3. Servicing Savings Products
Closure of accounts / Dropouts
Opening voluntary account passbook

4. Handling Cash Transactions
Cash collections (loans and savings)
Cash disbursements (loans and savings)
Handing over cash to second signatory

5. Sustaining Activities
Monitoring and Supervision
Staff meetings
Fund raising efforts / relations / queries
Perform accounting and internal reporting
Recruitment and Training of staff
Maintenance of MIS/ Computer work
MIS software development
Visitors
Banking
General Administration

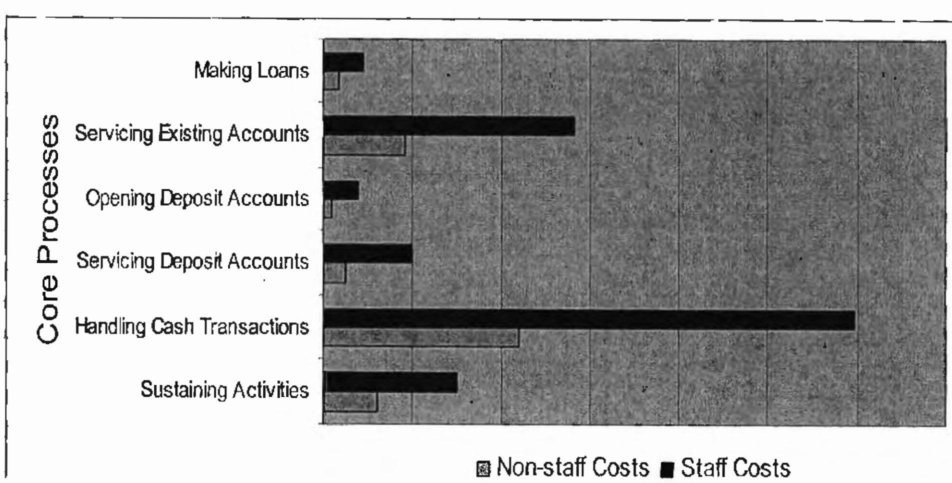
10

Staff Time Estimates

- Options: Timesheets/Interviews/Observation/Technology
- Questions: timesheets (real-time or backward looking) vs. interviews
- Test the timesheets and incorporate feedback (from a different branch) before beginning
- A longer period of observation will incorporate more tasks that are important, but occasional

11

Costs per Activity: SafeSave



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Drivers and Unit Costs: CBB examples

Activity	Cost Driver	Unit Cost
Issue Passbook	Number of new accounts	3.03
Compute interests	Number of closed accounts	62.73
Disburse cash	Number of closed accounts	13.96
Prepare bookkeeper's entries and type/sign tickets	Number of accounts- All Products	0.22
Do fund transfer to/from branch or head office	Number of accounts- All Products	0.21

- **Cost Drivers: Trigger activities, make expenses happen**
- **Unit Costs: Critical management tool to track over time**

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Drive Costs to Products: CBB

Activity: Do fund transfer to/from branch or head office			
Driver: Number of accounts, all products			
	Driver		Activity Cost
Total	**11,662**		**2,507**
Agriculture Loans	536		115
Small Commercial Loans	74	**Unit Cost =**	16
Microfinance Loans	1,583	0.21	340
Other Loans	557		120
Passbook Savings	8,604		1,849
Term Deposits	309		66

- **Products "consume" activities according to their share of the driver multiplied by the unit cost**

14

Analysis: Savings Cost by Account Size

Account range	Cost	Cost/bal
0 – 10	817	164.80%
11 – 50	509	34.20%
51 - 100	622	14.10%
100 - 200	669	6.30%
200 +	410	2.80%
Total	3,026	9.50%

- **ABC allows detailed analysis, including by customer type**

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Viability Analysis: SafeSave

		P2	P3-L	P3-C	P4
Transfer rate (funding alternative)		8.0%	8.0%	8.0%	8.0%
	minus interest cost	11.0%	0.0%	8.0%	3.0%
	minus reserve cost	2.8%	0.0%	2.0%	0.8%
interest contribution		-5.8%	8.0%	-2.0%	4.3%
Opening Deposit Accounts		0.1%	0.2%	0.4%	1.0%
Servicing Deposit Accounts		0.2%	0.4%	1.2%	1.0%
Handling Cash Transations		0.8%	2.0%	4.7%	4.6%
	plus fees	0.0%	0.0%	0.0%	0.0%
contribution before sustaining		-6.9%	5.4%	-8.3%	-2.5%
	minus sustaining costs	0.2%	3.2%	7.6%	8.4%
= Bottom line		-7.0%	2.2%	-15.9%	-10.8%

Note: preliminary figures subject to revision

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Action Plans

ABC Discoveries	Action Plan
CBB: Savings products are borderline viable	Lower interest rates
CBB: Manual processes have very high costs (eg. Computing interest on term deposit withdrawals)	Increase automation and improve MIS systems
SKS: Savings are not contributing financially	Redesign the product to make it more popular, market it more aggressively, and incorporate cost recovery measures
SKS: Too much field staff time and money is spent on traveling	Investigate ways to change methodology (extension offices, etc.)
SafeSave: Routine data error correction is very expensive	More care must be taken by staff Introduction of Palm Pilots may help
SafeSave: Non-staff admin expenses are 35% of total- far too high	Set budgets that provide incentives to staff to eliminate/absorb excessive costs

17

DESIGNING, MANAGING AND MARKETING INNOVATIVE SAVINGS PRODUCTS

Moderator: William Brands

Brian Branch
José Linares
David Grace

SAVINGS MOBILIZATION

Brian Branch
Savings Best Practices Conference
World Council of Credit Unions
Washington DC
November 5-6, 2002

Credit Union / Micro- Savings Savings Mobilization:

- **Savings Life Cycle**
- Savings Protection
- Savings Services
- Interest Rates
- Savings Management

SAVINGS LIFE CYCLE

THE SAVINGS LIFE CYCLE

- New members access credit in small amounts.
- Increasing with successful repayment.
- Expand their loan activity e.g. to establish and expand enterprises.
- Take out larger loans for housing and production needs.
- These same members initially put very little into deposit savings.
- As their assets and income increase, they save more and borrow less.
- Members become net savers, investing their savings in deposit services which are with-drawable and offer market rates of return.

SAVINGS PROTECTION

SAVINGS BEHAVIOR

- 1. SAFETY
- 2. CONVENIENCE
- 3. RETURN

Savings Protection Through:

- Lines of Defense
  - Provisions for loan losses
  - Reserves (Institutional Capital)
  - Paid-in Shares
- Financial Management Disciplines
  - Standards for Asset Quality & Earnings on Assets

SAVINGS SERVICES

Savings Behavior

- 1. SAFETY
- 2. CONVENIENCE
- 3. RETURN

SAVINGS SERVICES

- RANGE:
  - Trade-offs between Convenience (Liquidity) and Return
    - Small Savers seek Access
    - Larger Savers seek Return
  - Niche Products
  - Program (Purpose Driven) Products

Range of Products

Fully Liquid	Semi-Liquid	Predictable Flows	Short Term Frozen Deposits	Long Term Accumulating Accounts
Passbook Account	Limited With-Drawals	Program Savings	Certificate of Deposit	Retirement Accounts

Defining Characteristics

- LIQUIDITY, ACCESS TO SAVINGS
- REAL RATE OF RETURN
- MINIMUM BALANCE
- TRANSACTION COSTS

Savings Services: Passbook or Regular Savings

- Advantages (Member):
  - Easy access
  - Voluntary
  - Minimal opening amount required
- Advantages & Disadvantages (CU):
  - Attractive service mobilizes large volume
  - High transaction costs for marginal accounts
  - High volatility

22 Ecuador Credit Unions (March 2001)

Account Size (US $)	Volume Savings		Number Accounts	
0 – 100	11,387,591	19%	634,817	81%
101 – 300	12,899,450	22%	101,027	13%
301 – 500	7,995,400	13%	20,810	3%
501 – 1,000	9,542,151	16%	15,244	2%
1,001 +	18,025960	30%	9,734	1%
Total	59,850,552	100	781,632	100

Savings Services: Fixed Term Savings

- Features:
  - Is a contract
  - Fixed interest rate
  - Withdrawal or renewal upon maturity
  - If withdrawn before maturity, with interest rate penalties

Savings Services: Fixed Term Savings

- Advantages (Member):
  - Better interest rate than other savings services
  - Can serve as loan guarantee
- Advantages & Disadvantages (CU):
  - Targeted at a market niche with savings capacity.
  - Higher financial cost.
  - New pricing must be very susceptible to interest rates.

Savings Services: Programmed Savings Account

- Advantages (Member):
  - Better earnings than on regular savings
- Advantages & Disadvantages (CU):
  - Stable flow of monthly installments
  - Solution to market need cycles
  - Only one withdrawal at maturity

  - Service specific market niches

Savings Services: Programmed Savings Account

- Examples:
  - School Fee Savings
  - Christmas Club
  - Vacation Savings
  - Housing Savings Plan

Savings Services: Child Youth Savings

- Advantages & Disadvantages (CU):
  - Financial education for future market
  - Access point to market to parents
  - Stable savings
  - High cost of transaction for small accounts
  - Low volume
  - Requires much direct marketing

INTEREST RATES

SAVINGS BEHAVIOR

- 1. SAFETY
- 2. CONVENIENCE
- 3. RETURN

Interest Rates on Deposits

- General Principles:
  - Competitive in the Market.
  - Higher than the Inflation Rate to Yield Positive Real Rate of Return.
  - Reviewed Periodically.
  - Vary per Product.
  - Structured in Scales by Amounts, Terms.

Interest Rates on Deposits

- Scales:
  - Differentiated According to Service, Product
  - Differentiated According to Transaction Costs
    - Lower Rates on High Relative Transactions
  - Differentiated According to Amount
    - No Return on Accounts below Bare Minimum
    - Higher Rates on Larger Amounts
  - Differentiated According to Period / Term

Guatemala Credit Union

Account Size (US $)	Regular / Passbook	3 Month Fixed Term
0 – 5	0 %	-
6 – 17	4%	-
18 – 84	8%	9%
85 – 175	8.5%	9.5%
176 – 877	9%	10%
878 – 1,754	10%	12%

Term Deposits: Nicaragua (11 CUs) (2/02)

$ US	1 – 3 Mos	4 – 6 Mos	6 – 9 Mos	9 – 12 Mos	12 + Mos
200	7.25%	8.75%	10.0%	12.0%	13.0%
500	7.25%	8.75%	10.0%	12.0%	13.0%
1,000	7.50%	9.0%	10.50%	12.25%	13.0%
2,000	7.75%	9.25%	10.75%	12.50%	13.0%
5,000	8.0%	9.75%	11.0%	12.75%	13.0%

Term Deposits United States CU (2/02)

6 Mos	9 Mos	12 Mos	15 Mos	18 Mos	24 Mos	30 Mos	36 Mos
2.50 %	2.50 %	2.87 %	3.21 %	2.92 %	3.26 %	3.31 %	4.04 %

Interest Rates on Deposits

- Illustrative Operational Points:
  - Interest capitalization periods: daily, monthly, or quarterly.
  - Interest calculation based on a daily balance or on a monthly average balance.
  - Rates on fixed term savings are fixed while rates paid on regular savings are variable.

Interest Rates on Deposits

- Differentiate rates by Product:
  - Passbook accounts base rate interest rate is set at x
  - Programmed accounts rates are $x+1$ (higher) than regular savings.
  - Term Deposit rates are $x+2$ (higher) than passbook savings.
  - Youth account rates are x-1 (lower) than regular savings.
  - Dividends on shares are higher than rates on passbook savings accounts and more than inflation.

SUMMARY

Credit Union / Micro- Savings Savings Mobilization:

- Savings Life Cycle
- Savings Protection
- Savings Services
- Interest Rates

SAVINGS BEHAVIOR

- 1. SAFETY
- 2. CONVENIENCE
- 3. RETURN

Savings Services

- RANGE:
  - Trade-offs between Convenience (Liquidity) and Return
    - Small Savers seek Access
    - Larger Savers seek Return
  - Niche Products
  - Program (Purpose Driven) Products

Interest Rates on Deposits

- General Principles:
  - Competitive in the Market.
  - Higher than the Inflation Rate to Yield Positive Real Rate of Return.
  - Reviewed Periodically.
  - Vary per Product.
  - Structured in Scales by Amounts, Terms.

Savings Product Development

Jose Linares Fontela
Independent Consultant
November 5, 2002

1

Savings Market Behavior

- The account balances of three savers are needed to finance a micro loan.
- Savings mobilization must therefore be open to and targeted at all social classes, even if an MFI exists to serve the low-income sector or the poor.
- The medium and high-income sectors usually will be *net savers* in MFIs, because they are not micro loan seekers.

2

WOCCU

Savings Market Behavior

- As net savers from all income levels are attracted to the MFIs, savings still play a social role as they begin to finance the micro loans for low-income level clients.
- One global market for savings does not exist, there are many market niches: savings products must be developed to satisfy the differing demands of these market niches.
- Passbook accounts tend to be less sensitive to rate offerings.
- Fixe[illegible] are very sensitive to rates and term conditions.

3

WOCCU

Savings Products Design

- People will only bring their money to MFIs if they are confident that they will get the full value of their money back without delays, objections or excuses; that the funds will be available according to the terms of the agreement under which they were deposited.
- Savings products must satisfy the potential savers demands in terms of:
  - Strong institutional image
  - Liquidity
  - Rate
  - Services

4

WOCCU

Savings Products Design

- Savings products must achieve a balance between rate (return) and liquidity (access).
- Savings products must have attractive packaging which includes:
  - Attractive logos
  - Recognizable brands
- Savings deposits must be accessible through branching and distance banking, depending on client demand.

5

WOCCU

Savings Products Design

- Savers demand that their relationships with their savings institutions be based on a high-quality customer service.
- The institution must strive for excellence in service: savers are more critical and sensitive than borrowers. Savings mobilization requires a totally different corporate culture than lending.
- The return on savings (rate paid) must be competitive in the local market, otherwise (1) the savings will not be attracted or (2) the MFI will be pay too much for the funds.
- Designing successful savings products is a complex and costly effort.

6

Savings Products Development

WOCCU

- A failed savings product is a significant financial loss to the MFI, because of the high investments required to produce and launch a final product.
- Product development is a marketing tool based on scientifically-designed research and facts. Savings products must be precisely designed and tailored to the local market demands.
- From the colors used in the packaging, the name used in the brand and the product concept, everything affects the final result of the savings product.

7

Savings Products Development

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- The process of development:
  - The needs of the market niche must be clearly stated and tested (through market research).
  - A prototype of the savings product should be designed and assembled.
  - A logo and a brand name must be defined.
  - A profit and loss model must be designed for the product to identify the conditions under which it will be profitable.
  - All the elements must be tested in the market niche with real clients of the MFI to validate the degree of acceptance. At this stage, a decision must be made to continue or abandon the product.

8

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Savings Products Development

- Once the final packaging is designed, product conditions are defined and the IT issues are solved, the finished prototype should be pilot tested.This pilot test should be monitored closely to find problems or opportunities and make the appropriate adjustments.
- Once the savings product has proven to be stable and accepted by the market, it is passed to production and offered across the institution.

9

WOCCU

Savings Products Marketing

- New savings products will need to be launched and offered in the market, this implies the design of a marketing strategy.
- The new savings product must be included in the institution's *Marketing Plan.*
- Expected goals for the new savings products must be defined. To ensure that they are attainable, the goals must balance:
  - The savings product financial results in the profit and loss model, and
  - The savings product competitive characteristics in the market, as compared to those of the competitors.

10

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Savings Products Marketing

- Externally, savings products can be marketed through:
  - Institutional image [illegible] up
  - Advertising
  - Promotions
  - Direct marketing
  - *e* Business and information technology
  - Branching
  - Sales
  - Community relationships

11

WOCCU

Savings Products Marketing

- Internally, savings products can be marketed through:
  - Cross selling
  - Staff training
  - Customer service excellence
  - Staff motivation and results orientation
  - Point of sale advertising
  - Promotions to the customers
  - Data mining

12

Savings Products Marketing

- Marketing deals with customer and market behavior; therefore a significant part of the budget must go to market research and intelligence.
- Competition for savings is aggressive in the financial markets of all countries worldwide.
- Marketing is costly, because the market requires a minimum investment in marketing efforts for products to be perceived well and to motivate the savers to deposit their funds.
- Later, additional resources are needed to keep the saver with the institutions, and away from the wooing of competitors.

13

Final Considerations on Savings Products Development

- Successful and profitable savings products last a long time, giving the institutions access to cheaper funds for many years (Passbook savings have been in use for more than fifty years).
- To attract savings, MFIs must have solid corporate images. Without a solid image, savers will not bring their money, no matter how intense the marketing effort is. Usually, MFIs are identified with lending, in which little attention is required for institutional image.
- Savers seek high-quality services, speed in the operations, and good attention from the staff.

14

WOCCU

Final Considerations on Savings Products Development

- Designing, developing, researching, testing and marketing savings products requires significant investment.
- As the savings products and the marketing of them involve significant investment, continuous research must be conducted to avoid costly mistakes.
- Institutions must be realistic and adjust the rates and conditions to the market. Otherwise, they will have poor products, that will not be used by the savers--no matter how strong the marketing effort.

15

WOCCU

Final Considerations on Savings Products Development

- All marketing tools must be used to promote the savings products, both externally and internally.
- Internal marketing efforts are critical because if savers become motivated by the external marketing effort and visit a branch of the institution, all the investment will be lost if the staff in the branch is not capable of closing the sale of the savings products, due to lack of knowledge or attitude.

16

WOCCU

Final Considerations on Savings Products Development

- Mobilizing savings in MFIs is possible if institutions are willing to adapt themselves to a new way of doing business.
- Mobilizing savings is a hard task, but it is feasible if the right tools and procedures are implemented.
- Mobilizing savings implies significant changes in an MFI's culture.
- It is worth it to make the effort and get involved in savings mobilization in order to have access to infinite funds in local markets.

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WOCCU

Thanks for your attention, Your questions will be welcome

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WOCCU

Innovative Saving Products: The Role of Remittances

Dave Grace
World Council of Credit Unions
November 5, 2002

WOCCU

International Remittance Network (IR*net*) - Credit Union Response

- A safe, secure and economical way for individuals to send remittances since 1999
- Designed for small international payments
- A tool to reach underserved/ unbanked in U.S. & developing countries

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U.S. Remittance Activities

- Highest immigration level since 1930s, but immigrants are 4 times more likely to not have access to financial services = less opportunity
- 68% of Latino immigrants age 18-24 are unbanked and 73% of this group are sending money home
- Providing savings facilities to documented and *undocumented* immigrants in US
- Sending money at lowest cost in market; disclosing and guaranteeing exchange rates – but challenging

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Characteristics of Transfers

- Occur on a monthly repeating basis
- Average transfers $300-$500 to individuals of low and moderate means abroad
- Convenience is the most important factor for immigrants sending money

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Why Dev. Finance Organizations interested in Remittances?

- Avenue to grow membership
- Tool to increase savings
- Source of new fee income
- Additional service offering to existing members

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Impact of Remittances in LAC

- $23 billion in remittances to LAC in 2001 from US
- Remittance as a % of GDP: Nicaragua (24%), Haiti (20%), El Salvador (14%), Jamaica (13%), and Ecuador (10%)
- Equal 40% of total Foreign Direct Investment (FDI) to LAC
- Remittances are 4 times greater than Official Development Assistance to LAC

WOCCU

Linking Savings & Remittances

- Savings institutions distributing remittances:
  - Facilitate Access to Accounts
  - Encourage Financial Inertia

- In urban Mexico, remittances are 20% of capital investments in microenterprises
  - 33% of capital investments in heavy remittances states

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Credit Union Impact in El Salvador

- Credit unions have distributed $17 million in the last 12 months ($430 average size remittance)
- 25% of transfers are to members (data set of 650 transfers)
- 10% of the value of remittances is being saved; Central Bank estimates 1% of remittances is saved
- 37% of members deposit some portion of remittances
- First get the transfers, next membership, then **savings**

WOCCU

Credit Union Impact in Guatemala

- Credit unions have distributed $15 million in the last 12 months ($420 average size remittance)
- 42% of transfers are to members (data set of 515 transfers)
- 14% of transfers result in a new member for the CU

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Commonalities in El Salvador and Guatemala

- Credit unions earning $1.50 per [redacted]ansaction, federation earn $1.50 per transaction
- Volumes are growing 20% per month
- 65% of transfers go to 25% of the credit unions participating -- local marketing matters!
- Requirement to have broad national physical networks with established clearing and settlement systems

WOCCU

Partnership IRnet - VIGO

- IRnet partnership with VIGO enables transfers to 41 countries
  - 20 years experience, non-bank FI
- Desire to add CUs outside the US
  - Mexico, Jamaica, Philippines
- High visibility, media, academic politicians, consumers

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WOCCU's Lessons Learned

- There needs to be equal interest on both sides
- Financial standards are a prerequisite
- Market is more competitive than microcredit
- Scale is everything

WOCCU

What About ATMs?

- Does not facilitate account access and savings
- Can be cost effective, but programs from big US banks to-date have been more costly
- Availability of networks and transaction limits

WOCCU

Questions???

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EFFECTIVE SUPERVISION OF SAVINGS

Moderator: Robert Christen

Glenn Westley
Matthias Arzbach
Carlos Cuevas

Regulation and Supervision of Credit Unions: Major Controversies

Glenn Westley
Inter-American Development Bank
Nov. 5-6, 2002
Conference on Best Practices in Savings Mobilization
Washington, DC

Why is Prudential Supervision of Credit Unions Important?

- Helps to keep the CU on the straight and narrow path of maintaining financial disciplines and prudent management
- Protects small depositors, who have neither the information nor the capacity to monitor the level of risk taken on by the CU

2

Credit Unions vs. Banks: Structural Differences

- CUs have a cooperative ownership and governance structure: share capital not traded, 1 person-1 vote
- CUs generally much smaller
- CUs generally less well diversified geographically

3

Credit Unions vs. Banks: Regulatory Differences

- *Minimum capital and permissible operations
- *Capital adequacy
- External debt
- Governance
- Multipurpose CUs
- Non-member deposits

4

Minimum Capital and Permissible Operations

- **Banks:** Min. K reqs. are put on banks to ensure investors have enough at stake to avoid excessive risk-taking. Also, to ensure a smooth startup of opertions.
- **CUs:** But CUs don't have investors like this. They are a coop, set up to provide services to members.
- In many cases, they are the only, or one of a few, financial institutions serving an area.
- Startup costs for very small CUs can be tiny (e.g., don't need to be computerized or operate full time).

5

The Minimum Capital & Permissible Operations Controversy

- Example of Bolivia (similar regulation was pending in Paraguay):
- CUs with capital < 150,000 SDRs (about US$ 200,000), can't be supervised by the Superintendency and so can't accept deposits, only shares
- So: no liquid deposit instrument.
- This may force the closure of many CUs that can't find merger partners.
- May also prevent the startup of new CUs, especially in small communities, where they may be most needed.

6

The Minimum Capital & Permissible Operations Controversy (2)

- Importance of the unregulated CUs: they are in 180 of Bolivia's 311 municipios. 90 of these 180 would have no services from any financial institution if the unregulated CUs were closed down.
- Development challenge in LAC: increase financial depth by extending the fin. system to unserved and underserved pops. and thus reap economic growth and equity gains.
- Effectively closing down many members of one of the major types of FIs serving these unserved and underserved pops. goes in the wrong direction and is a bad idea.

7

Solving the Minimum Capital Controversy

- 1st best solution: Superintendency supervises all but the tiniest CUs (< 100 members)
- Big objection: cost. Rebuttal: worthwhile to CUs to pay even the full cost of good sup.
- 2nd best solution: Superintendency supervises only the largest 20 or 30 CUs and delegates supervision of the rest (except the tiniest).
- Discussed below: to whom do we delegate?

8

Capital Adequacy: Controversy over the Ratio

- Capital provides a cushion that protects depositors and shareholders from the effects of CU or bank risk-taking. CUs should generally have a higher ratio than banks (which benefits CUs by helping prevent insolvency) for 2 reasons:
- Governance. CUs don't have strategic investors who: i) can respond quickly to capital calls, and ii) have incentives to scrutinize management very closely for maximum efficiency and safety.
- Geographical diversification. CUs - usually have a small number of offices in a limited geographic area.
  Banks: much more often regional or national in scope; and so more able to withstand local shocks.

9

Capital Adequacy: Controversy over Shares

- How to deal with share capital - 2 methods:
- WOCCU
- Bolivia
- Both agree that institutional capital should count (=risk reserves + retained earnings)

10

WOCCU's Method

- Problem with share capital: members may take their share capital and leave the CU anytime, e.g., when there's a negative shock
- WOCCU's solution: count only institutional capital, and keep it above 10% of assets
- Most CUs will need a period of years to reach this 10% level
- Simple, workable soln. Like that in U.S.

11

Bolivia's Method

- Bolivia counts share capital fully for capital adequacy purposes
- But modifies the rules on redemption of share capital for members leaving the CU. Specifically, the CU must suspend redemptions when it is in trouble:
    - CU would fall below the minimum capital adequacy ratio
    - Current or cumulative losses
    - Massive desertion of members

12

Pros and Cons of Bolivia Approach

- 2 problems - member shares may become:
- Stranded
- Decimated er totally lost (no effective exit mechanism if the CU starts to become insolvent)
- But, these 2 problems are also a source of advantage: incentives for the members to participate in the governance of the CU and to be a force for prudent management
- 3rd problem (easily fixed): need to restrict automatic loans (as well as share redemptions) when CU is in trouble

13

WOCCU Approach

- Also can generate incentives for good governance and prudent management ...
- ... since most CUs are far from 10%
- If the Superintendency penalizes the CUs for not achieving the 10% goal in a timely way (fines, intervention, closure). Then, members may push for prudent mgmt. and the earning and capitalization of profits.

14

External Credit Limits

- We should limit CU borrowing from non-commercial sources (donors and government) ...
- Because this external credit has many deleterious effects:
- Displaces deposit mobilization
- Creates dependency on donor/government programs that one day may be scaled back or eliminated
- Creates a culture of courting donors instead of providing good service to depositors (undercutting client-oriented CU management)
- Often unbalances the natural equilibrium in CUs and leads to borrower domination (weak on loan screening & recovery and on enforcing prudential controls)
- Bolivia limit: 1/3 assets on government credit
- Suggested limit: 5-10% assets on government + donor credit

15

Credit Union Supervision

- Two major controversies:
- What is the role of delegated supervision (if any)?
- To whom should we delegate?

16

Delegated Supervision

- Typically in LAC, sup. is delegated to the CU Federation.
- Hence, the Superintendency escapes the cost and trouble of supervising CUs.
- But the Federation typically has no more (and often less) access to resources than the Superintendency. So this merely passes the buck; it doesn't solve the basic problem of providing enough resources to ensure good quality supervision.
- A good soln - user fees: it's worthwhile for CUs to pay even the full cost of their supervision, for good sup.

17

Delegated Supervision: The Problem

- Major problem: conflict of interest. The CUs own the federation and comprise its board of directors
- Very difficult to intervene/close your owners, especially the large and powerful CUs. Other federation role: promo
- The problem is particularly acute in recessions, when quick action may be most needed
- Example of Costa Rica: good technical work, not acted on
- Best case scenario: Peru. Strong leader who has closed several mid-sized CUs. Isn't sure about large CUs or what will happen after he is gone. Episodic functioning.

18

Supervision: Solutions

- 1st best: Superintendency supervises - if it's able & willing to do a good job: able & willing to enforce, doesn't drain CU supervisory resources for too long during bank crises.
- 2nd best: Delegate supervision to a supervisory entity independent of the CUs (with a Board that has no CU members) - along the lines of Guatemala's Ratings Board. Future possibilities: Bolivia's unsupervised CUs, Panama.
- 3rd best: German model - 2 or more regional CU supervisory federations. These have professionalized Boards, and never supervise the CU of a Board member. No promotional functions (DGRV and BVR do this).

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Supervision: Solutions (2)

- In the 2 delegated models, the Superintendency should keep a close eye on the whole supervision process as a quality check and retain the power to sanction the CUs and CU supervision entity.
- So, auxiliary sup > delegated sup > self supervision
- In none of the models are safety net elements such as a stabilization fund or deposit insurance appropriate until a track record of good supervisory control has been established (or else you relax member oversight before replacing it with external oversight). Cases to watch: Mexico, Colombia.

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Supervision: Solutions (3)

- Don't be tempted by the Quebec (Desjardins) supervision model in which the Federation does the supervision. It doesn't work well in LAC, nor is it likely to in much of the rest of the developing world unless the CUs are federated and many other preconditions are met.
- It works in Quebec because the CUs there are like a single entity with franchises - they don't compete with each other, they have a single logo, etc. ("think MacDonalds"). Hence, individual CUs much more willingly accept discipline from the center, than the independent CUs in LAC. Also, there's more discipline in Quebec than in LAC, lots (1200) of small CUs, good training of supervisors, and a central bank that oversees supervision and retains sanctioning power.
- I believe Desjardins, in their international work, should spread the federated system first (as an answer to bank competition, etc.), and only if this is accomplished, suggest supervision by the federation.

21

Can Financial Market Policies Reduce Income Inequality?

Glenn D. Westley

Inter-American Development Bank

Washington, D. C.

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FOREWORD

How can we further develop a country's microfinance industry and what impact might this have on the country's income distribution? These are the twin questions tackled in this paper.

In attempting to further develop a country's microfinance industry, most donor and government efforts so far have focused on building retail capacity, that is, on starting up and strengthening microfinance institutions (MFIs) and credit unions. MFIs and credit unions are, after all, an important means by which microenterprises obtain credit, savings, and other financial services.

While it is important to continue to build retail capacity, this paper suggests that countries also have available an entire array of complementary policy measures that could greatly facilitate the delivery of financial services to microenterprises. MFIs, credit unions, and their clients will not have to swim so much against the tide if countries provide the public goods discussed here, including improved legal and regulatory frameworks in several areas and modernized legal registries, credit bureaus, and other institutions that support expanded intermediation activities.

These policy measures constitute a second generation of financial reforms, which aim to expand financial services to the bottom 40 percent of the economy that is now poorly nourished by such services. These measures are a follow-on to the first generation of financial reforms, which eliminated interest rate controls, freed bank entry, dismantled targeted credit programs, privatized and closed state banks, and reduced reserve requirements toward prudential levels. These first generation reforms have both made microlending possible (with its necessarily high interest rates), and, by fostering greater efficiency and competition in the banking sector, have helped stimulate the present-day drive by financial institutions to serve the microenterprise niche. The second generation financial reforms are meant to capitalize on this favorable macrofinancial environment and help bring to completion the task of making financial services available to most or all creditworthy enterprises in Latin America and the Caribbean.

This paper also marshals substantial arguments and data to support the contention that improving the access of micro and small enterprises (collectively called "smaller enterprises") to financial services could have an important salutary impact on a country's income distribution. To demonstrate this, the paper shows first that many poor own or are employed by smaller enterprises, second that smaller enterprises are indeed poorly served with formal and semiformal credit, and third that providing financial services to smaller enterprises increases their income and employment and reduces income inequality to an important degree.

Using household survey data from 15 Latin American countries, the paper finds that while the microenterprise sector accounts for 56 percent of all earners in the region, it includes 70 percent of the region's poor earners (with 35 percent of the poor earners being single-person-firm owners and the other 35 percent microenterprise employees). Given this huge presence of the poor in microenterprises, we must conclude that if we aim to reduce inequality in Latin America by increasing the incomes of poor earners, much of our efforts will need to focus on microenterprise owners and employees.

Alvaro Ramírez
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INTRODUCTION

Highly imperfect financial markets appear to be an important source of income inequality in Latin America. Implementing policy changes from a broad agenda of second generation financial reforms that is emerging in the region offers the possibility of helping to reduce this inequality by altering the conditions under which financial markets function. The primary problem whose foundations and ramifications we shall explore in many dimensions is the fact that in most countries of Latin America, banking institutions have shown a great reluctance to serve the lower end of the business market, namely, micro and small enterprises (hereafter, "MSEs" or "smaller enterprises"). As we shall see, large numbers of poor people both own and are employed by these firms. These two facts—that smaller enterprises have few financial services but many low-income owners and employees—together with the impact that greater access to credit and deposit services can have on the income levels of MSE owners and their employees, is the basis for the argument that the financial reforms discussed here can help reduce income inequality.

The proposed second generation financial reforms are *not* designed to help lower-income groups by simply delivering transfers to them, as was widely attempted in earlier decades with large-scale subsidized credit programs. Such methods created well-known inefficiencies and often did not succeed in redistributing income toward the poor, because the rich and powerful frequently captured the benefits.

Rather, the reforms proposed here attempt to make lasting structural improvements in how financial markets work, picking out needed changes in areas that are of particular benefit to smaller firms and their employees. The proposed reforms aim to make changes in the laws and regulations that surround financial transactions, in the institutions that support intermediation activities, and to the participants (financial institutions and borrowers) themselves.

These reforms largely take the form of the provision of either public goods that facilitate the flow of credit and other financial services to smaller firms or else training that is underprovided by the private sector.[1] The former category (public goods) consists of reforms in the following areas: improving regulation and supervision of credit unions and microfinance institutions (the main financial institutions that lend to microenterprises), improving the legal framework for secured transactions and modernizing supporting institutions, reducing informality, establishing or strengthening credit bureaus, and improving the legal and regulatory framework for leasing and factoring. In the latter category (training) belongs the strengthening of credit unions and microfinance institutions.[2]

Since the set of smaller enterprises is a very heterogeneous group, with the incomes of the owners and employees ranging from extreme poverty to very well to do, it is difficult to say a priori what the impact of the suggested reforms on the overall income distribution would be. However, three points can be made.

First, since the suggested policy interventions are generally low-cost means for increasing the access of marginalized groups to financial services, and since there is a growing body of evidence that increased financial depth is associated with greater economic productivity and growth,[3] the proposed

[1] Public provision of training may be justified up to a point by the fact that those who receive training may move to other financial institutions over time. Hence, private financial institutions, unable to capture the full social benefits of the training they provide to their personnel, will tend to invest less than is socially optimal in training activities.

[2] Some of this institutional strengthening goes beyond what could strictly be called training, for example including upgrading of management information systems and physical plant, undertaking market research, and rewriting strategic plans and operational manuals. Nevertheless, equity arguments may justify governments and donors making these investments in private sector institutions.

[3] For example, King and Levine (1993) find that a 10 percentage point rise in the ratio of private banking-system credit to GDP is associated with an increase in

reforms are likely to be desirable on efficiency grounds in any case. Moreover, their impact is potentially far-reaching. Based on economic censuses and other data, Westley and Shaffer (1999) find that micro and small enterprises appear to play a much larger role in economic production than is sometimes realized. For example, microenterprises alone account for approximately 20 percent of GDP and micro plus small enterprises account for approximately 40 percent of GDP in Brazil, Mexico, Belize, and the Dominican Republic (the only four countries for which sufficiently reliable data could be obtained). Hence, reforms of the type proposed here, that help provide financial services to the 20 to 40 percent or so of the economy that is poorly supplied with these services, could have macroeconomically significant impacts on productivity and growth.

Second, some of the suggested policy reforms can be targeted to serve low-income MSEs. For example, since poverty rates are generally much higher in rural than in urban areas (Table 1, below), one may put particular emphasis on strengthening credit unions and microfinance institutions located in or desiring to expand into rural areas. An effort to bring financial services to the poor in both rural and urban areas can also be made by carefully selecting from all credit unions and microfinance institutions those that serve a poor clientele in either area. It may also be beneficial to aim some of the training and strengthening programs at helping intermediaries to understand the potential profitability of serving the mass, low-income market segment, and to transfer to them technologies for efficiently delivering credit and deposit services to this market segment.

Third, there may be a natural market tendency for financial services to increasingly reach lower-income level microentrepreneurs as competition increases among financial institutions serving the whole range of smaller enterprises. Financial institutions may increasingly look for new niches that can be profitably exploited and may thus turn more and more to serving the large mass of lower-income microentrepreneurs. Thus, even if some of the policy changes suggested here do not immediately improve the income distribution (because their main initial beneficiaries are the larger MSEs with higher-income owners and employees), they may increasingly do so over time.

This paper consists of two parts. Part I presents empirical evidence and discusses likely mechanisms through which provision of additional financial services to smaller firms might reduce income inequality in Latin America, fleshing out the arguments made in the opening paragraph. It also presents international cross-section and Latin American evidence that this channel is an empirically important means for improving income distribution in the region. Part II discusses a number of specific reforms aimed at increasing smaller firm access to financial services.

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the annual GDP growth rate of about 1/3 of a percentage point. Ghani (1992) finds an even larger growth effect, approximately 1/2 of a percentage point. Westley (1994) discusses several channels through which increased intermediation may result in productivity and growth rate gains.

I. REDUCING INCOME INEQUALITY THROUGH IMPROVED MSE FINANCE

We begin with a series of three propositions, accompanied by empirical evidence. Taken together, the three propositions show that by providing credit and other financial services to smaller enterprises, we can reduce income inequality at the national level. The three propositions are as follows. First, the majority of the poor own or are employed by smaller enterprises. Second, smaller firms have very little access to formal or semiformal credit. Third, providing credit and other financial services to smaller enterprises can reduce income inequality (through a number of means, or channels). The empirical evidence marshalled in these three sections and in a final, fourth section strongly suggests that the income inequality reductions could be quite substantial.

Many Poor Own or Are Employed by Smaller Enterprises

The principal result of this section is that 70 percent of Latin America's poor earners are either employees of microenterprises[4] or are owners of a firm with no employees at all (single-person-firm owners). Such a high percentage implies that if we aim to reduce inequality in Latin America by increasing the incomes of poor earners, much of our efforts will need to focus on microenterprises in general and on microenterprise employees and single-person-firm owners in particular. The remainder of this section explains and elaborates on this key result.

Based on recent (1997-99) household survey data from 15 Latin American countries, Table 1 shows the percentages of employees and of firm owners with incomes below the poverty line, both for the overall population and for those living in rural areas. Two methods are utilized for determining whether an earner is poor: whether his/her individual earnings fall below an earner's poverty line, and whether the total household income per capita of the household to which the earner belongs falls below a per-capita-income poverty line.[5] While poverty is traditionally thought of in terms of the latter concept (household income per capita), we also examine individual incomes as a means to compare the earnings of different subgroups of the population (including employees of microenterprises and of larger firms, and owners of businesses with and without employees), uncontaminated by the income levels of other household members.[6] For purposes of the major comparisons we make, both poverty measures tell the same story. Important stylized facts from Table 1 include the following:

- *Employees.* Poverty rates among employees of microenterprises are substantial, much higher than among employees of larger firms (33 percent vs. 15 percent for the household poverty measure and 44 percent vs. 16 percent for the individual poverty measure).[7]

[4] In this section, microenterprises are defined as firms with five or fewer employees.

[5] Table 1 explains the procedures used to determine these poverty lines.

[6] We could compare the average income levels of these various groups, but since our interest really lies on the lower tail of the income distribution, we prefer to look at the percentages with earnings below some threshold.

[7] All percentages given in this section are unweighted averages of the 15 individual country values. See Table 1 for additional details. Unweighted averages are used in order to give measures that are more typical of the values likely to be encountered in any given country. Unweighted averages are not skewed by extreme values in one or two large countries, while weighted averages sometimes would have been.

Table 1
Poverty Rates, Judged by Household Earnings per Capita and by Individual Earnings [a] (% terms)

	Household Earnings per Capita		Individual Earnings	
	National Sample	Rural Areas	National Sample	Rural Areas
1. All Employees and Firm Owners	26	48	31	50
2. Employees	22	43	26	40
3. Microenterprise Employees [b]	33	50	44	52
4. Other Employees	15	33	16	29
5. Firm Owners	31	53	40	58
6. Owners of Firms without Employees	31	52	43	60
7. Owners of Firms with Employees	20	38	20	35

[a] Each value shown in the table is an unweighted average of poverty rates in 15 countries (Argentina, Bolivia, Chile, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela), calculated from recent (1997-99) household surveys of each country. Following Psacharapoulos (1993), we employ a poverty line of US$ 60 per month per person in 1985 dollars, converted to each country's local currency value in the year of the survey using 1985 purchasing power parity exchange rates and local consumer price indices.

Each country's resulting poverty line, thus expressed in local currency, is then compared to the total income per capita of each household in that country to determine whether or not all earners in that household will be classified as poor.

To obtain the poverty line for individual earners, we multiply the $60 per month per person (expressed in local currency in the year of the survey) by the dependency ratio (=population/number of earners), which is calculated for each individual country from its household survey. These ratios typically range from two to three, and account for the fact that each earner supports a certain number of dependents. Finally, these poverty lines are compared to the income of each earner to determine whether or not that earner is classified as poor.

[b] Microenterprises are defined as firms with five or fewer employees.

• *Firm Owners.* There is significant poverty among single-person-firm owners, with an average poverty rate above that of wage earners as a whole (31 percent vs. 22 percent for the household poverty measure and 43 percent vs. 26 percent for the individual poverty measure). Poverty rates for owners of firms with one or more employees are lower (20 percent for both the household and individual poverty measures).

• *Rural versus National.* The poverty rates given in the preceding two bullets are based on the entire national sample, urban and rural areas combined. Poverty rates are substantially higher for those located in the rural areas. This is true across the board: for microenterprise and other employees, for owners of both single-person and larger firms, and with either definition of poverty.

Microenterprise employees and single-person-firm owners are large groups, containing an average (across the sample of 15 countries) of 30 and 26 percent of total earners, respectively. Given their high concentrations of poor, these two groups contain about 70 percent of Latin America's poor earners, with approximately 35 percent coming from the group of microenterprise employees and another 35 percent coming from the group of single-person-firm owners. These last three percentages hold with either definition of poverty, and for the rural areas as well as the national sample (i.e., about 70 percent of the rural poor also consist of microenterprise employees and single-person-firm owners). Hence, we reach the conclusion that if we aim to reduce inequality in Latin America by increasing the incomes of poor earners, much of our efforts will need to focus on microenterprise employees and single-person-firm owners.

Smaller Enterprises Are Poorly Served with Formal and Semiformal Credit

There is plenty of evidence that smaller firms are poorly served with credit from financial institutions. Table 2 shows that only 2.6 percent of the 59 million microenterprises in Latin America have formal or semiformal credit from a microfinance institution (MFI).[8]

Even leading microlending institutions in Latin America have small loan portfolios compared with the formal financial system (Table 3). Combining all formal (i.e., regulated) and semiformal sources of credit (semiformal sources consisting of NGOs and unregulated credit unions), total credit going to microenterprises is only about $2.5 billion in 1999 (see Table 4). This is merely one-half of one percent of the $499 billion that commercial banks provided to the Latin American private sector in 1999 and probably less than one percent of banking system credit going to *firms* of all sizes in the region.[9]

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[8] While Table 2 provides perhaps the most detailed and accurate data available on the share of microenterprises with MFI credit, these data still suffer from several shortcomings. Nevertheless, these shortcomings are not likely to be important enough to change the general result that only a very small share of microenterprises in Latin America have credit from a formal or semiformal source. The shortcomings can be divided into those that affect the numerator and those that affect the denominator of the share statistic: (number of microenterprises with MFI credit)/(total number of microenterprises). It is likely that the data reported in Table 2 on both the numerator and denominator are underestimates of their true values for most countries and for the region as a whole.

The numerator is likely to be an underestimate because the data used for the number of microenterprises with MFI credit do not count any of the clients of credit unions or of many smaller MFIs. This is the most serious deficiency of these numbers. While Robert Christen (the author of the study from which the numerator values are taken) estimates that his data cover about 80 percent of the total MFI clients, the omission of all credit union clients is more serious. Table 4, below, shows that the credit union loan portfolio with microenterprises is twice that of the MFIs. If the average loan size of the credit unions were the same as that of the MFIs, this would mean that the credit unions would serve twice as many microenterprises as do the MFIs, so that 7.8 percent (rather than 2.6 percent) of all microenterprises would have credit from a credit union or MFI. But because credit unions serve many middle class as well as lower-income microentrepreneurs, the average size of their microenterprise loans may be above that of the MFIs, implying that significantly less than 7.8 percent of microenterprises have an MFI or credit union loan. There is an additional consideration that further reduces the estimate of the share of microenterprises with an MFI or credit union loan. This consideration comes into play because what Table 2 really measures is the sum of the number of loans on the books of each MFI. Individual microenterprises may have more than one loan outstanding at a given time with one or more MFIs (or credit unions), thus reducing the number and share of microenterprises with credit.

The Table 2 data on the total number of microenterprises (the denominator) are also likely to underestimate the true values because the household surveys on which these data are based classify each earner according to the earner's primary source of income. This means that the data in the denominator do not count any microenterprises that earners consider to provide secondary sources of income.

[9] The figure of $499 billion is obtained from the *International Financial Statistics*, line 22d. It represents the total private credit extended by commercial banks in the 26 borrowing member countries of the IDB at the end of 1999, converted to dollars. This $499 billion omits credit to the private sector extended by "other banking institutions" (that are not commercial banks) and thus is an underestimate of total banking system credit to the private sector. However, consumer lending (credit cards, residential mortgages, etc.) is perhaps 25-30 percent of total banking system private credit, the bulk of private credit going to traditional business lending in such sectors as industry and commerce. Hence, if $499 billion is an overestimate of private *business* credit from the banking system, it is probably not so by too much (the two omissions tending to cancel each other out). Finally, as noted in the footnotes to Table 4, total microenterprise credit from the banking system, NGOs, and credit unions is more than the $2.5 billion shown in that table (due to the omission of some, generally smaller, institutions), but is almost certainly less than $5 billion. Even with all of these adjustments, then, microenterprises appear to receive less than one percent of banking system credit to firms of all sizes.

Table 2 Share of Microenterprises in Latin America with MFI Credit						
Country	Date of Household Survey	Number of Single-Person Firms	Number of Firms with 1-5 Employees[a]	Total Number of Microenterprises	Number of Microenterprises with MFI Credit	Share of Microenterprises with MFI Credit
Bolivia	1999	1,300,313	62,008	1,362,321	379,117	27.83%
Nicaragua	1998	377,148	40,422	417,570	84,285	20.18%
El Salvador	1998	606,569	60,617	667,186	93,808	14.06%
Honduras	1999	832,941	58,239	891,180	107,054	12.01%
Chile	1998	1,069,139	138,045	1,207,184	82,825	6.86%
Guatemala	1998	1,328,476	93,238	1,421,714	71,187	5.01%
Costa Rica	1998	232,328	78,891	311,219	12,794	4.11%
Ecuador	1998	1,396,139	298,524	1,694,663	65,719	3.88%
Dominican Republic	1998	1,315,016	77,172	1,392,188	49,437	3.55%
Colombia	1999	5,726,653	775,152	6,501,805	219,240	3.37%
Paraguay	1998	319,113	668,213	987,326	30,203	3.06%
Peru	1997	4,102,561	2,763,632	6,866,193	185,431	2.70%
Panama	1999	267,854	21,150	289,004	6,390	2.21%
Mexico	1998	8,503,552	1,770,393	10,273,945	67,249	0.65%
Uruguay	1998	314,891	27,018	341,909	1,600	0.47%
Brazil	1999	16,567,943	2,421,810	18,989,753	62,485	0.33%
Argentina	1998	1,807,615	103,555	1,911,170	4,940	0.26%
Venezuela	1999	2,906,975	340,296	3,247,271	2,364	0.07%
Latin America Total Firms		**48,975,225**	**9,798,375**	**58,773,600**	**1,526,128**	
Latin America - Weighted Average Share[b]						**2.60%**
Latin America - Unweighted Average Share[c]						**6.15%**

Sources: Household surveys for number of microenterprises; Christen (2000) for number of microenterprises with MFI credit, except for Panama. Christen's data refer to the second half of 1999 and cover most of the larger regulated financial institutions and NGOs lending to microenterprises, but do not cover credit unions. Data for the number of microenterprises with MFI credit for Panama are obtained from the IDB loan files, refer to December 1999, and are as follows: Multicredit Bank 3881, Credifundes 1549, and Mi Banco 960.

[a] Unlike the other 15 countries in the table, in the Dominican Republic, Colombia, and Brazil, the number of firms with 1-5 employees is not counted directly, but, rather, is calculated as 83% of the total number of firms with 1 or more employees. This 83% share is the overall ratio for the other 15 countries, taken as a whole, of the number of firms with 1-5 employees divided by the total number of firms with 1 or more employees.

[b] Calculated as (total number of microenterprises with MFI credit)/(total number of microenterprises).

[c] Calculated as the unweighted average of the 18 individual-country percentages shown in the final column.

Table 3 Microlending by Leading MFIs: Real Loan Interest Rates and Volumes of Microcredit					
Country	Lender	Real Interest Rate (%)	Volume of Loans Outstanding (US$ millions)	Number of Loans Outstanding (thousands)	Average Loan Size (US$)
Bolivia	Banco Sol	25	66	76.7	861
Bolivia	Caja los Andes	25	30	33.7	892
Bolivia	FIE	28	16	23.5	681
Chile	Banco de Desarrollo	44	16	15	1067
Colombia	Finamérica	32	16.8	10.3	1636
Dominican Rep.	Banco Ademi	n.a.	41	13.9	2943
Ecuador	Banco del Pacífico	27	3	8	375
El Salvador	Financiera Calpiá	30	26.5	34.4	771
Guatemala	Banrural	n.a.	30	21	1429
Paraguay	Financiera Visión de Finanzas	37	8.7	8.5	1016
Peru	Mibanco	61	13.1	37.6	350
MEAN		34	24.3	25.7	1093

Sources: Real loan rate data are generally from 1999, and are as given in the Private Sector Initiatives Corporation (PSIC) reports to the Inter-American Development Bank. In the case of Mibanco (Peru), the PSIC data refer to 1997. In two cases—Banco de Desarrollo (Chile) and Banco del Pacífico (Ecuador)—the real loan data are from 1995-96, as reported by Baydas, Graham, and Valenzuela (1997). All other data (last three columns) are from Christen (2000) and refer to June-December 1999.

Table 4 Supply of Formal and Semiformal Credit to Microenterprises in Latin America (1999 Stock, US$ millions)	
1. Commercial Banks, *Financieras,* NGOs, and Other Microfinance Institutions	878[a]
2. Credit Unions	1654[b]
TOTAL	2532

[a] This estimate is from Christen (2000), and includes most of the formal and semiformal providers of microcredit in Latin America and the Caribbean besides the credit unions. Data are for June-December 1999. Christen estimates that his data cover about 80 percent of the microcredit provided by all MFIs in Latin America and the Caribbean.

[b] WOCCU (2000) provides data on total credit as of December 1999 of all WOCCU-affiliated credit unions in Latin America and the Caribbean. Outstanding credit for Costa Rica is not available for December 1999, and so we have used the December 1998 credit value, given in WOCCU (1999). Loan data for Argentina, Colombia, and Venezuela are not available for December 1999 or 1998, and savings data are not available for 1999, and so for Argentina and Colombia we have used the 1998 level of savings, which has typically been approximately equal to lending in these two countries (as it has for Latin America more generally). For Venezuela, credit and savings data are not available for either 1999 or 1998, and so we have used the December 1997 value for credit, given in WOCCU (1998). From an analysis of 55 credit unions in Guatemala, Honduras, and Bolivia, we find that 40 percent of total credit goes to microenterprises (farm and non-farm), and employ this value to derive the estimate given in the table. WOCCU estimates that WOCCU-affiliated credit unions account for at least 70 percent of all credit union lending in Latin America and the Caribbean in the years referred to by these data.

In contrast, Westley and Shaffer (1999) have estimated that microenterprises account for approximately 20 percent of Latin American GDP, and so it would appear that, relative to their output, these firms receive a disproportionately small share of credit from formal and even semiformal sources.

Does this minimal use of credit mean that small borrowers need less credit, or that they face highly restricted access to it? It is difficult to measure access to credit directly because limited use of it could, in principle, reflect either minimal demand or a restricted supply. However, there is evidence that small borrowers face more restricted access to credit than do larger borrowers. A number of studies have presented evidence that small borrowers show clear signs that their activities are restricted by the inability to obtain credit, and that larger borrowers are less affected by such credit constraints. Box 1 surveys some of these studies.

Another piece of evidence that smaller enterprises have many high-return projects waiting in the wings, frustrated by lack of finance, is the very high loan rates routinely paid by these firms when credit is made available to them.[10] Moreover, when good microlending programs are started up, they often attract a huge following despite charging high real loan rates. For example, by 1997, Banco Sol in Bolivia was only 10 years old (five years as an NGO followed by five years as a bank) and already served over one-third of the total clients of the entire Bolivian banking system.

Providing Credit and Other Financial Services to Smaller Enterprises Can Reduce Income Inequality

The provision of financial services to smaller enterprises helps to reduce income inequality through at least five means, or channels. These five channels involve: the use of credit for business purposes; the use of credit for nonbusiness purposes; the use of noncredit financial services, especially savings services; demographic and human capital effects that result from the income increases associated with the first three channels; and macroeconomic impacts on the aggregate investment ratio.

The first channel is perhaps the one most widely considered when thinking about the impact of financial services on the income levels of poorer households. In this channel, smaller enterprises purchase goods and services (machinery and equipment, raw materials, hired labor, etc.) in advance of production to meet both investment and working capital needs. We often observe that very shallow financial systems provide credit only to large businesses and wealthy individuals for such purchases. As the financial system deepens and competition among formal financial intermediaries increases, medium-size and smaller enterprises gain access to loans. It is likely that as smaller enterprises obtain credit, they will undertake many high-return projects that their own resources and those obtainable from informal sources (family and friends, moneylenders, suppliers, etc.) had not been sufficient to permit them to undertake. As noted earlier, one piece of evidence that smaller enterprises have many high-return projects waiting in the wings, frustrated by lack of finance, is the very high loan rates routinely paid by these firms when formal credit finally does become available to them (Table 3). In any event, since the decision to borrow is voluntary, the loan should enhance the welfare of the smaller enterprise owner and thus, to the extent that low-income entrepreneurs are the ones receiving the credit, improve the distribution of income.

Moreover, as the numerous impact studies surveyed by Sebstad and Chen (1996) make clear, smaller firm owners, including those below the poverty line, derive substantial income gains from access to credit, with the gains typically increasing over time as additional, larger loans are extended to them.[11] These studies also report substantial em-

[10] Table 3 gives the real (after-inflation) lending rates of some of the leading MFIs in Latin America.

[11] This is not to say that business failures don't occur among borrowers. For example, Hulme and Mosley (1996; 1998) find that while some borrowers *are* left worse off after they have made use of their loans, they are a distinct minority. In the 13 programs whose

ployment creation by microloan programs. As shown in Table 1, the wage income levels of a sizable share of microenterprise employees still place them below the poverty line. To the extent that microcredit programs create jobs for such low-income earners, these programs are likely to be strong contributors to reducing income inequality. Finally, the fact that some smaller firms face a credit constraint (Box 1) lends further support to the idea that there will be increases in smaller firm output, income, and employment as this constraint is eased.

The second channel considers nonbusiness uses for credit. The finding here is that even when poor households use loan proceeds for nonbusiness purposes, their incomes are often increased over what they otherwise would have been. Hence, the distribution of income is improved. How might this occur?

Sebstad and Cohen (2000) carry out field studies of seven microlending programs and survey the extensive impact analysis literature. They find that in many microlending programs, a significant minority of loan recipients use at least a portion of their credit for nonbusiness purposes. The authors document many ways in which credit used for such purposes often improves household income levels, particularly in coping with shocks and economic stress events. Shocks and economic stress events include: a) systemic factors that affect large groups of people such as recessions, inflations, floods, earthquakes, droughts, hurricanes, and other natural disasters; b) individual emergencies such as illness, accidents, death, fire, theft, and job loss; and c) life cycle events such as marriages, funerals, childbirth, festivals, establishing a household, and education. Such shocks and economic stress events can have a much greater impact on the income levels of poor households, which typically have few assets to help them cope with these contingencies.

In the face of such shocks and stress events, loans allow recipients, particularly poor recipients, to attenuate or reverse downward pressures on household income levels in the short and longer runs. For example, loans may permit households to continue obtaining medical care, paying educational expenses, eating three meals a day, and generally maintaining or improving their human capital.

Loan proceeds may also be used to improve or enlarge housing, which sometimes doubles as workspace, especially for very small firms. This may permit a household business to be started or to expand, increasing household income. Many basic housing improvements can also have beneficial effects on the health and well-being of household members, which can have positive impacts on family income.

At times, borrowers may use some of their loan proceeds to help friends, relations, and others in their communities during times of economic duress for these other individuals. This builds valuable social assets that can be drawn on in times when the person who has given, in turn, has an emergency.

While Sebstad and Cohen (2000) find that microloans are primarily used to invest in one's own business, their study highlights the many ways in which nonbusiness loan uses can increase income. These nonbusiness loan uses can be especially important for the poor, who are particularly vulnerable to economic stressors due to their near-subsistence income levels and thin cushion of assets.[12]

impact they evaluate, all are found to raise the average income levels of program participants. These findings of a positive overall impact are similar to those found in other impact studies.

[12] Even if the credit is used for pure consumption (with no income increasing effects at all), it is still a voluntary transaction and should still be expected to increase the general well-being of the low-income borrower and thus improve the distribution of income broadly defined (to include such welfare gains). This kind of welfare gain is particularly apparent in cases of consumption smoothing, in which a loan allows a low-income household to maintain its consumption of basic necessities despite a temporary shortfall in income.

Box 1
Credit Constraints

Beyond the tiny share of microenterprises with formal or semiformal credit and the small amount of total credit that microenterprises receive from these sources, there are two other types of evidence that smaller firms face significant credit constraints: surveys and analyses of market data. National surveys of micro and small enterprises often ask about major business problems, including lack of finance. Although these self-reporting data are properly deemed less reliable than market data, it is difficult to detect credit constraints in market data. This is because of the problems of disentangling statistically whether businesses that receive no formal credit simply aren't demanding it or are judged not to be good credit risks on the one hand, or whether, on the other hand, they are really being rationed by the financial intermediaries. Because of this difficulty, evidence of credit constraints based on analyses of market data is limited.

Among the few studies to attempt the detection of credit constraints from observed market behavior using reasonably recent Latin American data are Mushinski (1995) and Barham, Boucher, and Carter (1996). Based on data from three regions in Guatemala, these studies find that smaller firms desiring bank credit received it much less often than larger firms. Furthermore, credit unions in the three areas provided loans to a substantial percentage of these smaller, bank-rationed firms, suggesting that the companies were creditworthy enterprises. Jaramillo, Schiantarelli, and Weiss (1996) estimate the Euler (accumulation) equation for capital stock allowing for adjustment costs in a panel data set covering 420 Ecuadorean manufacturing firms over the years 1983-88. They find that smaller firms faced significant credit constraints both before and after interest rate ceilings were removed in Ecuador, while larger firms never did. Since smaller firms are defined as those with a capital stock of up to US$ 600,000 in 1975 prices, this study shows that even fairly sizable firms with substantial collateral can face credit constraints.

By asking firms directly whether they want to obtain credit and cannot, one may also obtain an indication of whether MSEs face a credit constraint. Nonetheless, these data must be interpreted with care because: (a) they are not based on actual behavior, (b) the price of credit is rarely made explicit (though may be understood to be at "market rates"), and (c) not all firms desiring credit would be deemed good credit risks by financial intermediaries.

Pons and Ortiz (1994) provide perhaps the most straightforward estimate of this type. Based on a national survey, they find that 42 percent of the smaller enterprises in the Dominican Republic would like to have credit and don't, and another 16 percent aren't sure. (The remaining 42 percent didn't want credit for a variety of reasons, including the fact that some already had it.) The impact of credit market restrictions extends even beyond this sizable group, however, as there are an unknown number of households that would like to begin their own businesses but don't for lack of credit to finance their start-up or subsequent operations.

Several other national surveys ask about major business problems, including credit constraints. In Guyana, Bresnyan (1996) finds that 62 percent of microenterprises face a "severe" or "very severe" "lack of cash in running their business," as opposed to a constraint that is "not severe." In the same survey, 39 percent cited the lack of finance as affecting the ability of the firm to grow. Magill and Swanson (1991) find that lack of sustained access to finance is by far the biggest problem that microenterprises face in Ecuador, even placing ahead of lack of market. EIM/International's (1996) survey of Trinidad and Tobago and ESA Consultores (1996) survey in Honduras both find that market opportunities are the biggest problem microenterprises face, followed in each case by lack of finance.

The third channel involves noncredit financial services, particularly savings services. In rural areas, even poor people often save in order to carry over income from one harvest to the next. Rutherford (2000) makes it clear that a great many of the poor in urban as well as rural areas save or would like to save in order to meet the kinds of emergency and life cycle needs described in discussing the second channel. In the absence of financial institutions that locate in lower-income rural and urban areas and offer deposit accounts, savings must be done in nonmonetary forms (jewelry and other valuables; house bricks and other building materials; livestock, crops, and other capital and inventory; etc.) or by holding cash if it is to be done at all (see Gadway and O'Donnell, 1995). These forms of savings have serious disadvantages, including the erosion of value with the passage of time (for example, cash may lose value with inflation, bricks may deteriorate, and grain may spoil), the possibility of theft, the high transactions costs that typically accompany the conversion of illiquid assets into cash (with a likelihood of additional losses if a sale must be made quickly because of an emergency), and problems of indivisibility (one cannot slaughter half a cow, sell half a ring, etc.).[13]

With their savings in commodities, households that need cash may be forced to choose between borrowing from informal markets at high interest rates or paying the high transactions costs and facing any indivisibility problems associated with converting illiquid assets into cash. Access to a liquid savings account would allow households to meet their routine and emergency liquidity needs more easily and cheaply, and thus avoid erosion of their income and wealth.

By avoiding the disadvantages of in-kind and cash savings, liquid deposit facilities also may encourage many households that would not have saved to become savers or to save more than they otherwise would have. The presence of savings or more savings in a household can help raise household income in a number of other ways. As McKinnon (1973) and others have pointed out, savings is an important means by which individuals start up or expand a business of any kind. Savings also permit individuals to take advantage of sudden business or other opportunities when they present themselves (e.g., the opportunity to purchase cloth or other business inputs in bulk when there is a sale). In many of the same ways that are discussed with reference to the second credit channel, savings can also help households resist downward pressures on their incomes from shocks and economic stress events by helping them to maintain or improve human, physical, and social assets. And savings are an excellent means for facilitating consumption smoothing.

Savings may also raise household income levels by facilitating entry into higher-risk, higher-return lines of business activity. Savings do this by providing a readily available cushion of financial support in case of failure. For example, such a cushion might allow farmers to shift out of a lower-risk, diversified cropping pattern, and specialize to a greater extent in higher-valued crops, with the knowledge that they have saved resources at hand to meet their families' most urgent needs in case things go badly. Farmers that are successful in this may, over time, become not just savings, but also credit, customers of the bank, with loans used to finance increased production costs and the purchase of livestock, equipment, and other assets. Low-income urban entrepreneurs might follow a similar trajectory, for example with the production and sale either of higher-value merchandise or of a larger quantity or variety of products. Again, savings provide a safety net for the household against the worst effects of business failure.

Finally, with more savings available, the supply of funds that may be used for informal lending will expand, driving down the informal lending rate, and widening the use of such credit. This may particularly benefit smaller enterprises and lower-income households, which, lacking access to formal loans, may disproportionately use informal credit.

[13] In periods of rapidly rising prices, commodities may, of course, serve as an inflation hedge, much as a reasonably remunerated deposit account does. However, the other disadvantages of holding savings in nonmonetary form still apply.

The fourth channel operates through demographics and human capital. It begins where the first three channels leave off, with an increase in the income levels of low-income families. Part of this increment in family income may be attributed to an increase in the labor force participation of women. Access to credit or savings facilities may allow women to start a business, in some cases part time and at home (possibly due to child care responsibilities) or, in other cases, full time and out of the home. It may also permit women with existing businesses to increase their incomes. Families with higher total incomes tend to have fewer children, leading to even greater levels of family income per capita because of the reduced family size. In the longer run, the human capital of the children born into these families also tends to be greater than it would have been in the absence of the expanded availability of financial services, as greater educational attainment and improved health status are both strongly related to family income, particularly to the income of the mother.

The fifth channel is macroeconomic in nature. As financial systems deepen and credit becomes more available, the ratio of aggregate investment to GDP should increase because of the relaxation of borrowing constraints. This rise in the investment ratio tends to drive down the rate of return on investment (due to diminishing marginal returns to capital) and increase real wages (since on average each worker now operates with more capital). Because the distribution of physical capital is far more concentrated in the hands of the well-to-do than is the distribution of income (see, for example, Wolff, 1991), this reduction in the rate of return to capital tends to reduce income inequality.

Empirical Evidence on the Finance/Inequality Link

This section provides evidence that the argument made so far—that providing financial services to smaller enterprises can reduce income inequality at the national level—is not only a valid proposition, but also an empirically important one. Specifically, this section shows that Latin American countries have relatively shallow financial systems and that such systems are strongly associated with greater inequality. That is the main result. Household survey data are also analyzed to obtain further supporting evidence that lack of smaller-firm finance could be an important contributor to greater income inequality. Finally, empirical evidence is presented showing that at least a few dozen credit unions and several MFIs have reached many poor, and thus could, in fact, raise incomes and reduce inequality through the many channels discussed in the preceding section.

Compared to East Asia and the Industrial Countries, Latin America Has Shallow Financial Systems ...

In the 1960s, financial depth—measured either by the ratio of broad money supply to GDP (i.e., M2/GDP) or by financial system credit to the private sector as a share of GDP (i.e., private credit/GDP)—was only about 25 percent higher in the emerging East Asian countries than it was in Latin America (see Table 5). But Latin America's macroeconomic and financial instability, financial repression, and relatively slow economic growth during much of the following decades slowed its financial development. East Asian financial depth steadily pulled away, and by the 1990s stood at two to three times the Latin American average. While part of this difference may simply reflect larger borrowers getting more credit in East Asia, such a sizable divergence may also stem from a broadening of the East Asian financial systems to include smaller firms, including many smaller firms that are linked to large firms through supply chains. In contrast, as we have already discussed, smaller firms in Latin America often find it very difficult to obtain credit.

Table 5 Financial Depth by Region (% terms)			
		M2/GDP	
Period	**Industrial Countries**	**Latin America & Caribbean**	**East Asian Miracle Countries**
1960-70	51	21	28
1971-81	54	29	38
1982-92	57	37	55
1993-96	74	38	89
		Private Credit/GDP	
Period	**Industrial Countries**	**Latin America & Caribbean**	**East Asian Miracle Countries**
1960-70	41	13	17
1971-81	47	21	31
1982-92	59	24	55
1993-96	77	27	86

Source: *International Financial Statistics.* The regional averages presented in this table for each period are calculated as unweighted averages of financial depth, averaging first across years and then across countries. Unweighted averages are used in order to give measures that are more typical of the values likely to be encountered in any given country. Unweighted averages are not skewed by extreme values in one or two large countries, while weighted averages sometimes are.

... And Shallow Financial Systems Are Associated with Greater Inequality

Is there any evidence that the relatively shallow Latin American financial systems have contributed to increased income inequality in the region? As shown in Deininger and Squire (1996, Table 5), it is certainly true that the Gini coefficients are much higher in Latin America than they are in East Asia or in the Industrial Countries. However, there are a number of other factors besides differences in financial depth that might explain Latin America's greater income inequality. Even after controlling for many of these other factors in international panel data regressions, however, I still generally find that financial depth has a statistically significant and negative association with income inequality (see Technical Annex, Table A1 for a representative sample of the regressions I have run). To give an idea of the magnitude of this effect, in regression 2 of Table A1, a 10 percentage point increase in M2/GDP (e.g., an increase from 20 percent to 30 percent) is associated with a decline in the Gini coefficient of 1.15 percentage points (e.g., a drop from 40 percent to 38.85 percent). The 50 percentage point difference in M2/GDP between East Asia and Latin America in the 1990s, then, would account for 5.75 (=5x1.15) percentage points of the difference in Gini coefficients between the two regions, or about one-half of the observed difference of 11 percentage points. The share of the income inequality differences between the two regions that is explained by differences in financial depth in the preceding decades is substantially smaller, however, given the much smaller differences in financial depth between the two regions in those periods.

The above findings of a significant and quantitatively important effect of financial depth in explaining variations in the Gini coefficient across countries and over time is corroborated by the other major international study in this area, that of Li, Squire, and Zou (1998). This study also finds M2/GDP to be significantly and negatively associated with the Gini coefficient, and consistently so even after including numerous sets of additional independent variables to control for other factors deemed pertinent to explaining differences in income inequality across countries and over time.[14]

Household Survey Data Further Underscore the Importance of Finance

Beyond these international cross-section studies, Latin American household survey data suggest that inequality in the access to finance by firms of different sizes could well have an important effect on the overall distribution of income for countries in the region. Consider the following statistics. First, the income derived from unincorporated enterprises owned by household members averages 30 percent of total household income (while 65 percent is from wages and five percent from miscellaneous sources—interest, dividends, rents, remittances, pensions, etc.).[15] Second, household business income is distributed quite unequally, with a Gini coefficient that averages 0.56 (vs. 0.44 for wage income) in the 14-country sample. The substantial share of total household income that is obtained from business profits, and the significant inequality in the distribution of this business income, combined with the earlier demonstrations of the positive impact that credit availability generally has on income levels, support the notion that increasing the access of smaller firms and poor entrepreneurs to credit could play an important role in reducing income inequality in Latin America. This contention is further buttressed by the fact that approximately 70 percent of poor *wage* earners work in firms with five or fewer employees, the same firms that are probably most negatively affected by the lack of outreach of the Latin American financial systems.

Credit Can Reach the Poor

Finally, I present empirical evidence that at least a few MFIs and a few dozen credit unions in Latin America have reached the poor, and thus could, in fact, raise incomes and reduce inequality through the many channels discussed above. Navajas, et al. (1996) survey a total of 588 clients in five Bolivian MFIs and find the following percentages of poor borrowers: Banco Sol, 36 percent; Caja los Andes, 26 percent; FIE, 20 percent; Prodem, 81 percent; and Sartawi, 76 percent. The first three MFIs served urban areas in 1995 when the data were collected and the last two served rural areas. The five institutions together had a total of 167,000 microenterprise clients, of which 67,000 (or 40 percent) were poor, suggesting that credit can reach poor microentrepreneurs in substantial numbers.

Adding to this evidence, Dunn (1999) carried out a sample survey in August 1997 of 400 clients of ACP (a large MFI, now called Mibanco) in Peru. Selection criteria ensured that this sample was representative of ACP's overall clientele. The study finds that 28 percent of ACP's clients were poor.

Sample survey evidence from four studies by the World Council of Credit Unions (WOCCU) indicates that credit unions can also reach many poor. Taking random samples of members from credit unions participating in WOCCU credit union strengthening programs, the following percentages of members were found to be poor in the following countries and years: Ecuador, 1996—56 percent; Ecuador, 1999—18 percent; El Salvador, 1996—22 percent; and Nicaragua, 1997—49 percent.[16]

[14] In fact, my study and that of Li, Squire, and Zou are similar in many ways. The Li, Squire, and Zou study employs the Deininger and Squire (1996) set of Gini coefficients for 49 developed and developing countries over the years 1947-94. My study adds a few additional Gini coefficient observations to this set, and uses 11-year averaged data instead of Li, Squire, and Zou=s five-year averages. Most importantly, perhaps, I test a number of explanatory variables that were not included in the Li, Squire, and Zou study.

[15] These percentages represent unweighted averages taken over household surveys in 14 countries: Argentina, Bolivia, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Honduras, Mexico, Panama, Paraguay, Peru, Uruguay, and Venezuela.

[16] These poverty rates were calculated using a poverty line of US$ 2 per day per person together with the income data reported in the following four studies, respectively: Mesbah (1997), Vallejos (1999), Mesbah (1998), and Mesbah (1997a).

Each of these studies is based on sampling from 9 to 14 credit unions, with the total number of observations ranging from 300 to 1227.

More poor were reached than are indicated by the above-cited 67,000 poor clients out of 167,000 in Bolivia or by applying the poverty rates just presented for ACP and the credit unions to the total number of ACP clients and the total number of members in the surveyed credit unions. This is true, first, because of the employment effects noted earlier. Second, even considering only firm owners, the poverty rates given above understate the share of poor microentrepreneurs who were served by the MFIs. This is because while many MFI clients start off poor, after receiving several loans and/or after having had access to savings services for a few years, the incomes of some of these clients will have risen above the poverty line. In other words, there may be quite a difference in the poverty rates of the set of existing clients as they are now versus the set of existing clients as they were when they first became clients.

II. FINANCIAL MARKET POLICIES TO REDUCE INEQUALITY

What can be done to make financial services more broadly available, in particular to smaller enterprises? Most countries in Latin America have already taken steps in this direction by eliminating interest rate ceilings, freeing bank entry, dismantling subsidized targeted credit programs and other forms of state-imposed credit allocation, privatizing and closing state banks, and lowering reserve requirements. These first generation liberalizing reforms have been conducive to the delivery of financial services to smaller firms in two ways. First, it becomes possible for financial institutions to charge the high interest rates such lending requires. Second, by fostering greater competition and efficiency in serving traditional, large-firm customers, intermediaries are encouraged to look for new, unexploited market segments such as serving smaller firms.

For countries that have not yet created more competitive financial markets or eliminated interest rate ceilings (including those countries that have reimposed interest rate ceilings such as Colombia and Ecuador), these are certainly important steps to take toward the goal of providing smaller firms with an increased level of financial services, and thereby attempting to reduce income inequality. However, as discussed earlier, very little formal or semiformal credit is reaching microenterprises even in many of the countries that have liberalized their financial systems, and many smaller firms face significant credit constraints. So one may ask, what else can be done?

The remainder of this paper consists largely of a discussion of a number of second generation financial reforms. The aim of these reforms is to deepen financial markets by extending financial services to much greater numbers of MSE participants. To the extent that financial services reach single-person-firm owners and help raise their incomes or reach somewhat larger enterprises and help create jobs, the reforms proposed here will help groups that contain the great majority of poor earners in Latin America. The second generation financial reforms discussed here are: improving prudential regulation and supervision of credit unions and MFIs (regulation and supervision are treated in two separate sections); improving the legal framework for secured transactions and modernizing supporting institutions; reducing informality; establishing or strengthening credit bureaus; improving the legal and regulatory framework for leasing and factoring; and strengthening credit unions and MFIs.

Improving Prudential Regulation of Credit Unions and MFIs

Many countries in Latin America have a body of prudential banking regulations that impedes lending to microenterprises. These regulations are typically designed with traditional commercial bank lending technologies and large loan sizes in mind. Their application in the microfinance setting generates unnecessary difficulties and inefficiencies for credit unions and MFIs (the two main types of financial institutions that lend to microenterprises). These difficulties and inefficiencies raise the already high cost of making microloans, increase the risk of insolvency for lenders, and restrict microcredit supply. In turn, these impacts reduce the incomes of many poor people who own businesses or who would be employed in the microenterprise sector. These ill effects can be eliminated by applying a more appropriately designed set of regulations to financial institutions making microloans.

In order to understand this issue (and additional discussion later on), Box 2 describes the salient features of the microlending technology that has been used successfully by a large number of MFIs around the world and in Latin America to make very small loans (e.g., \$50 to \$1500) while at the same time achieving delinquency rates that are on a par with those of the commercial banks (2 to 3 percent) and containing administrative costs. This technology is fundamentally designed to ensure that borrowers are *willing* to repay their loans, in addition to making the more traditional banking checks that they are *able* to repay. Two major variants of this technology exist, individual and group lending, and high repayment rates have been achieved with both methods.

Box 2
The Microlending Technology

In ***group lending***, credits are granted to small, self-formed groups. These groups serve three purposes. First, they screen out bad credit risks since the whole group is held responsible if anyone in the group defaults, and hence they reduce the costs of gathering creditworthiness information. Second, they exert social pressure in the event a borrower fails to repay and, at the same time, offer the possibility of voluntary mutual aid by means of informal, within-group loans to a member in difficulty. Third, they offer the potential to further reduce administrative costs by allowing the bank to make and service a single group loan in place of several individual loans.

Individual lending is grounded in a detailed investigation and assessment of the borrower's character and his/her likely willingness to repay. Initial loan screening often includes visits to the business site and home, and talks with business associates and neighbors. An analysis of the overall business/household's cash flow (ability to repay) is also performed. Loans are generally extended based on these assessments, rather than being secured with physical collateral, which the microentrepreneur typically has very little of, and which would, in any case, entail prohibitive costs to take possession of and sell. ***Thus, in contrast to traditional bank lending, group and particularly individual microlending is said to be information intensive instead of collateral intensive.***

The remaining elements apply to both individual and group lending techniques:

- Repayment is further encouraged by a ***progressive lending scheme*** in which borrowers are first given very small loans with short terms. If successfully repaid, the loan amount and term are progressively increased in subsequent rounds of borrowing. In addition to rewarding repayment, this scheme also serves to establish a credit history for borrowers who typically have none to begin with, allowing the lender to decide whether to make larger, riskier loans based on this history.
- ***Frequent repayment schedules*** are employed to facilitate monitoring of borrowers.
- ***Incentive pay*** is used to help solve the MFI's principal-agent problem, with a loan officer's remuneration determined to a significant degree by his/her loan volume and portfolio delinquency rate.
- ***Staff are often drawn from the local service area***, so they have better access to information about potential borrowers.
- To help keep delinquency rates low in larger microlending programs, ***specialized software*** is used that tracks each individual loan and provides daily delinquency reports to loan officers. ***Delinquencies are followed up*** the next day or soon after.
- In order to reduce the borrowers' transactions costs and the intermediary's loan default losses, ***loan officers spend much of their time in the field***, screening new clients and checking on old ones, particularly those who are delinquent. The lender's ***administrative costs are held down*** by using inexpensive transportation (e.g., motorcycles, bicycles, and city buses), directly entering field-collected data into portable or hand-held computers (in lending programs of larger size), and maintaining relatively modest main and branch offices, in keeping with the fact that the program serves a clientele of more limited means.
- In order to increase the value to borrowers of the lending institution's credit services, and thus encourage loyalty and repayment, the ***loan approval and disbursement period is normally very rapid*** (often a matter of a few days).
- ***Microloan interest rates are set considerably above average commercial bank lending rates*** in order to cover the higher administrative cost margins of making much smaller loans. These cost margins are typically 15 to 30 percentage points or more, depending on average loan size, total program volume (due to economies of scale), and other factors.

We now discuss a number of key areas in which inefficient and ill-advised regulations are found or in which important regulations are absent. These are: minimum capital in nominal terms, capital adequacy, loan documentation and provisioning, external credit limits, governance regulations, and operational restrictions. Some of these regulatory problems are quite widespread in the region.[17]

Minimum Capital in Nominal Terms and Special MFI Windows

This section concludes, first, that the possibility of opening special MFI windows, with lower minimum capital requirements in nominal terms (e.g., US$ 1 million for MFIs versus US$ 5 million for banks), merits particular attention in Latin America. Second, the imposition of minimum capital requirements on credit unions together with the restriction that only those credit unions meeting these requirements can mobilize deposits—as has been legislated in Bolivia and is under consideration in Paraguay—is likely to be far from the ideal arrangement. I discuss two alternative arrangements that I believe are superior, both of which involve supervision of all but the tiniest credit unions and zero minimum capital requirements. These points are discussed in order.

MFI Windows

The 1990s have been a time in which many of the countries of Latin America have made great strides in improving the prudential regulation and supervision of their banking systems (see, for example, IDB, 1996, Part II, Ch. 4). Yet few have opened special windows by means of which NGOs can graduate to become regulated financial intermediaries capable of taking deposits. Such windows typically offer lower minimum capital requirements than those mandated for banks or *financieras*, but a more restricted range of permissible operations (typically prohibiting checking accounts, certain foreign currency operations, etc.). Special windows have been available in Bolivia and Peru since 1995 and have been recently opened in Honduras and El Salvador. These windows offer MFIs the possibility of providing valuable deposit services to their clients and, at the same time, greatly expanding their microcredit portfolios by leveraging scarce capital resources with deposits.

In their discussion of the MFI industry worldwide, Christen and Rosenberg (2000) offer a number of important preconditions and cautions to those advocating opening MFI windows in additional countries. First and foremost, the country's banking system must be reasonably well regulated and supervised before an attempt is made to further deepen the financial system by opening an MFI window. Second, there must be a supply of licensable NGOs, with clear institutional and financial strength and a track record of commercial-level profits, but insufficient capital to use existing bank or *financiera* windows. Third, even if these two preconditions are satisfied, opening a special window carries with it the risk that the regulatory authority may impose controls that are deleterious to microfinance. These might include interest rate ceilings (which can also be imposed on MFIs even if there is no special MFI window, as Colombia and Ecuador have recently demonstrated), restrictions on uncollateralized lending, limits on institutional ownership of MFIs, or other controls that are incompatible with current microfinance practices and potential innovations.

These three points are all well taken, particularly when discussing the MFI industry worldwide. However, if there is one region of the world that is most ready to open special MFI windows—with due consideration given to the risks entailed by these windows versus their benefits—it is Latin America. This is demonstrated by recent data published in the *Microbanking Bulletin*, which tracks 124 MFIs worldwide. The April 2001 issue (Tables 1 and D) shows that over half of the 124 MFIs are financially self-sufficient and that approximately two-thirds of the self-sufficient institutions worldwide are located in Latin America. In addi-

[17] See Jansson and Wenner (1997), Rock and Otero (1997), Berenbach and Churchill (1997), Christen and Rosenberg (2000), and IDB (2001) for further discussion of issues related to the regulation and supervision of MFIs and credit unions.

tion, Latin America has been a leader over the last decade in modernizing prudential bank regulations and improving supervision. Very impressive gains have been made in these areas in at least a dozen countries in the region (IDB, 1996, Part II, Ch. 4).

Superintendencies have often cited budgetary restrictions as the cause for not opening special MFI windows (and for also refusing to supervise any or many credit unions). This argument is not justified. As Christen and Rosenberg (2000) note, even if MFIs paid the full cost of their supervision, they would have to add only about three or four percentage points to their loan rates to cover these costs. Given the already high spreads MFIs charge, another three or four percentage points are not likely to be critical to either microenterprise loan demand or to microentrepreneur income levels. This means that superintendencies would not have to cross-subsidize MFI supervision; they could dedicate every peso collected from banks to bank supervision and rely exclusively on MFI supervision fees to pay for MFI supervision. This opens up the benefits of supervision to the MFIs without taking any resources away from the clearly central task of protecting the integrity of the banking and payments systems. We conclude that MFI windows merit an especially close look in Latin America, particularly in those countries meeting the two preconditions given above.

Credit Union Restrictions

We now turn to the issue of imposing minimum capital requirements on credit unions and restricting deposit mobilization for those credit unions that do not meet these requirements. For example, in Bolivia, only credit unions with capital of about US$ 200,000 or more are eligible to be supervised by the bank superintendency and thus to mobilize deposits. The remaining, unregulated credit unions are permitted to accept only share certificates, which are redeemable only when a member leaves the credit union. Share certificates do not offer liquidity, a key feature of deposit accounts.

Bolivia's arrangement is far from ideal. Credit unions in Bolivia, as in much of Latin America, provide financial services to many people who otherwise would lack access. UNDESCOOP, a provider of technical assistance services to credit unions in Bolivia, has estimated that unregulated credit unions are present in approximately 180 of Bolivia's 311 *municipios* (a territorial division somewhat akin to a U.S. county). Of these 180 *municipios*, 90 would be without the services of any financial institution if it were not for the presence of an unregulated credit union. UNDESCOOP has also estimated that while some unregulated credit unions will merge and become regulated entities if the law is enforced and unregulated credit unions are barred from taking deposits, a great many of the unregulated credit unions will simply close down or will be greatly reduced in size and scope owing to the loss of deposit accounts.[18]

Two better solutions to the problem of how to deal with credit union deposit-taking both involve allowing all credit unions to continue to take deposits. These solutions recognize the fact that credit unions are often the only institutions in an area providing financial services, particularly in rural areas, where so many Latin American credit unions operate. The development challenge in Latin America is to increase financial system depth by extending the reach of financial institutions to unserved and underserved populations, and thus to reap the resulting economic growth and equity benefits. A strategy that restricts and closes credit unions, which are one of the major types of financial institutions serving these unserved and underserved populations, goes in the wrong direction, and so appears to be far from the ideal solution.

[18] Personal communication from Jorge Vargas Ortega, the general manager of UNDESCOOP. Westley and Branch (2000, Overview ch.) discuss the many obstacles to credit union mergers, and therefore, why the scenario described in the text would be likely to occur. One important obstacle to mergers is the fact that each credit union has a relatively large number of owners. This makes a merger much more difficult than in the case of corporations, where a majority of the shares often belongs to a small number of shareholders.

As will be discussed at greater length in the next section, on supervision, the first best strategy for dealing with the deposit-taking activities of credit unions is for a government entity, such as the banking superintendency, to supervise all but the very smallest credit unions (i.e., all credit unions with more than 50-200 members, say), providing that this government entity is capable and willing to supply good quality supervision services to the credit unions.

As with the MFIs, budgetary constraints should not stand in the way of this strategy. The credit unions generally can and should pay the full cost of their supervision, so that the superintendency would not have to divert resources from the important task of bank supervision. It would be in the credit unions' long-run interest to pay even the full cost of good quality supervision given the benefits conferred by such oversight. Credit unions could often pass the added costs on in the form of higher loan rates, particularly since they typically charge the same or less for their small loans than do the banks for their much larger loans. Moreover, many credit unions are located in rural areas, where they often have captive markets and substantial discretion to increase loan rates. In any case, good supervision may result in credit unions making significant efficiency gains, which may obviate the need for any loan rate increases at all. In addition, good supervision helps credit unions to become safer, more stable financial institutions. This, in turn, attracts deposits, thus providing additional resources for growth, service expansion, and further cost reductions through scale economies.

The second best strategy for dealing with the deposit-taking activities of credit unions would be for the superintendency to supervise only a much smaller set of the largest credit unions, for example, those with more than US$ 200,000 in capital (the present arrangement in Bolivia). The superintendency would delegate supervision of credit unions falling below the size cutoff to an oversight body that is *independent of the credit unions*. If the superintendency is unwilling or incapable of providing good quality supervision to even the largest credit unions, then the independent oversight entity would supervise all of the credit unions. The next section, on supervision, describes this strategy further.

Under both strategies, no minimum capital requirement is imposed. And, in both cases, the very smallest credit unions (those with less than approximately 50-200 members) would not be supervised. Rather, they would be treated essentially as ROSCAs or private savings clubs, which are small enough for the members to know each other very well. Because there is little desirability in restricting or controlling activities that are, for all practical purposes, informal finance, the very small credit unions would not be supervised.

Capital Adequacy

For several important reasons, the minimum ratio of capital to risk-weighted assets required of credit unions and MFIs (their capital adequacy ratios) should be higher than the capital adequacy ratio required of commercial banks. Yet, in Peru for example, the same ratio is required of all financial intermediaries, including all banks, regulated MFIs, and credit unions. In Bolivia, the same ratio is applied to all banks and regulated MFIs and to some credit unions. The same ratio is also applied to all banks and regulated credit unions in Argentina, Costa Rica, Ecuador, and Uruguay.

There are at least three reasons why MFIs and credit unions should be required to maintain higher capital adequacy ratios than banks. These have to do with governance, diversification, and earnings volatility.

Governance. In general, MFIs are largely owned by development organizations (especially donor and government agencies) and NGOs. For-profit private investors account for little or none of the capital base of most MFIs. In credit unions, each member has one vote regardless of his/her share capital holdings. Therefore, in contrast to banks, both MFIs and credit unions lack profit-driven investors on their boards of directors who: a) are willing and able to respond promptly to capital calls in order to replace lost capital and stave off bankruptcy; and b) scrutinize management closely to be sure it operates as efficiently and profitably as possible (staying within a given level of risk tolerance), and thus maintains a level of financial performance that is as consistently solid as possible.

Diversification. Most credit unions and MFIs consist of one or a handful of offices located in a very limited geographic region. Therefore, they are geographically very undiversified in their loan portfolio and, in the case of credit unions, in their funding sources, which consist largely of local deposits. If an adverse local event occurs, these undiversified credit unions and MFIs may sustain grave financial damage. In contrast, banks are much more often regional or national in scope and consequently more able to withstand local shocks.

Earnings Volatility. This factor applies more to MFIs than to credit unions because MFIs much more consistently employ a lending technology in which administrative costs are a high percentage of loan amounts (say, 20 percent or more), whereas credit unions employ a lending technology much more like that of commercial banks. A significant part of the MFIs' large administrative cost outlays occurs during the early part of the loan cycle, especially for new client recruitment and loan analysis. If a substantial share of an MFI's loan portfolio goes into default, the MFI's earnings can be very gravely affected since the MFI does not receive the high interest rate charges that are meant to compensate for the high administrative costs. In contrast, commercial banks have much smaller administrative costs associated with their lending, often under five percent of the amount lent. If their default rate increases suddenly for whatever reason, their earnings are not reduced by nearly as much as for MFIs. This difference is magnified further by the fact that the bank typically can recover more of its loan losses by selling pledged collateral than can the MFI, since the MFI relies far more on character and cash flow information than on physical collateral (Box 2). Because large negative earnings can quickly decapitalize a financial institution, MFIs need to maintain a thicker capital cushion than banks in order to reduce their probability of bankruptcy to a similar (hopefully low) level.

To compensate for these three disadvantages, the capital adequacy ratios of MFIs and credit unions should be higher than for banks. The capital adequacy regulations noted earlier for Peru, Bolivia, Argentina, Costa Rica, Ecuador, and Uruguay may be seen as well-intentioned attempts to not penalize MFIs and credit unions by requiring of them higher capital adequacy ratios than are required of banks. In fact, however, these regulations are misguided because the MFIs and credit unions need the additional capital to protect themselves from the otherwise greater likelihood of insolvency.[19]

It is also possible to err in the other direction and demand much too high a capital adequacy ratio for MFIs and credit unions, overly suppressing their intermediation activities. Argentina has a risk-weighted capital adequacy standard that places a particularly onerous burden on microlenders. The risk weights used for determining capital adequacy are given in a schedule that goes as high as seven for very high interest rate loans, implying required capital of 80.5 percent of loan amount (seven times the basic 11.5 percent requirement). The rationale for such high risk weights is the assumption that high interest rate loans are risky loans. This assumption misses the mark in the case of microfinance, where high loan rates are generally the result of high administrative costs, not necessarily of high risk.

Finally, we turn to a capital adequacy practice for credit unions that is of questionable merit. Both Bolivia and Colombia permit larger credit unions to have much lower capital adequacy ratios than

[19] It is not enough, as some have argued, simply to require that MFIs and credit unions strongly provision against loan losses. If there is a large negative shock and many borrowers are forced into delinquency and then into default, the resulting provisions (and subsequent losses) may render the MFI or credit union insolvent. What is needed is a thicker cushion of capital before the onset of the shock, so that the MFI or credit union can absorb the resulting losses without becoming bankrupted and thus defaulting on depositors and other creditors.

smaller credit unions, on the premise that larger credit unions are safer than smaller ones. In Bolivia, the capital adequacy ratios vary in steps from 20 percent for the smallest supervised credit unions down to 10 percent for the largest ones. In Colombia, the range is even wider, from 30 percent down to nine percent.

To at least some of those who have worked extensively with credit unions, these differentials make little sense (e.g., see Richardson, 2000). In Latin America, one finds many small, well-managed credit unions and many large credit unions that are financial disasters, as well as the reverse. If there is any size versus safety pattern at all, it may well be the opposite of that implicit in the Bolivian and Colombian regulations. The reason for this is that as credit unions become larger, some outgrow the capacity of their member-based boards or their managers to administer them effectively. Recent empirical evidence from Colombia and Peru supports the proposition that larger credit unions are not necessarily safer (IDB, 2001). In both countries, no relation was found between credit union size (measured by total assets and by net worth) and credit union safety or quality (measured by a composite CAMEL type of rating and also by key single indicators such those measuring profitability, portfolio quality, and efficiency).

Loan Documentation and Provisioning

Bank superintendencies throughout Latin America typically require that regulated banking institutions gather extensive documented information in the course of granting each loan, in order to help the lender and regulator assess loan risk. Among the standard requirements for business loans are the past three to five years of balance sheets and income statements, documents establishing the value of physical assets owned, and information on existing liens. As explained in Box 2, individual microenterprise loans are normally extended on the basis of a current cash flow analysis of the combined household and business and a character assessment of the borrower. Group loans are extended on the basis of group guarantees and screening. Superintendencies that do not tailor reporting requirements to fit the nature of the lending methodology being used to make microloans, as some in the region do not, but instead insist on the presence of balance sheets, income statements, duly registered physical collateral, and other information where it is largely irrelevant, drive up the already-high administrative costs of making these loans (see IDB, 2001).

Traditional bank lending is collateral intensive and microlending is information intensive, yet both systems are capable of producing very high rates of repayment. Accordingly, 100 percent specific loan provisions for any non-collateralized loans whose repayment is overdue by even a single day, or general provisioning of 20 percent for all non-collateralized loans (late or not) vs. 1 to 3 percent for collateralized loans, would seem to inflict unduly harsh penalties on microlenders that have sufficient management quality to be supervised. Yet these regulations have been employed in several Latin American countries.

External Credit Limits

For credit unions, the amount of borrowing from noncommercial sources (in particular, from donors and governments) should be strictly limited in order to avoid situations in which these intermediaries are used as conduits for targeted credit programs, such as the agricultural credit programs of the past or the microenterprise credit programs of today. Reliance on such external funding sources has many deleterious effects, discussed in detail in Westley and Branch (2000, pp. 6-7), among which are the following. First, external credit tends to displace deposit mobilization, which is an important financial service in its own right. Second, it builds an unhealthy reliance on external donor or government programs that may one day be scaled back or eliminated. Third, reliance on external credit also builds expertise and a culture within credit unions of courting donors rather than providing good service to depositors, thus undercutting efficient, client-oriented credit union management. Finally, external borrowing unbalances the natural equilibrium in credit unions between net depositors and net borrowers, often leading credit unions to become borrower dominated. Such credit unions tend to offer low loan and deposit rates and to be weak on enforcing loan recovery and maintaining prudential controls, as has been seen in so many credit unions in Latin America that received donor and government funding in the 1970s and 1980s.

Most countries in Latin America do not regulate the level of credit union external debt. An exception is Bolivia, which restricts credit union borrowing from the government to one-third of total assets. This regulation is a good start but should be broadened to cover all debt from either government or donors. In light of the many pernicious effects of external credit, even lower limits are advisable on prudential grounds, perhaps of around 10 percent of total assets.

While it is inappropriate to impose external credit limits on non-deposit taking MFIs (which depend on external grants and loans for their funding), such limits may be useful and important for deposit-taking MFIs. As for credit unions, these external credit limits may help to strengthen the provision of deposit services, build self-reliance and a culture of service to clients instead of to donors and governments, and create a constituency of clients (namely, the depositors) interested in the maintenance of careful prudential management of the MFI. Tucker (1999) and Portocarrero and Nunura (1999) find that the Peruvian rural banks (the *cajas rurales)* receive over half of their total liabilities from government credit programs and that this is one of the major factors contributing to their weakness.

Governance Regulations

Bolivia has adopted a particularly extensive and well-conceived set of regulations meant to improve credit union governance. Moreover, in order to assist credit unions in bringing their bylaws into compliance with these regulations, the Bolivian superintendency has issued model bylaws that the credit unions may adopt wholesale or use as a guide to modify their existing bylaws. These regulations and bylaws are an excellent model for adaptation by other countries that regulate credit unions.[20] They may also serve as a good starting point for creating a similar set of governance regulations for MFIs. Such MFI governance regulations need to address many of the same problems addressed by credit union regulations. They could also address the special MFI problem of encouraging the transition from institutional ownership to ownership by private, for-profit investors.[21]

Among the major provisions of the Bolivian credit union governance regulations are those that define the principal functions of the board of directors—as distinct from the functions of management—and the numbers, qualification and disqualification criteria, and liability of credit union board members. The regulations define the functions and authority of the supervision committee—as the internal controller of the credit union with oversight over all credit union operations including those of the board of directors and management—as well as the liability of the supervision committee members. The Bolivian regulations mandate that credit unions have an internal auditor and that the auditor should be free to carry out his or her work fully and without restrictions. Loans to directors, senior management, and their families are prohibited. The Bolivian governance regulations put into practice many of the suggestions that Branch and Baker (2000) make in discussing governance problems and help the superintendency to prevent and control many types of credit union mismanagement problems.

Operational Restrictions

As noted in Jansson and Wenner (1997) and IDB (2001), many Latin American countries place minimum and sometimes maximum limits on the

[20] For more details on the Bolivian governance regulations, see Westley and Branch (2000, Chs. 8 and 11).

[21] One way this transition could be encouraged is by relaxing the minimum required capital adequacy ratio for MFIs that are majority owned by private, for-profit investors vis-a-vis those MFIs that are not. Even this relaxed ratio should still be higher than that applied to commercial banks given the greater earnings volatility and the generally lower levels of diversification of MFIs vis-a-vis banks.

number of hours per day and days per week that branches of regulated financial institutions can operate, usually mandating at least five days per week and five to eight hours per day. This may pose a particular problem for credit unions and MFIs, which may wish to open branches in rural or marginal urban areas where demand is not sufficient to justify such lengthy hours. Banco Sol in Bolivia, for example, has complained of this problem, having wanted to open branches in some areas for only two days per week.

Improving Prudential Supervision of Credit Unions and MFIs

If credit unions and MFIs are to have a long-term future as sound financial intermediaries, they almost certainly will have to be supervised. This is true for three reasons. First, prudential supervision helps financial institutions stay on the straight and narrow path of maintaining financial discipline and prudent management, something that so many unregulated Latin American credit unions and MFIs still have trouble doing today. Second, in the case of the MFIs, it opens the door for mobilization of deposits, a service that clients value highly, and one that allows MFIs to greatly leverage their capital base and expand their lending operations. Third, prudential supervision of deposit-taking institutions is important in order to protect and retain the confidence of the large number of small depositors who do not have the information or capacity to monitor the level of risk taken on by the financial institutions to which they have entrusted their savings.

Even though prudential supervision is important for protecting depositors and for the other reasons stated above, many superintendencies in Latin America have been unwilling to supervise any credit unions, much less all of them.[22] This is a clear defect in the region's prudential supervision systems, which leaves millions of depositors relatively unprotected and thousands of credit unions without much needed external discipline. Credit union federations in several Latin American countries have tried to fill this gap at least partly by attempting to supervise some or all of the credit unions that are federation members. This type of supervision has serious defects and can be improved upon by using one of two alternative systems described below. As will also be shown, there is some question about whether the banking superintendency is always the ideal body to supervise either the credit unions or the MFIs, even in cases where it has assumed these responsibilities. These issues are discussed in the first subsection below.

Just as credit unions and MFIs need to be regulated differently from banks, so they also need to be supervised differently. A number of these special supervisory considerations are discussed in the second subsection below.

Who Should Supervise MFIs and Credit Unions?

Until recently, there has been widespread agreement that if the government is to supervise MFIs and credit unions directly, the responsibility should be given to the existing bank superintendency—assuming that it has displayed reasonable competency in supervising banking institutions—rather than creating a separate MFI or credit union supervisory agency. Creating a new agency would be costly and inefficient in view of the substantial expenditures that would have to be duplicated in state-of-the-art information systems and specialized personnel. Keeping banking, MFI, and credit union supervision together in one institution would also facilitate a consistent regulatory approach to and treatment of different types of supervised financial institutions, and help avoid giving one institution an unfair advantage over another.

Despite these powerful arguments, some have begun to question the wisdom of entrusting the bank superintendency with the supervision of MFIs and credit unions, particularly when MFIs and credit unions represent only a small share of the financial system, as they do in most Latin American countries.[23] This is because the foremost responsibility

[22] Arzbach and Duran (2000) review the extent of credit union supervision in 16 Latin American countries.

[23] Credit unions lend substantially more than MFIs (Table 4), and yet credit unions typically account for only

of the bank superintendent is to protect the integrity of the overall banking and payments systems, as it rightly should be. This means, however, that when banks get into trouble, inspectors and analysts may be taken away from their normal MFI and credit union supervision duties and assigned to the banking sector. They may be redeployed for extended periods of time to watch over either the troubled banks or the rest of the banking system in order to make sure that problems do not spread. Meanwhile, MFI and credit union supervision is likely to suffer.

For example, during Peru's 1998-99 economic downturn, the bank superintendency closed two troubled banks, merged one, and watched carefully over a number of others that were weakened. To accomplish all this, MFI inspectors and analysts were assigned to the banking system.[24] As a result, numerous MFIs had to wait two to three years for their annual inspection visit and the analysis based upon it.

If it turns out that as a result of banking system problems, MFIs and credit unions receive little or no effective supervision from bank superintendencies during substantial periods of time, the conventional wisdom concerning the superiority of this supervisory arrangement may have to be reconsidered. The question would then become, who should supervise the MFIs and credit unions instead? We examine this first for the credit unions, and then return to the MFIs.

In some Latin American countries, such as Peru and Mexico, credit union supervision is delegated, typically to the credit union federation. The superintendency often retains the right to oversee the supervision process and to impose sanctions on credit unions that violate the regulations—powers it retains, for example, in both Peru and Mexico.

one to three percent of financial system lending in most Latin American countries (Figure 1, below). Credit unions and MFIs account for similarly small shares of financial system deposits and assets.

[24] Since credit union supervision is delegated to the credit union federation, these resources could not be similarly diverted.

A common argument made for delegating credit union supervision is that the bank superintendency does not have the resources needed to supervise so many additional financial institutions. The difficulty with delegating supervision, however, is that credit union federations typically have even less access to resources than do bank superintendencies. Hence, delegated supervision merely passes the buck. It does not solve the basic problem of ensuring that there are enough resources to provide good quality supervision; in fact, it may well exacerbate this problem.[25] A better solution to the resource problem is to give whomever supervises the credit unions the authority to charge the credit unions the full cost of their own supervision. As argued in the previous section, it is likely to be in the long-run interests of the credit unions to pay even this much, providing that the supervision is of good quality.

An even more fundamental flaw of the delegated supervision model is that it suffers from a severe conflict-of-interest problem. This problem stems from the fact that the federation is being asked to play two roles at once. In addition to its normal role as promoter of (and lobbyist for) credit unions, it is also being asked to serve as the regulator of credit unions. Since the credit unions own the federation, and credit union representatives comprise the federation's board of directors, the federation is likely to find it difficult to sanction and close down its credit union owners. This will be especially true when the larger and more powerful credit unions are the ones requiring such remedial actions.

A recent example of this problem is Costa Rica, where, in the mid to late 1990s, credit union supervision was delegated to Audicoop, an auditing and supervision cooperative owned by the credit unions. Audicoop boasted a competent professional staff that did good technical supervisory

[25] For example, the Peruvian credit union federation, FENACREP, collects enough revenue from its supervision fees to inspect only about 40 of its 130 member credit unions each year. It remains to be seen how Mexico will fare on this issue with its recently created system of delegated credit union supervision.

work. However, Audicoop's board of directors consisted of representatives of the supervised credit unions. As a result, the technical staff's recommendations for remediation and sanctions were consistently overturned by Audicoop's board of directors. Board members did not want to punish their own credit unions or those of their friends. Because of the ineffectiveness of the delegated supervision system, the Costa Rican superintendency discontinued it in 1998.

At best, delegated supervision systems are likely to work episodically: badly during some periods of time, somewhat better during other periods of time. Peru provides an example of this. At the time of this writing, the credit union federation there has a strong leader, who was formerly a deputy minister in the Peruvian government. In his role as credit union supervisor, he has successfully enforced the credit union regulations, and even closed down several mid-sized credit unions. However, he is unsure about whether even he could close down some of the larger credit unions were it necessary to do so. And he is also unsure about what will happen after he is gone. If he is succeeded by a weaker leader, credit union supervision in Peru may well go the way of Costa Rica. I conclude that delegating supervision to the credit union federation is an inherently weak model, whose weaknesses may be overcome from time to time by a leader strong enough to resist his own board of directors.

Three Models

This section describes three supervisory arrangements that I believe are improvements over the badly-flawed model of delegated supervision. While these are described in terms of credit unions, each could work for MFIs as well. The three are given in declining order of what I believe will work well in Latin America.

The first choice remains direct supervision by the public sector, for two reasons. First, the protection of thousands of small depositors is essentially a public sector function. Second, a public agency does not suffer from the federation's conflict of interest problem. For the efficiency and consistency reasons described earlier, the supervision of credit unions would typically be handled by the bank superintendency, provided that it is able to do a good job of enforcing the credit union regulations (that is, provided it is not corrupt, incompetent, or overwhelmed by other responsibilities, for example) and that it is willing to do so as well. These conditions for the bank superintendency to be the first choice as credit union supervisor include the condition that credit union supervision resources are not drained for too long a period of time in response to banking system problems, as discussed earlier. If any of these conditions are not met by the bank superintendency, it may be best to create another public sector entity to undertake credit union supervision despite the inefficiencies and inconsistencies that this may create. For example, in the U.S., separate government agencies supervise banks and credit unions.

The second best system for credit union supervision is for the government to delegate supervision to a private supervisory entity that is *independent* of the credit unions. The credit unions would have no, or at most one, representative on the board of directors of such an entity (out of a total of five or more board members). The board of directors would consist of people such as representatives of the bank superintendency and finance ministry, and might also include eminent people in finance from the country's private sector or universities. Such a system is under consideration in Bolivia (for the credit unions that are not regulated by the bank superintendency) and in Panama. The Guatemalan credit unions, which are not supervised, have created a private rating agency whose board is structured along these lines. The idea in Guatemala is to provide credit union ratings that are impartial and uncontaminated by self-dealing, an objective that mirrors the goal here of providing impartial supervision.

The third best alternative is to adopt the German model of delegating supervision to two or more regional credit union supervision federations.[26] The

[26] The Germans call these, "regional auditing federations." But the word "auditing" is used very broadly and includes all of the activities typically carried out by

board of directors of each regional federation consists of representatives of that region's credit unions. The advantage of having at least two such federations is that, following the German model, regional federation A never supervises the credit unions of federation A's board members. Rather, federation B does that. Three other factors or principles explain the success of the German model in Germany, and these should be adopted insofar as possible in Latin America by countries attempting to use this system there. First, the boards of directors of the regional federations are highly professionalized. Members often remain on these boards for a very long time, with ties to their original credit unions eroding quickly over time in an atmosphere that fosters professionalism in supervision. Second, the regional federations do only supervision. They perform no promotional or lobbying functions; these functions are carried out by separate organizations (DGRV and BVR). Third, it is likely that Germany brings more discipline to the task of making such a supervision system work than will most countries in Latin America.

Two final points should be made about supervision. First, in the last two models (of delegated supervision), the bank superintendency should closely oversee the supervision process in order to ensure that it is being carried out competently and without bias. For the same reason, the bank superintendency should also retain the power to sanction the credit unions and the entity to which it has delegated supervision.

Second, in none of the three supervision models is it appropriate to introduce safety net elements such as deposit insurance or a stabilization fund until a track record of good supervisory control has been established.[27] Otherwise, oversight by credit union members is relaxed before it has been adequately replaced by external oversight, introducing potentially very severe problems of moral hazard. That is, many credit unions may be tempted to operate in an overly risky fashion, reasoning that there is great upside potential to the risks they are taking, while the downside potential is now limited by the safety net. These actions could have the most serious repercussions for the financial stability of the overall credit union system. Two cases that merit attention in this area are Colombia and Mexico. Both have recently decided to include credit unions in a deposit insurance scheme. It remains to be seen if adequate supervisory control is first established. Mexico is an especially worrisome case in this regard because it is relying on a system of delegated supervision, which we have argued is, at best, effective episodically. Yet, the deposit insurance scheme is meant to be offered permanently.

How Should MFI and Credit Union Supervision Differ from Bank Supervision?

Providing good supervision for MFIs and credit unions requires that superintendencies (and other supervisory entities) modify the methods that have traditionally been used for commercial bank supervision in a number of key areas. Given the recency of MFI and credit union supervision in most Latin American countries, this adaptive process is still in its early stages. Supervision modifications for MFIs and credit unions are discussed separately because the required adaptations are generally quite different for the two types of institutions.

MFI Supervision[28]

This subsection discusses the areas in which there are important differences between best practice MFI supervision and best practice bank supervision: portfolio quality assessment; systems, policies, and procedures; loan technology; loan tracking systems; MIS reports and follow-up; early warning indicators; fraud control systems; loan size limits; and liquidity risks.

An important traditional method used for assessing bank portfolio quality, namely, the desk analysis of a limited number of loans, does not work well for microfinance. Bank supervisors can examine the

financial institution supervisors.

[27] A stabilization fund collects regular contributions from all participating credit unions and uses these funds to shore up ailing credit unions, hopefully before these credit unions slide irreversibly into insolvency.

[28] This subsection draws significantly on CGAP (1998).

loan files of many or all of a bank's largest 300 borrowers and from this analysis can often assess the quality of a substantial share of the bank's assets. In contrast, MFI portfolios typically consist of thousands or even tens of thousands of tiny loans. An analysis of any reasonable number of these loans does not generally provide coverage of a very high percentage of the MFI's assets. Further, bank supervisors can peruse a bank's individual loan files for financial statements, project and market analyses, and assessments of the value of pledged collateral. In contrast, MFI loan files generally provide none of this information since MFI loans are extended on the basis of either a character and simple cash flow analysis or else group guarantees (Box 2). This makes it very difficult to assess the merit of microlending decisions from a desk analysis of loan file information.

Given the difficulties of directly analyzing a large share of the loan portfolio, MFI supervision needs to focus on verifying the existence of adequate systems, policies, and procedures, particularly with regard to the loan portfolio, which comprises the bulk of most MFIs' assets. The remainder of this subsection considers some of the key systems, policies, and procedures that need to be analyzed.

First and foremost, supervisors must fully understand all aspects of the credit technology used by best-practice MFIs (Box 2). Only in this way can they make an informed judgment about whether the MFIs they are supervising are effectively controlling risks and costs, particularly in the critical analysis and collection phases of the loan cycle.

The loan tracking system is a key piece of an MFI's management information system (MIS). Supervisors must make sure that the loan tracking system properly reflects loans disbursed, payments received, and the delinquency status of all outstanding credits. Supervisors should take a significantly-sized stratified random sample of loans—stratified by branch office, loan officer, refinancing status, and any other important criteria—to check the tracking system against the ledger accounts and also to see where loan quality problems are arising. Field visits to a subsample of the individual borrowers should be made in order to check on the realism of the loan quality data being reported by the MFI.

MFI supervisors must verify whether the MIS produces timely reports for management in intelligible form and whether management then acts on these reports expeditiously. A good example of this is in the area of delinquency control. An axiom of microfinance is that delinquency must be maintained at reasonably low levels if the MFI is to be successful. The MIS of good MFIs produces reports of all delinquent loans in each loan officer's portfolio on the first day of loan delinquency. An increasingly severe range of actions should then take place starting within a day or two, beginning with the loan officer contacting the delinquent borrower, up through demand letters, and finally ending with legal action (with the last coming as quickly as within 30 days for some best-practice MFIs). The very existence of this series of predictable enforcement actions by itself helps to keep delinquency rates down.

A related issue is the rapidity with which MFI delinquency rates can deteriorate due to lax management combined with a portfolio of short-term, uncollateralized loans. Because of this problem, supervisors need to be sure that MFIs generate and utilize a system of early warning indicators. This system might look for such things as high levels of management or staff turnover, deposit rates that are substantially above the market, unusually rapid increases in loan volume, and changes in other variables that may be useful in predicting future problems, according to experience and analysis. MFI supervisors should also examine how management reacts when its early warning system indicates that there may be difficulties ahead.

Supervisors must assess the adequacy of MFI fraud control systems. Most MFI fraud is not at the treasury or other level that leaves a paper trail, in contrast to most cases of bank fraud (which typically do leave a paper trail of loans that were not duly recorded, properly signed off on, etc.). Rather, MFI fraud occurs at a level before any data are entered into the management information system.

Common fraud problems in MFIs include phantom loans (loans to nonexistent or front businesses), kickbacks to loan officers for easy treatment of loan delinquency, and nonreporting by loan officers of their clients' payments. MFIs are particularly prone to these problems given the perforce decentralized nature of their operations, with loan officers responsible for efficiently screening and administering large numbers of small loans simultaneously.

Effective fraud control systems include the following. To catch phantom loans and kickbacks, a person or unit in the MFI (ideally with loan officer or collection experience) visits all seriously delinquent clients and makes unannounced visits to a certain share of all other loan clients. To catch underreporting of the day's collections by loan officers, a loan officer's supervisor compares loan collections estimated at the beginning of each day with actual collections at the end of the day. The supervisor visits any loan accounts that cause discrepancies.

Another special MFI problem that supervisors must be vigilant about occurs when MFIs move into loan sizes above the limits of their loan methodology. The MFI may be able to handle loans in the $100 to $2500 range with the usual microfinance loan technology. Experience has shown, however, that if the MFI starts to make loans to larger firms for $10,000 to $20,000 or more, particularly to first time borrowers, it may well run into trouble. This is because such loans require a more profound cash flow and financial analysis of the firm and of the firm's collateral. The supervisor must assess whether the MFI is exceeding its own capacity for loan appraisal in this way.

Finally, supervisors must be aware that liquidity risks pose particular dangers for MFIs. This is because of the nature of their lending technology, which motivates repayment today with the promise of increasing loan sizes tomorrow. If clients get wind of a liquidity crunch that impairs the ability of the MFI to make further loans, word will spread quickly, and repayment of existing loans will often drop precipitously. Supervisors must take special care to check whether there is a sufficient liquidity cushion to cover likely contingencies and avoid this problem.

Credit Union Supervision

This section discusses the areas in which best practice credit union supervision departs significantly from best practice bank supervision: external credit, borrower domination, volunteer credit committees, fixed assets, and the low salary problem.

The preceding section, on regulation, has already enumerated many of the ill effects associated with credit union borrowing from noncommercial sources such as donors and government. Supervisors must be keenly aware of this issue, both to enforce any current regulation that limits such external borrowing and to be watchful for the ill effects caused by weak or nonexistent regulations in this area, either present or past.

One of the legacies of the extensive external borrowing that credit unions undertook in the 1970s and 1980s is the fact that so many of these institutions are still borrower dominated today. These credit unions are typically controlled by those desiring low interest rate loans and normally do little or no analysis of their loan applicants' ability or willingness to repay. These credit unions are generally weak on loan recovery and often have very high delinquency rates (the extent of which is sometimes hidden by accounting tricks such as only counting the missed payments, rather than the entire loan balance, as overdue). Loan provisioning is typically inadequate. As a result of their low loan rates, the interest rates that these credit unions can afford to offer depositors is generally low as well. This means that few serious depositors join these credit unions, at least if they have a bank or other reasonable alternative place to save. Because of their anemic deposit mobilization, such credit unions are chronically short of loanable funds. They often ration what funds they have by queuing applicants and lending a maximum of only a fairly low multiple of a member's contributed share capital (three times shares is a common loan limit).

This loan rationing sometimes leads to favoritism, with credit union directors and managers and their families and friends obtaining favored treatment (earlier consideration of loan applications, larger loan amounts, etc.).

Supervisory bodies that face borrower dominated credit unions need to take and oversee actions on a number of interrelated fronts, including the following. First, supervisors should limit external credit in whatever way they can: by enforcing any existing regulations and, if necessary, through other forms of supervisory persuasion (holding up branching requests, etc.). Second, delinquency rates and other credit quality indicators should be carefully checked and recalculated as necessary to conform to accepted standards; adequate loan loss provisions should also be made. Third, proper loan analysis and loan recovery programs should be put into place. Fourth, credit manuals and procedures should be modified so that different types of loans (e.g., business, consumer, and home mortgage) are analyzed differently, rather than using only one standard loan form and methodology to analyze all loan types. Fifth, borrower dominated credit unions should be strongly encouraged to raise the interest rates offered on their deposits in order to attract serious savers. This will give these credit unions new funding sources from which to expand lending, eliminate loan rationing, and begin to offer new products of interest to their members, while simultaneously beginning to counterbalance the domination of their membership and board of directors by borrowers. Sixth, borrowing rates should be increased so that the credit union earns a profit. Most or all of these profits should be capitalized (rather than distributed to members) since credit unions typically have a very small cushion of institutional capital to protect member savings and shares and to serve as a funding source for future growth.

Supervisors must ensure that volunteer credit committees (composed of credit union members) play an appropriate role. In small credit unions, volunteer credit committees often do a good job of deciding on loan applications. This is because the credit committee members together often possess better information on the riskiness of their fellow borrowing members than a loan officer ever could. However, as credit unions grow toward several thousand members, credit committee volunteers cannot personally know all of the loan applicants. Further, it becomes impractical for the credit committee to approve all loans, given the large number of these operations. In any event, credit committee members do not possess the specialized risk analysis skills that are needed when detailed personal knowledge is no longer available. Therefore, as credit unions grow in size, volunteer credit committees should be disbanded or should assume the role of randomly reviewing whether loans comply with the credit union's policies and procedures. In place of the volunteer committee, loan decisions should be made by a technical committee composed of loan officers and credit managers.

Supervisors need to discourage or prevent credit unions from spending either too little or too much on fixed assets. Sometimes as a consequence of borrower domination (and the meager income flows that result), credit unions do not have enough resources to bring their physical appearance—premises, furniture, etc.—up to a reasonable standard. In other instances, adequate resources may exist but are not being allocated to this purpose. A shabby and unprofessional appearance discourages savers and stunts expansion, and thus can be quite damaging to the financial health of a credit union. At the other extreme, some credit union directors and managers spend lavishly on unproductive, showy fixed assets in order to serve their social goals or desires for self-aggrandizement.[29] Both extremes are to be avoided and merit supervisory attention.

Finally, credit union supervisors must be cognizant of the low salary problem. This is a chronic problem for credit unions in many parts of Latin America, in which the salary levels of credit union officials are held down by a membership that compares its own income level to that of the credit union officials. Low credit union salaries relative to those paid elsewhere in the financial sector often result in low effort and morale, high personnel

[29] In some countries, such as Chile, there is a tradition of credit unions spending excessively on fixed assets.

turnover, and a general inability to recruit and retain high-quality staff. Credit union directors, managers, and members must be educated on the damaging effects that low salaries have on credit union performance, including poorer loan quality (from weaker loan screening and collection efforts) and lower productivity and profits.[30] And they must be strongly encouraged through the supervision process to change this practice, particularly when it is having very harmful effects.

Improving the Legal Framework for Secured Transactions and Modernizing Supporting Institutions

In most Latin American countries, poorly formulated laws and inadequate or nonexistent legal registries impede the use of both movable goods and real property as collateral to secure loans. While this is a general system failure that affects firms of all sizes, its greatest impact is likely to be on small firms, rather than on large firms or microenterprises, a point we shall develop in this section. We begin the discussion by examining the nature of the problem, which has three major components: the creation, perfection, and enforcement of security interests.[31]

The Creation of Security Interests

The laws of many Latin American countries stipulate that only certain specific goods or certain classes of goods, but not others, may be used as collateral. This is frequently very limiting, as the gaps are often quite substantial and generally without any modern rationale. Many countries in Latin America also do not allow for *continuing security interests*, so that if the pledged asset is sold, the creditors often cannot automatically attach the proceeds, as creditors can in the United States and Canada, for example. Another useful device that is frequently not available in Latin America is the *floating security interest*. In Uruguay, for example, if a bank lends $50,000 against 100 head of cattle it must identify a particular 100 head by tattoo or other means, which makes loan monitoring very expensive. By contrast, in the United States and Canada, a loan can be based on a floating security interest in "$50,000 in cattle."

The desired reforms in this area are that people should be permitted to enter into contracts in which they can pledge a wide variety of assets as collateral. Lenders should be able to establish and retain their claims in an efficient manner.

The Perfection of Security Interests

This can be very difficult in Latin America. To be sure that there are no prior superior claims on an asset pledged as collateral, lenders must be able to search for such claims in the legal registry. In Uruguay, for example, this is quite difficult because the lender must know the date of the prior pledge; one cannot search by the name of the borrower or by using a description of the pledged asset. This process is even more cumbersome in Bolivia, where claims are filed chronologically and one must look through the entire registry for prior pledges. Further complications arise when, as occurs with some prevalence in Latin America, one needs official permission to search a registry. This permission may be difficult to obtain, perhaps involving bribes, delays, and uncertainty of ultimate access.

The desired reform in this area is to create accurate registries that are accessible to the public and inexpensive to search. This will facilitate the credit extension process. Strengthening or privatizing public registries is one possibility, as is introducing competition among public registries or permitting private registries to compete with public ones.

The Enforcement of Security Interests

[30] Westley and Shaffer (1999) find that the impacts of low salaries on credit union delinquency rates and profits in a sample of 55 credit unions in Bolivia, Guatemala, and Honduras are statistically significant and quantitatively quite strong.

[31] See Fleisig, Aguilar, and de la Peña (1994) and Fleisig (1995a; 1995b) for additional discussion.

In Uruguay, it typically takes six months to two years to repossess and sell collateral. A lengthy legal process involving the courts is required, rather than a rapid administrative procedure outside the court system. Such delays, with their attendant risks and costs, are quite common in Latin America.

The desired reform in this area is to change the law to permit private parties to agree to rapid, nonjudicial enforcement of contracts.

What impacts do these deficiencies have on the economy? The slow enforcement of security interests is particularly detrimental to the use of movable property as collateral. During the lengthy period of time it takes the lender to repossess and sell the pledged equipment or inventory, machinery may be left to rust, grain to rot, or cattle to die or be slaughtered. Or any of the pledged assets may be sold or shipped out of the country. Since movable property constitutes more than one-third of Latin America's capital stock and annual fixed investment, this is obviously an issue of great importance. If firms cannot purchase movable property using credit, or can only do so at the high interest rates normally reserved for unsecured loans, then firms will economize more on capital because of its greater cost or the lack of financing. And if banking institutions are less involved in such lending, they will carry out less of the project screening, liquidity provision, and risk pooling that helps intermediation raise investment productivity levels and overall economic growth rates. Because of these effects, together with the higher user costs of *real property* (due to the significant costs and risks to the lender of perfecting and enforcing security interests even in those types of assets), both income per capita and its growth rate will be lower than in a system in which movable and real property can be used effectively and inexpensively to secure loans.

How are these income losses distributed? The negative impacts are likely to be greatest on small firms run by less wealthy individuals. Wealthier businessmen and larger businesses are more likely to have real property assets, while small firms may have only their inventory or perhaps some equipment to pledge as security for a loan. Since real property is much more likely to preserve its value during lengthy enforcement proceedings, wealthier real property owners are more likely to be able to get credit or get it at much lower rates than small firm owners with only movable property to offer as collateral.

The negative impacts of these failings in the system of secured transactions are likely to be the greatest for small businesses for another reason as well. Given the substantial and largely fixed costs associated with perfecting and enforcing security interests, the interest rates charged on small loans will have to be increased by a much greater amount than the interest rates charged on large loans in order to recover these costs.

These secured transactions problems are also likely to affect small enterprises more than microenterprises. This is because microenterprise loans are normally based on cash flow and character assessments or on group guarantees (Box 2). In contrast, small firm loans—typically in the range of US$ 15,000 and higher—are much more often secured using physical property because of the greater loan size. Nonetheless, the availability of microenterprise credit may also be negatively affected through the credit chain. Microentrepreneurs may be able to obtain credit from their suppliers and purchasers if these suppliers and purchasers can obtain credit from the banking system using as collateral the equipment or inputs they are selling to the microentrepreneurs or the goods they are buying (or holding in inventory that they have already bought) from the microentrepreneurs. If suppliers and purchasers cannot obtain bank credit because of faulty secured transactions laws and supporting institutions, then less trade credit is likely to be available to microenterprises.

To summarize, improving Latin America's framework for secured transactions and modernizing the supporting institutions would probably increase the incomes of firm owners across a broad spectrum of firm sizes, with perhaps the greatest impact on the income of small firm owners vis-a-vis that of large firm owners and microentrepreneurs. Nevertheless, low-income subgroups of microenterprise owners and smaller firm employees do stand to make significant income gains.

Recognizing the potential importance of these reforms, several countries in Latin America have recently examined the issue of overhauling their secured transactions laws, including Argentina, Bolivia, El Salvador, Honduras, Mexico, Nicaragua, Peru, and Uruguay. Bolivia and Mexico have recently passed reform bills in this area.

Reducing Informality

Regulated banking institutions typically lend only to officially sanctioned businesses, not to unregistered enterprises. This increases the cost of credit for unregistered businesses and diminishes their likelihood of being able to borrow.[32] This section shows that unregistered enterprises tend to be very small firms owned by lower-income individuals (Box 3). It discusses the potential for reducing income inequality by making more and lower-cost credit available to these enterprises by increasing their formality levels through reductions in the initial and recurrent costs of formality and through land titling programs. By registering themselves, these firms can also take advantage of numerous other benefits of formalization besides credit access, some of which are presented in Box 3.

The barriers to formality are of two types, initial and recurrent, and it is reasonable to consider reducing both of them. The initial costs of registration can be substantial. For example, de Soto (1989) found in an actual experiment that to set up a small garment factory in Lima took 10 months, involved 11 separate and time-consuming procedures with various ministries and other state institutions, and cost US$ 1232 in fees, bribes, and lost profits, which equaled nearly three years of wages at the minimum salary level. Tokman (1992) also finds high access costs to legality in other Latin American countries. The time to register a small firm in the group of Latin American countries he studied was 10 months on average, ranging from about one month in Bolivia, Brazil, and Chile to two years in Guatemala. By contrast, Chickering and Salahdine (1991) report that a similar procedure takes about three hours in Florida and four hours in New York.

Formidable as the initial costs of formality may be, the recurrent costs, which must be paid every year, are likely to be even greater. These include such things as payment of income, payroll, and other taxes, as well as minimum wages and mandated fringe benefits; constraints on and additional costs of dismissal; and compliance with government-imposed procedural and paperwork requirements. On this last point, de Soto (1989) surveyed 37 formal firms operating in sectors with high levels of informality and found that 40 percent of the working time of administrative personnel was spent complying with the government's bureaucratic procedures, a cost that seems clearly exorbitant. The question of whether state-imposed taxes and regulations make labor costs too high and dismissal restrictions too strict is discussed in IDB (1998, Ch. 6). It is argued that most countries in Latin America would be well-advised to reduce many of these barriers to formality as a way to increase formalization rates and extend labor code protections and benefits—as well as the other advantages of formality, including better access to capital—to a larger percentage of earners.

[32] See, for example, de Soto (1989), Loayza (1996), McPherson and Liedholm (1996), and Orlando (1998). As an example of the high cost of borrowing, de Soto (1989) notes that in Lima in 1985 the nominal borrowing rate for informal firms was 22 percent per month, versus 4.9 percent for formal firms of comparable size.

Box 3
Informal Enterprises

What are the characteristics of unregistered, or informal, enterprises? As discussed by numerous studies in this area, including those cited above, informal firms are:

- usually very small, in order to escape detection by the authorities and avoid potentially severe penalties in the form of fines or capital confiscation.
- often owned by those with lower educational levels, since the better educated are typically better able to navigate the bureaucratic obstacles to become registered. The better educated also tend to be more aware of and able to take advantage of some of the other, noncredit benefits of being formal such as government training and technical assistance programs, the ability to enter into and enforce legally binding contracts and obtain insurance, and the ability to bid on municipal procurement contracts.
- usually a much greater share of rural enterprises than of urban enterprises, which at least partly results from the fact that the former businesses are located much farther from administrative centers and thus are less likely to be caught and punished.
- often associated with home-based businesses, firms without a fixed location, and enterprises with very little capital because in each of these cases detection is more difficult. Informal firms also tend to maintain less capital in cases in which the penalty for detection includes capital confiscation.

These characteristics of informal firms (very small, rural, less human and physical capital, etc.) imply that, as a group, the owners of such firms will almost certainly have much lower incomes than the owners of formal firms.

What are the benefits to unregistered firms of formalization, beyond those noted in the second bullet above? Benefits include the fact that formal firms:

- may be able to obtain cost reductions by utilizing more capital equipment and operating in a single, fixed location.
- can avail themselves of the benefits of police and judicial system protection from crimes against their property.
- may pay much less in bribes to corrupt officials than do informal businesses. For example, de Soto (1989) found in Peru that the former pay an average of one percent of their gross income in bribes, versus 10 to 15 percent for the latter.
- may freely use advertising, an advantage whose significance is suggested by the fact that two-thirds of all small business customers in the U.S. are brought in by the signs displayed outside of shops and factories.
- may limit the personal liability of their owners through incorporation.

Land Titling

The discussion has thus far focused on the formalization of businesses through the lens of registration and subsequent compliance with tax, labor, and other codes. However, there is another sense in which reducing informality may increase the opportunities for low-income individuals to increase their earnings. Programs to regularize the land titles of small farmers and urban squatters may provide both groups with a potentially acceptable form of collateral and thus greater access to credit. De Soto (2000) discusses these and other benefits of properly titling real property and other assets.

Cross-Country Regression Evidence

Using a number of indicators, Loayza (1996) estimates the share of GDP produced by the informal (unregistered) sector in 14 Latin American countries in the early 1990s. He then employs these data along with several other standard variables to explain the growth rate of real per capita GDP in the 1980-92 period. He finds that the informality variable is always significant in his estimated growth equations, and consistently has a coefficient value of around -1.3, indicating that a completely informal economy would have a growth rate 1.3 percentage points below that of a completely formal one. The question then becomes, how are the income losses associated with greater informality distributed?

To attempt to answer this question, I employed Loayza's informality data to explain the average value of the Gini coefficients over the 1982-92 period for the same 14 Latin American countries. Although the data sample is quite limited, and it is generally very difficult to explain inequality in the Latin American cross-section alone, I do find greater informality to be significantly associated with greater inequality, as the preceding discussion has suggested.[33]

Credit Bureaus

Public credit bureaus typically gather together the credit histories of all banking system borrowers, or all such borrowers with loans above a certain size. They are generally established by banking superintendencies to be of assistance in the task of supervising financial intermediaries. Credit bureaus help to assure the safety and soundness of the banking system by giving supervisors a tool to detect borrowers that may not be overextended at any single financial institution but *have* overborrowed from the banking system as a whole or are engaged in other irregularities.[34] Superintendencies may permit individual financial institutions to utilize this credit history information by either directly accessing the superintendency's database (usually for a fee), or by selling the data to private credit bureaus which in turn market the information to the financial institutions.[35]

Since smaller businesses often possess little collateral with which to secure a loan, one of the few resources they may have to help them obtain credit is their history of repayment of past loans. By making this credit history information widely available, a credit reporting system lowers the risk of losing access to credit for smaller firm entrepreneurs who wish to be geographically mobile or must relocate for any reason. It also potentially permits smaller firms to lower their cost of credit since the intermediary from which they have borrowed no longer has an information monopoly about the smaller firm's willingness and ability to repay loans.[36] Finally, credit bureaus stimulate the flow of credit to smaller firms because lenders know that if these borrowers default the information will be made public, damaging the small firm's credit reputation. Seeing that they have this disciplining device, financial institutions will be more willing to make loans, particularly to smaller firms, which may have little of the usable collateral that larger firms can offer to help ensure loan repayment.

In view of the potential for both efficiency and distributional gains, the policy recommendations that come out of this analysis are to consider: (a) establishing public credit reporting systems where they don't exist, (b) extending their coverage to smaller banking system loans where they do, and (c) ensur-

[33] Table A2 in the Technical Annex contains a few representative regressions.

[34] In Peru, for example, the banking authorities cite their recently expanded credit bureau for helping to stop a credit bubble in which consumers would borrow from one bank to pay another, much like a check-kiting scheme.

[35] Alternatively, a group of financial institutions may agree to pool information on their borrowers and thus create a purely private credit bureau. The fact that these lenders lack the superintendency's power to compel other financial institutions to participate has often limited the scope and utility of such credit reporting services.

[36] Of course, these two benefits (cost of credit and geographic mobility) apply to firms of all sizes, but they are particularly important for smaller enterprises since these firms often lack the collateral that would enable them to obtain a loan easily and cheaply from a financial institution that they have not dealt with before.

ing wide access to this information (by the financial institutions and, for reasons of accuracy and transparency, by the credit report subjects themselves).

Candidates for these reforms include countries that currently do not have a credit bureau, including Trinidad and Tobago, Suriname, Guyana, Belize, and the Bahamas. Other countries in the region have credit bureaus with substantial loan size cutoffs, which do not track many smaller-firm loans. These countries include Colombia, Paraguay, and Uruguay, which have loan size cutoffs of US$ 12,500, US$ 2500, and US$ 18,000, respectively. At the other end of the spectrum, a number of countries have very extensive loan reporting systems. For example, the credit bureaus in Bolivia, Chile, Costa Rica, Dominican Republic, Ecuador, Peru, and Venezuela cover all size loans. A recent example of reform is Honduras, which, until 1999, did not have any credit bureau. The Superintendency installed a credit bureau in that year which tracked loans above 300,000 lempiras (about US$ 21,000) and then expanded the credit bureau to cover loans of all sizes in the year 2001.

Leasing and Factoring

Leasing and factoring offer ways for firms that currently possess little or no physical collateral to obtain loans, and thus may be of special interest to smaller firms. The problem addressed in this section is that a variety of legal, regulatory, and tax obstacles may impede more widespread use of these instruments to obtain durable equipment financing (in the case of leasing) or loans based on accounts receivable (in the case of factoring).

In leasing, the bank (or other financial institution) buys a piece of equipment that the firm would like to use, and retains ownership. The enterprise utilizes the equipment and pays a monthly rent (which represents interest on the credit outstanding plus amortization). An advantage of leasing over a straightforward bank loan, in which the enterprise would own the equipment and use it as collateral, is that, as the equipment owner, the bank does not have to be concerned about creating or perfecting a security interest. It can be sure that no one else has a legal claim on the equipment. In addition, in the case in which the firm defaults on its lease, *if* the bank can take possession of the equipment, it can sell that equipment immediately in the secondhand market (since the bank is the owner). This is perhaps the major advantage of leasing. By contrast, in a straight loan against collateral, the bank often must engage in lengthy proceedings to obtain a court order allowing it to sell the pledged asset (since the firm is the owner). With a lease as for a loan, however, the bank must often go through a long legal process to take possession of the equipment since it resides on the firm's property.[37] Thus, with leasing, one escapes some but not all of the problems associated with secured transactions. To facilitate leasing, then, parties should be permitted to contract for rapid and low-cost repossession of leased equipment in cases of default.

Other barriers to the more widespread use of leasing include regulatory and tax obstacles. On the former, allowing banks to enter the leasing business in Chile in the 1980s (as partial or sole owners of leasing companies) led to a large increase in leasing activity there. As a result of this, leasing became an important way in which credit was made available to smaller enterprises in Chile. It is not uncommon for a micro or small enterprise in Chile to lease equipment for as little as US$ 2000. Tax barriers can also stand in the way of leasing. If bank loan interest payments are tax deductible but lease payments are not, leasing will not flourish. In Argentina, until fairly recently, there was a double taxation problem. The leasing company paid the 21 percent value added tax when it bought the equipment, and then the lessee paid it again when he or she leased the equipment. Only in the last few years has legislation repealed the former levy, eliminating this problem.

[37] An exception to this occurs for leased vehicles, which can be seized on the streets since streets are considered public areas. This is why vehicle leasing is much more common in most Latin American countries than the leasing of other equipment that remains on the lessee's private property.

A pioneer in the microcredit field, Bangladesh's Grameen Bank, has more recently also been demonstrating the feasibility of microleasing with a program that began by leasing power looms to poverty-level weavers in the Dhaka Zone in 1992. The Grameen Bank's program has since expanded to cover a wide variety of products (including sugarcane grinders, power tillers, battery chargers, ball-point pen production machines, baby taxis, and mini transport) in all 14 zones covered by the bank's operations. As of December 2000, the Grameen Bank had a leasing portfolio of US$ 7.8 million, with an average lease size of US$ 526 and a default rate of three percent. Nearly 68 percent of the lessees had moved into ownership of the equipment financed. The leasing program is open to second-time borrowers from the bank's microloan program, with leasing terms of up to three years and lease payments collected on a weekly basis.[38]

In factoring, the firm obtains a loan by making use of a somewhat nontraditional form of movable property collateral, its accounts receivable. This form of finance may be of particular interest to smaller firms since they are often labor intensive and may not have significant amounts of real property or even equipment that could be used to secure a loan. If, however, the smaller firm has substantial accounts receivable, particularly from large, bankable firms (for example, because they supply parts, other inputs, or services to these large firms), the smaller firm may be able to secure low-cost financing. This is because the interest rate charged on its receivables financing is primarily a function of the credit rating of the large firm, rather than of its own credit rating.

Since factoring is merely a special case of using movable property collateral to secure a loan, the obstacles to wider availability of such credit include all of the barriers discussed above in the section on secured transactions. Hence, to expand the use of factoring and thus the opportunities for smaller firms to obtain credit, the law must allow security interests to be created using invoices as collateral, there must be a way to verify that no one else has a prior claim on these invoices, and there needs to be a low cost means for lenders to enforce their security interests in case of default.

Strengthening Credit Unions and MFIs

This is the final financial market policy we shall consider for reducing income inequality. It may be considered a policy choice insofar as governments and countries can choose to what degree they will actively strengthen—and encourage donors and others to actively strengthen—the main formal and semiformal financial institutions that serve microenterprises, namely, credit unions and MFIs.

Very substantial government and donor resources have, in fact, been spent on strengthening these institutions in many, though not in all, Latin American countries. Most of these technical assistance funds have been channeled to MFIs, rather than to credit unions. This disparity is due, at least in part, to the perception that Latin American credit unions largely serve the middle class. While many middle class individuals undoubtedly are credit union members, the experience of a number of World Council of Credit Union personnel and of the author is that the Latin American credit unions also serve many poor persons. The data presented at the end of Part I, although very partial, corroborate these experiences, indicating that roughly the same percentage of credit union and MFI clients are poor. Moreover, the presence of middle class individuals in Latin American credit unions is

[38] Thanks to Syed M. Hashemi of CGAP and Dipal C. Barua, General Manager of the Grameen Bank, for this information. For more on microleasing and the Grameen Bank's program, see Gallardo (1997) and Dowla (1998).

often of great benefit to the poor credit union members. This is because the middle class members as a whole are generally sizable net savers while the poor are typically net borrowers. Hence, the middle class members effectively fund much of the borrowing the poor do from credit unions.

The great imbalance in the technical assistance support provided to MFIs versus credit unions by donors and governments appears even more unfortunate and unwise in light of the following:

- Though it is not widely recognized, credit unions are, in fact, the dominant supplier of microenterprise credit in Latin America, by a margin of two to one (Table 4).
- Credit unions provide savings services on a far broader scale than MFIs. Most MFIs offer little or no savings services.
- Credit unions provide a much broader range of credit products than MFIs, including housing and consumer loans, which MFIs are only beginning to offer.[39]
- A much greater share of credit unions than MFIs are located in rural areas, where financial services are far scarcer and poverty rates are substantially higher than in urban areas.

Despite these many advantages, credit unions have fallen far short of their potential. This is illustrated in Figure 1, which shows aggregate credit union deposits and loans relative to those of the commercial banking system in all Latin American countries for which data were available and in several industrial countries. The figure shows how severely stunted the credit union movement still generally is in Latin America, and suggests that there is great potential for expansion and growth. We now consider why the credit unions are operating so far below their potential in Latin America and what can be done about it.

Strengthening Credit Unions

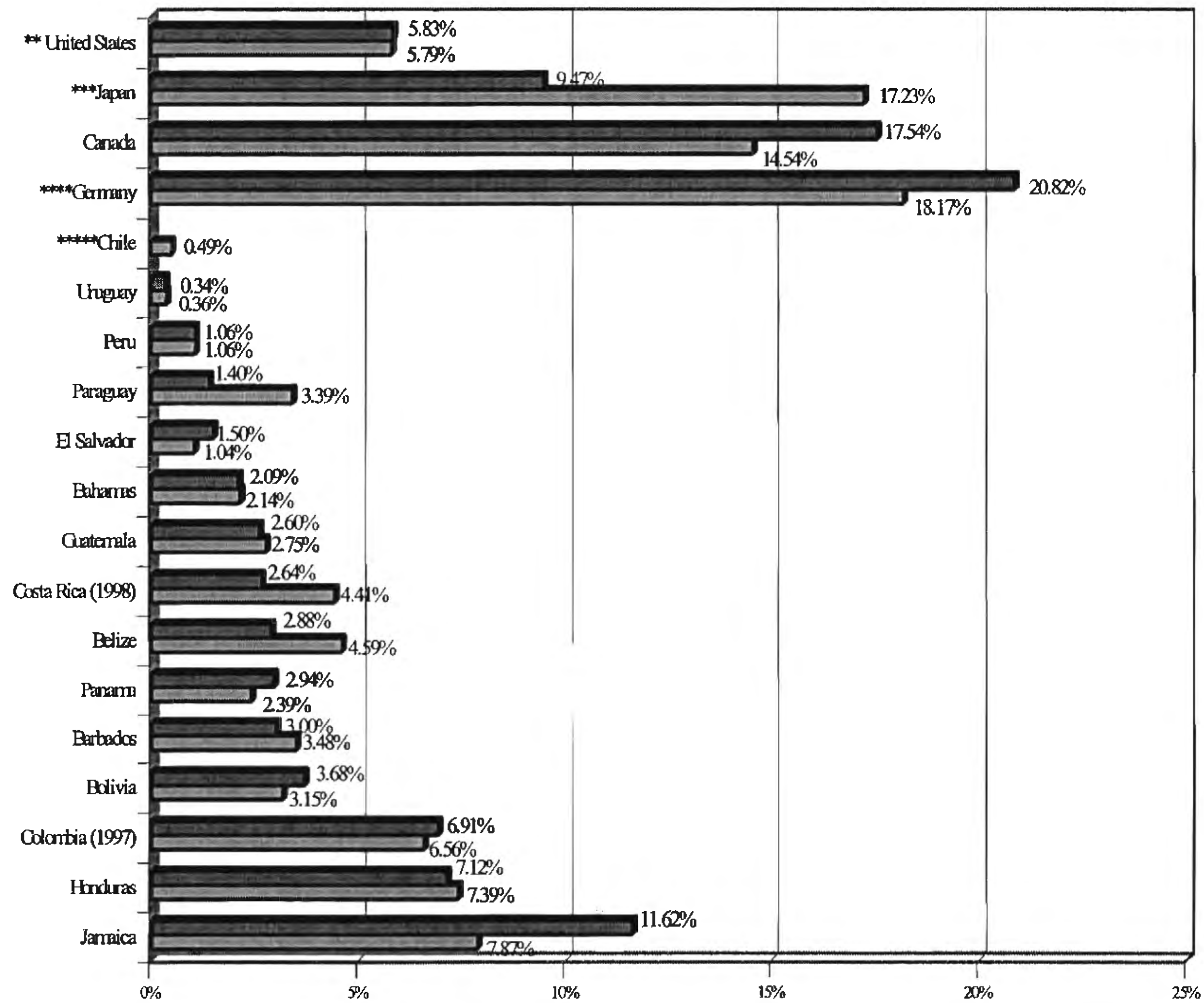
We begin with a brief explanation of why Latin American credit unions are operating so far below their potential. Credit unions in Latin America were generally established in the 1950s, 1960s, and 1970s with the strong social welfare purpose of assisting the poor. Many were organized by Catholic priests and U.S. Peace Corps volunteers. They typically lacked professional management and were weak at loan recovery and at earning and retaining profits for future expansion. They usually kept loan rates very low in order to benefit borrowing members. Low lending rates meant that deposit rates were also normally kept low. But with substantial grant and soft loan funds available from donors, many credit unions grew rapidly in this period anyway despite the lack of deposit mobilization, loan recoveries, and retained earnings. With the drying up of much of these donor funds in the 1980s and 1990s, the credit union movements in many Latin American countries became moribund.

How can credit unions be turned around? Strengthening programs have great potential for improving the performance, including the sustainability and outreach, of credit unions in Latin America. Strengthening programs begun in the mid to late 1980s in Guatemala and the Dominican Republic and in the mid 1990s in Ecuador have produced excellent results in this regard, while those in Honduras and Bolivia have made substantial strides. Box 5 presents highlights of the Guatemala case.

Strengthening programs must, of course, be tailored to the particular weaknesses and needs of the credit unions being assisted. Among the major defects in credit union policies and practices that are commonly encountered and addressed in these programs are low deposit rates and weak deposit mobilization, low loan rates and little earning or capitalization of profits, opaque financial information and undisciplined financial practices, inadequate risk management, low salary levels and difficulties retaining adequate quality of labor, and

[39] As discussed in Part I, housing and consumer loans can facilitate important physical and human capital investments. Housing loans can go to improve or expand space that doubles as a work area. Consumption loans may be used to purchase basic health and education services and maintain nutrition levels. They also permit households to smooth consumption and cope with shocks and economic stress events, actions that can greatly enhance household welfare.

Figure 1
Credit Union Market Penetration: Loans and Deposits, 1999*



* For each country, the upper bar gives the ratio of credit union deposits to total money plus quasi-money. (Unless otherwise noted, the latter is taken from the IMF's *International Financial Statistics*, line 34 plus line 35.) The lower bar gives the ratio of credit union loans to private sector loans by the commercial banking system. (The latter are taken from line 22d of the *International Financial Statistics* except as noted.) Credit union data are from WOCCU (2000) and refer to 1999 unless another year is noted next to the country name.

** For the U.S., thrifts are included with the commercial banking system.

*** All data for Japan are taken from Bank of Japan (2000).

**** For Germany, credit union data are taken from Deutsche Bundesbank (2000), while the data for money, quasi-money, and private sector loans by the commercial banking system are taken from *International Financial Statistics*.

***** Data for deposits are not available for Chile.

Box 4
Credit Union Policies and Practices: Common Failings

- ***Low Deposit Rates.*** Deposit rates are frequently set quite low, often well below commercial bank rates. Because credit unions are typically riskier institutions in which to deposit funds than banks, a competitive credit union deposit rate would normally exceed the bank rate. In the past, when credit unions have raised deposit rates to this level, deposit mobilization has often increased sharply, greatly expanding the outreach of the credit unions and their capacity to offer loans.

- ***Low Loan Rates and Little Capitalization of Profits.*** Loan rates in Latin American credit unions are typically set so that very little or no profit is earned. Moreover, a large proportion of any profits that are earned is frequently paid out in dividends to members. Consequently, credit unions typically have very little institutional capital to serve as a base for future expansion or to buffer negative shocks and thus help ensure their long-run sustainability.

- ***Opaque Financial Information and Undisciplined Financial Practices.*** Problems in this area include underreporting of loan delinquency, failure to write off loans that are more than one or even several years overdue, inadequate provisioning for loan losses, and overstatement of current year profits and capital by such accounting gimmicks as deferring operating expenses or amortizing them over several years, and overstating asset values. As a consequence of these practices, financial statements lose their meaning and good financial management of the credit union is made far more difficult. Inadequate provisioning also poses a threat to the credit union's often-small capital base and thus to its sustainability.

- ***Inadequate Risk Management.*** Many credit unions in Latin America are of the traditional type that take the view that their members have a right to borrow up to a certain multiple of (e.g., three times) their share capital. A single brief form suffices for all loan types: consumer, housing, business, etc. Loan collection efforts are often weak. Modern credit unions greatly relax or eliminate these share-multiple ceilings. They also solicit appropriate, detailed information about borrowers in order to properly assess risks, grant loans based on risk-return criteria similar to those used in banks, and push hard for loan repayment.

- ***Low Salary Levels.*** A chronic problem in Latin American credit unions is that salary levels are often held down by a membership that compares their own incomes to those of the credit union officials. Credit union salary levels typically are set well below those paid elsewhere in the financial sector, which often results in low effort and morale, high turnover, and a general inability to recruit and retain high quality staff. This frequently undercuts credit union performance and financial health.

- ***Poor Public Image.*** Many credit unions are in great need of upgrading their physical facilities, instituting a professional dress code and launching a marketing and promotional campaign.

Box 5
Credit Union Strengthening in Guatemala

When the technical assistance team from the World Council of Credit Unions (WOCCU) arrived in Guatemala, they found that credit unions there suffered from all of the problems described in this section and more: low deposit and loan rates, little institutional capital, erratic provisioning, poor quality of financial information, weak risk management practices, uncompetitive salary levels, and so forth. Working with a group of 20 of the largest and most promising credit unions, the WOCCU team overhauled key prices, policies, and practices and put into place improved auditing and control, strategic planning, marketing, information, and other systems. The effort was highly successful by nearly any measure.

From program initiation in 1985 until its end in 1993, the delinquency rate on the consolidated, 20 credit union portfolio fell from 30 percent to 8.1 percent. Provisioning of loans overdue more than one year increased from 36 percent to 100 percent during the same period. Institutional capital rose from 4.5 percent of assets to 10.7 percent, while total assets in real terms increased at an average compounded rate of 17 percent per year. The total number of credit union members nearly doubled. With the strengthening program having created a base of financially-solid, well-managed credit unions, growth then further accelerated.

In the next six years (1994-99), the number of members tripled and real assets nearly quadrupled. At the same time, financial solidity was maintained, with the delinquency rate on the consolidated portfolio falling slightly to 7.4 percent and the consolidated capital/asset ratio increasing somewhat to 12.6 percent.

a poor public image. (Box 4 provides additional details.) Obviously, such major failings seriously jeopardize the performance and sustainability of credit unions, and their ability to provide quality financial services to large numbers of microenterprises and households, including many poor ones. In addition to putting these major building blocks into place, strengthening programs often attempt to improve other important areas of credit union operations and management, including strategic business planning, internal auditing and controls, general personnel and incentive policies, and information systems.

Strengthening MFIs

Whether it be Banco Sol and other group lenders affiliated with Accion International or Caja los Andes and other individual lenders associated with IPC or any other of the 205 leading Latin American microfinance institutions listed in Christen (2000), the success story of the region's MFIs is well known. A number of Latin American MFIs have maintained delinquency rates below the levels typically found in commercial banks and a few have reached profitability rates achieved by only a few banks (see, for example, Jansson and Taborga, 2000; Kahn and Jansson, 2001; and Jansson, 2001). Large infusions of government and donor money for institutional strengthening (as well as for on-lending and equity investment) have contributed much to making possible these achievements. Despite these substantial accomplishments, most MFIs still suffer from important deficiencies and continue to face serious challenges.

It is useful to divide the discussion of MFI strengthening into two parts, by type of MFI. The first type consists of the large number of unregulated MFIs (the NGOs) plus the relatively smaller number of regulated entities into which NGOs have transformed themselves (the "upgrades"). The second type consists of an also relatively smaller number of commercial banks and other, similar banking institutions such as *financieras* that have added microlending to their traditional banking activities (the "downscales").[40] The inherent strengths of each of these two types of institutions and the challenges they face are normally quite different.

The great strength of the NGOs and upgrades, particularly in relation to the goal of reducing income inequality, is that most of these institutions are deeply committed to reaching and improving the lives of lower-income microentrepreneurs. The great weakness of these institutions, particularly the NGOs but also the upgrades to some extent, is that most are not run by professional bankers, but instead by people with a social mission. Hence, they must learn many of the same financial disciplines described earlier for credit unions, such as: keeping loan rates up (despite the high costs this imposes on the group they are trying to assist); boosting productivity and containing costs so as to earn and capitalize profits (to help ensure sustainability and underwrite future growth); controlling credit risks and keeping loan delinquency down; provisioning adequately; and rapidly expanding outreach while maintaining portfolio quality and profitability. Those that become regulated (the upgrades) and go on to take deposits must also become proficient at looking after the vastly more complex liabilities side of their operations: liquidity management, asset/liability matching, selection and pricing of appropriate deposit instruments, and so forth. The leverage provided by deposit-taking, however, allows the former NGO to greatly expand its credit outreach, as well as provide valuable savings services to its target population. In this way, its impact on the income distribution may be multiplied many times over.

Downscales normally have the opposite set of problems and advantages. Although they are run by professional bankers, many lack the social commitment to serve low-income microentrepreneurs. We first discuss the strengths of downscales and then describe their weaknesses, the latter being the subject of strengthening programs.

[40] In Christen's (2000) inventory, there are approximately 25 upgrades, 25 downscales, and 155 NGOs.

Banks and *financieras* are attractive platforms from which to begin offering services to a large number of microfinance clients for several reasons:[41]

- They are regulated institutions, fulfilling the conditions of ownership, financial disclosure, and capital adequacy that help ensure prudent management.
- They have the physical infrastructure, including branch networks, from which to reach out to a substantial number of microfinance clients.
- They have well-established internal controls and administrative and accounting systems to keep track of a large number of transactions.
- Their private capital ownership structures tend to encourage sound governance, cost-effectiveness, and profitability, all of which lead to sustainability.
- They offer deposit services as well as loans.

NGOs enjoy few, if any, of these advantages, while upgrades typically acquire many, though not all, of them. For example, most upgrades continue to be owned primarily by NGOs and development organizations. These NGOs and development organizations typically do not push as hard for cost effectiveness and profitability as do the downscales' for-profit investors. Upgrades often do not offer extensive, or in some cases, any, deposit services. And, reflecting the fact that upgrades are generally newer institutions, they may not have as extensive a branch network from which to offer financial products to microenterprises as do many downscales.

A disadvantage of working with downscales is that often they may have little positive impact on income inequality, at least at first. Banks, especially, may not reach down to many low-income microentrepreneurs. They may choose instead to serve the larger, wealthier microentrepreneurs, finding this to be profit maximizing if there is little competition as yet in this market segment. Over time, of course,

[41] This discussion is taken from Baydas, Graham, and Valenzuela (1997).

additional competition may appear, and some banks may find it profitable to lend to lower-income firm owners.[42] Not all downscales fit this pattern, however. For example, in Paraguay, it appears that a significant share of the initial micro-credit clients of the *financiera* downscales were poor.

Downscales, and programs meant to strengthen them as providers of microfinance services, face a number of challenges:

- Downscales must adapt to a very different credit technology (Box 2). They must recruit and train a different type of loan officer from those they are accustomed to, and they must ensure that these loan officers achieve and maintain high productivity levels in order to reduce cost margins and generate profits.
- The bonus system normally used to motivate and reward loan officers for good performance may cause jealousies and morale problems for loan officers in the rest of the bank or *financiera*, who typically are not eligible to earn such bonuses.
- The kind of management information system needed for microlending differs from that required by traditional banking, and there are often substantial challenges to be overcome in integrating the two.
- It may be a problem, particularly in larger banks, to attract good managers to run the microlending program. This is because, by its size and profitability, the microlending program will often be considered a second class assignment, especially in the crucial first years of the program's existence.
- Downscales must overcome the cultural challenge of working with and providing service to a much poorer clientele, living in poorer areas, than the downscales and downscale staffs are accustomed to.
- As discussed in the sections on regulation and supervision, the superintendency may not understand microfinance very well. It may apply usury ceilings and other inappropriate and burdensome regulations and supervisory practices to MFIs, including downscales, which are always regulated and therefore always subjected to these inappropriate regulations and practices.
- Several years of hard work overcoming all of the above difficulties may be required to build a sizable portfolio of solid loans that will have any meaningful impact on a downscale's overall profits. Expectations must be brought into line with this reality, and the will must be found to persevere in solving difficult problems despite the absence of any substantial short-run payoff.

Most of these challenges are very different from those faced in programs to strengthen credit unions, NGOs, and even upgrades. Committed leadership is required within the downscale in order to see these many challenges through. Experience has shown, however, that this commitment can be fragile, as it is often supplied by only one or two visionary board members. The provision of expertise through donor or government technical assistance programs can be of great help in overcoming these problems and assisting a bank or *financiera* to extend financial services to unserved and low-income microenterprises.

[42] Even the wealthier microentrepreneurs, however, may hire low-income workers, which could have beneficial impacts on the income distribution.

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TECHNICAL ANNEX

Table A1 Financial Depth Measures in the Gini Regressions					
Variable	**Reg. 1**	**Reg. 2**	**Reg. 3**	**Reg. 4**	**Reg. 5**
M2/GDP	-15.4 (3.87)	-11.5 (2.59)	-12.6 (2.49)		
Pvt. Credit/GDP				-10.4 (3.97)	-2.87 (1.17)
Constant	50.3 (29.3)	48.1 (9.48)	35.3 (4.98)	45.4 (35.6)	40.1 (8.15)
EXPSURVEY	-3.69 (2.50)	-5.44 (3.85)	-5.71 (3.87)	-2.33 (1.54)	-5.78 (4.78)
COMM	-13.8 (4.45)	-10.7 (3.17)	-14.3 (4.71)	-12.3 (3.55)	-12.6 (3.28)
MEANAGE		-.69 (3.97)	-.18 (.81)		-.38 (2.57)
URBANPOP		3.53 (.98)			
URBAN2		41.4 (3.60)	52.5 (4.17)		47.3 (4.44)
XNFUELY		8.79 (.99)			
LLAND		1.48 (2.28)	4.41 (5.22)		3.82 (6.00)
LATLAND			-6.79 (2.73)		-8.49 (4.86)
RGDPSTD		61.6 (2.20)	67.0 (2.29)		69.8 (3.02)
OPO		.049 (2.04)			
OPEN			.109 (4.67)		.078 (4.08)
MEANSCHOOL			-.29 (.62)		
STDSCHOOL			.70 (.62)		
R^2	.399	.588	.607	.154	.573

The table reports regression coefficient estimates, with t-statistics in parentheses.
Coded Explanatory Variables: EXPSURVEY, MEANAGE, MEANSCHOOL—see Table A2; COMM =1 for Communist countries, =0 otherwise; URBANPOP—share of the population living in urban areas; URBAN2 = URBANPOP*(1-URBANPOP); XNFUELY = non-fuel primary exports/GDP; LLAND=ln (agricultural land per capita); LATLAND = LLAND*(distance to equator), to capture differences between land in tropical and temperate climates; RGDPSTD—standard deviation of real GDP growth rates, a measure of volatility; OPO = (Exports + Imports)/GDP, a measure of openness; OPEN—the residuals of a regression of OPO on ln(population), to net out the tendency for large countries to be closed; STDSCHOOL—standard deviation of the number of years of schooling completed for the population aged 25-64.

Table A2 Gini Regressions for 14 Latin American Countries Using Loayza's Informality Measure[a]			
Variable	**Regression 1**	**Regression 2**	**Regression 3**
INFORMAL	0.45 (2.00)	0.41 (1.63)	0.50 (1.73)
Constant	30.15 (2.73)	37.9 (1.68)	28.6 (1.06)
EXPSURVEY	-6.66 (3.97)	-7.06 (1.66)	-7.41 (1.69)
MEANAGE		-0.22 (.40)	-0.28 (.47)
MEANSCHOOL			1.18 (.68)
R^2	0.32	0.36	0.44

[a] The countries covered by the regression are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Panama, Peru, Uruguay, and Venezuela. The table reports regression coefficient estimates, with t-statistics in parentheses.

Explanatory variables: INFORMAL—Loayza's informality measure; EXPSURVEY—dummy variable, = 1 if the Gini coefficient is based on a household expenditure survey, =0 if based on a household income survey; MEANAGE—mean age of the population; MEANSCHOOL—mean number of years of schooling completed for the population aged 25-64.

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DGRV - German Co-operative and Raiffeisen Confederation

Latin America and Caribbean Coordinating Office

Dr. Matthias Arzbach

WOCCU / USAID / DGRV - "Best Practices in Savings Mobilization"

Panel "Effective Supervision of Savings"

Washington, D.C. - November, 5th and 6th, 2002

DGRV

Agenda

- International standards for deposit taking institutions
- Credit Unions in Latin America: a sample of 18 countries
- Monitoring and regulating numerous and small institutions (credit unions)
- The Germany model as a way out?
- Tough auditing as a solution?
- Tendencies in supervision (Basel II, ...)

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I.

International and national standards for deposit taking institutions (DTIs)

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Some definitions

- **DTIs** - Deposit taking institutions
  - **MFIs** - Microfinance institutions
    - **CUs** - Credit Unions

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International Standards

- Basel Committtee for Banking Supervision (BCBS)
  - "Basel I" (1988)
  - "Basel II" (2003 / 2006 - ?)
  - Market Risk (1996)
  - 25 Principles of Effective Banking Supervision (1997)
- 40 Recommendations of FATF-GAFI
- US-GAAP / IAS

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National Standards

- Liquidity
- Minimum reserve requirements
- Restrictions on capital movements
  - Argentina's "Corralito"
- Provisions for NPLs
- Etc.

6

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Reasons for supervision

- **Protect savings of the public**
- Protect integrity of the financial system
  - ◆Payment systems
  - ◆Transmission process for monetary policy, etc.
- Ensure functioning of individual DTIs
  - ◆Avoid contagion
  - ◆Protect small savings

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Objects of supervision?

- Basel: "internationally" active banks
  - ◆US: "Basel II"
    - "Non-complex banks", "credit unions" exempt
  - ◆EU: Application to all DTIs
- Payment system / monetary policy: all participants
- Deposit protection schemes: all DTIs
- Money laundering: all DTIs, and more...

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... and the MFIs?

- In many ways they **should** be supervised
  - ◆Exceptions: pure credit cooperatives that cannot accept deposits
- But **how**?
  - ◆Large number of institutions
  - ◆Small size

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II.

Some characteristics of financial markets in Latin America

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Low savings rate leads to ...

- Low gross investment
- Insufficient growth
- External debt to finance gap between investment and saving
- Low monetization in the national financial system

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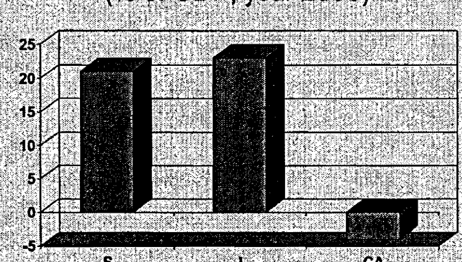
An example: Brazil
(% of GDP, year 2000)



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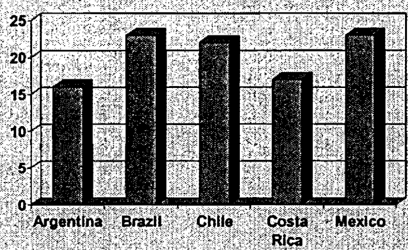
"I/Y": it is worse elsewhere in LA ...



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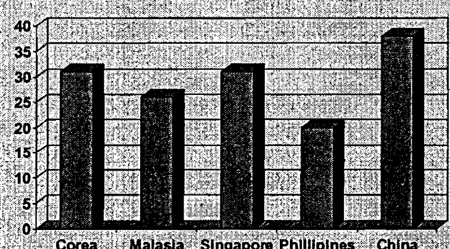
"I/Y": Compare with Asia !



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Caution is advised:

- Savings in national accounts have very little to do with savings in the financial system, even over time
  - stocks vs. flows, different concepts, ...
- But: there are striking parallels:

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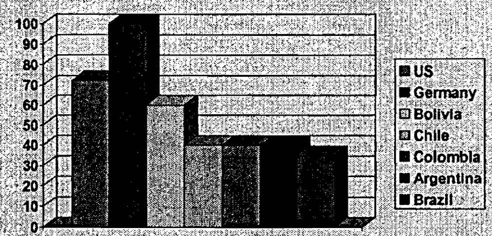
Deposits / GDP (%)



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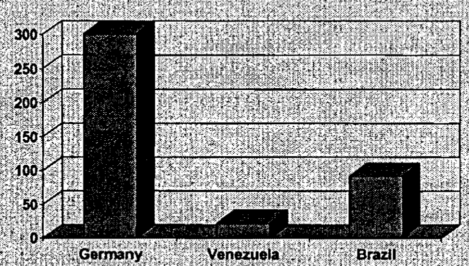
Bank assets / GDP (%)



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Why is that so?

- Macroeconomic developments are not organic
  - ◆MEX 1994 - 95
  - ◆ARG 1989 - 91 / 2002 - ...
  - ◆ECU 1998 - 99
  - ◆VEN 1994 - ...
- Different "culture" of savings
- Low capacity of savings (poverty)
- Etc.

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Consequences of low monetization

- High systemic risk
- High interest rate spreads
  - ◆Germany: 1,5 %-points
  - ◆Chile: 4,5 %-points
  - ◆Latin America (average): > 10 %-points
- Explained and aggravated by
  - ◆Inefficiencies of financial sectors
  - ◆NPLs (PAR > 20%, CHL = 2%)
  - ◆Short-term deposits prevail

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Structural weaknesses

- Concentration in:
  - ◆Urban areas
  - ◆High and middle income class
  - ◆>>> Partial "underbanking"
- Are Credit Unions (CUs) a remedy ?
  - ◆Latin America as an example

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III.

Credit Unions (CUs) in Latin America

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Why supervise CUs?

- They are "financial intermediaries"
- CUs accept deposits from the public
  - ◆from non-members
  - ◆from members in large numbers (E.g.: *Cupocrédito* in Colombia)
- Savers in CUs deserve the same protection as bank clients
- Governance problems make them vulnerable and may require a solution by "external" control

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... and **other** (= non-CU) MFIs?

- They may be DTIs and thus "financial intermediaries"
- Examples:
  - ◆"Fondos Financieros Privados" (FFPs) in Bolivia
  - ◆"Organizaciones Privadas de Desarrollo" (OPDs) in Honduras
- Again, savers deserve the same protection

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Sample: 18 countries

- **Mexico and Central America (7)**
  - ◆Mexico
  - ◆Costa Rica
  - ◆El Salvador
  - ◆Guatemala
  - ◆Honduras
  - ◆Nicaragua
  - ◆Panama
- **Caribbean (1)**
  - ◆Dominican Rep.
- **South America (10)**
  - ◆Argentina
  - ◆Bolivia
  - ◆Brazil
  - ◆Chile
  - ◆Colombia
  - ◆Ecuador
  - ◆Paraguay
  - ◆Peru
  - ◆Uruguay
  - ◆Venezuela

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Co-operatives with financial activities - **South America**

Country	Co-op. Banks	CUs	Others
Argentina	2	350	2 (Cajas de Crédito)
Bolivia	-	113	-
Brazil	2	1400	34 (Coop. Centrales)
Chile	-	81	
Colombia	-	250	2 (Coop. Financiera)
Ecuador	-	431	-
Paraguay	-	350	-
Peru	-	175	-
Uruguay	-	36	6 (Coop. Intermed.)
Venezuela		170	-

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Co-operatives with financial activities - **Central America/Mexico/Caribbean**

Country	Co-op. Banks	CUs	Others
Costa Rica	-	69	-
El Salvador	-	80	47 Cajas Créd. Rural 7 Bancos Trabajadores
Guatemala	-	140	-
Honduras	-	130	-
Mexico	-	157	11 SAPs 32 Uniones de Crédito 210 Cajas Solidarias 220 Cajas Populares
Nicaragua	-	208	-
Panama	-	217	-
Rep. Dominicana	-	110	-

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Market shares (CUs)

- **High (>5%)**
  - Bolivia
  - Paraguay
- **Low (<1%)**
  - Argentina
  - Brazil
  - Chile
  - El Salvador
  - Mexico
  - Nicaragua
  - Venezuela
- **Medium (1-5%)**
  - Colombia
  - Costa Rica
  - Ecuador
  - Guatemala
  - Honduras
  - Panama
  - Peru
  - Dominican Republic
  - Uruguay

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IV.

Regulating DTIs - The challenge of finding an equilibrium

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Solvency ratios - Banks

- 8-9% (Basel or "Basel +")
  - Chile
  - Colombia
  - Ecuador
  - Mexico
  - Panama
  - Venezuela

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Solvency ratios - Banks

- >9% ("Basel ++")
  - Argentina
  - Bolivia
  - Brazil
  - Costa Rica
  - El Salvador
  - Guatemala
  - Honduras
  - Nicaragua
  - Paraguay
  - Peru
  - Dominican Rep.
  - Uruguay

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Solvency ratios - supervised CUs

- **Minimum solvency ratio**
  - Argentina (11,5%)
  - Bolivia (10-20%)
  - Colombia (9%)
  - Costa Rica (10%)
  - Uruguay (10%)
- **Maximum leverage**
  - Brasil (5:1)
  - Chile (2:1)
  - Costa Rica (10:1)
  - Mexico (UCs, 40:1)
  - Peru (11:1)
- **None**
  - Mexico (SAPs)

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Minimum capital to obtain the licence - banks

- **High (>10 mill. USD)**
  - Chile
  - Colombia
  - El Salvador
  - Mexico
- **Low (< 5 mill. USD)**
  - Argentina
  - Paraguay
  - Dominican Rep.
  - Venezuela
- **Medium (5-10 mill. USD)**
  - Bolivia
  - Brazil
  - Costa Rica
  - Ecuador
  - Guatemala
  - Honduras
  - Nicaragua
  - Panama
  - Peru
  - Uruguay

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Capital for licensing - CUs

- **None**
  - Argentina
  - Bolivia
  - Chile
  - Costa Rica
  - Ecuador
  - El Salvador
  - Guatemala
  - Honduras
  - Nicaragua
  - Panama
  - Dominican Rep.
  - Uruguay
  - Venezuela
- **High**
  - Argentina (Cajas)
  - Bolivia (CACs, nivel IV)
- **Moderate**
  - Bolivia (CACs, nivel I/III)
  - Colombia (Coop. Fin.)
  - Ecuador (CACs ab.)
  - Uruguay (Coop. Int.)
- **Low**
  - Brasil
  - Colombia (CACs)
  - El Salvador
  - Mexico (SAPs)

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Problems associated with the CUs´ capital

- High volatility (seen by the member and treated like sight deposits...)
- Lack of possibility to inject large amounts of capital rapidly in stress situations (absence of a strategic investor)
- Absence of entry barriers

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V.

Supervision of DTIs

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Financial supervisors

- **Independent Superintendency**

" Kemmerer mission"

- Bolivia
- Chile
- Costa Rica
- Ecuador
- El Salvador
- Guatemala
- Honduras
- Nicaragua
- Panama
- Peru
- Dominican Rep.
- Venezuela

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Financial supervisors (2)

Anglosaxon model

- Superintendency depends of the Treasury Department
  - ◆Colombia
  - ◆Mexico
- Supervision by the Central Bank
  - ◆Argentina
  - ◆Brazil
  - ◆Paraguay
  - ◆Uruguay

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? ...

... and the credit unions ?

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Legal foundations

- In Banking Acts
  - ◆Argentina
  - ◆Bolivia
  - ◆Ecuador
  - ◆Uruguay
- Just Co-operative Societies Acts
  - ◆Guatemala
  - ◆Honduras
  - ◆Mexico
  - ◆Nicaragua
  - ◆Panama
  - ◆Paraguay
  - ◆Dominican Rep.
  - ◆Venezuela

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Legal foundations (cont.)

- **Specialised Acts or Decrees**
  - Argentina
    - CACs
  - Bolivia
  - Brazil
  - Chile
  - Colombia
  - Costa Rica
  - El Salvador
  - Mexico
    - SAPs Credit Unions
  - Peru
  - Uruguay
    - CACs

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Co-operative Institutes - organization

- **Independent**
  - Colombia
  - Costa Rica
  - El Salvador
  - Guatemala
  - Honduras
  - Nicaragua
  - Panama
  - Dominican Rep.
  - Venezuela

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Co-operative Institutes (cont.)

- **Departments in Ministries**
  - Argentina
  - Bolivia
  - Chile
  - Ecuador
  - Mexico
  - Paraguay
  - Uruguay
- **Do not exist at all in**
  - Brazil and
  - Peru

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Co-operative institutes - Problems

- Supervision of CUs is not sufficiently specialised
- Permanent conflict of interests between fostering and controlling the sector at a time

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CUs and supervision - status quo

- **Some or all CUs supervised** (11)

◆ Argentina
◆ Bolivia
◆ Brazil
◆ Chile
◆ Colombia
◆ Costa Rica
◆ Ecuador
◆ El Salvador
◆ Mexico
◆ Peru
◆ Uruguay

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CACs and supervision (cont.)

- **No CU supervised** (7)

◆ Guatemala
◆ Honduras
◆ Nicaragua
◆ Panama
◆ Paraguay
◆ Dominican Republic
◆ Venezuela

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Criteria for incorporation in supervision

- **All** (2)
  - Brazil
  - Peru
- **Acc. to legal form** (2)
  - Argentina
  - Mexico

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Criteria for incorporation (cont.)

- **Size** (6)
  - Bolivia
  - Colombia
  - Costa Rica
  - Ecuador
  - El Salvador
  - Uruguay
- **A defined list** (1)
  - Chile

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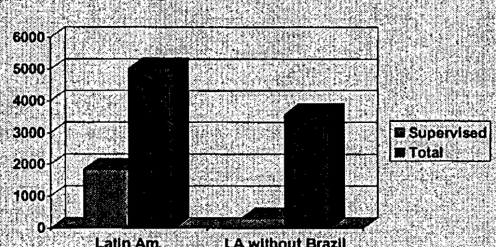
Summing up: Institutions ...



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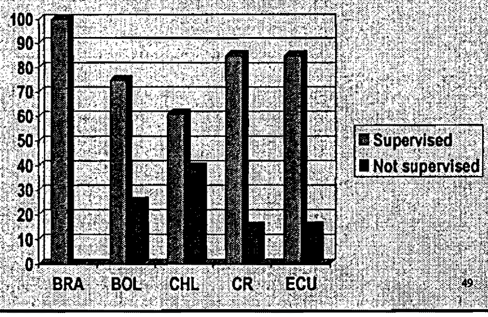
... and volumes (% of total assets)



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Types of supervision
(order: diminishing interference of the State)

- **Direct supervision**
  Co-operatives controlled directly by the Super-intendency *("on site" and "off site")*
- **Auxiliary supervision**
  private agent (e.g. Federation) performs some functions of supervision (mandate by the Superintendency)

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Types of supervision specialized in cooperatives (cont.)

- **Delegated supervision**
  Superintendency **(=principal)** delegates to a high degree functions of control to a private **agent**
- **Self-control**
  Federation of co-op. performs control of its members only on the basis of an **own** regulatory framework and monitoring process

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Monitoring of CUs/MFIs *versus* banks

- Like banks
  - CAMEL, CAMELS, ...
  - E.g.: ARG, URU, COL, CR
- Differentiated monitoring
  - PERLAS, Alerta Temprana, ...
  - E.g.: BOL, BRA

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Monitoring CUs

- *conf.* DGRV study on monitoring, october 2002
  - *conf. Handout (in spanish)*
- Monitoring systems of official (-direct control-) and "private" supervisors (-auxiliary, delegated, self-control-)

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Number of indicators

Argentina	165	AVERAGE 64
Bolivia	44	
Brazil	162	
Chile	60	
Colombia	43	
Costa Rica	13	
Ecuador	25	
Mexico	41	
Peru	25	

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And what is special for CUs? - Governance

- Dominance of net debtors
- Loss of identification and social control in large and open CUs
- High volatility and lack of lower ceiling for capital *"redeemibility"*

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Partial supervision leads to regulatory arbitrage

- Incentives to abstain from supervision: "flexibility", tax advantages, ...
- Example: ECU - CUs only took deposits and did not accept capital - counterproductive, produced high leverage ! (recently eliminated)

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Obstacles for direct supervision of MFIs

- **High number**
  Many CUs (and geograficaly dispersed)
- **Low (or no) capital requirements**
- **Macroeconomic importance negligent**
  Market shares low; no systemic impact

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Possible ways out

- 1.- Doing **nothing** about it
- 2.- **Auxiliary** supervision
- 3.- **Delegated** supervision
- 4.- **Self-control** by the MFI-/co-op. sector

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1.- Fatalistic approach: Nobody does anything ...

- Nicaragua
- Panama
- Paraguay
- Venezuela

- Sustainable ?

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2.- Auxiliary supervision

- State relies on services of a private agent
  - ◆Federation of co-op. (or MFIs)
  - ◆Auxiliary institutions of the sector
    - • Auditing firm ("Audicoop"), etc.
- Problems
  - ◆Sufficient independence?
  - ◆Sectors´s cohesion sufficient?

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Auxiliary supervision

	Costa Rica	Brazil	El Salvador
Year (Law)	1994 / 95	1999	2000
Auxiliary supervisor	AUDICOOP	Central Co-op.	FEDECRÉDITO FEDECACES
Principal supervisor	SUGEF	Banco Central do Brasil	SSF

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Auxiliary supervision

	Mexico	Chile	Ecuador
Year (Law)	2001	2002	2001 (possibility)
Auxiliary supervisor	Federations	FECRECOOP	Not defined yet
Principal supervisor	CNBV	Min. of Economy	SIB

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3.- Delegated supervision: Peru

- Since 1992
- CU-Federation FENACREP as delegated supervisor
- Faculties
  - ◆Prudential regulation: stays with official supervisor
  - ◆Intervention, sanction: FENACREP
- Supervises federated (98) and non-federated CUs (77)

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4.- Self-regulation and self-control

- El Salvador
  - FEDECREDITO
  - FEDECACES
- Guatemala
  - FENACOAC
- Honduras
  - FACACH
- Dominican Republic
  - AIRAC
- Colombia (project abandoned)
  - CONFECOOP (SIAC)

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Summing up...

- 11 out of 18 countries supervise CUs
- Of these 11 countries,
  - 9 supervise directly
  - 1 by auxiliary supervision
  - 1 by delegated supervision
- But: tendency is auxiliary supervision
- Why?
  - Because "first best" is not possible
  - Because delegated supervision is perceived as to go "too far"

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VI.

The German model as a way out?

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German co-operative banks

- Regulation: **"level playing field"** with other intermediaries (esp. private banks and savings banks)
- Auxiliary supervision performed by auditing federations

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Co-operative banks in Germany: A three level system

- Co-operative Banks (1.500)
  - ◆ Local / Co-operatives
- 1 Regional Co-op. Central Bank (WGZ)
  - ◆ Regional / Co-operative
- DZ Bank (Frankfurt)
  - ◆ National, central co-op. bank
  - ◆ Corporation

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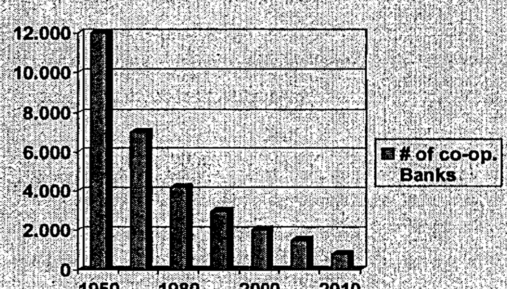
Strong process of M & A´s



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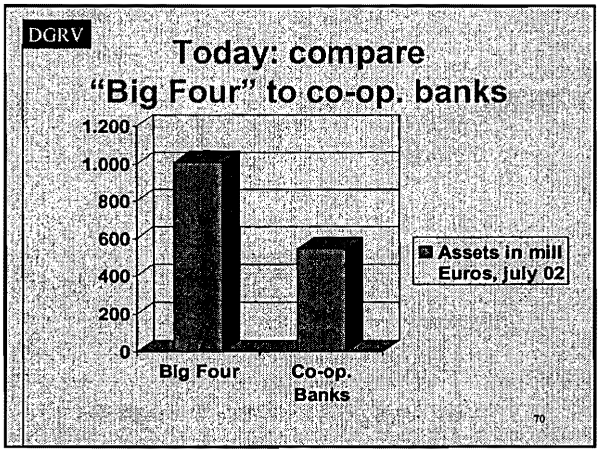
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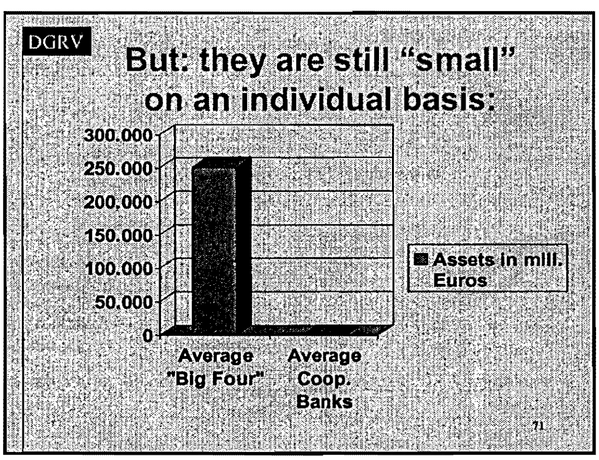
Today: compare
"Big Four" to co-op. banks
1.200
1.000
800
600
400
200
0
Big Four
Co-op. Banks
Assets in mill Euros, july 02
70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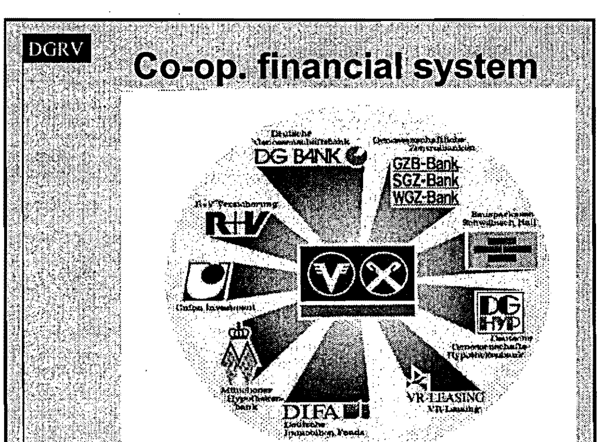
But: they are still "small"
on an individual basis:
300.000
250.000
200.000
150.000
100.000
50.000
0
Average "Big Four"
Average Coop. Banks
Assets in mill. Euros
71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Co-op. financial system
DG BANK
GZB-Bank
SGZ-Bank
WGZ-Bank
R+V
DG HYP
VR-LEASING
DIFA

Co-op. banks: General characteristics

- Legal form: Co-operatives
- Controlled by Superintendency (FFSA)
- Banking Act fully applies
- Operations:
  Sight deposits, credit cards, credit and savings operations also with non-members
- Accounts in the Bundesbank
- Deposit protection scheme

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Federations

- **DGRV**
  German Co-operative and Raiffeisen Confederation
  BVR
  Specialized Federation for co-operative banks
- **11 Regional Auditing Federations**
  Highly professionalized, independent

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Federation, auditing and deposit protection

- **Federations:**
  Affiliation to a Regional Federation of Cooperatives ist mandatory
- **Auditing:**
  External auditing on the part of the Federation is mandatory
- **Deposit protection:**
  Mandatory affiliation to Deposit Protection Fund for all members of the Federation

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Banking supervision in Germany: the three pillars

- **Superintendency (FFSA)**
  - Controls on site and off site
  - Prudential regulation (after consulting with Bundesbank)
  - Grants and revokes licences
- **Bundesbank**
  - Assists in supervision
  - Bank statistics
- **Auditors**
  - Important auxiliary role

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"Auxiliary Supervision"

- **§ 8 (1) Banking Act runs:**
  - "The FFSA may enlist the services of other persons and institutions to assist in the performance of its functions"
- **Applied to**
  - Co-op. banks and savings banks
- **Auxiliary supervisors are**
  - Regional auditing federations

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Advantages for the Superintendency

- Auxiliary supervision covers
  - Nearly 90% of institutions
  - aprox. 70% of assets
- FFSA can control 2.400+ banks with only 550 staff (+ 600 in Bundesbank)
  - 50 staff in the FFSA for co-op. banks

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Limits of auxiliary supervision

- Sanction
  - Federation can´t impose sanction
- Intervention
  - remains the privilege of the FFSA
- Responsibility
  - Auxiliary supervision does not imply the delegation of responsibility

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"Success story"

- Since 1935 no co-op. Bank. Broke,
- No saver lost a cent (or "pfennig")
- Federations deserve the trust the State puts in them

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Compare with LA ...

- Germany
  - Regionality
  - Subsidiarity
  - Common Corporate Identity
  - High cohesion
  - Strong Federations
- Latin America
  - No principle
  - Low cohesion
  - Weak Federations or politically dependent

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Conclusions

- **Auditing is vital, but...**
- **German model can be applied only in certain conditions in Latin America**

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VII.

Auditors as auxiliaries to the Superintendencies to control MFIs

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What preconditions have to be fulfilled...

- **... for auditing given that the German model can´t be applied easily** (weak Federations, political dependencies, ...) **?**
- Study DGRV on **monitoring of CUs**, october 2002 (see handout in spanish)

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Preconditions

- Supervisory Board should pick the auditor
- Rules for rotation
- Avoid financial dependency from one (-big-) client
- Auditor should not be able to receive a credit from his client
- Separate auditing and consulting

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VIII.

The future of financial supervision

... and the implications for MFIs

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Perspectives

- **"Basel II"** - The New Capital Accord
  - ◆will differentiate capital requirements strongly
  - ◆will reenforce monitoring
  - ◆will (probably) lead to more demanding capital requirements
  - ◆will be effective as of end 2006: be prepared !!!

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Perspectives

- "Basel II" (cont.)
  - **Pillar 1:** new minimum capital requirements
  - Rating agencies are big winners
  - Is private qualification suitable for CUs?
  - Weigh costs against benefits !

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Perspectives

- "Basel II" (cont.)
  - **Pillar 2:** ongoing supervisory process
  - will enhance methods of monitoring on site and off site
  - how to does this fit into the context of scarce ressources of supervisors and multiple institutions?

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Perspectives

- Supervisor has to rely increasingly
  - on the **auditor**
    - Confindence crisis (Enron, WorldCom, ...)
    - Rules of rotation of auditors
    - Supervisory Board selects auditor
  - on **internal control**
  - s. Basel consultative papers (BCBS) - 2001/02

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Perspective

- The DTI **itself** has to ensure an adequate control of risks, the supervisor ensures the adequacy of the internal process

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Perspectives

- Basel II (cont.), **Pillar 3**
- Enhanced disclosure
  - Access to credit registers
  - Public, regular and timely information
- Market discipline
  - ... can work in these conditions
  - Secondary markets for subordinated debt

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Perspectives

- Supervision more proactive
  - EWSs
  - Timely, preventive action instead of just shutting down a troubled DTI
    - Basel II: "rapid remedial action"
  - And in this context: a more adequate (and less "hostile") prudential regulation
    - Negative example: Argentina

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Enhanced prevention of money laundering

- FATF-GAFI
  - 40 recomendations
  - "Black list" of non-cooperating countries and territories ("NCCTs")
    - 19 entries in black list
    - *Guatemala* from Latin America
    - Panama and Cayman Islands on monitoring list

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This holds true for the MFIs/CUs?

- Tendencies are valid almost entirely for MFIs
- ... and there are some special features for them:

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Perspectives: Supervision of CUs

- Tendencies that help supervisors
  - M & A's will go on ("consolidation"),
- promoted in part by supervisors themselves
  - Entry barriers
    - Capital for licensing
    - Mandatory studies on viability
  - Specialization
  - Stabilization of capital

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Perspectives: MFIs (cont.)

- More ...
  - (Auxiliary) supervision
  - Deposit protection schemes for MFIs
  - Relations with central banks
    - Minimum reserve requirements
    - Refinancing (OMOs)
    - Payment system

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Perspectives: Payment systems

- "RTGS" is every time more popular for **large amount** payment systems
  - More secure
  - High demand of liquidity
- For **small** payments?
- Hybrid forms: e.g. Costa Rica
- To participate in payment system **supervision** normally is a precondition

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„Financial stability"

- „Financial Stability Forum" (FSF)
  - Since 1999
  - Secretariat in the BIS Basel
  - It is not a standard setting body, but "synthesized" the
  - **12 elements of financial stability**

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FSF - Checklist: No. 1-3

- „Code of Good Practices on Transparency in Monetary and Financial Policies" (IMF)
- „Code of Good Practice on Financial Transparency" (IMF)
- „General / Special Data Dissemination System" - GDDS / SDDS (IMF)

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FSF - Checklist: No. 4-5

- „Principles and Guidelines on Insolvency Regimes for Developing Countries" (IBRD)
- „Principles of Corporate Governance" (OECD)

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FSF - Checklist: No. 6-7

- „International Accounting Standards" - IAS (IASC)
- „International Standards on Auditing " - ISA (International Federation of Accountants - IFAC)

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FSF - Checkliste: No. 8-9

- „Core Principles for Sistemically Important Payment Systems" (Committee on Payment and Settlement Systems - CPSS Basel)
- „The Forty Recommendations of the FATF" (FATF)

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FSF - Checklist: No. 10-11

- „Core Principles for Effective Banking Supervision" (Basel Committee on Banking Supervision - BCBS)
- „Objectives and Principles of Securities Regulation" (International Organization of Securities Commissions - IOSCO)

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FSF - Checklist: No. 12

- „Insurance Supervisory Principles" (International Association of Insurance Supervisors - IAIS)

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... and...

- ... even if CUs and other MFIs are **not explicitly mentioned** (like in "Basel I"), normative power will catch up with them
- Supervision will be every time more **universal**
  - E. g. money laundering
- **Dialogue** between MFIs and the supervisor is getting better (more intense and more democratic/friendly)

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For more information

www.dgrv.de

www.dgrv.org

Home Page in spanish and portuguese

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Fore more information

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German Co-operative and Raiffeisen Confederation

Auditing of German Co-operative Banks

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Bonn, october 2002

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ABBREVIATIONS

BA	Banking Act
CC	Commercial Code
CSA	Co-operative Societies Act
FFSA	Federal Financial Supervisory Authority
MLA	Money Laundering Act

AUDITING OF GERMAN CO-OPERATIVE BANKS

A. BACKGROUND

1. Historical Development

The co-operative movement in Germany started in the middle of the 19th century. As more and more people organised themselves in co-operatives, soon from within the movement the desire for competent external help and assistance in business-related matters arose. Today, this has to be seen as the starting-point for co-operative auditing in Germany.

At that time, auditing was still voluntarily. However, as part of the self-administration, it was well to the fore, although Friedrich-Wilhelm Raiffeisen and Hermann Schulze-Delitzsch had different thoughts about the performance of the audit.

Later, first co-operative federations were created which took up the standing rule for external revision in their statutes. By the years the principles for revision - nowadays called auditing - were developed corresponding to the changing and more demanding co-operative needs.

In the 1870ies, several co-operatives in Germany experienced serious financial trouble. Above all, internal organisational weaknesses (i. e. management problems - at that time honourable but rather inexperienced persons were often managing co-operatives -) caused - due to a lack of external supervision - losses for the members of co-operatives. This development initiated discussions first within the co-operative movement (Raiffeisen, Schulze-Delitzsch, etc.), later between the co-operative leaders and the national government, aiming at setting common standards for all co-operatives in Germany. Co-operative Federations offered basic audits to member-co-operatives on a voluntary basis. These led to a stabilisation of the sector.

As a result of the development, the Co-operative Act of May 1, 1889 took up the obligation for auditing of co-operatives. This was the first legally prescribed audit for companies in Germany. Co-operatives had to undergo regular audits either executed by co-operative auditing federations or by free-lance auditors. The audit executed by the co-operative federations comprised both financial audit as well as management audit.

The new regulations led to a significant improvement of the performance of co-operatives in the following years. However, in the depression of the late 1920ies, some co-operatives again had to experience difficult times. Interesting enough, it were above all those co-operatives which had not joined an auditing federation but had decided to be audited from outside the sector.
In 1929, preparations for a first major amendment of the Co-operative Act started. In 1934, the revisions finally went into force. The important change for the co-operative movement was that membership in an auditing federation became mandatory for every co-operative; the auditing regulations were more precisely and thoroughly defined.

Since that time, in Germany it is the auditing federation composed by co-operatives which is responsible for the correct and timely audit of its members and it is not any longer the individual co-operative which has to take care of that.

The compulsory co-operative auditing serves the interests of the members, the creditors and the management of the co-operatives as well as to public interests.

2. Auditing of co-operative banks in Germany

As co-operatives, the German Volksbanken and Raiffeisenbanken are subject to the Genossenschaftsgesetz (GenG), the Co-operative Societies Act (CSA). The CSA defines the framework for all aspects of co-operative activities in Germany. Basic principles, for instance as regards co-operative audit, are specified.

As banks, all Volksbanken and Raiffeisenbanken are subject to the Kreditwesengesetz (KWG), which is the German Banking Act (BA), as well as to the Handelsgesetzbuch (HGB), the German Commercial Code (CC). The BA sets the rules which are compulsory for all banks in Germany (regulations for business activities, auditing, etc.), the CC defines regulations which apply to all business activities in Germany (bank as well as non-bank/ co-operative as well as non-co-operative).

Both BA and CC are amended - if necessary - in order to guarantee full implementation of European law. At any point in time, all German laws which concern banks (thus including co-operative banks) fully meet EU requirements. Up to now, it had not been necessary to adjust the CSA, as the German law has always been regarded as a good standard within Europe.

In addition to the laws, all banks in Germany are subject to the same public authorities, the Federal Banking Supervision (Bundesaufsichtsamt für das Kreditwesen, Berlin) and the Deutsche Bundesbank (Frankfurt/Main). Both institutions co-operate in the banking supervision.

As regards the yearly audit, all three laws, CSA, BA, and CC are the basis for the auditing activities in the co-operative banking group. Here again, CSA sets the frame, i. e. the general organisation of the audit and both BA and CC define the way how the audit is executed.

It is important to notice, that the Volksbanken and Raiffeisenbanken in Germany receive no special treatment as banks in Germany. A specific co-operative banking-law or a specific co-operative banking supervision doesn't exist. All banks and banking groups in Germany are treated equally ("level playing field").

B. CO-OPERATIVE AUDITING FEDERATIONS

In Germany, the auditing federations are responsible for organising and maintaining the auditing structures within the context of the relevant laws. The organisation of the co-operative auditing federations (also called auditing associations) gradually developed over the time. The rural (later Raiffeisenbanken) and urban (later Volksbanken) co-operative banks constituted at the end of the last century their own federations with particularly field-emphasis. One of these fields was auditing.

Today, the German Co-operative and Raiffeisen Confederation in Bonn (DGRV, Deutscher Genossenschafts- und Raiffeisenverband e. V.) is the head-federation with the authority to conduct audits nation-wide. It emerged through the amalgamation of the urban and rural organisations in 1971. Under the roof of DGRV there are 11 regional (sub)-federations and 6 specialised auditing federations (special co-operatives). Each has audit-authority within their region.

In accordance with § 54 CSA, each co-operative bank must belong to a federation, which is officially entitled to conduct audits. Theoretically a co-operative Bank can withdraw its membership after a decision of the general assembly, but within an imposed period of time, fixed by the register-court, a new membership in another federation has to be verified. However, this has not been the case so far.
The federation can only fulfil all tasks and duties as assumed, if the necessary preconditions, i. e. a sufficiently sized staff of specially (bank)-trained federation auditors and an adequate administrational apparatus are secured.

The training of auditors is organised within the co-operative group. Here, it is one of the responsibilities of DGRV to set the common standards for this training.

Federation auditors start their training as assistants for three years. Bank-apprentice- ship and/or an university-degree is an initial requirement. As all other training programmes within the group, future auditors receive both training on-the-job as well as theoretical training in the co-operative academies (located at regional and national level). Having passed a final examination after a three-month-seminar at Akademie Deutscher Genossenschaften (ADG) in Montabaur, candidates can start as federation junior-auditors. With this system of training, the requirements of § 55 (1) CSA are fulfilled.

The rationale behind the system of co-operative auditing federations is, that like this an accumulation of a high amount of detailed, highly specialised know-how is achieved. This results in a higher quality of audit. Furthermore, the system of auditing federations assures an independent audit. The co-operative auditor can perform his work non-regarding any private business aspects. He and the auditing federation are totally independent as they have secure incomes.

The Federal Banking Supervision is at any time entitled to execute on-spot audits in credit institutions without prior notice (§ 44 (1) BA). A specific suspicion is not necessary.

C. MANDATORY CO-OPERATIVE AUDIT IN GERMANY

1. General Outline

As mentioned above, § 54 CSA requires that every co-operative is obliged to be member of a co-operative auditing federation. The timely and correct audit is in the responsibility of the federation.

The CSA prescribes in § 53 that "the facilities, the financial position and the management of the co-operative" are to be audited yearly (or all 2 years if the balance sheet total is below 2 million DM). Both BA (§ 27) and CC (§340 k) refer explicitly to the § 53 CSA. Therefore the audit of co-operative banks is not only a financial assessment (like in other private companies) but also an assessment of the management. This guarantees a high degree of information in the auditors report.

In essence, it is an audit not only for the proper compilation of the annual accounts, but a comprehensive management audit as well. The co-operative audit is a service audit, effective for the future. It is not merely a stock-taking of the past.

The certification of the financial statement for credit co-operatives is provided in connection with the auditing of the year-end statement (§ 26 (1) BA). The auditing procedures are determined in the CC (§ 316 (3), §317 (1)).

The auditing federation has the right and the obligation to point out serious shortcomings in the economic position, in organisation and management. It will make recommendations accordingly and at a later date evaluate and control whether the recommendations have been put in place.

The group of German Public Savings Banks have similar regulations for their audit. The audit of this group is performed by the auditors of the savings bank association. The third banking group in Germany, the commercial banks, are audited by private auditing companies. Only co-operative banks have management audit. Therefore, the report by the auditor has a very high quality and provides the banking supervision as well as the general assembly with important pieces of information which go far beyond a mere evaluation of the financial situation.

Therefore, the auditing federation can be regarded as a knowledgeable adviser of the organs of the affiliated co-operative in questions of management and accountancy. This also requires a high degree of mutual trust and respect between the auditor and the bank-managers. This experience of continuous advice and service is also useful for the audit itself.

2. THE AUDIT

2.1 Introductory Remarks

The Banking Act puts primary topics for auditing for credit institutions, thus also for co-operative banks:

- Organisation and supervision of the bank
- Capital and liquidity requirements
- Large exposure regulations
- Special reporting requirements
- Licensing,
- Safe-custody account audits
- Money laundering
- Deposit guarantee scheme.

The audit is conducted by following the auditing principles and instructions issued by the auditing federation in accordance with professional guidelines set by the Chamber of Certified Public Accountants and the Institute for Certified Accountants.

In addition, the Federal Banking Supervisory Authority requires the integration of statements on specific topics in the annual or intermediate financial statements of a credit institutions. Some of these are:

- The shape of the internal revision (internal control system); the quantitative and qualitative shape of the system has to meet all requirements for the size of the audited bank;

- The organic degree in accounting, EDP-configuration and recognised defects;

- Charge for provision against bad and doubtful debts and latent risks;

- Observance to § 18 BA; disclosure of financial circumstances from a single borrower owing more than 250.000 DM to the credit institution;
- Reports to the Deutsche Bundesbank for loans to a single borrower which, taken together, amount to or exceed 10 percent of the banks liable capital (large exposures).

The auditor must immediately notify the chairman of the supervisory board upon making important findings, which require measures right away by the board.

If in the course of the audit the auditor learns of facts which might threaten the final certification of the audit, or which might even endanger the existence of the bank or gravely impair its development or which indicate that the managers have seriously violated the law or the articles of the association, he has to make - according to § 29 (2) BA - an immediate report to the FFSA and Bundesbank.

2.2 Financial Assessment

The audit of the financial position is concentrated above all on the situation of assets, finances and revenue as well as on efficiency and profitability. It is based on accountancy; the audit itself includes the totality of assets and liabilities at their full value, hidden reserves, acute and latent risks, uncertain payables and expenses, imminent losses form pending business, the formation of sufficient reserves/depreciation reserves. Conclusions and evaluations concerning the structure and suitable application of equity result from this, along with observations and assessments of the financial situation and structure as well as liquidity position. When considering and evaluating the revenue situation, the auditor must direct his formal observations to a certain degree to how the board has pursued the co-operative promotion principles.

2.3 Management Assessment

The management assessment must ascertain both formal and substantive regularity within management. It must be investigated whether the necessary personnel and material measures have been undertaken in accordance with relevant laws and regulations and the business policy, and whether these measures can be viewed as appropriate in the framework of the co-operative principles and business structure. The assessment is concerned with the management mechanism and its activity. The management functions include organisation, planning, information, auditing, internal control, accounting, personnel policy and technical operating ability. The organisation as a component of this functional mechanism includes both the internal and external organisation of the co-operative. The audit also encompasses the management policy, planning and supervision. In particular the fulfilment of the promotional policy and the observation of the principles regarding equal treatment of all members are to be studied.

The audit also serves to assess the personal dependability and specialised qualifications of the management, which are to be measured on the level of their responsibility according to § 34 CSA.

2.4 Other Specialised Audits

There are three more points the auditor has to observe:

(1) Deposit guarantee scheme

The deposit guarantee schemes of the banking groups in Germany can require additional audits. If one of those has taken place, the auditor shall submit his report on this audit to the FFSA and the Bundesbank immediately (§ 26 (2) BA).

The National Federation of German Volksbanken and Raiffeisenbanken e. V. (BVR) is responsible for the administration and management of the so-called "co-operative guarantee fund". The fund was established more than 60 years ago and has guaranteed ever since not only the deposits of members and customers of the Volksbanken and Raiffeisenbanken but covered institutional protection. With this scheme the demands of the EEC-Directive 94/19 of May 30, 1994 are more than fully implemented. If, during a regular audit, an auditor recognises the possibility for serious losses in a co-operative bank which might require actions by the guarantee-fund, he is obliged to inform - besides the banking supervision - BVR about it, too.

(2) Money Laundering Act (MLA) of October 25, 1993

The auditor has to examine the security measures determined by law for all credit institutions. He has to represent and criticise the arrangement by the bank to prevent money laundering, the way how suspicious cases have been handled by the bank, and if all relevant information has been given to the prosecuting attorney. The result of the examination shall be taken down in the report (§ 14 (2) MLA).

(3) Safe-custody account audits
Pursuant to § 30 BA, safe custody account audits shall be carried out once a year where banks conduct securities business or safe custody business. Volksbanken and Raiffeisenbanken act as universal banks and will be audited in the above mentioned way.

2.5 Reporting

Having finished the audit, the auditor presents an oral report to both the managing board and the supervisory board. He informs about the presumable results of the audit (§ 57 (4) CSA). Later, the auditing federation makes a written report on the results of the examination (§ 321 (1) CC). This report is certified by the auditor if no objections have been raised in a certain period of time (§ 322 (1) CC). Additional comments to or refusal of the financial statement is possible if there are particular reasons.

The final certified auditing report is sent to the FFSA.

D. INTERNAL CONTROL

1. General Remarks

Besides the external audit each credit institution in Germany is required to have an internal revision. In the co-operative sector, as in all other banking groups, this internal control is individually organised.

2. Supervisory Board

Under § 38 CSA, the supervisory board is required to supervise the managing board on its business-methods in all branches of the administration. At any time it may ask for information by the managing board and inspect the books and records. The supervisory board has to examine the annual financial statement, the management report and the proposal for the annual surplus / annual deficit.

The general assembly has to be informed about the results of the examination before the final determination of the annual financial statement. This co-operation by the supervisory board is part of an advanced superintendenting, especially in those cases when large loans (large exposures) are granted by the managers (§ 13 (2) BA).

3. Internal Revision

In 1976, the Banking Supervision set common standards how to shape internal controllership. Each bank is obliged to have an internal control system. In each bank, the procedure for internal control is fixed in written instructions for the bank. The particular working steps have to be decided individually for each of the bank's departments.

The internal reviser is directly responsible to the board of managing directors. He shall have received a specific training for his job and not be drawn to working positions which are incompatible with his primary one. Working papers are to be filled out completely and revision-reports have to be made. The reports shall be send to the managing board. They have to be kept available for the (external) auditors at any time.

In addition, each credit institution has to present monthly reports to the Bundesbank and the Banking Supervision, which contain recent information on their activities and performance.

4. The General Assembly

The members of the co-operative exercise their rights in the general assembly (§ 43 CSA). Among others, the general assembly determines the annual financial statement (§ 48 CSA). Before doing so, the members can ask the chairman of the supervisory board or the auditor for explanations about the annual financial statement, managing statement and on the final report of the auditing federation.

E. SUMMARY

The German co-operative sector has for more than 60 years a system of compulsory membership in federations and compulsory audits for co-operatives.

The audit and control of co-operative banks in Germany is organised in two ways. There is both the external audit by auditing federations and in each bank a system of internal control and revision.

Mandatory external auditing is determined by three laws:
§§ 53, 54 CSA
§§ 26 (1), 27 BA
§§ 316, 317, 340k CC

Additional audits are executed according to:

§ 26 (2) BA	Deposit-guarantee-scheme audit (Guarantee-fund)
§ 44 BA	Special audit
§ 14 (2) MLA	Money laundering audit

Internal revision is determined by:

§ 38 CSA	Supervision by the supervisory board
§ 48 CSA	Determination of annual financial statement

Regulations by the FFSA on Internal Control
Monthly reports to the Bundesbank / Banking Supervision

It is to stress that the CC limits itself to a mere audit of the annual statement.
The BA adds to this regulations the necessity that an (external) auditor comments in his report on the general situation of a bank, the management of the loans portfolio, etc.
The CSA goes even further and requires that credit co-operatives have an annual audit of their management (business structure, assessment of the institution, the organisation of internal procedures, management mechanisms and activities, management policy etc.). This specific form of additional annual audit exceeds all other requirements and contributes significantly to the successful performance of the co-operative banking group.