Linkages between formal and informal financial institutions in extending financial services to the poor

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Introduction

One of the most important innovations in development finance in recent years has been the emergence of microfinance. Millions of very poor people receive and repay small loans, even though they possess few assets or skills. At least two decades of experimenting lead donors and practitioners in developing countries to identify and duplicate best practices – just think about the famous Grameen Bank. However, this so-called financial frontier has been slow to develop in many developing countries. Millions are still not reached with any form of sustainable or reliable finance, with many of the existing providers of microfinance institutions being completely dependant on donor subsidies

During 2003 AID[2] hosted a conference on rural finance in Washington DC. During this conference all major donor agencies emphasized their commitment to continue searching for solutions through active experimentation and innovation. Amongst these pledges was that of the Ford Foundation, which offered, as part of their effort to develop strategies that build assets for the poor, to fund an international research project on financial linkages. The research analysed how linkages between financial institutions are a potential solution to the sustainability issues surrounding microfinance. The results from this Ford sponsored study, coordinated by FAO, in Africa, Asia and Latin America are presented in an article published in the March 2006 edition of the Small Enterprise Development Journal. This note reports briefly on the research findings.

The theory behind financial linkages

Linkages between established or formalized financial institutions and less formal or informal financial systems create new possibilities for delivering microfinance to the poor. The literature on financial linkages is based on how the information and enforcement problems in credit markets result in a mismatch of resources and abilities between formal and informal lenders. While formal financial institutions have extensive infrastructures and systems and access to funds, they are usually further removed from rural or poor clients, making it very difficult to obtain adequate information and reducing risks. In contrast, informal financial institutions operate close to rural clients, possess quite good information and enforcement mechanisms and are typically more flexible and innovative. However, they are constrained in the services they can offer since informal institutions lack resources and infrastructure to serve clients beyond a small geographic area, resulting in highly concentrated loan portfolios.

Linkages between formal and informal financial institutions appear to be able to reduce the high information and enforcement problems that increase transaction costs in rural credit markets. **For purposes of this large research initiative, a financial linkage was defined as any mutually beneficial partnership between a formal and a less formal institution that results in the expansion of rural financial services**. This “expansion” does not just refer to reaching more of the same clients; but strives to provide access to previously unserved (or new) segments of the rural population or to broaden the variety or improve the quality of financial products and services.

The cases investigated, in Africa, Asia and Latin America show a rich variety of such financial linkages. For purposes of the study the recipients of these financial services were defined as all rural smallholders, enterprises, households, small traders and local organizations and associations, and any previously unbanked rural people, such as subsistence farmers and women were included. Figure 1 illustrates the range of financial institutions in the developing countries. The range is

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[2] Agency for International Development. Paving the way forward for rural finance: An international conference on best practises. Conference held in June 2003, Washington, DC.

presented as a continuum of formality, i.e. the institutions towards the left are more established and formal.

Figure 1: Continuum of formality

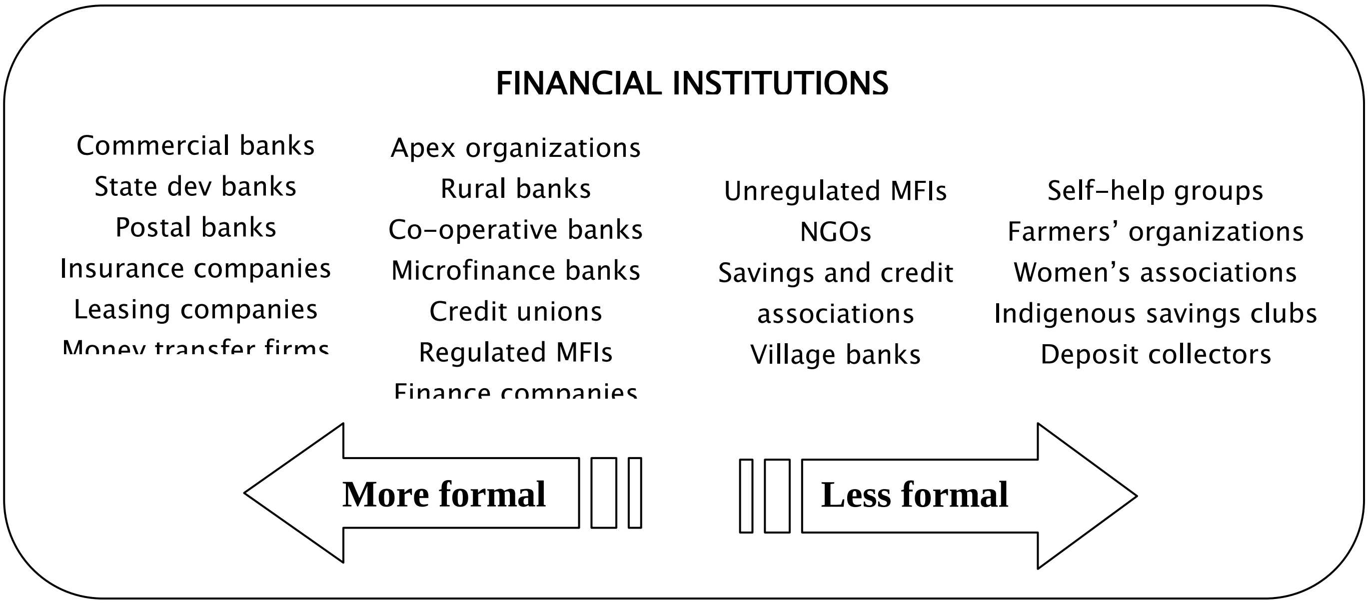

Figure 1 shows the diverse range of linkage actors operating as potential partners, with the more formal actors represented by private and public commercial banks and apex organizations and more informal actors being self-help groups, village banks, savings and credit associations, financial NGOs, and rural/community banks. Other actors that also play a significant role in financial linkages include insurance companies, money transfer firms, utility companies, and even government departments involved in the disbursement and/or collection of salary and pension payments. Numerous linkages, established for many reasons between these partners were identified in this research. We grouped financial linkages into two broad categories:

- ***Direct financial linkages*** refers to linkages between financial institutions in which the main purpose of the linkage is to help less formal institutions *diversify* their sources of funding, *expand* their loanable funds and/or *balance* liquidity shortages and excesses. A typical example of this type of linkage is a bank or apex organization offering bulk loans to MFIs for on-lending to clients.

- ***Facilitating linkages*** refers to linkages between institutions in which the formal institution "hires" the less formal institutions to act on its behalf. This type of linkage facilitates the transactions, such as remittances, the payment of utilities, and the mobilisation of savings or even facilitates loan payout. Typically the one partners or financial institution will pay the other partner a fee to "facilitate" the transaction.

Research findings

Over the last 4-5 years many private banks and insurers have entered the microfinance market by establishing direct financial and facilitating linkages with less formal actors. ICICI Bank, India's second largest commercial bank partners with microfinance institutions (MFIs) in unique ways to extend credit directly to India's numerous self help groups (SHGs) in rural areas (Harper and Kirsten, 2006). ICICI uses the MFIs as facilitation agents to help screen and monitor the members of self help groups.

AVIVA Life India, a leading global insurer, uses microfinance institutions to sell life insurance products to rural people. In Tanzania, CRDB Bank Limited, a private bank has aggressively entered the market by offering MFIs a range of financial services from long and short term loans and credit lines to various payment and transfer instruments (Piprek, 2005). To do this the bank has set up an entire microfinance unit dedicated to the development of this new market segment.

Public, private or community owned apex or wholesale organizations continue to play a significant role in expanding financial services in non-traditional markets through direct financial linkages. In the Philippines, the government-owned apex organization, PCFC, partners with different microfinance players by offering wholesale credit and training to them. PCFC select and train these MFIs, and then "accredits" them to on-lend. In Honduras, a private first and second-tier organization, Covelo Foundation, offers bulk loans and lines of credit to MFIs and plays a significant role in strengthening MFI internal systems and controls to improve self-regulation mechanisms.

Private microfinance banks and financial NGOs establish linkages with various actors in an effort to expand the scope and scale of their businesses, enabling them to survive in competitive, maturing microfinance markets. Fundación para Alternativas de Desarrollo (FADES), a non-regulated, non-government organization in Bolivia, strategically created a number of inter-institutional linkages allowing them to offer their clients an array of services, such as deposit and money transfer facilities, bill payment and salary and pension contribution collections (Gonzalez-Vega and Quiros, 2005). In Kenya, the recently privatized microfinance bank, K-Rep Bank, links with various MFIs and SACCOs as a way to minimize costs and further its business (Sabana, 2005).

Interpreting the results
Deriving lessons from 12 case studies conducted in 11 different countries on three different continents is very complex and makes use of many assumptions. We identified the following research themes to assist with the interpretation:

- What was the motivation behind the initial creation of the linkage;
- Clarifying the contracting mechanics and their effectiveness in dealing with risk, conflict resolution, and profit sharing;
- What were the linkage outcomes at client and institutional levels;
- What is the role of capacity building in establishing and sustaining linkages;
- Financial system develop and the potential for linkages

Linkage motivation
One of the significant observations emanating from the research is that linkages between two financial institutions are rarely *spontaneous*. The evidence indicates that the direction of or impetus for the linkage is often from the more formal to the less formal partner, and the motivatation for the linkage is often external rather than internal or spontaneous. ICICI Bank in India might appear to have taken a deliberate decision to link with partner MFIs to increase its outreach to the poor. However, this seemingly internally driven linkage was initially motivated more by the imperative of regulatory compliance, after acquiring new banking assets rather than by autonomous action. The so-called priority sector targets, which require all commercial banks to lend at least 40 percent of their net credit (at an interest rate not more than 4 percentage points above their prime lending rate) to priority sectors - rural areas, small industries, exporting firms, housing and agriculture – forced ICICI Bank to take initiatives to reach further and deeper into 'priority areas'. While it is often claimed that a "larger social purpose" (Banerjee and Duflo, 2004) seems to inspire Indian banking, the initial motivation in the ICICI case still seemed to be compliance rather than a social objective. It may turn out that ICICI has made the happy discovery of profitable new markets due to its acquisition of assets in unfamiliar territory. Its capacity to apply unorthodox and sophisticated solutions in these circumstances may prove a lasting contribution to linkage methods.

Contracting mechanics
Inherent in any investigation about linkages between financial institutions are issues of contract design and how issues like risk, profit sharing, conditionalities and conflict resolution are resolved. Risk mitigation of the loan portfolio is an important yet complex component in designing linkage contracts, especially when MFIs *facilitate* loans on behalf of their formal partners. ICICI Bank is furthest along in this area as it has designed a range of risk mitigation mechanisms. For example, ICICI requires partner MFIs to open fixed deposit accounts in the amount of 8 – 15 percent of the total value of the MFI loan portfolios purchased by ICICI. The required amount varies according to the perceived quality of the portfolio purchased.

Conditionalities embedded into the linkage contract, typically by the formal institutions, are often binding on their less formal partners. In the cases reviewed, we observed that some MFIs were compelled to accept restrictive terms and conditions from funders. MFIs often do not have a choice but to accept these conditionalities, since their own regulatory status prevents them from accessing capital through deposit taking or straight loans. Examples of such conditionalities include PCFC, the government owned apex requiring its MFI clients to use a preset lending methodology, the Grameen model; BPD, the provincial bank in Bali requiring its partner LPDs to save only with their bank only; and FINCA/Costa Rica being pressured to accept requirements on interest rates, staffing and equipment purchase decisions.

Linkage outcomes
Any financial linkage between two partners must have a measurable outcome. The effect of the linkage on the partners was observed and reflected on, but more importantly, we asked if the linkage resulted in access to previously unserved segments of the rural population or a bigger variety or improved quality of financial products and services. We observed that financial linkages do expand the amount and nature of financial services in rural areas as reflected in our discussion below on client and institutional outcomes.

<u>Client level</u>
Linkage arrangements between formal and less formal financial institutions certainly expanded financial outreach into rural areas. Over a million clients have received loans from institutions linked to PCFC funding in the Philippines. More than 20,000 individuals living deep in the rugged countryside of Rwanda now access credit and other financial services of the Peoples Banks on a regular basis, and many group members are leveraging their creditworthiness to open personal accounts. In Tanzania, CRDB has reached close to 80,000 new rural clients through 157 SACCOs by offering loans, savings and money transfer services. Unfortunately our research did not have access to baseline data to ascertain to what degree these clients included new segments of the rural population. What we could measure is the improved quality brought about by linkage conditions. Self help group clients in India have been empowered by their partnerships to interact direct with other banks, negotiating better terms and conditions for the products and services received.

Linkages also served to broaden the variety of products and services. In Bolivia, Costa Rica, Honduras and India well-established MFIs with an explicit strategy of improving and expanding client services, are offering an array of integrated services. They are not just providing direct loans, but are delivering life, livestock, weather and health insurance, money transfer and bill payment as well as pension and salary payment services. For example, more than 200,000 clients now have access to life and other insurance products because of AVIVA's partnerships with several MFIs operating in rural India. In Bolivia more than 25,000 former and new clients can transfer and receive money from Santa Cruz and can receive pension payments and pay electricity and phone bills in branches much closer to their homes. Many of these services are delivered to fill gaps in the market, and it might be that other financial service providers, such as insurance companies, or commercial banks, claims this role for themselves, once the MFI linkage has demonstrated that such financial deepening is possible.

<u>Institutional level</u>
We could more fully observe the impact of the linkage arrangement on the *institutions* involved. An example is FADES, the non-regulated Bolivian NGO which entered into a dozen strategic linkages with private and public sector organizations in an effort to increase its rural outreach. Between 2000 and 2004 a very rapid expansion of its branch network caused FADES to experience a decline in the average number of rural clients per branch; which motivated them to find innovative solutions to sustain their extensive branch network. FADES decided to opt for linkages with several non-financial institutions, and offered to facilitate electricity payments, pension transfers and to sell several utility cards on behalf of government institutions. This broader array of services led to an increase in the flow of people at the branch, it ensured a flow of funds at the branch level that reduced the need for transfers within the network, and the fees charged were sufficient to pay for several expenses at the branch, such as the cashier's salary and electricity and water bills. These innovative linkages have the potential of developing into major sources of revenue, thus contributing to FADES' overall sustainability (Gonzalez-Vega & Quirós, 2005).

Capacity building
Capacity building is an essential ingredient in fostering successful linkages between different institutional actors. It is essential to strengthen the capacity of microfinance intermediaries to build and maintain these linkages or partnerships with new partners. Training is needed in the following areas: how to evaluate and select good partners, how to design and negotiate partnership contracts, how to select and train new and/or old staff to develop and manage partnerships, how to set up new components of MIS to account for the revenues and costs associated with new business lines, and how to evaluate properly the costs and benefits of partnership.
Of the twelve cases reviewed more than half had an explicit component to build the general managerial capacity of the informal actors. In the case of Rwanda, CARE International organizes and trains SHGs on savings and credit operations. In the Philippines, PCFC through its partnership with CARD NGO provides training course to MFIs and others wanting to access wholesale funds but fail to meet the necessary precondition to do so. In the cases of BPD-LPD linkage in Bali and Covelo in Honduras we see more of mentoring and supervisory role happening between the more formal and less formal institutions. However, none of the cases have included explicit assistance and/or training intended to help the less formal actors engage more *effectively* in the partnerships; however, we did observe much experimentation and leveraging of learning (or *learning by doing*) by less formal institutions to establish more suitable partnerships with commercial banks and insurers in India and Bolivia.

Financial system development and the potential for linkages
The state of development of a country's financial system dramatically affects the potential for financial linkages. In countries where formal and less formal institutions are both weak, the potential for linkage is extremely low. In contrast, in countries where formal and less formal institutions are both strong the potential for linking is quite high. Conning and Kevane (2002) use the analogy of islands (institutions) linked with bridges (transactions), and indicate that: "Where financial intermediation is more developed, a dense network of actual or potential bridges across islands will be in place". They continue to indicate that "bridging the gaps" between the local, informal partners and the national, formal partners is something that will increasingly happen, as a country develops.

Using formal-informal dichotomies to describe the financial systems in the countries reviewed a few cases can be highlighted to demonstrate the potential for linkages. For example, in Rwanda, where both the formal and informal financial sectors are relatively weak the potential for linkages is extremely low. A case in which the potential for linkages is higher is in India which has a strong formal financial sector, but a relatively weak informal sector. In fact, building the capacity of MFI partners seems to one of the biggest challenges facing both ICICI Bank and Aviva Life in the country. In contrast, in Bolivia where the informal sector is thriving, it is difficult for an MFI like FADES to find a reliable formal partner for mobilizing deposits.

Conclusion
The microfinance industry is enriched by innovative efforts to combine the comparative strengths of different types of institutions, as illustrated by the on-going debate around commercialization of microfinance. How can linkages between formal and less formal financial institutions help expand rural financial services? The twelve cases studies examined herein offer a shopping bag full of options, from commercial banks using the infrastructure and local knowledge provided by MFIs to reach self help groups, to large international insurance companies gaining thousands of clients by linking their insurance products to every loan that an MFI makes. While the first example increases the availability of finance, the other widens the product range available to the rural poor. Clearly, linkages offer mutually beneficial solutions for both formal and less formal financial institutions.

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