



Village banks: the new generation

How IFAD helped FINCA set its village banking programmes on the road to commercialization



What is FINCA?

FINCA International, Inc. provides financial services to the world's poorest families so they can create their own jobs, raise household incomes, and improve their standards of living. FINCA delivers these services through a global network of locally-managed, self-supporting institutions.



Microfinance puts savings, insurance, credit, transfer services and other financial products within the reach of poor people. As outreach to new clients improves and inclusive financial sectors begin to take shape, microfinance institutions (MFIs) face a growing need for loan capital. In response, many MFIs are exploring the models of mainstream financial institutions like banks and credit unions to attract new capital to the sector.

Despite the benefits of new capital, the process of commercialization in microfinance carries a number of risks. Many MFIs are seeking targeted technical assistance to take advantage of the benefits of commercial funding while managing these risks. Donor resources, such as the grant that IFAD provided to FINCA, can help MFIs access this technical assistance, lessen the risks of commercialization and better serve poor clients.



IFAD's technical assistance grant to FINCA: commercializing village banks in Latin America

IFAD awards technical assistance grants to promote innovation and knowledge sharing among its partners in the field. Currently, 10 per cent of IFAD's portfolio is in the form of grant funding.

The objective of the US\$600,000 grant to FINCA was to improve the quality and volume of financial services reaching the poor by strengthening the FINCA village banking affiliates that serve them in Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico and Nicaragua.

Work funded by the grant ran from 1999 to 2002.

Village banks and commercialization

What is village banking?

FINCA was founded on the village banking model of microcredit, under which neighbours in a poor community form a borrowing group. Each group member is required to save 20 per cent of the money they borrow and agrees to repay any other member's default from these savings; there is no other collateral for the loans. The groups are self-selecting so default is rare and the savings form the beginnings of an asset base for the borrowers. FINCA provides capital for the groups and staff visit the weekly meetings to supervise repayment. Otherwise, the groups are self-governing: they elect their own officers, devise and enforce their own policies, and keep their own books.

With strict adherence to the principles of village banking, FINCA affiliates have achieved excellent repayment rates. Anecdotal evidence from clients has demonstrated the programme's strong social impact, especially among the poorest people. Village banking programmes, on average, also succeed in higher outreach in rural areas than other lending methodologies.¹ After more than 20 years of operations, FINCA affiliates throughout the world continue to provide some of the smallest loans to the poorest clients.

¹ IDB/CGAP inventory of 176 MFIs, as cited by Glen Westley in *A Tale of Four Village Banking Programs: Best Practices in Latin America* (March 2004).

What is IFAD and why is it involved in microfinance?

The International Fund for Agricultural Development (IFAD) is a specialized agency of the United Nations dedicated to enabling rural poor people to overcome poverty. Microfinance is an important part of its work and puts credit, savings, insurance and other basic financial services within the reach of rural poor women and men. Almost three quarters of IFAD programmes and projects provide financial services to the rural poor. As of April 2005, this represented an investment of US\$740 million, approximately 23 per cent of all IFAD loans.



What is commercialization?

Commercialization involves taking a market-oriented approach to the provision of financial services and gaining access to private sources of funding. There are two notable trends in the commercialization of microfinance. The first is the entry of private, for-profit financial intermediaries, such as banks and credit unions, into the microfinance sector. The second is the transformation of MFIs, like the FINCA affiliates, into licensed financial institutions. FINCA Ecuador, for example, has made the greatest progress towards commercialization and was the first FINCA affiliate to secure a licence to operate as a deposit-taking entity. For FINCA programmes, gaining access to private sources of funding, such as commercial loans, has been critical in the process of commercialization.

Why commercialize?

The demand for village banking services is growing. The United Nations Capital Development Fund estimates that the global demand for microfinance services is as high as 500 million households. As of 2002, only 30 million of these households had access to sustainable microfinance services.² In response to this demand, village banking programmes are pursuing the commercial funding that will enable them to grow, improve their performance, and make microfinance services available to more rural poor people worldwide.

What are the obstacles to commercialization?

In some cases, the influence of donor funding has created MFIs that are not fully aligned with commercial banking principles. Some MFIs, including village banking programmes, may:

- lack the capacity to produce business plans and cash-flow estimates
- lack transparency, adequate internal controls and management information systems
- generate high operating costs
- fail to establish clear ownership and governance structures

On their part, most mainstream financial institutions are unfamiliar with the microfinance sector and the objectives and methods of MFIs. This unfamiliarity with village banking programmes makes it difficult for commercial banks to assess the value and quality of the assets. Banks are also hesitant to lend in a sector without a successful track record that is easily understood.

The challenge for the microfinance industry, including FINCA affiliates, is to address their own shortcomings, build a dialogue as well as trust with mainstream financial institutions, and adopt commercial norms while maintaining core social objectives.

² <http://uncdf.org/english/microfinance/facts.php>





What does commercialization involve?

During the process of commercialization, MFIs work to gain access to commercial funds by:

- improving planning capacity, transparency and internal controls
- reducing operating costs
- clarifying ownership and governance structures

When village banks gain access to commercial funds, their assets grow and their loan portfolio expands, enabling them to offer microfinance services to a greater number of poor families. Commercialization often also gives MFIs the opportunity to further develop and diversify their products, which means they can better serve the needs of their target market.

The impact of commercialization

Access to commercial funding has been part of a virtuous cycle for FINCA affiliates. By overcoming one of the main constraints to growth, it has enabled FINCA village banks to increase the scale of their operations. Combined with a drop in operating cost ratios, this resulted in an increase in earnings that has strengthened the financial position of FINCA village banks. This can be seen in the growth in the equity of the village banks that participated in the work funded by the IFAD grant. The aggregate value of their net assets doubled from US\$5 million to US\$10 million by the end of the programme. Aggregate assets now stand at US\$15 million.



IFAD's grant to FINCA

IFAD provided a grant to FINCA to improve the quality and volume of financial services reaching rural poor people in Latin America. The programme funded by the grant aimed to strengthen organizational capacity to deliver microfinancial services through the institutional development of FINCA affiliates.

At the beginning of the programme, FINCA conducted specialized institutional assessments for each of its targeted affiliates. The evaluation methodology, which was designed by FINCA, was linked to a planning tool that set strategic and operational targets. On the basis of the assessments, an institutional strengthening programme was designed for each affiliate, responding to the most significant weaknesses undermining their potential for expansion and sustainability. These institutional assessments also had repercussions for access by affiliates to commercial funding, because they were used to assess eligibility for credit-enhancement facilities, such as loan guarantees, offered by FINCA's Village Bank Capital Fund.

With IFAD's support, FINCA was able to further refine the village banking model and reward clients and groups that met higher performance standards. FINCA has designed a system that differentiates between high- and low-performing groups and offers incentives to clients and groups with superior repayment histories. These incentives include items that top the list of client requests: larger loans, grace periods and more flexible repayment schedules.

Key achievements of the grant

- Outstanding loans increased significantly: during the lifetime of the grant, the village banking portfolio of the five FINCA affiliates rose by 150 per cent, from approximately US\$6 million in March 1999 to US\$15 million in March 2001 (see Chart 1). This growth continued after the grant programme was completed: as of 2005, the portfolio was worth approximately US\$30 million.
- The number of active clients grew from 55,000 to 80,000 during the period of the grant, and had reached 124,000 by June 2005 (see Chart 2).
- Access to external borrowing increased: it stood at virtually nothing in 1999, had risen to US\$5 million by March 2002, and has since doubled to US\$10 million in 2005.
- The five FINCA affiliates targeted by the grant programme have all shown sustained decreases in administrative cost ratios.

Chart 1
Loans outstanding

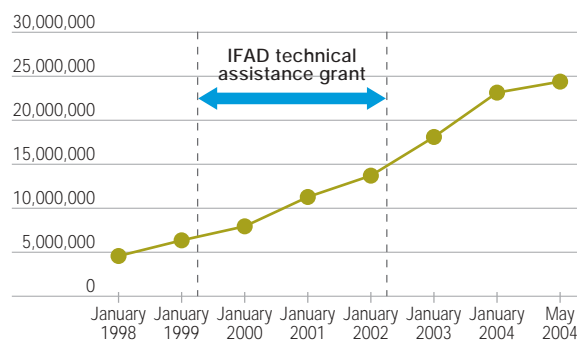
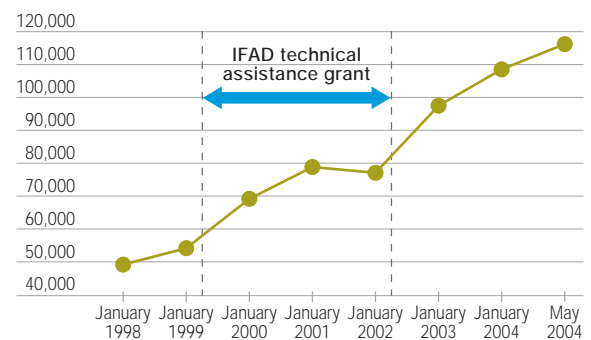


Chart 2
Active clients (consolidated)

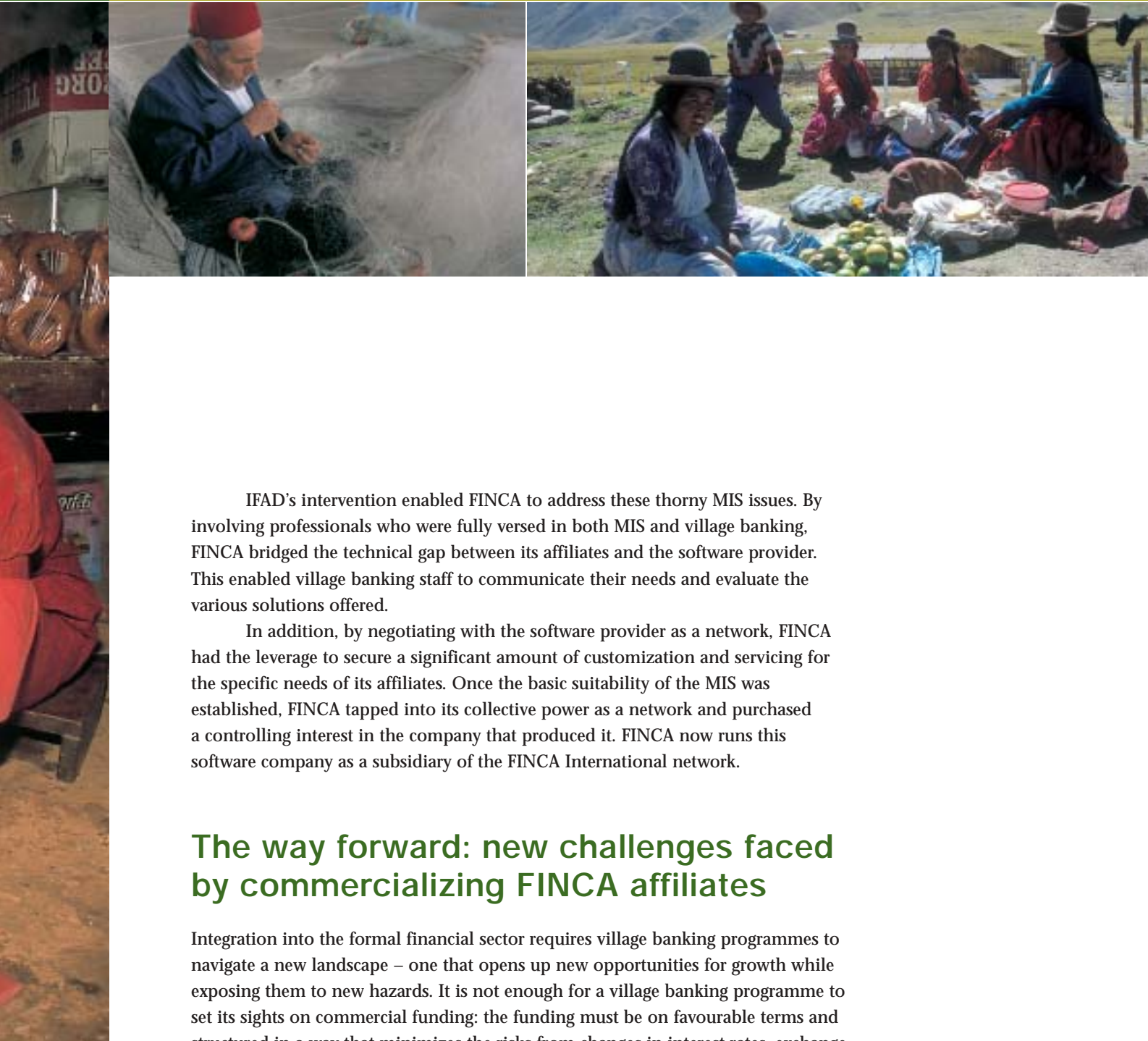


For FINCA affiliates in Latin America, both the value of loans outstanding and the number of active clients increased significantly during the period of the IFAD grant. This growth has continued and even accelerated since the close of the grant.



FINCA and management information systems

Management information systems (MIS) have a profound impact on virtually every business process. MFIs often find themselves working around their MIS, cramped by the constraints of a generic system, or struggling to customize and maintain the underlying software with inadequate support.



IFAD's intervention enabled FINCA to address these thorny MIS issues. By involving professionals who were fully versed in both MIS and village banking, FINCA bridged the technical gap between its affiliates and the software provider. This enabled village banking staff to communicate their needs and evaluate the various solutions offered.

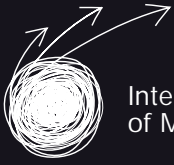
In addition, by negotiating with the software provider as a network, FINCA had the leverage to secure a significant amount of customization and servicing for the specific needs of its affiliates. Once the basic suitability of the MIS was established, FINCA tapped into its collective power as a network and purchased a controlling interest in the company that produced it. FINCA now runs this software company as a subsidiary of the FINCA International network.

The way forward: new challenges faced by commercializing FINCA affiliates

Integration into the formal financial sector requires village banking programmes to navigate a new landscape – one that opens up new opportunities for growth while exposing them to new hazards. It is not enough for a village banking programme to set its sights on commercial funding: the funding must be on favourable terms and structured in a way that minimizes the risks from changes in interest rates, exchange rates, regulations and refinancing. To lessen these risks, the next generation of technical assistance to commercializing MFIs will emphasize specialized expertise in financial, banking, tax and commercial law.

Despite the potential pitfalls, the trend towards the commercialization of village banking programmes is sure to increase, driven by a growing need for loan capital. Technical assistance will continue to play a role in this process, enabling programmes to seize the benefits of commercial funding while managing its risks.

As the microfinance industry continues to tap into the strengths of the commercial banking sector, the strategic use of donor resources will help village banking programmes and other MFIs access the vast pool of non-donor funding. IFAD's grant to FINCA demonstrates one way in which donors can prepare MFIs to reap the benefits of commercialization, while lessening the risks.



International Year of Microcredit 2005

Microfinance is a valuable tool for fighting poverty – especially in the developing world's rural areas, where more than 800 million extremely poor people live. By putting credit, savings, insurance and other basic financial services within their reach, microfinance can give millions of poor women and men the opportunity to overcome poverty themselves.

In designating 2005 as the International Year of Microcredit, the United Nations created a platform for Member States, UN agencies and microfinance partners to unite to build sustainable and inclusive financial sectors and achieve the Millennium Development Goals (MDGs). The five key objectives for the International Year of Microcredit are to:

- Assess and promote the contribution of microfinance and microcredit to the MDGs
- Increase public awareness and understanding of microfinance and microcredit as vital parts of the development equation
- Promote inclusive financial sectors
- Support sustainable access to financial services
- Encourage innovation and new partnerships by promoting and supporting strategic partnerships to build and expand the outreach and success of microcredit and microfinance





How village banking programmes improved their performance during the grant

FINCA Honduras

FINCA Honduras was hard hit by Hurricane Mitch in October 1998, which left many clients unable to repay loans. The effects of the hurricane-related delinquency were magnified the following year when the institution suffered a general decline in almost all respects, including financial performance.

FINCA used the institutional assessment to identify the weaknesses in this affiliate; these included unqualified staff, weak implementation of controls and high costs. The strategy designed to improve the performance of FINCA Honduras focused on restoring the quality of the loan portfolio, reversing erosion of its equity, eliminating sources of fraud and reducing costs. By the end of the IFAD grant, these efforts had paid off. The portfolio at risk had fallen to less than 4 per cent, from an all-time high of 12 per cent when the grant programme began.

FINCA Nicaragua

In FINCA, as in other MFIs, management information systems (MIS) are usually a back-office concern, used to capture data related to loans, income, expenses and bank accounts, and to produce reports. Under the IFAD grant, FINCA pushed its MIS further into the field. In Nicaragua, FINCA had relied on commercial banks to cash loan disbursement cheques for its clients and to collect payments. When this arrangement led to crowded banking halls, the commercial banks threatened to suspend these services. In response, and with support from the Central American Bank and IFAD, FINCA implemented a teller system to service its clients directly in its offices.

For FINCA, the creation of teller-equipped branches was a critical step in extending its services to more rural areas. When it relies on commercial banks to process loan transactions, FINCA's reach is limited to the places where the banks have branches. By breaking this dependency, FINCA can create its own infrastructure in areas beyond the reach of commercial banks. This process has been complemented by a significant decentralization of FINCA's administration, thus creating an extended platform for faster growth in rural areas.



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