A Tale of Four Village Banking Programs

Best Practices in Latin America

Glenn D. Westley

Inter-American Development Bank

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Mail Stop B-0800
Inter-American Development Bank
1300 New York Avenue, N.W.
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e-mail:	sds/msm@iadb.org
Fax:	202-312-4134
Web site:	http://www.iadb.org/sds/mic

Foreword

The field of microfinance is developing rapidly in many directions at once. Among these, there are strong tendencies toward ever-greater levels of commercialization, an upscaling of the target clientele in the direction of larger microenterprises and even small enterprises, and increased levels of formal supervision from banking superintendencies. Somewhat paradoxically perhaps is the simultaneous occurrence of a strong trend of increasing outreach to very poor microentrepreneurs, the "low end" of the microfinance market. One of the leading actors in this effort to bring microfinance services to the very poor has been those microfinance institutions providing village banking services. In fact, a core mission of the village banking movement has been to use microfinance as a tool to help alleviate poverty.

Some numbers may help to make the situation clearer. One indicator of the more intense poverty focus of village banking comes from a recent IDB/CGAP survey of 176 of the largest and most sustainable microfinance institutions in 17 Latin American countries. It was found that the average outstanding balance of all village bank loans was $150, compared to $329 for solidarity group loans and $980 for individual loans. Village banking has grown very rapidly as well. Over one-quarter of the 176 surveyed microfinance institutions were offering village bank loans, often as their primary or even sole loan product. More clients were served by village banking loans in these 17 Latin American countries (410,000) than by solidarity group loans (350,000).

Village banking was introduced in Bolivia in the 1980s as a very rigid model. It involved fixed loan terms and initial loan sizes, mandatory weekly repayment meetings, working capital loans only, forced savings at a prescribed pace, no interest on savings, no access to savings for clients who remained in the village bank, and graduation of the entire village bank after three years. Since that time, many of these rigid characteristics have been relaxed as village banking institutions have increased their drive toward greater sustainability and scale while maintaining their focus on poverty.

Although village banking has relaxed many of its original rigidities, it still has not gone far enough. This paper examines each major element of the village banking technology and how it has been liberalized so far, particularly in four leading Latin American village banking institutions. It then analyzes how this liberalization process may be usefully carried forward in the future and makes numerous best practice and policy recommendations to achieve this.

Álvaro R. Ramírez
Chief
Micro, Small and Medium Enterprise Division

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Executive Summary

Village banking has arrived. In a recent IDB/CGAP inventory of 176 of the largest and most sustainable microfinance institutions (MFIs) in 17 Latin American countries, 47 MFIs offer village banking. Their village bank loans collectively cover a total of 410,000 clients with $61 million in portfolio and an average loan balance of $150. The number of clients served through village banking now exceeds the number served through solidarity group lending (350,000). Village banking institutions (VBIs) range from NGOs offering only village banking to regulated commercial banks offering village banking alongside solidarity group and individual microloans.[1] Geographically, the clients of VBIs range from remote rural regions to peri-urban and urban areas. However, the percentage of clients residing in rural areas is higher for village banking clients than for group or individual loan clients. In addition to this greater rural focus, the target clientele of most VBIs are very poor microentrepreneurs, and virtually all are women. One indicator of the more intense poverty focus of VBIs, taken from the MFI inventory cited above, is the low average balance of $150 for village bank loans, versus $329 for solidarity group loans and $980 for individual loans.

Employing a unique data set on client retention, we find that leading VBIs in Latin America have client retention rates significantly below a comparison group of individual and solidarity group lenders. Based on this fact and the substantial rigidities, transactions costs, and risks that village banking imposes on its clients, we argue that village banking needs to continue becoming more flexible and client-oriented in order to increase client satisfaction, retention, and impact. By improving client satisfaction and retention, VBIs will also facilitate increases in their own sustainability and scale.

Most of the paper (Chapters 2-3) is devoted to deriving and discussing numerous best practice and policy recommendations, with many of these recommendations focused on the theme of increasing the flexibility and client-orientation of village banking. The paper analyzes the current practices of four leading Latin American VBIs: FINCA Nicaragua, Pro Mujer Bolivia, Compartamos (in Mexico), and CRECER (in Bolivia). By making a detailed examination and analysis of the major aspects of the village banking methodology employed by these leading VBIs, we aim to show what lies behind their success. Each VBI's practices are studied critically and compared with those of the other VBIs, all within the context of the village banking experience and literature worldwide and especially in Latin America. This allows us to analyze what appears to be working well and what appears to need improvement, that is, what are good, bad, and questionable VBI practices, with particular reference to Latin America.

The remainder of this Executive Summary provides a brief digest of these best practice and policy recommendations. For readers without a background in village banking, this summary occasionally may be hard to follow, reflecting the fact that we are trying to summarize a great many conclusions in a small space. The text should elaborate on and clarify any difficult points. Readers who are totally unfamiliar with village banking may wish to read the first few pages of Chapter 1, including the section entitled, "What Village Banking Offers," in order to have a basic understanding of village banking before going on to read the rest of this Executive Summary.

[1] We use the term VBI to denote any microfinance institution offering village banking loans, even if it also offers other types of credit as well, such as solidarity group or individual loans.

The best practice and policy recommendations summarized here begin with how the village banks are structured and delinquency is controlled, and progresses on to cover the major characteristics of the VBIs' credit technology: loan size, repayment frequency, loan term, early payoff, repayment tracking, and the use of solidarity group and individual loans. These recommendations conclude with a discussion of village banking's savings services—including both forced and voluntary savings—as well as the internal account, non-financial services and the issue of licensing, and the role of village banking in rural finance.

Meeting length. Frequent, lengthy meetings are one of the most common causes of client desertion. One technique for reducing the length of meetings (and lessening loan delinquency) is to employ solidarity groups within the village bank. Each solidarity group works simultaneously to count member loan repayments and savings contributions. Group members may also lend to each other to cover any shortages. Pro Mujer's experience with not allowing meetings to end until all loan delinquencies are cleared up has led to notoriously long meetings, many client complaints, and dropout problems. Pro Mujer is giving strong consideration to eliminating this practice.

Delinquency control. Being able to make loans and recover a very high percentage of them is a *sine qua non* of achieving sustainability. The four VBIs analyzed in detail in this study have achieved impressively low loan delinquency rates, often under one percent. For this reason, the methods they use to control delinquency are described in detail. Here, it will only be said that all four remedy the delinquency problems of individual village bank members using varying combinations of: loans from other village bank members, the constitution of new collateral (often household goods) by delinquent borrowers, and the appropriation of forced and voluntary savings. All of these mechanisms are backed by the threat that if the village bank does not somehow repay its loan, it will lose access to future loans and other services from the VBI. The higher the quality of these credit and other services, the greater the motivation clients will have to repay. In addition, these VBIs and others encourage repayment using monetary incentives such as fines for late payments and the return of commissions to village banks in which all members repay on time. As an added incentive, Compartamos risk prices their village bank loans. All village banks start off paying a flat interest rate of 5.5 percent per month on their loans.[2] This interest rate is reduced to 4.5 percent flat for village banks that compile a good repayment record and is increased to 6.5 percent flat for village banks with a poor record. While the overall delinquency control strategies used by the four VBIs are generally very good, there are a few areas of concern, including cases in which voluntary savings are used inappropriately and delinquency feedback is slow.

Maximum loan size and the loan ladder. At $1400 for Compartamos, $1000 for FINCA Nicaragua and Pro Mujer Bolivia, and $800 for CRECER, the maximum loan sizes allowed by the four VBIs are generally quite reasonable. They are a far cry from the $300 maximums that were credited with causing substantial client desertion among Latin American VBIs in the mid 1990s. The loan ladder—which gives the largest size loan available to a village bank member at each loan cycle—appears more problematic in its intermediate steps in the case of two of the VBIs, CRECER and Pro Mujer Bolivia. Both of these institutions might usefully allow clients to progress more rapidly to the final maximum loan size, as clients are allowed to do in Compartamos and FINCA Nicaragua.

[2] Flat interest is computed on the original loan amount, not on the remaining balance. For example, clients with a 4-month loan and a 5.5 percent per month flat interest rate would pay 22 percent (=4 x 5.5 percent) of the original loan amount in interest, or $22 on a $100 loan.

A potentially-important innovation that might allow VBIs to decrease credit risk while simultaneously increasing loan amounts all along the loan ladder would be to give village bank members training in how to calculate household savings and loan repayment capacity. The rather arbitrary limits placed on borrowing by the loan ladder could then give way, at least somewhat, to a more flexible and reasonable approach based on the fact that village bank members would have a better understanding of each member's loan repayment capacity.

A potentially very useful way for VBIs to retain and serve clients whose credit needs exceed the village bank loan ceiling is to offer individual or solidarity group loans to this clientele. VBIs that offer individual or group loans should still maintain a reasonably high ceiling for the size of their village bank loans, in order to accommodate those clients who wish to satisfy all of their credit needs within the village bank.

Repayment frequency. Significant evidence is presented that the changeover from village banking's traditional weekly repayment meetings to biweekly meetings can be very beneficial in practice to both VBIs and their clients. More limited evidence suggests caution in the use of monthly repayments because they may result in high levels of loan default. Another important lesson of experience is that little may be accomplished if it is left up to loan officers to voluntarily switch village banks over from weekly to biweekly repayments. The loan officers often fear increased loan delinquency and the impact that this may have on the amount of incentive pay they receive. VBIs that want to make the switch from weekly to biweekly repayments may have to act more decisively, for instance, by offering the choice directly to village banks or by simply mandating the change. Finally, it is argued that the changeover from weekly to biweekly repayments should first be introduced as a choice since, for various reasons, some village banks may prefer to remain on a weekly repayment schedule. If biweekly repayments are successful and widely adopted, but there is a significant minority of village banks that still prefers to meet and pay weekly, the VBI might consider charging these clients the extra cost of providing this service—in order to retain a popular product but protect its own sustainability and capacity to expand outreach.

Loan term. An area in which VBIs should almost certainly offer their clients greater choice is in the term of their village bank loans. This is true for at least two reasons. First, it costs the VBI relatively little to do this, primarily some reprogramming of its systems. Second, for reasons discussed in Chapter 2, some clients and village banks prefer longer-term loans while others prefer shorter-term loans. Unfortunately, of the four VBIs surveyed here, only Pro Mujer Bolivia is committed to offering its village banks any real choice of loan term; thus, this is generally a weak area even among these leading VBIs.

Early payoff of loans (loan prepayment). Loan prepayment is a useful option that VBIs can offer to help their clients overcome the rigidity in the starting dates of their village bank loans. For example, by prepaying their existing VBI loan, village bank clients may be able to obtain a fresh (and perhaps larger) loan to help them restock their inventories in advance of the Christmas holidays or other peak selling periods.

Tracking individual payments. All VBIs must keep track of each village bank's forced savings and loan payments at the *village bank level*. In addition, VBIs may choose to track forced savings and loan payments at the *individual client level* as well—as is done by three of the four VBIs surveyed here. It may surprise some readers that implementing individual client tracking can have fairly modest costs (depending on the initial state of the VBI's information system), while returning several important benefits.

Solidarity group and individual loans. Solidarity group and individual loans offer important avenues through which a VBI can address the diverse credit needs of its target population, and thus help to keep client satisfaction and retention rates high. By offering group or individual loans alongside traditional village banking loans, a VBI allows clients to choose whether they want the greater flexibility and possibly reduced risks and transactions costs of a group or individual loan, or the savings and non-financial services offered by a village bank loan. Forcing clients to leave their village banks in order to access a group or individual loan—as two of the surveyed VBIs do—has two key drawbacks, and should be seriously reconsidered. First, it appears to greatly reduce client demand for the group or individual loan product. Second, it forces village bank members to give up all of the supports and other non-credit benefits of village banks, which many members value very highly.

VBIs should be careful not to commit the error of one of the four VBIs, which allows its incentive pay scheme to greatly favor village bank loans over group and individual loans, stunting the growth of the group and individual loan programs. VBIs should also be careful to avoid the mistake of another of the four VBIs, which offers exactly the same repayment frequency and loan maturity for its group and individual loans as it does for its village bank loans. This misses an important opportunity to diversify its product offerings in a way that meets a greater range of client needs.

Finally, VBIs that do not permit internal account loans may be interested in Compartamos' new "parallel loan" product, which Compartamos began pilot testing in March 2003. The product appears quite successful in at least partly replacing internal account loans with individual loans from the VBI. Compartamos expects to have 20,000 parallel loan clients by December 2004, after full product rollout.

Forced savings. VBIs typically require each village bank member to save. We make the following four recommendations about these forced savings:

- Less forced savings. VBIs with good repayment performance—for example, delinquency rates of under five percent—should strongly consider capping client forced savings balances at no more than 10-20 percent of the amount the client has borrowed from the VBI in the current loan cycle.

- Varying rates of forced savings. VBIs can usefully recognize that some village banks are riskier than others by varying the following ratio:

  $$\frac{\text{Client forced savings balance}}{\text{Amount the client has borrowed from the VBI in the current loan cycle}}$$

  This ratio would be set lower for all clients of village banks with good repayment records and higher for all clients of village banks with poor repayment records. In this way, cash collateral is increased where it is needed and decreased where it is not.[3]

- Greater access to forced savings (increased liquidity). VBIs should strongly consider following the lead of Compartamos and CRECER and offering their clients a village banking product in which forced savings are freely available at the end of every loan cycle without having to leave the village bank.

[3] This is the same ratio that the first bullet suggests capping at 10-20 percent. Taking these two suggestions together, this ratio might be set at five percent for all clients of village banks with very good repayment records, 10 percent for all clients of village banks with reasonably good repayment records, and 15-20 percent for all clients of village banks with weaker repayment records.

- Illiquidity options. For clients who prefer their savings to be illiquid, VBIs can offer products from a range of options, including traditional village banks (with forced savings that are available only when the client leaves the village bank or in an emergency), contractual savings products, and certificates of deposit. For VBIs that do not mobilize savings themselves, these last two products would be offered through a partner financial institution that is licensed to accept deposits.

Voluntary savings. VBIs normally provide village bank members an opportunity to save voluntarily, over and above the amounts the members are forced to save. We make the following four recommendations about these voluntary savings:

- Voluntary savings through the village bank account. VBIs should allow village bank members to save as much as they want by making voluntary deposits in the village bank savings account. This deposit service should be maintained even if internal account loans are discontinued.

- Access to voluntary savings (liquidity). VBIs should allow a village bank member to make withdrawals from her voluntary savings at all village bank meetings unless her savings are tied up funding internal account loans. In this case, the member may have to wait to withdraw her savings until the internal account loans are repaid, possibly until the end of the loan cycle.

- Earmarking. VBIs that allow internal account loans should also allow village bank members to designate whether their voluntary savings are to be used for such loans or should only be deposited in a financial institution. The same choice should be allowed for forced savings.

- Individual voluntary savings accounts. If it is possible to arrange, the VBI should consider offering its clients individual savings accounts for their voluntary savings.

While these recommendations may seem straightforward, only the first is implemented by all four VBIs surveyed here.

Internal account loans. Perhaps no subject in village banking elicits such heated debate among practitioners as the question of whether to permit internal account loans. The reason for this is that allowing these loans has many strong advantages and disadvantages. This section of the paper aims to increase our understanding of some of the key advantages and disadvantages of permitting internal account loans, in order to help VBIs make a more informed choice. Partly, this is done by applying data to test key hypotheses, an important contribution of the paper. For example, the data suggest—contrary to what some have hypothesized—that eliminating the internal account may not increase the VBI's loan delinquency rate (on the VBI's loans to the village banks) and may not increase loan officer productivity either. The latter might occur, for instance, if loan officers did not take advantage of shorter meeting times to squeeze in more meetings per week, but simply spent a little more time going from one meeting to the next or shortened their workday. The policy conclusion from this is that the theoretical benefits of eliminating internal account loans may not always be realized, and that strong management oversight may be critical to ensuring that they are. The four VBIs surveyed here provide fertile ground for discussing these and other internal account issues since two of the four VBIs (Compartamos and FINCA Nicaragua) have chosen to eliminate internal account loans and the other two have not.

Non-financial services and the issue of licensing. Two major conclusions are reached with regard to non-financial services. First, the provision of non-financial services

(NFS) by VBIs may, under certain circumstances, constitute an exception to the widely-held principle that best practice calls for microfinance institutions to provide financial services only (the minimalist model of microfinance). That is, the provision of NFS should not necessarily disqualify a VBI from being considered a best-practice VBI and therefore lead to the recommendation that these services should be spun off or eliminated. Second, bank superintendencies should not disqualify VBIs from becoming licensed, deposit-taking institutions simply because they provide NFS. Other factors should be considered—including the cost and quality of the NFS and the VBI's performance—in order to make that determination. In summary, we find that, under certain circumstances, VBIs offering non-financial services can be considered best practice VBIs and should be allowed to become licensed and mobilize deposits from the public.

Role of village banking in rural finance. Governments and donors looking to strengthen rural finance systems should consider the role that VBIs can play, given that many VBIs already have a strong rural presence. As noted in Chapter 1, the percentage of borrowers residing in rural areas is higher for village banking clients (29 percent) than for solidarity group clients (17 percent) or individual loan clients (8 percent). VBIs can and do reach both farm as well as non-farm rural households. Strengthening and expanding the operations of rural VBIs (as well as other types of MFIs already located in the rural areas) may work better than trying to lure urban commercial banks out to rural areas. The lack of rural lending experience of these banks may constitute a formidable barrier to their entry into rural markets.

1. Nature and Performance of Village Banking

Village banking has arrived. In a recent inventory of 176 of the largest and most sustainable microfinance institutions (MFIs) in 17 Latin American countries, 47 offer village banking (Table 1.1).[4] Their village bank loans collectively cover a total of 410,000 clients with $61 million in portfolio and an average loan balance of $150. The number of clients served through village banking now exceeds the number served through solidarity group lending (350,000). Village banking institutions (VBIs) range from NGOs offering only village banking to regulated commercial banks offering village banking alongside solidarity group and individual microloans.[5] Geographically, the clients of VBIs range from remote rural regions to peri-urban and urban areas. However, as data shown below will indicate, the percentage of clients residing in rural areas is higher for village banking clients than for group or individual loan clients.

In addition to this greater rural focus, the target clientele of most VBIs are very poor microentrepreneurs, and virtually all are women. Women are targeted in light of their special social needs (discussed below) and their well-known propensity to invest more than men in the health, education, and general well-being of their children and families.[6] One indicator of the more intense poverty focus of VBIs is the low average balance of $150 for village bank loans, versus $329 for solidarity group loans and $980 for individual loans. Despite village banking's apparently greater focus on poor clients and on rural areas, a number of VBIs show impressive levels of loan recovery and sustainability, as data presented later in this chapter demonstrate.

The major purpose of this paper is to derive best practice lessons and policy conclusions about village banking in Latin America. The main method of analysis used to derive these lessons and conclusions is to compare and contrast the current practices of four leading Latin American VBIs—FINCA Nicaragua, Pro Mujer Bolivia, Compartamos (in Mexico), and CRECER (in Bolivia)—with each other and against the background of the general village banking experience and literature worldwide and especially in Latin America. Chapters 2 and 3 are devoted to a discussion of these best practice lessons and policy conclusions, respectively, with Chapter 3 far briefer than Chapter 2.

The present chapter complements Chapters 2 and 3 by providing an introduction to village banking and what it offers. Chapter 1 then goes on to present a unique data set on client retention rates and argues that village banking needs to increase the flexibility and client-orientation of its methodology in order to improve client retention and impact, as well as VBI sustainability and scale. Chapter 1 also provides a thumbnail sketch of the four VBIs that are analyzed in depth in Chapters 2-3 and explains why these four were chosen for this analysis. Chapter 1 concludes with a discussion of the structure and performance of the village banking industry in Latin America. By comparing the performance of village banking to that of solidarity group and individual lenders, this discussion sheds light on two important issues: a) the rationale for using the village bank lending methodology and how this ra-

[4] In this paper, a microfinance institution (MFI) is any financial institution, regulated or not, that offers financial services to microenterprises.

[5] We use the term village banking institution (VBI) to denote any microfinance institution offering village banking loans, even if it also offers other types of credit as well, such as solidarity group or individual loans. We follow the *Microbanking Bulletin* in defining solidarity group loans as those made to groups of 3-9 borrowers and village bank loans as those made to groups of 10 borrowers or more.

[6] This propensity is discussed, for example, in IDB (1999).

Table 1.1
Type of Loans Made by MFIs in Latin America

Type of Loan	Number of MFIs Making These Loans	Total Number of Borrowers	Total Loan Portfolio ($ million)	Average Loan Balance ($)
Individual loans	155	984,167	964	980
Group loans	74	350,607	115	329
Village bank loans	47	410,352	61	150
All loans (all MFIs)	176	1,745,126	1140	653

Source: All data are from the IDB/CGAP inventory of 176 MFIs in 17 Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, Uruguay, and Venezuela). An attempt was made to select the larger and more sustainable (or potentially more sustainable) MFIs in each country. The 176 MFIs represent 91 percent of the 193 MFIs from which data were sought, a very high response rate. The data in Table 1.1 generally refer to mid 2001.

tionale may be different from what is traditionally thought, and b) how VBIs compensate for their small average loan sizes in order to become sustainable. Both discussions have important strategic planning implications for VBIs.

What Village Banking Offers

Village banking offers several important services:

- Credit—in the form of a loan to a group of approximately 15-30 individuals
- Savings services—both forced and voluntary
- Non-financial services—informal and sometimes formal as well
- The internal account—offered by some VBIs, the internal account provides additional credit, savings, and non-financial services.

Each of these services is now briefly discussed. Readers already familiar with village banking may wish to skip to the next section.

Credit. Village banking starts with a loan from the village banking institution (VBI) to a group of approximately 15-30 individuals. In this way it resembles solidarity group lending, only the group size is larger than the 3-7 individuals who commonly receive a solidarity group loan. The 15-30 individuals form a village bank, adopt bylaws, and learn how to keep records of all financial transactions. They elect a president, treasurer, and perhaps other officers to run meetings, collect and disburse money, and generally manage the affairs of the village bank in receiving and providing services. Analogous to the case of solidarity group lending, all village bank members are responsible for the repayment of the loan that has been granted by the VBI to the village bank and divided among its members. If the village bank fails to repay its loan to the VBI, it typically faces the cutoff of all VBI-provided services. Therefore, village bank members have strong incentives to admit only responsible individuals to the village bank, who are likely to repay their loans on time. Since it is fundamentally the village bank that decides the size of the loan each village bank member receives—with some input, perhaps, from the VBI loan officer, who is the VBI's representative to the village bank—all village bank members also have incentives to

make sure that no individual borrows more than she is capable of repaying.[7]

Forced savings. VBIs typically require each village bank member to save. These *forced savings* are often a significant percentage of the amount the member has borrowed from the VBI. For example, forced savings range from 10 to 32 percent of the amount borrowed in the four leading Latin American VBIs analyzed in this study. Forced savings serve at least two major purposes. First, they act as cash collateral, to deter the complete failure of village banks and lessen the effects of such failures on the VBI. Forced savings are also used to cover the more routine cases of individual loan delinquency that do not threaten the village bank's existence. The second purpose of forcing village bank members to save is to introduce them to the discipline and habit of saving and to the possibilities that having a sizable savings balance could open up for them. For example, a sizable pool of savings could be used for emergencies, to pay school fees and other large household expenditures, to buy tools or machinery, or to start another business.

Because they act as cash collateral, forced savings are undoubtedly useful to the VBI. However, the utility of forced savings to clients is more open to debate. This is because of the compulsion that *all* clients must save *all* of the time regardless of the business or other uses that they might have for these savings. In addition, these savings are often made quite inaccessible to the client. Many clients might be able to more quickly increase their incomes and escape poverty if they were allowed to take some or all of their forced savings contributions and invest them in their own businesses, either as additional working capital or to buy tools and equipment. VBIs differ in the degree of inaccessibility they impose: some allow clients to withdraw their forced savings at the end of every loan cycle (typically, every 16-24 weeks), while other VBIs allow clients to access these savings only when they leave the village banking program or perhaps in cases of severe emergency, such as a hospitalization. While requiring all clients to save all of the time appears to have important drawbacks, advocates of forced savings argue that many clients lack the willpower to save on their own. Moreover, if clients are allowed easy access to their savings, they might spend these savings on relatively trivial consumption items or feel pressured to help relatives and friends in financial need. Chapter 2 discusses this issue further and presents evidence on the desirability of forced savings, concluding that many village banking programs should probably make their requirements less rigid.

Voluntary savings. VBIs typically also provide their clients the opportunity to save voluntarily, over and above the amounts they are forced to save. One of the great advantages of village banking is that it provides a way not only to offer its clients credit, but also savings services. By pooling all of their forced and voluntary savings together in a single deposit account, members of a village bank can often overcome the deposit minimums and low balance fees imposed by many banks and other deposit-taking financial institutions. When members are located some distance from the financial institution, using this single village bank savings account can also drastically reduce transactions costs for the savers. One or two village bank members can make the trip for many, combining deposits and withdrawal requests along with VBI loan repayments in a single journey. VBIs that permit internal account lending provide savers with the added possibility of earning much higher interest rates than those normally paid by banks, on both voluntary and forced savings (see the discussion of the internal account, below).

Informal non-financial services. Village banks meet regularly (generally weekly or biweekly, sometimes monthly) to collect each member's loan payment, take savings

[7] Since village bank clients are overwhelmingly women, we adopt the convention of referring to them using the feminine pronouns, such as "she" and "her."

and pay out savings withdrawal requests, and transact other business. While these meetings take members away from their own businesses for a significant period of time (a meeting typically lasts 1½ -2 hours), they are the vehicle through which village bank credit and savings services are delivered. These regular meetings also provide members with a number of other benefits, which include what may be called informal non-financial services. Among these services are the networking, informal technical assistance, empowerment, enjoyment from socializing, and the sense of belonging that can all come with participation in a village bank. Pro Mujer emphasizes the last two of these benefits when they describe why many of their Bolivian clients refuse to leave their village banks and take individual loans even though the individual loans are often larger and have much more flexible repayment terms. Opportunity International underscores the importance of the networking that takes place among the businesswomen in many of their village banks. Because of this phenomenon, Opportunity International believes that it is important to offer the alternative of solidarity group loans, not just individual loans, to village bank members needing larger or more flexible loans. Informal technical assistance and empowerment are also important benefits of village banking. The former refers to village bank members sharing knowledge and ideas to help one another with business problems. Empowerment is a widely-cited benefit of village banking and is particularly relevant to women. It is described briefly in Box 1.1.

Formal non-financial services. Some VBIs offer formal non-financial services and some do not. For example, of the four VBIs examined in detail in this paper, CRECER and Pro Mujer Bolivia offer formal non-financial services and Compartamos and FINCA Nicaragua do not. CRECER and Pro Mujer Bolivia take 20-30 minutes during each village bank meeting to provide all village bank members with education in how to improve their businesses and in a number of basic health areas. Pro Mujer Bolivia also provides primary health care services such as vaccinations, breast examinations, and counselling using nurses and other trained professionals. Chapter 3 discusses the rationale for VBIs to provide non-financial services to very poor clients. It also argues that under certain circumstances offering such services should not disqualify a VBI from being able to become a licensed, deposit-taking financial institution.

Internal account. Perhaps no subject in village banking elicits such heated debate among practitioners as the question of whether to offer internal account loans. The reason for this is that there are many strong advantages and disadvantages associated with offering these loans. These advantages and disadvantages are explored in Chapter 2. In preparation for this, Box 1.2 discusses how the village bank internal account works and how it provides important additional credit, savings, and non-financial services.

Box 1.1
Empowerment

Freedom from Hunger (1996, p. 3) offers an excellent explanation of the meaning of empowerment and the role of village banking in empowering its members. "By helping the poor to successfully manage their own self-help groups and help each other to use credit to increase their incomes and begin saving, these [village banking] programs engage them in vital activities that improve their confidence, self-esteem, and control of their environment. They undergo a profound psychological transformation that many writers today call 'empowerment'—a transformation of attitude from 'I can't' to 'I can.' Reinforced by their successful use of credit and their solidarity with others in their village bank, the poor expand their awareness of the possibility of improvements in their lives."

It is particularly empowering for village bank members to see their income and savings grow since members play such a large role in managing their own village bank. For example, members decide who will be allowed to join and remain in the village bank and what size loan each person will receive during each loan cycle. Members also elect officers, serve as officers (on a rotating basis), run meetings, keep the books, and set their own rules such as levying fines for missing loan payments or arriving late to meetings. If the VBI permits an internal account, the village bank members decide who will be allowed to take out an internal account loan and what size loan they will be granted. Village banks that are divided into several solidarity groups (a device that may serve to shorten meetings and reduce loan delinquency problems, as discussed in Chapter 2) offer additional leadership opportunities to those who serve as the head of each solidarity group.

Village banking focuses almost entirely on women because women so often need the empowerment that village banking provides. Freedom from Hunger (2002, p. 6) explains this in eloquent terms. "The education of girls is [often] treated as a low priority and, although mothers are the primary caretakers of young children, their status in the community is perilously low. In the face of such enduring obstacles, a woman's doubt in her ability to create positive change becomes ingrained. Yet hope and strength spring from the collective courage of women who gather together."

Increasing the Flexibility of Village Banking

This section shows that leading VBIs in Latin America have client retention rates significantly below a comparison group of individual and solidarity group lenders affiliated with Accion International. Based on this fact and the substantial rigidities, transactions costs, and risks that village banking imposes on its clients, this section argues that village banking needs to continue becoming more flexible and client-oriented in order to increase client satisfaction, retention, and impact. By improving client satisfaction and retention, VBIs will also tend to increase their own scale and sustainability through a number of channels. For example, with a greater percentage of village bank members satisfied and remaining in the program, client growth rates will increase, not only because there are fewer dropouts but also because new clients will likely become easier to attract. Portfolio growth will be fueled by the growth in the client base and also because, with clients tending to remain in the program longer, many will take out larger loans. VBI scale and sustainability will be increased for all of these reasons and because VBIs will avoid the high costs of replacing dropouts with new clients who must be given initial training in the village banking methodology and started off with tiny loans.

Box 1.2
The Internal Account

Money is collected from several sources in the internal account, and then used to make loans to village bank members. In addition to being a source of supplemental credit, the village bank internal account also provides members with savings and non-financial services.

The internal account is primarily funded from the following sources: the forced and possibly voluntary savings of village bank members (savings usually account for most internal account funds), fees and fines levied by the village bank on its members, interest income earned by lending out internal account funds to members, and interest earned by placing funds in a commercial bank account. In addition, while VBIs generally insist that each member repay her VBI loan on a regular basis (e.g., weekly or biweekly), a few VBIs, such as CRECER, allow these payments to remain in the village bank's internal account for many weeks at a time. For example, in its 16-week loan cycle, CRECER only removes member loan repayments from the village bank internal account in weeks 12 and 15. This allows the village banks to use these funds for additional internal account lending during most of the loan cycle.

The internal account funds are used to make supplemental loans to village bank members, including loans for emergencies, consumption, and additional business needs. Generally, these internal account loans can begin and end at any time during a single loan cycle. Thus, in both purpose and timing, internal account loans are more flexible than the external account loans members have with the VBI. Members also like internal account loans because they are normally repaid in bullet fashion, that is, with a single repayment of both principal and interest at the end of the loan term. This allows members additional time to work with all of the money they have borrowed and may reduce the effective interest rate they pay. On the other hand, internal account loans are often much smaller in size than the member's external account loan—either because of the limited amount of funds available in the internal account or because the VBI's rules require them to be so. Thus, while internal account loans may reduce the demand for external account loans, they rarely eliminate the need for external funds.

The internal account also provides an important savings vehicle. Instead of village banks earning only a few percent per year by placing their forced and voluntary savings in a commercial bank deposit account (an interest rate that is typical now in many Latin American countries, with their low inflation rates), the internal account often yields 2.5-5 percent per *month* on savings that are loaned out to other village bank members. This is because internal account loans normally carry an interest rate that is at least as high as the rate the VBI charges on its own (external account) loans to village bank members. These high internal account loan rates are generally mandated by VBIs in order to avoid further reducing the demand for their external account loans.

The village bank decides which of its members will receive internal account loans and how much they will be granted, and also does all of the bookkeeping. By acting as a vehicle for village bank members to manage and invest their own money, the internal account provides members with an additional source of empowerment, business skills training, and group solidarity. While these are valuable non-financial services, the internal account also gives rise to several new problems: issues of favoritism in granting internal account loans, internal account loan delinquency, and fraud problems arising from village bank officers or other members stealing or misusing internal account funds.

Compared to individual loans, village bank loans are very inflexible. Each member of a village bank receives a loan from the VBI that starts on exactly the same date and has the same term and the same repayment frequency (usually weekly or biweekly). Although different members are normally allowed to have different size loans, there is generally a cap imposed on the maximum size of the loan to any single village bank member. This is done so that small borrowers in a village bank are not required to guarantee loans that are much larger than their own since a default on even one of these large loans could be very burdensome for the small borrower. In contrast, microentrepreneurs who take out individual loans from a microfinance institution (MFI) are normally able to start their loans on a date of their own choosing. These microentrepreneurs are also likely to have much greater flexibility to request the loan term and repayment frequency that best suit their individual needs within the range of what is offered by the MFI and perhaps after successfully repaying one or more loans (to establish their creditworthiness). Finally, microentrepreneurs with individual loans are not likely to face as low a ceiling on maximum loan size as they would with a village bank loan since there are no considerations of risk to small borrowers to take into account.

Village banking imposes other important inflexibilities on its clients that individual lenders normally do not. The most important of these is the forced savings requirement discussed above. Unlike the inflexibilities imposed by village banking on its loans, however, the village bank forced savings requirement appears to be inherently useful to at least some of the village bank clients, though it may be detrimental to others.

Finally, village banking also imposes important transactions costs and risks on its clients. However, it is unclear whether these transactions costs and risks are more onerous on the whole than the transactions costs and risks imposed on clients by the individual lending methodology. Village banking clients must attend frequent and lengthy meetings, with village banks in Latin America typically meeting every week or two and the village bank meetings normally lasting 1½-2 hours. By contrast, individual loan clients do not have to attend weekly or biweekly meetings, but each individual loan client must instead carry his or her loan repayments to the lender—often once a month, but sometimes every week or two, depending on the MFI and client. Village banks must maintain bookkeeping records of all financial transactions and most are required to take member loan repayments and savings to town for deposit after each meeting. On the other hand, the village bank meetings and the bookkeeping requirements also offer the possibility of imparting important non-financial services, as discussed earlier. Finally, village bank members must bear the risks of guaranteeing the loans of everyone in the village bank, a risk that is avoided under the individual loan technology.

In summary, although village banking offers important savings and non-financial services that individual lending does not provide, many village banking clients may not value these services enough to be worth the inflexibilities, costs, and risks that the village banking methodology imposes on them. These clients may try out village banking for a while but then drop out once the program's rigidities and demands become clear to them. Some VBIs are aware that they have a problem in this area, as revealed both in conversation and in the literature. For example, Natilson (2000, p. 21) refers to Pro Mujer Bolivia's "low client retention rates" and McCord (2000, p. 19) cites "relatively high dropout rates" in FINCA Uganda.

Table 1.2 shows that VBI client retention rates are indeed low compared to the retention rates achieved by individual and solidarity group lenders. This suggests that village banking still needs to increase the flexibility and client-orientation of its methodology in order to improve client satisfaction and retention, as well as VBI sustainability

and scale. Specifically, Table 1.2 presents client retention rates for the years 2000-02 for a number of VBIs as well as for a comparison group of individual and solidarity group lenders. All retention rates are calculated using the same formula, so that the data shown are fully comparable. Table 1.2 gives retention rates for Pro Mujer Bolivia, FINCA Nicaragua, and Compartamos, that is, for each of the four VBIs analyzed in detail in this paper except CRECER, these data being unavailable for CRECER. Retention rates are also shown for the other Pro Mujer program on which comparable data could be obtained (Nicaragua) and for the seven FINCA International programs in Latin America. In addition to presenting the average retention rates for the seven FINCA

Table 1.2
Client Retention Rates

MFI	Country	2000	2001	2002	Average 2000-02
Pro Mujer	Bolivia	60	61	73	65
FINCA	Nicaragua	71	55	61	62
Compartamos	Mexico	87	97	92	92
Pro Mujer	Nicaragua	59	61	67	62
FINCA	Honduras	77	31	47	52
FINCA	Haiti	100	100	99	100
FINCA	Latin America – average of 7 programs[1]	65	52	58	58
Accion International	Average of 15-17 Latin American affiliates[2]	75	73	71	73

Note: All client retention rates (CRR) are calculated using the same formula:
$CRR = C_1 / (C_0 + NC)$, where C_1 is the number of clients at the end of the year, C_0 is the number of clients at the beginning of the year, and NC is the number of new clients (that enter the program during the year). For example, if all clients present at the start of the year (C_0) and all the new clients (NC) remain in the program until the end of the year, then $C_1 = C_0 + NC$, and the client retention rate equals 1 (or 100%). If only half of each group remains at the end of the year, then $C_1 = .5 (C_0 + NC)$, and the client retention rate equals 0.5 (or 50%).

[1] The seven FINCA Latin American programs are: Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, and Nicaragua.
[2] The averages given are based on all of Accion International's Latin American affiliates that have the data needed to calculate client retention rates, except Compartamos. Compartamos is excluded because it is a VBI; all other affiliates are primarily individual or solidarity group lenders. The averages given are based on 17 affiliates in the years 2000 and 2002 and 15 affiliates in 2001. The following 13 affiliates provide client retention rates for all three years (country in parentheses): Acción Empresarial (Panama), Banco Solidario (Ecuador), BancoSol (Bolivia), BanGente (Venezuela), FAMA (Nicaragua), FED (Ecuador), Finamérica (Colombia), FINSOL (Honduras), Fundación Mario Santo Domingo (Colombia), Fundación Paraguaya (Paraguay), Génesis (Guatemala), Mibanco (Peru), and Propesa (Chile). The following seven affiliates provide client retention rates for some of the years (country and years in parentheses): ADMIC (Mexico, 2001, 2002), Cooperativa Emprender (Colombia, 2000, 2002), CREDIFE (Ecuador, 2002), Emprender (Argentina, 2000, 2001), FENAPE (Brazil, 2000), FUNDAP (Guatemala, 2000), and SogeSol (Haiti, 2002).

Sources: All data are obtained directly from Pro Mujer, FINCA, Compartamos, and Accion International.

programs taken together, the individual retention rates are given for Haiti and Honduras. These are the two FINCA programs with the highest and lowest average retention rates over the 2000-02 period, respectively. Finally, to serve as a basis against which all of these VBI retention rates can be compared, Table 1.2 presents the average of the retention rates for all of the Accion International individual and solidarity group lenders in Latin America on which data were available.[8]

The Table 1.2 data show that, with the exception of Compartamos and FINCA Haiti, VBI retention rates are generally 10-15 percentage points below the average retention rates of the Accion International solidarity group and individual lenders.[9] Because most VBIs serve the lowest income segment of the microfinance market, they arguably face less competition in this market than the Accion International affiliates face in the segment they serve, which generally consists of more mainstream microfinance clients. This would suggest even more strongly that village banking needs to improve its product since it has lower client retention rates despite quite possibly facing less competition.

This call to increase the flexibility and client-orientation of the village banking product is really a call to continue an ongoing process. Village banking was introduced in the 1980s as an even more rigid product than it is today, a product in which everyone in the village bank had the same size starting loan, the loan size ceiling was set at a very low $300, all meetings and loan repayments were weekly, the loan term was always a very short 16 weeks, and forced savings were only available once the member left the village bank or perhaps in cases of serious emergency. Chapter 2 is devoted to an examination of how these and other major elements of the village banking methodology have been liberalized to date—particularly in four leading Latin American VBIs—and how this liberalization process may be usefully continued in the future.

Four Leading VBIs

The best practice and policy conclusions discussed in Chapters 2 and 3 are based in good measure on a detailed examination and analysis of four leading VBIs in Latin America: Compartamos, CRECER, FINCA Nicaragua, and Pro Mujer Bolivia. The reader will find information on these VBIs in three areas of the present study. Box 1.3 provides a brief introduction to these VBIs. The last section of the present chapter discusses a number of indicators measuring outreach, sustainability, loan delinquency, and other key aspects of the performance of the four VBIs. Finally, Chapters 2 and 3 discuss salient features of the village banking methodology used by the four VBIs. Together, all of this information provides a reasonably complete picture of the four VBIs analyzed in the present study.

The four VBIs analyzed here were selected for at least three reasons. First, a number of village banking experts were consulted, and they considered that these four are among the best VBIs in Latin America. This is corroborated by data presented below. For example, all four VBIs have remarkably low loan delinquency rates (often under 1 per-

[8] The preceding paragraphs compared the flexibility, transactions cost, and risk of village banking versus individual lending. In many ways, solidarity group lending occupies an intermediate position between these two extremes because it employs a group size smaller than that used by village banking but larger than the group size of one employed in individual lending. Thus, for example, solidarity group borrowers must negotiate the loan starting date, term, and repayment frequency with a smaller group than must village bank borrowers, and so flexibility to meet each individual's needs should generally be greater in the solidarity group than the village bank. Similarly, solidarity groups should require less meeting time than village banking.

[9] The very high client retention rates obtained by Compartamos and FINCA Haiti reflect, at least in part, the fact that these two VBIs face little or no competition over most of their service areas. The remaining VBIs do not enjoy such monopolistic positions.

Box 1.3
Four Leading VBIs

Compartamos. As a Mexican SOFOL (*financiera*), Compartamos is one of the few VBIs in Latin America that is regulated by its country's banking superintendency, and the only one of the four VBIs examined here with this characteristic. Despite its designation as a SOFOL, Compartamos is not licensed to mobilize deposits from the public. With 145,000 borrowers in December 2002, Compartamos serves the largest number of loan clients of any MFI in Latin America. Compartamos began operations in 1990 as the lending arm of *Gente Nueva,* a Mexican NGO, and became regulated in 2001. It is an affiliate of Accion International.

CRECER is an NGO working primarily in the rural areas of Bolivia, including many rural areas that are remote even by village banking standards. CRECER began operations in 1990, using the "Credit with Education" methodology of Freedom from Hunger. Freedom from Hunger is a U.S.-based international NGO that operates numerous village banking programs in Latin America, Africa, and Asia. CRECER became legally independent of Freedom from Hunger in the year 2001, though Freedom from Hunger still provides CRECER with technical assistance and sits on CRECER's board of directors.

FINCA Nicaragua is the largest of FINCA International's seven Latin American affiliates in terms of number of clients served. It is second (after Haiti) in terms of depth of outreach, as measured by average outstanding loan balance ($45 in Haiti and $109 in Nicaragua in December 2002). FINCA Nicaragua is an NGO and began operations in 1992.

Pro Mujer Bolivia, an NGO that began operations in 1990, is the oldest and largest of the four Pro Mujer affiliates, and considered Pro Mujer's flagship program. The other Pro Mujer affiliates are in located in Nicaragua, Peru, and Mexico and began operations in 1996, 2000, and 2002, respectively. Like CRECER and the other Freedom from Hunger programs, all Pro Mujer affiliates provide formal non-financial services to their village bank members, as well as credit and savings services.

cent) and generally impressive levels of outreach, cost efficiency, and sustainability. Second, all four VBIs report to the *Microbanking Bulleting*. This is the premier statistical reference on the microfinance industry, and is used here as an important source of accurate and comparable data to help in the analysis of best practices and in the formulation of policy recommendations.[10] Finally, the four VBIs span an interesting range of experience in a number of areas. For example, two of the VBIs (CRECER and Pro Mujer Bolivia) offer formal non-financial services and internal account loans, while the other two VBIs do not. The four VBIs face differing degrees of competition. While Compartamos faces little or no competition over most of its service area, Pro Mujer Bolivia and FINCA Nicaragua face significant competition in all of the areas they serve. CRECER is in an intermediate position, with little competition in remote rural areas but significant competition in the less remote rural and peri-urban areas it serves. The four VBIs differ significantly in the degree to which they serve rural clients, with the percentage of rural borrowers ranging from two percent for Compartamos

[10] All issues of the *Microbanking Bulletin* are available at The MIX (Microfinance Information eXchange), at www.themix.org. *The Microbanking Bulleting* only reports data on groups of MFIs. We are deeply grateful to Compartamos, CRECER, FINCA, and Pro Mujer for their generous permission to access the *Microbanking Bulleting* data on their individual institutions, and to the personnel of The MIX for cheerfully and efficiently providing these data.

to 67 percent for CRECER (Table 1.5). The degree to which poor clients are served, as proxied by average loan balance, also spans a significant range, varying from an average loan balance of $109 for FINCA Nicaragua to $298 for Compartamos (Table 1.5). Finally, as will be seen in Chapter 2, there are many interesting differences in the village banking methodology used by the four VBIs.

Structure of the Village Banking Industry in Latin America

As noted earlier, in a recent inventory of 176 of the largest and most sustainable microfinance institutions in 17 Latin American countries, 47 were found to offer village banking loans. Table A1 (in Annex A) presents data on these 47 individual VBIs. The data generally refer to mid 2001. Some of the salient characteristics of these 47 VBIs are as follows:

- While 17 Latin American countries were surveyed, VBIs were found in only 11 of these countries. No VBIs were found in Argentina, Brazil, Chile, Paraguay, Uruguay, and Venezuela. With the exception of Paraguay, these six are generally higher-income Latin American countries, which generally contain lower concentrations of the poor clients that VBIs typically look to serve.[11]

- While the 47 VBIs are spread over 11 countries (Bolivia, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, and Peru), 20 of these VBIs are found in only two countries: 11 in Peru and nine in Guatemala.

- Of the 47 VBIs, 42 are unregulated NGOs, two are downscales (Banrural and Bancafé in Guatemala), and three are upgrades (Compartamos in Mexico and two Peruvian EDPYMES, Edyficar and Solidaridad).[12] Despite being regulated by their countries' banking superintendencies, none of the three upgrades are permitted to mobilize deposits.

- Most of the 47 VBIs are multiproduct lenders, offering more than one type of loan. Only 13 of the 47 offer exclusively village bank loans; the remaining 34 offer individual or solidarity group loans as well. Of these 34 VBIs, 31 offer individual loans, 23 offer solidarity group loans, and 19 offer both individual and solidarity group loans.

- Of the 34 VBIs that offer individual or solidarity group loans, 13 VBIs have the characteristic that their village bank borrowers account for less than 50 percent of their total borrowers and six VBIs have the characteristic that their village bank borrowers account for less than 20 percent of their total borrowers. It may be somewhat of a misnomer to refer particularly to this last group of six microlenders by the term VBI. Some of these microlenders are really MFIs that have only a small number of village banking clients. Nonetheless, for simplicity, we retain the term VBI for an MFI with any village banking clients at all.

The Performance of Village Banking

Tables 1.3-1.5 present data on outreach, sustainability, and factors that determine sustainability for the four VBIs analyzed in detail in this study and for 12 comparison groups. The comparison groups consist of all the individual lenders, solidarity group lenders, and VBIs that report to the *Microbanking Bulletin,* both in Latin America (three groups) and worldwide (three more groups). The remaining comparison groups

[11] It is quite possible that some VBIs may have been overlooked in these six (and in the other 11) countries, especially smaller VBIs. It is also the case that some known VBIs did not respond to the survey's request for information, and thus do not appear in Table A1.

[12] A downscale is a commercial bank or *financiera* that offers loans to microenterprises. An upgrade is an NGO that has become a regulated financial institution.

are the subsets of these six groups that consist of only the financially sustainable MFIs.[13] While many interesting comparisons can be made with these data, for the sake of brevity we discuss only certain key comparisons. Interested readers are invited to further peruse the tables, which are largely self-explanatory.

Sustainability

Overall, individual lenders achieve higher levels of sustainability than VBIs, both in Latin America and worldwide. This is true for all four measures of sustainability shown in Table 1.3. However, when the focus is narrowed to the financially sustainable individual lenders and VBIs, the result is reversed in both Latin America and worldwide for all four sustainability measures except adjusted return on equity (AROE).[14] The fact that the very best VBIs have a higher adjusted return on assets (AROA) as well as higher financial self-sufficiency (FSS) and operational self-sufficiency (OSS) ratios than the very best individual lenders may surprise readers, who might rightfully wonder how VBIs, which make these tiny loans, can achieve such high levels of sustainability. The fact that the AROE of the sustainable VBIs is lower than the AROE of the sustainable individual lenders scarcely diminishes this accomplishment, as it simply reflects the fact that the individual lenders fund their credit operations with more debt and less equity than do the VBIs.

The sustainability levels of the four VBIs analyzed in detail in this study (Compartamos, CRECER, FINCA Nicaragua, and Pro Mujer Bolivia) are well above the averages reported for all VBIs, both in Latin America and worldwide. This relationship holds for all four sustainability measures, confirming the place of these four VBIs as being clearly well above average in this key area of performance.

Raison d'être of Village Banking

One of the key rationales that is often given for using the village bank lending methodology is that it reduces operating costs by providing a single loan to many small borrowers at once instead of providing a much greater number of individual loans to each small borrower. For example, the excellent book on village banking by Churchill, Hirschland, and Painter (2002, p. xiii) notes that this was one of the objectives that village banking was originally designed to accomplish. Table 1.4 tells a different story, however. It shows that the village banking methodology may not inherently offer higher rates of loan officer productivity than individual lending. For example, VBIs worldwide average 348 borrowers per loan officer, putting them ahead of individual lenders worldwide, which average 276 borrowers per loan officer. However, when attention is focused on the better individual lenders—specifically, on the financially sustainable individual lenders—loan officer productivity jumps to 422, well ahead of loan officer productivity for all VBIs (348) or all financially sustainable VBIs (286). A similar phenomenon occurs when attention is limited to Latin America: financially sustainable individual lenders do almost as well as or better than VBIs.[15]

The reason for this outcome is not hard to see. Individual lending has always had the great advantage of dynamic efficiency. By this it is meant that over time, individual

[13] The latest *Microbanking Bulletin* (July 2003) covers a total of 124 MFIs worldwide, of which 49 are in Latin America and 66 are financially sustainable. The number of VBIs covered is 20 worldwide and eight in Latin America.

[14] See Table 1.3 for an explanation of AROE and the other three sustainability measures (AROA, FSS, and OSS).

[15] It is not clear why financially sustainable VBIs have lower rates of loan officer productivity than all VBIs, both in Latin America and worldwide. It may be that the financially sustainable VBIs exercise more care and spend more time than average in tending to their village banks.

Table 1.3
Sustainability Measures
(in percent)

Individual VBI *or* MFI Group	**Country *or* Region and Type**	**Adjusted Return on Assets (AROA)**	**Adjusted Return on Equity (AROE)**	**Operational Self-Sufficiency (OSS)**	**Financial Self-Sufficiency (FSS)**
Compartamos[1]	Mexico	14.5	30.7	158	158
CRECER[1]	Bolivia	-0.7	-1.7	102	98
FINCA[2]	Nicaragua	8.4	20.4	129	119
Pro Mujer[3]	Bolivia	5.1	7.1	140	127
Individual lenders	Latin America – All MFIs[4]	1.2	12.9	117	107
Group lenders		-15.8	-24.2	100	92
Village bank lenders		-4.3	-9.3	98	93
Individual lenders	Latin America – Financially Sustainable MFIs[4]	5.3	37.0	130	125
Group lenders		3.0	13.5	122	115
Village bank lenders		12.4	14.1	135	131
Individual lenders	Worldwide – All MFIs[4]	1.4	6.1	123	111
Group lenders		-0.9	0.7	111	100
Village bank lenders		-5.6	-12.0	110	96
Individual lenders	Worldwide – Financially Sustainable MFIs[4]	5.1	16.6	137	127
Group lenders		5.0	13.2	133	124
Village bank lenders		12.6	14.3	182	149

Note: Following the *Microbanking Bulletin*, the following definitions are used:
AROA = Adjusted net operating income / Average total assets
AROE = Adjusted net operating income / Average total equity
OSS = Financial revenue / (Financial expense + Net loan loss provision expense + Operating expense)
FSS = Financial revenue, adjusted / (Financial expense + Net loan loss provision expense + Operating expense), adjusted
Adjustments are made in AROA, AROE, and FSS to eliminate the effect of subsidies and inflation and to standardize loan loss provisioning and loan write-off policies. Thus, AROA and AROE are simply the traditional return-on-assets (ROA) and return-on-equity (ROE) measures, after all of these adjustments have been factored in. In the same way, FSS is the same as OSS after these adjustments. See the *Microbanking Bulletin* for further details.

[1] All data are from the year 2001. In the case of CRECER, all four sustainability measures include the cost of providing non-financial services.
[2] All data are from the year 2000.
[3] All data are from the year 2002. All four sustainability measures for Pro Mujer Bolivia exclude the costs of providing non-financial services. As discussed in Chapter 3, when these costs are included, Pro Mujer Bolivia's AROA drops from 5.1 percent to 0.9 percent. Pro Mujer Bolivia's AROE and FSS have not been recalculated to include the cost of providing non-financial services.
[4] All of these data are from the years 2001 or 2002, mostly 2002.

Source: Microbanking Bulletin No. 9, July 2003, plus additional data cuts. All data presented here are the most recent available from the *Microbanking Bulletin* at the time of this study.

Table 1.4
Potential Determinants of Sustainability: Yield, Cost, Productivity, and Risk

Individual VBI *or* MFI Group	Country *or* Region and Type	Yield on Gross Portfolio (nominal %)	Adjusted Operating Expense/ Average Loan Portfolio (%)	Average Annual Salary of All Personnel ($)	Borrowers per Loan Officer	Portfolio at Risk > 30 Days (% of gross loan portfolio)
Compartamos[1]	Mexico	104.0	43.9	7001	390	1.2
CRECER[1]	Bolivia	50.9	37.5	6308	408	0.1
FINCA[2]	Nicaragua	60.0	42.5	4058	315	0.8
Pro Mujer[3]	Bolivia	37.1	25.0	3686	501	0.1
FINCA Latin America[3]	Average of 7 village bank programs	63.0		5214	293	2.0
Individual lenders	Latin America – All MFIs[4]	39.4	23.8	8025	345	5.0
Group lenders		40.4	61.7	7721	313	6.0
Village bank lenders		64.0	58.3	4431	438	2.7
Individual lenders	Latin America – Financially Sustainable MFIs[4]	38.8	17.8	8205	414	3.7
Group lenders		37.0	19.9	6699	393	7.6
Village bank lenders		68.0	42.1	3085	324	2.6
Individual lenders	Worldwide – All MFIs[4]	38.1	23.5		276	4.5
Group lenders		39.7	30.3		301	2.0
Village bank lenders		62.1	67.2		348	1.9
Individual lenders	Worldwide – Financially Sustainable MFIs[4]	36.0	17.0		422	3.9
Group lenders		40.1	24.6		309	1.8
Village bank lenders		62.6	41.6		286	1.6

Notes: Blank cells indicate missing data.
Following the *Microbanking Bulletin,* the following definitions are used:
Yield on Gross Portfolio = Financial revenue from loan portfolio / Average gross loan portfolio. This is a measure of the effective interest rate earned on loan operations. Financial revenue (and therefore Yield) includes all commissions and fees, as well as interest, paid on loans.
The Adjusted Operating Expense is the MFI's annual operating expense adjusted to remove the effect of any in-kind donations received by the MFI.

[1] All data are from the year 2001 except Average Annual Salary for Compartamos, which is from 2000.
[2] All data are from the year 2000.
[3] All data are from the year 2002 except Average Annual Salary, which is from 2000 for FINCA's programs in El Salvador, Honduras, Mexico, and Nicaragua. The value of 25.0 percent given for Pro Mujer Bolivia's Adjusted Operating Expense/Average Loan Portfolio includes only the costs of providing financial services. It excludes all costs associated with providing non-financial services.
[4] All data are from the years 2001 or 2002, mostly 2002.

Sources: FINCA International for all data on FINCA Latin America (average of seven programs) except for the average annual salary level. The FINCA average annual salary level and all other data are from the *Microbanking Bulletin* No. 9, July 2003, plus additional data cuts. The *Microbanking Bulletin* data presented here are the most recent available at the time of this study.

lenders develop information on each individual client's creditworthiness. This allows repeat loans to be made with much less analysis than is needed for the first loan or two, so that repeat loans can markedly boost loan officer productivity. High quality individual lenders—that is, lenders which offer high quality loan services and which are often financially sustainable—usually garner many repeat clients. This allows them to achieve loan officer productivity levels that surpass the levels attained by VBIs (and solidarity group lenders), who have the advantage of serving many clients at once but do not benefit nearly as much from these dynamic efficiencies. For example, according to Microrate's data for June 2003, two individual lenders in Colombia, the Women's World Bank affiliates in Bucaramanga and Popayán, have 629 and 724 borrowers per loan officer, much higher than the VBI productivity levels shown in Table 1.4.[16] Such high productivity levels are no accident; these two Women's World Bank affiliates have achieved similar and even higher levels of productivity for several past years.

For individual lenders to achieve high loan officer productivity levels, at least three conditions generally need to be met:

- a high percentage of repeat clients
- low delinquency levels
- absence of very intense competition

The first two conditions keep loan officer productivity high by reducing the amount of loan officer time that must be spent analyzing and monitoring loans (first condition) and going after delinquent borrowers (second condition). The importance of the third condition is illustrated by Microrate's loan officer productivity data for Caja Los Andes and FIE, two individual lenders in Bolivia. In December 1997, these two MFIs had 471 and 425 borrowers per loan officer. By June 2003, after several years of increasingly intense competition, these productivity levels had fallen to 248 and 242, respectively. This productivity decline is due in good measure to the greater levels of scrutiny to which all borrowers, including even repeat borrowers, have been subjected by individual lenders in Bolivia, including Caja Los Andes and FIE. This additional analysis has been necessitated by the increasingly intense competition among MFIs in Bolivia. Because of this competition, microentrepreneurs have found it easy to borrow from several MFIs at once, sometimes overindebting themselves. This, in turn, caused loan delinquency rates to rise sharply, and triggered the need for additional analysis in order to help bring delinquency rates back down.

Turning now to village banking, from a loan officer productivity standpoint, this methodology has the severe disadvantage that the loan officer must travel to and attend all village bank meetings, which are normally held every week or two. In addition, time must be spent organizing and training new village banks. These costs are avoided with individual lending, which helps explain why loan officer productivity in good individual lenders often exceeds loan officer productivity even in good VBIs. This is true despite the fact that village banking has the advantage over individual lending that it provides a single loan to many borrowers at once and relies on these borrowers (the village bank members) to screen out bad credit risks, set reasonable loan sizes, guarantee loan repayment, and keep track of all transactions.

Based on the empirical evidence, we conclude that the *raison d'être* of the village banking methodology does not appear to be that it provides higher levels of loan officer productivity and therefore lower costs than individual lending. Rather, what the village banking methodology really offers that distinguishes it from individual lending are the savings services, any specialized education and other formal non-financial services provided by the VBI, as well as the networking, informal technical assistance, empowerment benefits, enjoyment from socializing, sense of belonging, and other informal non-

[16] Microrate is a rating agency for microfinance. Their data can be found at www.microrate.com.

financial services that can all come with participation in a village bank. In short, the real advantage of village banking appears to lie in the savings and non-financial services it can provide, rather than in it being a platform from which credit services can be more efficiently delivered.

This conclusion has a very important implication. Many VBIs in Latin America are beginning to experiment with offering individual (and solidarity group) loans to their members, though typically only to those members who need larger size loans, such as $500 or more. The traditional justification for this is that offering small individual loans would be too costly. However, the dynamic efficiencies of individual lending mean that a good lender can likely deliver individual loans as cheaply as village bank loans, or even more cheaply. This implies that once VBIs learn how to do individual lending, they should be able to offer individual loans to *all* of their clients without increasing operating costs, not merely to their larger borrowers.[17] This would allow VBI clients to choose whether they want the greater flexibility and reduced risk of an individual loan or the non-credit benefits of a village bank loan. By offering individual loans to more of their clients, VBIs may gain an important means to increase client satisfaction and retention. The issue of individual loans is analyzed further in Chapter 2.

[17] These statements on operating costs require an important caveat. While individual lending may offer higher levels of loan officer productivity than village bank lending, village bank lending may still be done more cheaply than individual lending *if* VBIs can hire village bank loan officers more cheaply than loan officers to do individual lending. It is unclear whether the village bank loan officer's group facilitation skills are worth more or less in any given country's labor market than the individual loan officer's ability to do simple financial analyses, and, therefore, which type of loan officer VBIs could hire more cheaply.

Explaining VBI Sustainability

As noted at the beginning of the chapter, VBIs make much smaller loans than solidarity group or individual lenders. Since the operating costs of making a $100 and a $1000 loan, for example, are quite similar, VBIs tend to have much higher levels of operating cost per dollar lent than solidarity group or individual lenders. Table 1.4 shows two important ways that VBIs often achieve sustainability despite this handicap. First and foremost, VBIs set their effective loan rates an average of 25-30 percentage points above the effective loan rates charged by solidarity group and individual lenders. Second, VBIs pay their personnel an average of approximately half of what solidarity group and individual lenders pay. This pay differential may at least in part be explained by the fact that VBIs recruit people whose mindset is to help the very poor and who are reasonably comfortable working in impoverished surroundings. These people may put much less emphasis on their own levels of remuneration. A possible third factor explaining how VBIs achieve sustainability despite the handicap of small average loan size comes from the observation that VBIs have lower loan delinquency rates than solidarity group and individual lenders. However, the delinquency rate differences typically average only 1-3 percentage points (see last column of Table 1.4), and thus are not a major explanatory factor. VBIs looking to achieve sustainability might usefully consider these three factors, as well as the earlier analysis of loan officer productivity, when trying to set a strategic course toward this goal. However, this should not be interpreted as a rigid prescription since following the path set by what other VBIs have done is not necessarily the only way for any individual VBI to achieve sustainability.

Table 1.4 also allows us to make several observations about some of the potential determinants of sustainability for the four VBIs analyzed in detail in Chapters 2-3:

Yield. The effective interest rate earned by the four VBIs on their gross loan portfolio (i.e., the yield) is generally below the 64 percent earned by Latin American VBIs overall. This fact combined with the high sustainability levels of the four VBIs underscores the efficiency of these four organizations. The exemplar in this regard is Pro Mujer Bolivia. Its yield of only 37 percent is even below the average yield earned by individual lenders in Latin America, despite the fact that the average loan size of these individual lenders is far larger. The clear exception to the low yield rule is Compartamos. Its yield of 104 percent reflects its monopoly position in the Mexican market and its strategy of rapid expansion fueled by high profits.[18]

Adjusted operating expense/average loan portfolio. This operating expense ratio ranges from 25 to 44 percent for the four VBIs, well below the 58 percent average operating expense ratio for the Latin American VBIs overall. Pro Mujer Bolivia's ratio of 25 percent stands out among the four VBIs, a product, at least in part, of Pro Mujer Bolivia's high loan officer productivity (501 borrowers per loan officer) and low average salary level.

Average annual salary of all personnel (in U.S. dollars). All four VBIs have average salary levels below the average of the Latin American individual lenders ($8025). However, only Pro Mujer Bolivia and FINCA Nicaragua have average salary levels below the average of the Latin American VBIs ($4431). The average salary levels of CRECER ($6308) and Compartamos ($7001) are well above this latter benchmark.

Borrowers per loan officer. This is one of the few areas in which the four VBIs do not excel. Only Pro Mujer Bolivia reports a larger number of borrowers per loan officer than the average for VBIs in Latin America (501 vs. 438, respectively). CRECER and Compartamos (408 and 390, respectively) are fairly close to the average, while FINCA Nicaragua (315) falls well below.

Portfolio at risk > 30 days. All four VBIs excel at loan recovery, with delinquency rates of 0.1-1.2 percent, compared to 2.7 percent for the Latin American VBIs overall. As can be seen in Table 1.4, the MFIs reporting to the *Microbanking Bulletin* generally have delinquency rates that are quite low, reflecting the select nature of this universe.

Outreach

VBIs show impressive levels of overall outreach, as well as outreach to women and rural areas (Table 1.5). Their much lower average loan balances also support the contention that VBIs have a more intense poverty focus than other MFIs.

Overall outreach. The VBIs reporting to the *Microbanking Bulletin* show an impressive level of overall client outreach, averaging 24,000 clients per VBI in Latin America and 14,000 clients per VBI worldwide. By comparison, individual lenders in Latin America reach an average of only 16,000 clients and individual lenders worldwide reach an average of only 10,000 clients. The four VBIs analyzed in the present study all reach even more clients than the average Latin American VBI, with outreach levels ranging from 29,000 clients for FINCA Nicaragua to 145,000 clients for Compartamos. On the other hand, in Latin America, the average VBI's loan portfolio ($5 million) is less than half the size of the average individual lender's loan portfolio ($13 million), reflecting the fact that VBIs have much smaller average outstanding loan balances than individual lenders.

Outreach to women. As noted earlier in this chapter and shown in Table 1.5, VBIs focus

[18] Compartamos' AROA is 14.5 percent (Table 1.3). In banking, an AROA of 1-2 percent is generally considered to be a reasonably good performance and 5 percent is considered to be excellent.

largely on women. This is true of the four VBIs analyzed here, whose share of women clients ranges from 95 to 100 percent.

Rural outreach. In Latin America, the percentage of borrowers residing in rural areas is higher for village banking clients (29 percent) than for solidarity group clients (17 percent) or individual loan clients (8 percent). Thus, VBIs have a somewhat greater rural outreach than do other lenders. The four VBIs differ significantly in the degree to which they serve rural clients, with the percentage of rural borrowers ranging from two percent for Compartamos to 67 percent for CRECER.

Poverty outreach. Based on the IDB/CGAP survey of 176 MFIs in Latin America, Table 1.1 (presented earlier) showed that the average loan balance of village banking clients ($150) is well below the average loan balance of solidarity group clients ($329) and individual loan clients ($980). The *Microbanking Bulletin* data for Latin America, given in Table 1.5, tell much the same story, with average loan balances of $141, $698, and $1345, respectively. Both data sets point to village banking having a greater focus on poor clients and is consistent with the fact that many VBIs, including the four surveyed in this paper, have a conscious policy of challenging themselves to serve poor regions, neighborhoods, and clients. The average loan balance of the four VBIs span a range from $109 for FINCA Nicaragua to $298 for Compartamos, with Pro Mujer Bolivia and CRECER closer to the former value, at $143 and $145, respectively.

Table 1.5
Outreach Measures

Individual VBI *or* MFI Group	**Country *or* Region and Type**	**Total No. of Borrowers**[1]	**Loan Portfolio ($ million)**[1]	**Women Borrowers (%)**[2]	**Rural Borrowers (%)**[3]	**Average Loan Balance ($)**[1]
Compartamos	Mexico	144,991	43.2	98.5	1.8	298
CRECER	Bolivia	40,142	6.1	100	67.3	145
FINCA	Nicaragua	29,230	3.2	100	13.6	109
Pro Mujer	Bolivia	31,535	4.5	95	21.6	143
FINCA Latin America	Average of 7 village bank programs[4]	15,070	2.6	93	45.8	174
Individual lenders	Latin America – All MFIs	15,923	13.0	48.0	8.0	1345
Group lenders		25,307	28.4	66.2	17.1	698
Village bank lenders		24,182	4.9	96.7	29.4	141
Individual lenders	Latin America – Financially Sustainable MFIs	26,489	20.5	50.7		1322
Group lenders		41,789	49.0	65.6		927
Village bank lenders		43,496	10.0	96.2		179
Individual lenders	Worldwide – All MFIs	10,433	7.1	45.9		1223
Group lenders		24,689	5.5	73.0		343
Village bank lenders		13,801	1.8	88.6		149
Individual lenders	Worldwide – Financially Sustainable MFIs	16,582	11.3	44.3		937
Group lenders		34,423	15.4	75.7		544
Village bank lenders		18,236	3.2	83.3		188

Notes: Blank cells indicate data not available. All *Microbanking Bulletin* data are obtained from issue No. 9, July 2003, plus additional data cuts. These *Microbanking Bulletin* data are the most recent available at the time of the study.

[1] Data for the four individual VBIs (first four lines) and for FINCA Latin America (fifth line) are for the year 2002. These data are obtained from the *Microbanking Bulletin* for Pro Mujer Bolivia and directly from Compartamos, CRECER, and FINCA International for the remaining programs. All other data (for the MFI groups) are from the *Microbanking Bulletin,* with the underlying MFI data referring to either the years 2001 or 2002, mostly 2002.
[2] FINCA data are from FINCA International; all other data are from the *Microbanking Bulletin.* The data are from the year 2002 for FINCA and Pro Mujer Bolivia and from 2001 for Compartamos and CRECER. For the remaining data (on MFI groups), the underlying individual MFI data all refer to either the years 2001 or 2002, mostly 2002.
[3] All data are from the IDB/CGAP inventory of 176 MFIs in 17 Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, Uruguay, and Venezuela). The data generally refer to mid 2001. A borrower is considered to be rural if (s)he lives in a locality with population of 5000 or less. To obtain the share of borrowers who are rural in a given MFI, MFI personnel estimated the share of borrowers who are rural for each of their branches and then aggregated to obtain the rural share for the overall MFI. The value for FINCA Latin America is the average of four FINCA village bank programs (the only ones on which we have data), not seven. The four are Ecuador, El Salvador, Mexico, and Nicaragua.
[4] The seven FINCA Latin America programs are: Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, and Nicaragua.

2. Best Practices

This chapter compares and contrasts the current practices of four leading Latin American village banking institutions (VBIs): Compartamos, CRECER, FINCA Nicaragua, and Pro Mujer Bolivia. The range of practices that are described and analyzed begins with how the village banks are structured and delinquency is controlled, and progresses on to the major characteristics of the VBIs' credit technology: loan size, repayment frequency, loan term, early payoff, repayment tracking, and the use of solidarity group and individual loans. Finally, the chapter examines village banking's savings services—including both forced and voluntary savings—as well as the internal account.

By making a detailed examination and analysis of the major aspects of the village banking methodology employed by these leading VBIs, we aim to show what lies behind their success. Each VBI's practices are studied critically and compared with those of the other VBIs, all within the context of the village banking experience and literature worldwide and especially in Latin America. This allows us to analyze what appears to be working well and what appears to need improvement, that is, what are good, bad, and questionable VBI practices, with particular reference to Latin America.

Chapter 1 argues that village banking needs to continue increasing the flexibility and client-orientation of its products. The present chapter provides numerous suggestions for how to do this. A brief digest of these suggestions is provided in the Executive Summary. VBIs should not attempt to implement too many changes in their processes and products at once, or else operations could become unmanageable and costs and risks could spiral out of control. Rather, VBIs should select from the menu of possible changes, such as those discussed here, those that are most important to implement in their particular context, with the entire process guided by market research and an understanding of their clients' needs. For an excellent discussion of how to implement such changes, see Wright et al. (2001; 2002).

Meeting Length and Structure

Frequent, lengthy meetings are one of the most common causes of client desertion. For example, Painter and MkNelly (1999, p. 26) find this in their analysis of seven village banking programs (five in Latin America), with weekly repayment meetings ranking ahead of, for example, small loan size and inaccessible savings as a leading cause of client dissatisfaction. Churchill, Hirschland, and Painter (2002, p. 84) state: "Exit interviews commonly find that some clients get tired of attending meetings. While they may value them for a while, the opportunity costs of being away from their businesses for an hour or two each week eventually exceed the benefits." A survey conducted by CRECER in 2003 of its dropouts finds that difficulty attending meetings is the reason clients cite most often for leaving the program. In a survey carried out recently by FINCA Nicaragua, the biggest client complaint was the amount of time spent in meetings. Frequent, lengthy meetings are likely not only to reduce client retention rates, but may also adversely affect client accession rates, that is, the percentage of prospective clients who choose to join the program.

There are two ways of attacking this issue: making meetings shorter and making them less frequent. This section examines the first alternative and a later section on repayment frequency discusses the second alternative.

Among the four leading VBIs surveyed in this study, typical meeting times range from

Table 2.1
Meeting Length and Its Determinants

	Compartamos	CRECER	FINCA Nicaragua	Pro Mujer Bolivia
Typical meeting length (minutes) – assuming no major loan delinquency problems	35-60[1]	90	105	105
Time spent on specialized education and other formal non-financial services (minutes)	0	20	0	30
Has an internal account?	No	*Yes*	No	*Yes*
Uses solidarity groups?	No	*Yes*	No	*Yes*
Uses the "nobody leaves" rule?		No	No	*Yes*

[1] Many Compartamos village bank members arrive early to meetings, often by as much as 25 minutes. For those who arrive on time to the meetings, the meeting time is typically 35 minutes. Those arriving 25 minutes early will therefore spend 60 minutes at the meeting, and so the typical meeting length is given as 35-60 minutes.
Source: Survey of these four VBIs, carried out in August-September 2003.

a low of 35-60 minutes for Compartamos to 90 minutes for CRECER and to 105 minutes for FINCA Nicaragua and Pro Mujer Bolivia (Table 2.1).[19] While the meeting time for the last three VBIs falls within the general industry average of 1½-2 hours, Compartamos' meetings are exceptionally short. Partly this is a function of having eliminated the internal account, which Compartamos estimates to have reduced meeting times by an average of 45 minutes. In addition, Compartamos does not offer specialized education or other formal non-financial services. Hence, their meetings are devoted solely to collecting loan repayments and savings and to handling ordinary meeting business (such as checking attendance, hearing reports and announcements from the village bank officers and the Compartamos loan officer, and discussing any issues that have arisen). In contrast, CRECER and Pro Mujer Bolivia spend an average of approximately 20 and 30 minutes, respectively, delivering non-financial services, especially business skill training and health care information and services, plus substantial additional time managing the internal account.

How might meetings be made shorter, in order to improve client satisfaction and retention? One way to make meetings shorter would be to stop offering formal non-financial services and to drop the internal account. Both CRECER and Pro Mujer Bolivia argue strongly against either of these changes, saying that feedback from their clients indicates that both of these services are highly valued and provide a differentiated product and a competitive advantage in Bolivia's highly-competitive microfinance market.[20] On the other hand, Compartamos and all of FINCA's Latin American programs, including FINCA Nicaragua, dropped the internal account two to three years ago, reflecting a general industry trend toward elimination of this service. The de-

[19] These "typical" meeting times assume that there are no major problems with loan arrearages, which can greatly prolong meetings.

[20] Pro Mujer has recently begun to reconsider the internal account because of some of the difficulties it creates. Pro Mujer's newer programs, in Mexico and Peru, do not offer internal account loans. Neither do Pro Mujer Bolivia's most recently opened offices, in Potosí and Santa Cruz, which began operations in 2002-03. All of the older Pro Mujer locations in Bolivia continue to offer internal account loans.

bate about whether village banking should offer formal non-financial services and an internal account is complex, involving many factors, and is considered later in this study. Suffice it to say for now that one would not drop these services simply to shorten meetings, but rather for a whole series of reasons including the desire to reduce meeting length.

In contrast, there are some relatively straightforward ways to shorten meetings which do not involve curtailing services that may be highly valued. Some of these methods are obvious, though not always implemented as well as they might be: the loan officer should arrive on time to the meetings and urge all village bank members to do the same, fines should be levied on those arriving late (all four VBIs surveyed here do this, with the amount of the fine set by each village bank and the fine itself accruing to the village bank), payments should be handled expeditiously and accurately, and the meeting in general should be moved along efficiently in recognition of the value participants place on their time.

Both CRECER and Pro Mujer Bolivia utilize another device that significantly speeds up their meetings and that is not so obvious: the use of solidarity groups within the village bank. For example, 25 village bank members might be divided up into five solidarity groups of five members each. The problem this addresses is that a substantial share of meeting time consists of calling each individual village bank member up to the treasurer's desk and making sure that member pays the proper amount. By organizing the village bank into several groups, the groups can work simultaneously during the meeting to verify proper loan repayments and savings contributions, and to deal with any shortages that arise (for example, by having one group member lend to another to cover a shortfall). Then, only five people need to be called up to the treasurer's desk to make payments and announce any shortages that the group was not able to resolve on its own. (The wider village bank might then be called upon to remedy such deficiencies.) In addition to speeding up payments, the use of solidarity groups affords more leadership opportunities to village bank members and also provides an added layer of delinquency protection that can be of real value in reducing village bank delinquency rates. This last use of solidarity groups is considered further in the next section.

While FINCA personnel stated that employing solidarity groups could prove quite useful in speeding up payments, this might not be so in the case of Compartamos. This is because village bank members often arrive as much as 25 minutes early to Compartamos village bank meetings. Once the treasurer arrives (often early as well), she takes the individual payments of those who are already present and any others who filter in early. By the time the loan officer arrives, half of the people may have already had their money counted and payments checked off. Only another 20 minutes are often needed to complete the payment part of the meeting. This advantage would be largely lost if each person had to wait until her entire solidarity group arrived before paying.

Finally, attention is called in the last line of Table 2.1 to a practice that has not worked out well in actual application. Pro Mujer, in both its Bolivia and Mexico programs, does not end its village bank meetings until all loan delinquencies are cleared up. Village bank members are expected to extend a loan to any member with a payment shortfall. Many program dropouts complain of these long meetings and of coming to hate meetings instead of enjoying them. Pro Mujer is giving strong consideration to eliminating this practice.

Table 2.2
Loan Delinquency: 30-Day Portfolio at Risk (%)

	1999	2000	2001	2002
Compartamos	0.7	0.6	1.2	0.7 [2]
CRECER	0.2		0.1	0.2 [2]
FINCA Nicaragua	3.1	0.8	1.3 [2]	0.8 [2]
Pro Mujer Bolivia	0.4	0.2	0.9	0.1
FINCA – average of 7 Latin American programs[1]	3.7	2.1		4.1

Notes: The 30-day portfolio at risk measures the outstanding principal balance of all loans with arrears over 30 days divided by the total gross loan portfolio. Blank cells indicate missing data. All data refer to the end of year (December 31).

[1] The seven FINCA Latin American programs are: Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, and Nicaragua.

[2] Data are obtained directly from the VBI. All other data are obtained from the *Microbanking Bulletin,* with permission from Compartamos, CRECER, FINCA, and Pro Mujer.

Delinquency Control

Being able to make loans and recover a very high percentage of them is a *sine qua non* of achieving sustainability and large scale outreach in village banking, as it is in microlending more generally. The four VBIs compared here have impressively low loan delinquency rates, often under one percent and always under five percent (Table 2.2). This is not true of all VBIs in Latin America, where double-digit delinquency rates occur with some frequency. How, then, do these four VBIs control loan delinquency so well? We describe their methods in some detail, examining three major aspects of the control process: delinquency control mechanisms, repayment incentives, and delinquency feedback.

Delinquency Control Mechanisms

The four VBIs utilize an interesting variety of mechanisms to deal with delinquent loan payments. All are backed by the threat that if the village bank does not repay its loan, it will lose access to all future loans and other services from the VBI.

Table 2.3 compares the delinquency control mechanisms used by the four VBIs. The mechanisms are given in order of usage, starting just below the name of the VBI and working down the rows of the table. CRECER and Pro Mujer Bolivia fundamentally rely on cross-loans, that is, loans to a member with a payment shortfall from one or more other village bank members. Both of these VBIs divide village bank members into several solidarity groups. A member who is unable to make her loan payment would look first to her solidarity group for help. If the solidarity group is unable to provide a loan to make up the shortfall, a loan would then be solicited from the other village bank members. Often, these cross-loans from other group or village bank members are repaid within a day or two, sometimes after the delinquent member secures a loan from a family member or friend, or sells an asset. Both CRECER and Pro Mujer Bolivia believe that by creating a two-tier structure—and a strong sense of loyalty and responsibility within both the solidarity group and the village bank—they enhance repayment prospects, dealing more quickly and surely with loan arrearages.

Table 2.3
Delinquency Control Mechanisms

	Compartamos	**CRECER**	**FINCA Nicaragua**	**Pro Mujer Bolivia**
Loans from other members	First from the delinquent member's sponsor, then from anyone in the village bank.	First from the delinquent member's solidarity group, then from anyone in the village bank. Usually this is all that is done.		First from the delinquent member's solidarity group, then from anyone in the village bank.
New collateral			At the third week of delinquency, the delinquent member is asked to put up collateral (usually household goods). This collateral is sold near the end of the loan cycle if the overdue payments are not forthcoming.	
Withdraw savings	First from the delinquent member's own savings, then from the village bank's voluntary savings, and finally from the village bank's forced savings.	- The village bank sometimes authorizes withdrawal of *forced savings* to cover the shortage, so that internal account loans can be made. - The loan officer may pressure the village bank to cover the shortage with *voluntary savings* if the shortage occurs on one of the 2 or 3 weeks when voluntary savings are to be turned over to the loan officer for deposit in a bank.	First from the delinquent member's own savings, then from the village bank's voluntary savings, and finally from the village bank's forced savings.	The village bank sometimes authorizes the withdrawal of forced savings to cover the shortage, so that internal account loans can be made. This is strictly voluntary. Other than this, Pro Mujer Bolivia no longer takes the savings of a village bank unless it fails completely.

Notes: The mechanisms the VBI uses to cope with a delinquent loan payment are given in order of usage, starting just below the name of the VBI and working down the rows of the table.
A blank cell indicates that the mechanism is not used.
Source: Survey of these four VBIs, carried out in August-September 2003.

With one exception discussed at the end of this subsection, Pro Mujer Bolivia makes no use of member savings to control delinquency. This was not always so. If cross-loans were not forthcoming, Pro Mujer's programs in both Bolivia and Nicaragua used to cover payment shortfalls out of the village bank's joint savings account—just as CRECER, Compartamos, and FINCA Nicaragua sometimes still do. However, Pro Mujer's experience was disastrous. Clients complained that Pro Mujer preached the virtues of saving and put forward the accumulation of a significant savings balance as a major goal for clients. In reaction to the appropriation of their savings, resentful clients would often withhold payments in the next loan cycle equal to the amount of savings that Pro Mujer had taken from them. In this way, delinquency often spread from one or two individuals to many more village bank members.

Pro Mujer's disastrous experience demonstrates that, at a minimum, VBIs wishing to utilize savings as cash collateral must be very clear with clients that these funds may be called upon to help cover bad loans and that only by keeping current on repayment can village banks continue to access VBI loans and other services. Moreover, VBIs must not oversell clients on the virtues of accumulating a significant savings balance because clients will then be confused when they are asked to give up these balances to help control loan delinquency. To understand these conclusions, we must understand why taking member savings worked out so badly for Pro Mujer but not for the other three VBIs. First, consider the case of Compartamos and CRECER. Both VBIs are clear with their clients that the primary function of forced savings is to act as cash collateral in case of payment default, and only secondarily to help the client accumulate a significant savings balance. The way that these two VBIs take forced savings reinforces this message. They require that a client put up 10-20 percent of her loan amount at the start of the loan cycle (much as one would put up collateral) and they then return all of this money plus interest at the end of the cycle. With the message clear from the outset that savings may be appropriated to cover loan shortfalls, and with this message reinforced by the mechanics of the saving process, clients are less likely to react badly and withhold future loan payments if their savings are in fact taken to make up for payment shortfalls. On the other hand, FINCA Nicaragua, like Pro Mujer, tells its members that the main purpose of savings is to help the member accumulate a significant savings balance. In addition, however, FINCA Nicaragua places substantial emphasis on the fact that savings also act as cash collateral. FINCA Nicaragua appears to have avoided the client resentment that Pro Mujer faced because of this difference in emphasis.[21]

In contrast to Pro Mujer's bad experience taking savings, FINCA Nicaragua encountered serious difficulties using cross-loans to cover loan delinquencies. So many cross-lenders were not being repaid that FINCA Nicaragua decided to abandon this approach. Instead, delinquent members are asked to put up household goods or other collateral. These goods are sold in the last week or two of the loan cycle if payments are still not forthcoming. This has resolved most cases of delinquency, so that FINCA Nicaragua has not had to take client savings very often.

Compartamos resolves loan delinquency by first asking the village bank member who sponsored the delinquent member to cover the shortfall with a cross-loan. Failing this, volunteer cross-lenders are sought from among the other village bank members. Only if these mechanisms fail does Compartamos pressure the village bank to make up

[21] This appears to be true despite the fact that both of these VBIs collect small amounts of forced savings at every village bank meeting (instead of a larger amount before the loan is disbursed) and despite the fact that neither returns these forced savings at the end of the loan cycle unless the member withdraws from the village bank or has a serious emergency—giving savings an illiquidity that reinforces the idea of saving to accumulate a sizable balance.

the shortfall from savings, first from the delinquent member's own savings, then from the village bank's voluntary savings, and finally from the village bank's forced savings.

There are two serious drawbacks to taking the village bank's voluntary savings before its forced savings in order to cover loan delinquencies, a practice employed by both Compartamos and FINCA Nicaragua. First, the incidence is very unfair. Village bank members who save only what is required and volunteer no further savings escape much or all of the losses that arise if the delinquent member ultimately defaults. A much fairer distribution of this burden would be achieved if forced savings were taken instead of, or at least before, voluntary savings—so that the losses would be spread among all village bank members, not just among the voluntary savers. The second problem with the Compartamos and FINCA Nicaragua approach is that by taking voluntary savings before forced savings they discourage members from accumulating larger savings balances through voluntary savings contributions. This clearly runs counter to village banking's development mission, which is to help poor people work themselves out of poverty through the provision of savings, credit, and other services.

Because of these two drawbacks, VBIs should take village bank forced savings ahead of village bank voluntary savings. One can even make a good case that, in light of these two issues, voluntary savings should *never* be used to cover loan defaults. This case is particularly strong for VBIs such as the four examined here. These VBIs have achieved very low delinquency rates and all require significant forced savings. Therefore, the losses to these VBIs of not taking voluntary savings in the event of loan default would be minimal.

In all of the VBIs examined here, village bank savings cannot be withdrawn at will by the VBI. The village bank must give its consent; typically, a village bank officer such as the treasurer or president must sign a withdrawal slip along with a designated representative of the VBI. While the VBI cannot unilaterally appropriate village bank savings, it can exert considerable pressure on the village bank to allow it to access these funds. As noted earlier, VBIs exert this pressure by threatening the village bank that they will not receive any further loans or other services at the end of the present cycle if they do not play by the rules. In addition, VBIs that have retained the internal account, such as Pro Mujer Bolivia and CRECER, typically do not allow any internal account loans if the village bank is in arrears with the VBI. Both Pro Mujer Bolivia and CRECER observe this very reasonable rule, the logic of which is: why should the village bank be allowed to make further loans among its members when it could use those loan funds to clear up its arrears with the organization that is responsible for providing the village banking program in the first place, the VBI?

Member savings serve an important cash collateral function in all four VBIs surveyed here in one key situation: village bank failure. When a village bank closes, there are almost always loan delinquencies. In this circumstance, all four VBIs use member savings to make up for missed payments, thus reducing their own losses. This is even true of Pro Mujer Bolivia, which does not otherwise take member savings to cover loan delinquencies, except in this case of village bank failure. An important reason to retain forced savings as part of the village banking methodology is that they deter village bank failure (since members know they will lose their savings) and lessen the effects of such failure on the VBI.

Repayment Incentives

While all four VBIs surveyed here use effective mechanisms to control delinquency, as described above, these mechanisms are not the only factors explaining VBI delinquency rates. The characteristics of the village banking product are also important determinants

of client repayment rates, as well as of client accession and retention rates.

At the most basic level, clients are motivated to repay loans in order to maintain their access to the services provided. The better and more numerous these services are, the more likely it is that clients will repay. Consider a client who encounters difficulties in her business and hence is faced with the possibility of not being able to pay her next several loan installments in full. That client will have to decide to what extent she will take extraordinary measures to make up the shortfalls before the next several village bank meetings—measures such as working longer hours, reducing household expenditures, borrowing from relatives or friends, or selling an asset. Her decision on whether to take such measures, some of which may be very hard on her and her family, will depend to an important degree on the value she attaches to the village banking services. Thus, if clients are frustrated because loan amounts are too low, terms are too short, weekly payments are too difficult to manage, forced savings rates are too high, and forced savings too inaccessible—to name some of the key aspects of village bank product quality—then clients will be less likely to value the service highly and fewer will choose to repay their loans in a timely fashion. All of these aspects of best practice are discussed in other sections of this study, so that much of this study is relevant to the topic of delinquency control.

Cost is another element controlled by the VBI that affects the value clients assign to a village banking product and therefore influences the loan delinquency rate. If clients feel the interest rate charged is too high, the time spent in meetings is too long or fractious, or the delivery of weekly loan payments to a bank branch too difficult or dangerous, loan repayment will be affected. VBIs can exert control over all of these program elements.

Program location can affect loan delinquency rates in another way. Many VBIs, including Compartamos, have found that informal social sanctions among village bank members operate more effectively and encourage loan repayment to a greater degree in smaller towns and rural areas than in large cities, since ties among neighbors are often weaker in large cities. Village banking programs located in areas served by several good competitors may also have a more difficult time keeping loan delinquency rates down. Clients located in such areas who encounter difficulties in their businesses and therefore in loan repayment may be more likely to default and move on to one of the competitors, particularly if such default information is not shared among financial institutions. Or clients may overindebt themselves with loans from several financial institutions at once, and default on one or more of these loans.

As already noted, additional services can help motivate loan repayment. Two of the four VBIs surveyed here (CRECER and Pro Mujer Bolivia) have retained the internal account and also offer important non-financial services to their members. In addition, Pro Mujer Bolivia has established a strategic alliance with the regulated micro-finance institution, FIE. FIE offers individual deposit accounts with premium interest rates eight hours per day, five days per week to all Pro Mujer clients. These services are available in Pro Mujer's Focal Centers, where many (though not all) Pro Mujer clients come to hold their village bank meetings—and so access is very convenient. All of these VBI services are popular with their clients and thus help to keep loan delinquency rates low.

Finally, monetary incentives also affect loan delinquency. The village banks in all four VBIs examined here set fines for late payments, which do seem to have an impact on repayment behavior, according to the VBIs. In addition, Compartamos risk prices their village bank loans. All village banks start off paying 5.5 percent per month flat interest on

their loans.[22] This interest rate is reduced to 4.5 percent flat for village banks that compile a good repayment record and is increased to 6.5 percent flat for village banks with a poor record. Pro Mujer's Peru program takes a commission at the start of the loan cycle and returns half of it if the entire village bank repays on time. According to Pro Mujer, clients value this refund a great deal. It is a major reason that clients repay on time and an important force behind the nearly perfect repayment record of Pro Mujer Peru's village banks.

Delinquency Feedback

Effective delinquency control programs normally have rapid feedback on any missed payments. Best practice in the microfinance industry is that the loan officer should receive this feedback by the morning after the payment was missed and begin acting on this information within a day or two. Three of the four VBIs examined here receive information on missed payments by the next morning and typically begin acting on this information almost immediately (Table 2.4). However, one of the four VBIs, FINCA Nicaragua, must wait until the next village bank meeting, in 1-2 weeks, to find out about any loan delinquencies. FINCA Nicaragua has relations with a few commercial banks, to which village bank representatives go to deposit their loan payments and savings after each village bank meeting—much like the relation Compartamos has with two commercial banks in Mexico. However, unlike the Compartamos case, the Nicaraguan banks have not been willing to report any missing or insufficient loan payments to FINCA Nicaragua. Therefore, FINCA Nicaragua must wait until the next village bank meeting to examine the village bank's deposit receipt and find out if the proper payment was in fact made, and made in a timely fashion. To remedy this problem, and the additional problem of poor treatment of FINCA clients by the banks, FINCA Nicaragua is in the process of equipping its six branch offices with tellers and security apparatus so that they can function as payment reception centers. FINCA Nicaragua also plans to rent additional office space near large markets for the same purpose. Thus, while FINCA Nicaragua's delinquency feedback is not ideal, it is moving to improve the situation.

Maximum Loan Size and the Loan Ladder

Chapter 1 discusses the fact that, compared to individual lending, village bank lending is a very inflexible instrument. A potentially key aspect of this inflexibility is the limits embodied in the VBI loan ladder. The loan ladder gives the largest size loan available to a village bank member at each loan cycle. Table 2.5 presents the loan ladders for the four VBIs surveyed here. For example, Compartamos' loan ladder shows that the largest size loan available to an individual village bank member in her first, second, and third loan cycles is $150, $750, and $1400, respectively. The *maximum loan size,* or the largest size village bank loan an individual village bank member can *ever* obtain, is simply the highest of these loan cycle values, or $1400 in the case of Compartamos. This section critically examines the maximum loan sizes set by the four VBIs, as well as the remainder of their loan ladders.

The maximum loan sizes shown in Table 2.5—$1400 for Compartamos, $1000 for FINCA Nicaragua and Pro Mujer Bolivia, and $800 for CRECER—are a far cry from the $300 maximums that were often found in Latin American VBIs in the mid 1990s. These $300 maximums were credited with causing substantial client desertion at the

[22] Flat interest is computed on the original loan amount, not on the remaining balance. For example, clients with a 4-month loan and a 5.5 percent per month flat interest rate would pay 22 percent (=4 x 5.5 percent) of the original loan amount in interest, or $22 on a $100 loan. Hence, in the case of Compartamos' 16 weekly repayments, clients would repay $1.38 (=$22/16) in interest plus $6.25 (=$100/16) in principal each week.

Table 2.4
Delinquency Feedback

VBI	Feedback on Loan Delinquency
Compartamos	Receives daily activity reports on all village bank accounts from its two collaborating commercial banks.
CRECER	Feedback is immediate since loan payments are either given directly to the CRECER loan officer for deposit (two or three times during the loan cycle) or else to the village bank internal account, which is observed by the loan officer (during the remaining weeks of the cycle).
FINCA Nicaragua	FINCA Nicaragua's loan officer checks the commercial bank deposit receipt at the next village bank meeting, 1-2 weeks after the loan repayment deposit was made.
Pro Mujer Bolivia	Feedback is immediate for all village banks meeting in a Focal Center and using the FIE deposit window located there. Village banks not using the FIE deposit window in a Focal Center must deposit funds in a designated bank and show the deposit receipt at a Pro Mujer office, all on the same day as the village bank meeting.

Source: Survey of these four VBIs, carried out in August-September 2003.

Table 2.5
The Loan Ladder and the Maximum Loan Size
(in $)

Loan Cycle	Compartamos	CRECER	FINCA Nicaragua	Pro Mujer Bolivia
1	150	130	100	100
2	750	200	400	165
3	1400*	290	800	230
4		440	1000*	320
5		650		420
6		800*		545
7				710
8				850
9				1000*

Note: An asterisk (*) indicates maximum loan size for the indicated cycle and all subsequent cycles.
Source: Survey of these four VBIs, carried out in August-September 2003.

time. The current maximum loan sizes for the four VBIs surveyed here generally appear quite reasonable. They are set sufficiently high that only a small fraction of their clients (approximately 5-10 percent) are at or near this ceiling and thus are directly affected by it. Nonetheless, retaining these large borrowers is quite important for ensuring the sustainability of the VBI, not only because of the large interest income that these clients generate but also because, in order to qualify for such loans, clients normally must have an excellent repayment record. Accordingly, at the end of this section, we revisit the issue of maximum loan size and discuss the use of solidarity group and individual loans.

At the other end of the ladder, the maximum sizes for the first loan from the four VBIs are all in the $100-150 range. Following a common and quite reasonable village bank

ing practice, these four VBIs deliberately set these values low in order to limit potential losses for both the village bank and the VBI, given that these new clients have not yet demonstrated their willingness or ability to repay. In both the first and subsequent loan cycles, clients are by no means automatically granted the maximum size loan for that cycle. They must convince the other village bank members that they have the capacity and willingness to repay the size loan they request. The village bank must approve all loan requests and, through its solidarity guarantee, stand ready to make up any member's loan repayment shortfalls. The VBI loan officer may exert influence in this process if (s)he feels that some individual loan requests are too high, threatening the village bank with future repayment difficulties.

The intermediate steps on the loan ladder may cause the four VBIs more problems of client desertion than the final maximum loan size because far more clients are affected by these intermediate steps. The loan ladders of CRECER and Pro Mujer Bolivia may be especially problematic in this regard because they require six and nine loan cycles, respectively, to reach the final maximum loan amount—in contrast to three and four cycles for Compartamos and FINCA Nicaragua, respectively. While all four VBIs restrict clients to fairly low loan amounts in the first cycle in order to test their creditworthiness, starting with the second cycle, Compartamos and FINCA Nicaragua allow more dynamic clients with more lucrative businesses to move ahead rapidly in loan size. By contrast, in CRECER and Pro Mujer Bolivia, this progression is much slower. In recent exit surveys done by CRECER, many clients complained of overly restrictive loan size ceilings in the intermediate cycles.

With the vanishingly small loan delinquency rates that both CRECER and Pro Mujer Bolivia enjoy, both VBIs, in all probability, could usefully allow clients to progress more rapidly to the final maximum loan size. The financial sustainability of the two VBIs might be improved by such a change. Although CRECER and Pro Mujer Bolivia might have to accept a little more delinquency from some loans that would be overdimensioned, the increase in client retention rates and average loan sizes might, on balance, increase their sustainability levels. This result, taken together with the likely increases in client satisfaction, would make this loan ladder liberalization a very worthwhile change. Moreover, loan delinquency rates might not even rise. As the preceding section argues, making the village banking product more valuable to clients (by liberalizing the loan ladder) increases a client's motivation to repay her loan—even in the face of business difficulties or other obstacles—in order to maintain access to this product. Finally, the miniscule loan delinquency rates of Compartamos and FINCA Nicaragua demonstrate that such rates can be achieved despite very liberal loan ladders.

Assessing Loan Repayment Capacity

A potentially-important innovation that might allow VBIs to decrease credit risk while simultaneously increasing loan amounts all along the loan ladder would be to give village bank members training in how to calculate household savings and loan repayment capacity. At present, both CRECER and Pro Mujer Bolivia teach clients how to calculate weekly business profits as the difference between business income and business costs. To compute weekly household savings, other sources of household income would be added to this business profit calculation and household expenditures (including payments on any *other* loans besides the village bank loan) would be subtracted. Household savings, thus calculated, is what leading MFIs use to assess their clients' ability to service a loan. In order for the client to afford the loan, loan payments must be less than savings, perhaps by a margin to allow for economic downturns or other adverse events (such as in-

creased competition, illness, or loss of a major client).[23]

Teaching village bank clients how to calculate their loan repayment capacity would benefit both the village bank members and the VBI by reducing credit risk. It is crucial to train the village bank members themselves because it is they who must decide on the size of the loan each member is granted. The rather arbitrary limits placed on borrowing by the loan ladder could then give way at least somewhat to a more flexible and reasonable approach based on the village bank members having a better understanding of each member's loan repayment capacity. Such instruction would also benefit the village bank members as individuals since they would better understand their own household finances.

This instruction should also be feasible. While many village bank members are illiterate, most are quite numerate and can add and subtract sums of money very well. For example, many of the clients of both CRECER and Pro Mujer Bolivia have very low educational levels; however, both groups are taught how to calculate business profits. The calculation of household savings merely takes this calculation a step further. If such training is possible for very poor and illiterate village banking clients in one of the poorest countries of Latin America, then it is likely possible for much of the village banking clientele in the rest of Latin America.

[23] A common rule used by many MFIs is that loan payments must be less than 70 percent of household savings. Some MFIs allow this percentage to vary from loan to loan, setting lower percentages for cases in which business and other income flows are more volatile and higher percentages for cases of more stable income flows. The period over which savings is calculated (e.g., weekly or biweekly) is set equal to the repayment interval of the village bank loan. Thus, if loan repayments must be made every two weeks, biweekly savings are calculated.

Maximum Loan Size and Alternative Lending Modalities

There is an important tradeoff involved in setting the maximum size loan permitted to any village bank member, that is, the loan size associated with the final step of the loan ladder. On the one hand, a high maximum loan size is desirable because it allows the VBI to provide for the credit requirements of some of its oldest and most successful clients, to increase its development impact on this group, and to increase its own sustainability by retaining more of this profitable client segment. On the other hand, the VBI needs to avoid having too large a range of loan sizes. Small borrowers should not be asked to guarantee loans that are too large because even a single default on such loans could prove ruinous for these members.

The approximate 10:1 ratio of maximum loan size to maximum initial loan size that is seen in the loan ladders of FINCA Nicaragua, Pro Mujer Bolivia, and Compartamos (three of the four VBIs) is considered by some village banking experts to be as high as it is feasible to go without overly endangering small borrowers. However, if there are many clients with loans well below the maximum initial loan size—as is particularly true of the fourth VBI (CRECER), with its intense focus on rural poverty and its high tolerance for tiny loans—a smaller spread may be warranted. Such a spread is, in fact, observed for CRECER, with its ratio of maximum loan size to maximum initial loan size of 6:1.

Higher spreads are facilitated when large borrowers are asked to put up additional collateral; however, such added collateral requirements should not be made too inflexible. For example, some of Pro Mujer Bolivia's village banks ask their members who want to borrow large sums, such as $800-1000, to put up physical collateral in order to reduce the village bank's losses in case of default. Such requests do not reflect a fixed Pro Mujer policy, but rather are decided upon by the village banks on a loan-by-loan

basis, considering the riskiness of the large borrower and the capacity of the other village bank members to absorb losses. Compartamos used to have a much more rigid policy than this, requiring *all* of its larger borrowers to put up additional cash collateral. Compartamos did this by imposing higher forced savings rates on large borrowers.[24] Compartamos realized, however, that it was penalizing its oldest, best, most creditworthy, and least risky clients, and discontinued the practice approximately three years ago. CRECER's loan officers still typically set higher forced savings rates for larger loans (except in very rural areas, where the forced savings rate is fixed at CRECER's minimum rate of 10 percent). This policy runs into the same problem encountered earlier by Compartamos. A less automatic approach toward requiring additional collateral, such as that used by Pro Mujer, may better serve CRECER and its village banks by tailoring these requirements to the riskiness of the individual borrower and the needs of the individual village bank for added protection.

A potentially very useful way for VBIs to retain and serve clients whose credit requirements exceed the village bank loan ceiling is to offer individual or solidarity group loans to this clientele.[25] While individual and group loans are taken up in greater detail in their own section below, it is important for present purposes to note that they may be granted in two modalities: as a *supplement* to the village bank loan and as a *replacement* for the village bank loan. Many village bank clients with large loans dislike having to provide guarantees for numerous small village bank borrowers, whose businesses they consider unstable and risky. These larger clients may want to leave the village bank and obtain a *replacement* individual or group loan. In fact, they may do this either because of their desire to escape burdensome guarantee requirements or for the other reasons discussed in Chapter 1, namely, the transactions costs and inflexibilities that the village banking methodology imposes on them. Contrarily, other village banking clients may be less concerned about their obligations as loan guarantors or about transactions costs and product inflexibilities. These clients may put greater value on the savings and non-financial services offered by village banking, and so may seek to *supplement* their village bank loan, rather than replace it. As discussed in the section on individual and solidarity group loans, VBIs should give serious consideration to following Compartamos and offering these loans in both modalities. This differs from the practice of FINCA Nicaragua and Pro Mujer Bolivia, both of which offer only replacement individual and group loans.[26]

VBIs that offer individual or group loans should still maintain a reasonably high ceiling for the size of their village bank loans, in order to accommodate those clients who wish to satisfy all of their credit requirements within the village bank.[27] Doing otherwise may force far more clients than is necessary to obtain either a replacement or supplemental individual or group loan in order to obtain all of the credit they need. This is particularly undesirable if the VBI offers only replacement loans, as, for example, is the case with FINCA Nicaragua and Pro Mujer Bolivia. Many village bank cli-

[24] Clients with large loans had to put up as much as 40 percent of the loan amount in forced savings at the start of the loan cycle (before the loan was disbursed), versus only 20 percent for those with small loans.

[25] As discussed in Chapter 1, it may be as cheap for VBIs to offer individual loans as it is for them to offer village bank loans. Therefore, VBIs may reasonably consider offering individual loans to all of their clients, not just to their large borrowers. This more general use of individual loans goes beyond the scope of what is considered in this section, and is discussed later in the paper.

[26] CRECER offers no individual or group loans of any kind, either replacement or supplemental.

[27] By "reasonably high" we mean as high as possible without overly endangering the village bank's small borrowers—as discussed in the first three paragraphs of this subsection.

ents value very highly the non-credit services provided by the village bank and are loath to leave it, even if this means forgoing a larger loan. The lower the village bank loan ceiling is set, the more clients will face the dilemma of having to choose between an adequate size loan and the non-credit benefits of a village bank loan. VBIs should also maintain a reasonably high village bank loan ceiling in the case in which they offer supplemental individual or group loans. In this way, the VBI reduces the number of cases in which it must make two loans to one client (a village bank loan and a supplemental individual or group loan), thus reducing operating costs for the VBI and transactions costs for these clients.

Keeping village bank loan ceilings reasonably high has another potential benefit. High ceilings reduce the need for internal account loans, because clients are able to satisfy more of their credit requirements with their VBI loan. This means that if the VBI closes the internal account, as more and more VBIs are choosing to do, there will be less impact on clients and therefore fewer client dropouts. The relatively high loan ceilings offered by Compartamos and at least some of FINCA's Latin American programs help explain why these VBIs did not experience a large client exodus after they eliminated the internal account in 2000-01.

Loan Rationing

Some people might argue that the above discussion on the desirability of keeping the village bank loan ceiling reasonably high in order to adequately serve some of the VBI's oldest, best, and most profitable clients—that is, those clients who want large village bank loans—is subject to one important caveat. This caveat arises when there are insufficient funds available to permit creditworthy clients to have reasonably large size loans. In this case, one possible way to ration the available funds is to keep a low loan size ceiling in order to spread the VBI's funds more widely. While this rationing device might seem appealing on fairness grounds, its use should be carefully considered since it may lead to a substantial increase in the VBI's dropout rate. The lower the ceiling, the more dropouts there are likely to be. And the dropouts are likely to be the VBI's most profitable clients, namely, those at or near the loan size ceiling.

The following alternative way to ration limited funds should be considered instead. Rather than setting a low loan size ceiling, the VBI should set a reasonable one (as high as possible without overly endangering clients who have small loans)—or as close to this reasonable level as possible. Then, to ration its limited funds, the VBI would restrict the number of clients who are served, offering them all as market-driven a village banking product as possible—with as little curtailment of the loan size ceiling as it can. For example, a VBI starting up operations in a new area would serve only as many clients as it has funds to adequately serve. A VBI facing an unexpected reduction in funding would reduce the number of clients served through attrition, in order to avoid as much as possible lowering the loan size ceiling. VBIs that follow this strategy may retain many more of their large and profitable clients. They can then use the additional profits earned from these clients to expand their village banking program to more clients. Over time, this way of rationing credit may actually allow the VBIs to serve more clients (including more poor clients) and to provide better service than if they had followed the alternative strategy of setting a low loan size ceiling.

Repayment Frequency

This section presents significant evidence that the changeover from village banking's traditional weekly repayment meetings to biweekly meetings can be very beneficial in practice to both VBIs and their clients. More limited evidence suggests caution in the use of monthly repayments because they may result in high levels of loan default. Another important lesson of experience is that little may be accomplished if it is left to loan of-

ficers to voluntarily switch village banks over from weekly to biweekly repayments. The loan officers often fear increased loan delinquency and the impact that this may have on the amount of incentive pay they receive. VBIs that want to make the switch from weekly to biweekly repayments may have to act more decisively, for instance, by offering the choice directly to village banks or bysimply mandating the change. Finally, it is argued that the changeover from weekly to biweekly repayments should first be introduced as a choice since, for various reasons, some village banks may prefer to remain on a weekly schedule. If the biweekly product is successful and widely adopted, but there is a significant minority of village banks that still prefer to meet weekly, the VBI might consider charging these clients the extra cost of providing this service—in order to retain a popular product but protect its own sustainability and capacity to expand its outreach.

As noted in the first section of this chapter, frequent, lengthy meetings are one of the most common causes of client dissatisfaction and desertion. All of the four VBIs surveyed here except Compartamos are in the process of switching most or all of their clients over from weekly to biweekly loan repayments (Table 2.6). This change can be beneficial for clients, who now can spend more time with their businesses and families. It can also be beneficial for the VBIs, which can significantly reduce their costs, provided that loan delinquency does not rise too much and offset the gains associated with greater loan officer productivity. The changeover to biweekly loan repayments is far enough advanced in both Pro Mujer Bolivia and CRECER to see that it has been very beneficial to both of these VBIs and their clients.

Client Impact

Most clients prefer biweekly to weekly meetings even when they receive valuable non-financial services at the meetings. Good evidence on this point comes from both the CRECER and Pro Mujer Bolivia programs. In client satisfaction surveys, most clients rate CRECER's education modules and Pro Mujer Bolivia's health and other non-financial services very highly.[28] Despite this fact, when Pro Mujer Bolivia's village banks have been offered the option to switch from weekly to biweekly meetings, over 80 percent have elected to do so. Similarly, in the year 2000, CRECER moved all of its village banks from weekly to biweekly payments except for those village banks that wanted to keep meeting weekly. During this year, the percentage of village banks meeting weekly fell from 98 percent to 28 percent and has since fallen further to 10 percent, again indicating a strong preference for less frequent meetings despite the provision of valuable non-financial services.

VBI Impact

The changeover to biweekly loan repayments is far enough advanced in Pro Mujer Bolivia and CRECER to see much or all of the loan officer productivity impact, while the changeover process is still incipient in FINCA Nicaragua. Loan officer productivity in both Pro Mujer Bolivia and CRECER has increased by approximately 50 percent, largely as a result of converting most village banks over to biweekly repayments. It should increase somewhat more if the remaining village banks are converted to biweekly repayments or if, as explained below, client density rises. These productivity gains were achieved without any change in loan delinquency rates.

Pro Mujer Bolivia's changeover to biweekly loan repayments was initiated in 1998 by allowing all village banks in loan cycle three or later with good loan repayment and meeting attendance records the option of

[28] Chapter 3 reviews some of this evidence. For example, over 90 percent of the clients of each of these VBIs rates the non-financial services they receive as "useful" or "very useful."

Table 2.7
Borrowers Per Loan Officer

Year	Compartamos	CRECER	FINCA Nicaragua	Pro Mujer Bolivia
1997				331
1998	350		330	355*
1999	339	312	311	
2000	326	316*	315	
2001	390	408		516
2002		410 [1]	294 [1]	501

Notes: Blank cells indicate missing data. Asterisk (*) indicates the year in which village bank clients began to switch over from weekly to biweekly payments. All data refer to the end of year (December 31).
[1] Data are obtained directly from the VBI. All other data are obtained from the *Microbanking Bulletin,* with permission from Compartamos, CRECER, FINCA, and Pro Mujer.

VBI	
Comparta	
CRECER	ments as of September 2003. CRECER wants to reduce this percentage further and eventually move all village banks to biweekly payments. All new village banks must repay biweekly.
FINCA Nicaragua	*20% of village banks repay biweekly, 80% weekly.* Up until September 2003, it was left to the loan officer's discretion whether to move village banks with good loan repayment and meeting attendance records from weekly to biweekly payments. Using this system, only 20% of village banks were repaying biweekly by September 2003. FINCA is moving all village banks to biweekly payments by June 2004 and is increasing the loan ladder amounts. Also, all village banks are moving from 16- to 24-week cycles during the last quarter of 2003.
Pro Mujer Bolivia	*80% of village banks in loan cycle 3 or later repay biweekly; all others repay weekly.* Starting in 1998, all village banks in loan cycle 3 or later with good loan repayment and meeting attendance records were allowed the option of repaying biweekly instead of weekly. Most (though not all) of these village banks accepted the biweekly option. A 1-year experiment with monthly repayments, carried out in the year 2000 with high-performing village banks in El Alto, was disastrous. Seven of the eight village banks had to be closed because of excessive loan defaults.

Source: Survey of these four VBIs, carried out in August-September 2003.

repaying biweekly instead of weekly. As a result, 80 percent of the village banks in loan cycle three or later now repay biweekly. This changeover is primarily responsible for the increase in Pro Mujer Bolivia's ratio of borrowers per loan officer from 331 at the end of 1997 to 516 and 501 in 2001 and 2002, respectively (Table 2.7).

CRECER converted most of its village banks from weekly to biweekly payments in the year 2000. This change is primarily responsible for the increase in the ratio of borrowers per loan officer from 312 at the end of the year 1999 to 408 and 410 in 2001 and 2002, respectively, and to an average of 470 in the September-November 2003 period.

With loan officer remuneration accounting for approximately 15-30 percent of overall operating costs in a typical VBI, such productivity increases can yield substantial cost savings.[29] Moreover, Pro Mujer Bolivia and CRECER have achieved these cost economies while maintaining their exceptionally low loan delinquency rates (Table 2.2).[30] This ensures that the gains from re-

[29] In addition to these direct savings in loan officer remuneration, there will be significant additional cost savings, for example, in transportation costs and from fewer support and supervisory personnel.
[30] In addition to the delinquency rates shown in Table 2.2, Pro Mujer Bolivia's 30-day portfolio

ducing loan officer payrolls and associated costs are not offset by increases in the costs of provisioning for bad debts.

Some readers may wonder why the switch-over from weekly to biweekly meetings has not doubled the average number of borrowers per loan officer. After all, couldn't a loan officer who has managed 15 village banks, meeting each village bank every week, now attend to 30 village banks, meeting each village bank every two weeks? In contrast to this theoretical prediction, loan officer productivity has increased by approximately 50 percent in both CRECER and Pro Mujer Bolivia. The following four factors may account for this difference:

- First, and most simply, is the fact that in neither CRECER nor Pro Mujer Bolivia have *all* village banks made the switch-over from weekly to biweekly meetings (Table 2.6).

- Second, the switchover from weekly to biweekly meetings has not occurred in a vacuum. The effect of other factors operating at the same time are also reflected in the data. For example, Bolivia's severe economic slowdown and recession during the years 1999-2002 have undoubtedly increased the difficulties of making timely loan repayments for many village bank members. This may have forced loan officers to take additional time to deal with loan delinquency issues, reducing their productivity.

- Third, some of the difference may reflect the constraints imposed by geography. Each loan officer lives in one place and generally serves village banks in that area. For loan officers to increase the number of village banks they attend, they may have to serve village banks that are farther away. This means that when the change is made from weekly to biweekly meetings, they may not be able to double the number of village banks they manage, for example, from 15 to 30. Thus, productivity will rise by less than 100 percent. To the extent that over time the number of clients increases in geographic areas already served by the VBI (rising client density), loan officer productivity may increase, rising toward the theoretical 100 percent gain.
- The fourth factor that may explain the difference, at least for a few years, is that VBIs that make the switch from weekly to biweekly meetings may not want to suddenly dismiss a large number of now-redundant loan officers. They may instead wait for attrition in their personnel and growth in the number of clients to reduce the imbalance between the need for loan officers and their actual numbers. While this strategy has the advantages of keeping morale up and not wasting the VBI's investment in building up a corps of trained and experienced loan officers, it can be carried too far. In the case of CRECER and Pro Mujer Bolivia, the average annual client growth rates in the 1999-2002 period were 28 and 19 percent, respectively, so that the number of clients doubled in three and four years, respectively. While this is fast growth, it may or may not be fast enough for a policy of relying on attrition and client growth to be optimal. Whether this waiting strategy would be optimal would also depend on whether the new clients are located near the old clients and thus can be attended to by fewer loan officers or whether the new clients are scattered widely and are far from the old clients and thus require attention by a greater number of loan officers. It would also depend on the factors given in the preceding three bullets, all of which help determine the amount of the initial imbalance between the

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at risk was 0.7 percent in December 1997, just before the changeover to biweekly loan repayments was begun. This delinquency rate is quite comparable to the delinquency rates Pro Mujer Bolivia achieved after the changeover, which averaged 0.4 percent for the years 1999-2002 (Table 2.2).

need for loan officers and their actual numbers.[31]

Compartamos experimented briefly with shifting from weekly to biweekly payments, in the year 2000. Clients were shifted from 16 weekly to 16 biweekly loan repayments, thus also increasing the loan term from 16 to 32 weeks. According to Compartamos, clients often forgot which week the meeting was being held, leading to significant repayment problems over the lengthy repayment period. The fact that the other three VBIs have not had serious problems in this regard may raise questions about whether Compartamos was strongly committed to trying to make this pilot product work and whether it emphasized sufficiently the need for loan officers to firmly plant the next meeting time into people's consciousness. Moreover, such repayment problems can be expected to diminish over time as people become accustomed to the new payment interval. Finally, some of the problem may have been caused by clients' dissatisfaction with the dramatically increased loan term, which slows their advance to successive loan cycles and the potentially larger loans that this advancement affords.

Monthly Payments

Churchill, Hirschland, and Painter (2002) note that some VBIs employ monthly repayment intervals, mirroring the much more general shift among leading microfinance institutions in Latin America to monthly payments.[32] While the four VBIs examined in depth here have all received indications of at least some client interest in monthly loan payments, only Pro Mujer Bolivia has tried this out, in an experiment that provides an important cautionary tale. Pro Mujer Bolivia's small, one-year experiment was carried out in the year 2000 in the city of El Alto using eight mature village banks with very good repayment records. The results were disastrous: seven of the eight village banks had to be closed because of excessive loan defaults. The main problem was that clients couldn't save up for a month at a time; there was too much pressure to spend the loan repayment money. This probably reflects the low income levels of these clients and their urgent consumption needs.[33] Many clients ended up borrowing from moneylenders or other microfinance institutions to make their monthly payments, which often compounded their problems. Although this evidence is limited, it does point to a possible pitfall in making repayment intervals too long, particularly for a very poor clientele. Pilot testing would seem to be especially warranted before adopting a monthly repayment interval.

The Perils of Loan Officer Discretion

Another lesson of experience from two of the four VBIs surveyed here is that not too much may be accomplished if it is left to the loan officers to voluntarily switch even very well-performing village banks from weekly to biweekly loan repayments. Rather, if the VBI wants to make this switch, it may have to act more decisively, for instance, by offering the choice to village banks directly or simply by mandating the change. For example, prior to the year 2000, CRECER allowed its loan officers the discretion to move village banks with good loan repayment and meeting attendance records from weekly to biweekly payments after four loan cycles. Fearing increased loan delinquency and the impact this could have on the amount of incentive pay they would receive, few loan officers elected to do this. By the end of 1999, only two percent of village

[31] We are not claiming that CRECER and Pro Mujer Bolivia actually employed this waiting strategy. Their client growth rates are cited only to help illustrate the tradeoffs involved.

[32] This latter trend is discussed, for example, in Westley (2003, Chapter 5).

[33] Rutherford (2000) discusses at length the difficulties that poor people face when they try to save at home amid the many temptations to spend on oneself as well as to meet the urgent needs of one's immediate family and deal with the requests of importuning neighbors, friends, and other relatives.

banks were enjoying biweekly loan payments. At this point, CRECER changed course and allowed the village banks, rather than the loan officers, to choose between weekly and biweekly repayments, which resulted in 72 percent of village banks paying biweekly one year later (Table 2.6). FINCA Nicaragua employed a similar scheme involving loan officer discretion, with only marginally better results: 20 percent of village banks were paying biweekly as of September 2003. Starting in that month, FINCA Nicaragua began phasing in a mandatory changeover to biweekly payments.

The Issue of Choice

Should village banks be given a choice between weekly and biweekly payments, as Pro Mujer Bolivia and CRECER mainly do at present, or should all village banks be forced to accept biweekly payments, as FINCA Nicaragua is doing and CRECER may eventually do? The major argument for forcing all clients to accept biweekly payments is that the VBI can substantially reduce its costs, provided that loan delinquency rates do not rise too much. Further, clients often prefer biweekly payments, primarily because of the time they save, so that going over to mandatory biweekly payments may not create dissatisfaction among too many clients.

On the other hand, some clients do prefer weekly to biweekly repayments, and for these clients it may be wise to preserve the option of choosing either one. For example, some clients may have difficulty saving at home over the course of two weeks, akin to the difficulty discussed earlier that Pro Mujer clients encountered with monthly repayments. In some village banks, clients may derive enough enjoyment or benefit from the meetings that they prefer to meet weekly. In VBIs with internal accounts, some clients with fast rotation businesses (particularly merchants who need frequent restocking) prefer weekly meetings so that they have access to internal account loans every week, instead of every two weeks. Internal account loans are especially useful to such clients because they are available on short notice and normally are repaid in bullet form (a single payment of principal and interest at the end of the loan), thus allowing clients to use all of the loan funds during the entire loan period. Finally, if the changeover to biweekly payments is always linked with a longer loan term (as it is in the case of CRECER and FINCA Nicaragua), some clients may prefer to stay with weekly payments in order to keep their loan terms shorter.[34]

With these considerations in mind, our answer to the question about choice, posed at the beginning of this subsection, is as follows. Consider a VBI with weekly payments and a low delinquency rate (so that repayment is well controlled) that wants to reduce its costs by going over to biweekly payments. The VBI should introduce the biweekly option at first on a voluntary basis, offering it either to village banks in all loan cycles or, perhaps somewhat more conservatively (as Pro Mujer Bolivia does), only to village banks that have proven their repayment capacity during some initial loan cycles. This respects the fact that some village banks may want to remain on a weekly cycle. It also avoids the common village-banking pitfall of creating one-size-fits-all products, even when the cost to the VBI of offering some product variety is relatively small, as it is in the case of offering loans with both weekly and biweekly repayments. The new biweekly loan product should be

[34] Many clients prefer to keep loan terms short in order to progress to larger loans faster, and for other reasons discussed in the next section. CRECER has insisted that clients on biweekly payments accept a longer, 24-week loan cycle, so that the village bank can cover one of CRECER's education modules in a single loan cycle. FINCA Nicaragua is not constrained by this consideration, but has simply introduced both changes simultaneously because their market research indicates that the majority of clients prefer longer-term loans and less frequent repayments.

pilot tested to see whether: clients appreciate it, repayment rates stay high, and substantial cost savings are realized. Assuming positive results, the program could then be rolled out from pilot test areas to all eligible village banks.

What should the VBI do if there is a sizable minority of village banks that prefers to stay with weekly payments, given that such payments may significantly increase the VBI's costs and reduce its competitiveness and sustainability? One option is to simply mandate biweekly repayments for all village banks, on the theory that the VBI has much to gain and that the clients probably won't lose too much (though market research might prove this wrong). Probably a better option is to let the village banks that wish to continue with weekly meetings do so, but to charge them the extra costs of providing this service. By keeping a product that is popular with a significant segment of the VBI's client base, the VBI helps keep its client satisfaction and retention rates up. And by charging clients what the product really costs, the VBI protects its capacity to generate profits and expand the reach of its programs.

Loan Term

An area in which VBIs should almost certainly offer their clients greater choice is in the term of their village bank loans. This is true for at least two reasons. First, it costs the VBI relatively little to do this, primarily some reprogramming of its systems. Second, for reasons discussed below, some clients and village banks prefer longer-term loans while others prefer shorter-term loans. Unfortunately, of the four VBIs surveyed here, only Pro Mujer Bolivia is committed to offering its village banks any real choice of loan term; thus, this is generally a weak area even among these leading VBIs.

Since there are advantages to both longer- and shorter-term loans, some clients will inevitably prefer longer-term loans while other clients will prefer shorter-term loans. The primary advantage of longer-term loans is that they spread amortization payments over more time, making these loans more affordable. Shorter-term loans have two main advantages. First, by keeping the term short, village banks are able to progress up the loan ladder to larger loans more quickly. Second, shorter-term loans help overcome what may be called the starting date rigidity problem. Overcoming this problem is especially important to village bank members whose sales increase sharply around holiday periods such as Christmas or Easter or at other defined times of the year. Ideally, such members would like a new and perhaps larger loan just before these peak selling periods—to stock up on goods for resale or to purchase raw materials or other productive inputs.[35] Since village bank loans are normally granted soon after the preceding village bank loan has been paid off, loan starting dates often may not be timed well to meet the needs of such members. However, the chances are greater of getting a fresh loan when it is needed if fresh loans are granted more often, that is, if loan cycles are shorter. This is particularly so if the village bank is allowed to pay off its loans a few weeks early, a valuable option that all four VBIs surveyed here offer (see next section). For example, compared to village bank clients with a 24-week or a 1-year loan cycle, clients with a 12-week loan cycle have a much greater chance of getting their loan to start when they need it, particularly if the preceding loan can be paid off a few weeks early.

There is one additional factor that can affect whether clients would prefer a longer- or a shorter-term loan. This factor comes into play when longer-term loans are coupled with longer payment intervals (for example, as CRECER and FINCA Nicaragua are do-

[35] Even a *new* loan for the usual amount could be very helpful. A new loan of $300 gives the borrower the full $300 with which to work. However, as the borrower amortizes the loan over time, less and less of the $300 is effectively available to her to maintain a stock of goods for sale or to purchase raw materials for processing.

ing by moving clients from 16-week loans with weekly payments to 24-week loans with biweekly payments). In this situation, some clients may prefer a longer- or shorter-term loan, not for the term itself, but for the payment interval that accompanies it. As discussed in the preceding section, some clients prefer shorter payment intervals (e.g., weekly) and other clients prefer longer payment intervals (e.g., biweekly or even monthly).

The experience of Pro Mujer Bolivia illustrates the importance of offering village banks a range of different loan terms, in order to meet their varying needs. Pro Mujer Bolivia offers its village banks two alternatives to its standard 16-week loan, depending on the loan cycle the village bank is in. During a village bank's first loan cycle, it may elect a shorter, 12-week loan. Many do so, primarily to advance to larger loan amounts more quickly. Other village banks, including those with more modest future credit needs, opt for the 16-week cycle in order to keep their loans more affordable. After four or five loan cycles, village banks with good loan repayment and meeting attendance records are allowed to choose a 24-week term. Village banks with many merchants often stay with the shorter (16-week) term in order to have more frequent access to fresh capital. Many other village banks, particularly those whose members have larger loans, opt for the greater affordability of the 24-week loans.

While Pro Mujer Bolivia has made an admirable start in offering loan term flexibility, it could usefully do even more to meet the varied needs of its clients. For example, it might offer the option of 24-week loans sooner, perhaps even in the first cycle, as CRECER has done since the year 2000 (Table 2.6). Judging by CRECER's continued miniscule delinquency rates, despite having moved nearly all of its clients to 24-week cycles, this change need not increase credit risk. Pro Mujer Bolivia might also consider allowing 12-week loan terms beyond the first cycle, as a way to better meet the needs of its more dynamic village banks for larger loans or as a way to reduce starting date rigidity problems, particularly for its many merchants.

Compared to Pro Mujer Bolivia, the loan terms offered by the other three VBIs show even less flexibility. Compartamos imposes 16-week terms on all of its village banks. FINCA Nicaragua has done the same up through September 2003, but is moving all village banks to 24-week loan terms during the last quarter of 2003, regardless of their preferences. Since the year 2000, CRECER has permitted its village banks to choose between 16-week cycles (with weekly repayments) and 24-week cycles (with biweekly payments). However, it has taken the decision to eventually offer only the 24-week cycle. In addition, CRECER has insisted for some time that all new village banks employ the 24-week cycle. In order to placate clients with concerns that they would move up to larger loans more slowly because of the lengthened loan term, both CRECER and FINCA Nicaragua increased loan ladder amounts at the same time as they lengthened the loan term. In addition, both instituted biweekly payments, a change that is popular with many, but not all, clients (see preceding section). While it was clever to introduce these three changes simultaneously—in order to reduce the share of village banks that felt they were made worse off by the increased loan term—an even better strategy was overlooked: offering clients the *choice* between 16- and 24-week terms and perhaps between weekly and biweekly payments. By offering choice, these VBIs could better meet the varied needs of their thousands of clients and ensure that all village banks were made better off since all would have the option of continuing on with their existing loan term.

Early Payoff of Loans (Loan Prepayment)

Loan prepayment is a useful option that VBIs can offer to help their clients overcome the starting date rigidity problem de-

scribed in the last section.[36] All four of the VBIs surveyed here offer this option. Compartamos allows village banks to pay off their loans up to three weeks before the scheduled end of the loan cycle. Pro Mujer Bolivia and CRECER permit loans to be paid off up to four weeks in advance, though CRECER is changing this to three *meetings* in advance (that is, three weeks if the village bank repays weekly and six weeks if it repays biweekly). FINCA Nicaragua sets no limit on how early prepayment may occur, but finds that village banks can rarely afford to prepay by more than four weeks. Most of the prepayments to FINCA Nicaragua take place 2-4 weeks before the scheduled end of the loan cycle.

Substantial use is made of loan prepayment by the village banks. FINCA Nicaragua estimates that 40 percent of its village bank loans are paid off early. Both CRECER and Pro Mujer Bolivia report that prepayment is very common for loans ending around major holidays, permitting members to obtain new loans and increase their inventories of goods for sale and raw materials for processing in advance of these peak selling periods. Only Compartamos reports that little use is made of loan prepayment, with most of their early loan payoffs concentrated around Christmas.

Although prepayment is a useful tool for reducing the rigidity of the village banking loan, it has at least two important limitations. The first limitation arises in VBIs like CRECER that provide education or training during the payment meetings, and need at least a minimum number of meetings to cover one full education or training topic. Prepayments that reduce the number of meetings below this minimum cannot be allowed if the integrity of these non-financial services is to be protected. The second limitation is exemplified by the experience of FINCA Nicaragua: most village banks are sufficiently cash constrained that they cannot afford to take advantage of loan prepayment to the extent they might like, or sometimes even at all. Although FINCA Nicaragua allows their village banks to pay loans off as early as they wish, few of these village banks can raise the lump sum required to prepay by more than four weeks. This limitation also highlights the need, discussed in the preceding section, to give village banks some freedom to choose their loan term. For example, consider a village bank whose loan is up for renewal in September. It could be very helpful to this village bank if it could choose to receive a 12- or 16-week loan instead of a 24-week loan. In this way, the village bank could finish up the loan cycle just before the Christmas season and obtain a new and perhaps larger loan when such a loan would be most helpful. It is unlikely that the village bank could afford to prepay a 24-week loan early enough to achieve this, even if such prepayments were permitted.

Tracking Individual Payments

As any VBI must, the four VBIs surveyed here keep track of each village bank's forced savings and loan payments at the *village bank level*. In addition, three of the four VBIs (all except FINCA Nicaragua) track forced savings and loan payments at the *individual client level* as well. This section describes the benefits and costs of such individual client tracking, with the aim of helping VBIs decide whether individual tracking would be worthwhile in their case. It may surprise some readers that implementing individual client tracking can have fairly modest costs (depending on the initial state of the VBI's information system), while returning several important benefits.

Tracking individual payments offers several advantages to VBIs. For VBIs offering or planning to offer individual or solidarity group loans, such tracking provides a rich source of information to help assess individual creditworthiness. In the case of the four VBIs surveyed here, CRECER is considering offering such loans and the other three VBIs already offer them. Even for VBIs that offer only village bank loans, tracking indi-

[36] See the second paragraph.

vidual payments has at least four advantages. First, it provides a check on the village bank's own bookkeeping of individual member payments, thus helping to prevent simple mistakes as well as fraud. Second, tracking individual payments helps loan officers to monitor the interpersonal dynamics of loan repayment and patterns of delinquency more carefully over time. This may allow the loan officer to intervene strategically to head off a repayment crisis in the making. CRECER, for example, reports this to be an important benefit of their individual client information system. Third, by tracking individual payments, the VBI retains an institutional memory of who the problem payers are—even when loan officers leave and must be replaced, or are simply rotated. This is especially important in VBIs such as CRECER, which deliberately rotates its loan officers once a year as a fraud control measure. Finally, in larger or more transient population centers, the village bank itself may not always know that one of its members has a bad record of loan repayment in another village bank. The individual client information system can serve as a credit bureau for the village banks in this regard. McCord (2000, p. 19) reports that introducing individual client tracking was one of several important changes introduced in FINCA Uganda that led to rapid and dramatic improvements in performance.

Turning to the cost side, the VBI's information system may have to be modified in order to track individual payments. Once this has been done, the additional operating costs may be quite limited. The loan officers already attend all repayment meetings, and it should require little or no additional time for them to note down the amount paid by each village bank member during each meeting. The major additional operating cost consists of the salary of keypunch operators who must enter these data from each loan officer's log into the computer system and then generate the report the loan officer will bring to the next village bank meeting. The three VBIs that track individual loan payments have done it for years and report that the additional operating costs are quite modest.

Solidarity Group and Individual Loans

Solidarity group and individual loans offer important avenues through which a VBI can address the diverse credit needs of its target population and thus help to keep client satisfaction and retention rates high.[37] In the discussion earlier in this chapter of maximum village bank loan size, it was noted that a potentially very useful way for VBIs to serve and retain clients whose credit needs exceed the village bank loan ceiling (for example, $1000) is to offer these clients a solidarity group or individual loan, either as a supplement to or replacement for their village bank loan. Since these clients are normally the VBI's most profitable, retaining them is of great importance to increasing the VBI's sustainability and prospects for expansion. As discussed in Chapter 1, group and individual loans also offer clients much greater freedom to tailor the loan starting date, term, and repayment frequency to their individual needs—as well as to escape the burdensome guarantee requirements, other inflexibilities, and transactions costs imposed by the village banking methodology. Moreover, as demonstrated in Chapter 1, it may be as cheap for VBIs to serve clients using individual loans as it is using village bank loans. If this is even close to being true, VBIs may reasonably consider offering individual loans to all of their clients, not just to their large borrowers—since doing so will not substantially increase the VBI's overall costs. And, even if individual loans do cost a VBI more to offer than village bank loans, it can recoup these extra costs

[37] Solidarity group loans are typically granted to groups of 3-7 borrowers. In measuring the degree to which loans can be tailored to meet each individual's needs, group loans represent a compromise between the greater freedom of individual loans and the greater rigidity of village bank loans, which are granted to larger groups of approximately 15-30 borrowers at a time.

simply by charging more for the individual loans.

Despite the many advantages of group and individual loans, not every VBI should attempt to offer these loans. Wright (1998) and Wright, et al. (2001; 2002) provide excellent guidance on whether VBIs and other microfinance institutions should add a new product, such as a group or individual loan, to their existing range of products. This section does not attempt to summarize those discussions, but rather examines *how* to offer group and individual loans, for VBIs that have decided to do so.

VBIs that offer group or individual loans must still concern themselves with the discussion of the previous sections on building more flexibility and customer orientation into their village bank loan product. Many village bank clients value very highly the non-credit services they obtain in the village bank and are loath to leave it, even if this means forgoing a group or individual loan that would be larger or otherwise better suited to their needs. For example, village bank clients may appreciate the savings services, any specialized education and other formal non-financial services provided by the VBI, as well as the networking, informal technical assistance, empowerment benefits, enjoyment from socializing, sense of belonging, and other informal non-financial services that can all come with participation in a village bank. Therefore, VBIs should strive to improve both their village bank and other loan products, so that clients are presented with as good a menu of product choices as it is possible to offer. Clients can then choose whether they want the greater flexibility and possibly reduced risks and transactions costs of a group or individual loan, or the non-credit benefits of a village bank loan.

Of the four VBIs surveyed here, all except CRECER offer a solidarity group or individual loan product. Table 2.8 presents a number of characteristics of these group and individual loan products and provides the basis for several observations on best practice.

Two Problems

In all three VBIs, the number of group and individual loans (as of September 2003) is a tiny proportion of their total loans (Table 2.8, line 1). This is understandable in the case of FINCA Nicaragua, which just began

Table 2.8
Characteristics of Solidarity Group (G) and Individual (I) Loans

	Compartamos	FINCA Nicaragua	Pro Mujer Bolivia
1. Number of loans	G loans: 5300 I loans: 1260 (VB loans: 184,000)	G loans: 16 I loans: 0 (starting up) (VB loans: 29,000)	G loans: not offered I loans: 170 (VB loans: 32,000)
2. Where offered	19 of Compartamos' 68 branches		Cities of La Paz and Sucre
3. Loan officer for G and I loans separate from village bank loan officer?	Yes	Yes	Yes
4. Size	G loans: $150-1600[1] I loans: $500-5000 (VB loans ≤ $1400)	G loans: $400-2500 I loans: $400-5000 (VB loans ≤ $1000)	I loans: $500-3000 (VB loans ≤ $1000)
5. Repayment frequency	G and I loans: biweekly or monthly (VB loans: weekly)	G and I loans: weekly, but going over to biweekly by June 2004. (VB loans: same as G and I loans)	I loans of $500-800: biweekly. I loans >$800: monthly. (VB loans: weekly or biweekly)
6. Term	G loans: 3-6 months I loans: 3-10 months (VB loans: 16 weeks)	G and I loans: 16 weeks, but going over to 24 weeks by end 2003. (VB loans: same as G and I loans)	I loans: 6-12 months (VB loans: 12-24 weeks)
7. Must clients leave the village bank to take a G or I loan?	No	Yes	Yes
8. Perverse pay incentives reduce the number of G and I loans?	Yes	No	No
9. G and I loans offered only to village bank graduates?	No, offered to anyone	No, offered to anyone	Yes
10. VBI tracks each individual's payments in the village banks?	Yes	No	Yes

Notes: Comparative data for village bank loans are sometimes provided, in parentheses. CRECER does not offer solidarity group or individual loans, and hence does not appear in this table.
Abbreviations used for type of loan: Individual (I), Solidarity group (G), and Village bank (VB).

[1] Compartamos offers only solidarity group and individual loans in Mexico City. Outside of Mexico City, Compartamos offers only village bank loans and, in some locations, individual loans. Compartamos encountered substantial consumer resistance to village bank loans in Mexico City, and thus opted to replace them with solidarity group loans there. Because village bank loans are not offered in the capital, Compartamos permits solidarity group loans to be made there for as little as $150. This stands in contrast to the minimum size of $400-500 for the solidarity group and individual loans offered by the other two VBIs and to the minimum size of $500 for Compartamos' individual loans.

Source: Survey of these three VBIs, carried out in August-September 2003. All information in the table is given as of this date.

its group lending in January 2003 and its individual lending in September 2003. However, Compartamos and Pro Mujer Bolivia have offered these loans for several years. Why is group and individual lending in these two VBIs so limited?

There are at least two important problems that help explain the very limited number of group and individual loans made by Pro Mujer Bolivia and Compartamos (see Table 2.8, lines 7 and 8). First, the key reason that Pro Mujer Bolivia's individual loan product has not caught on is that any client in this VBI who wishes to obtain a group or individual loan is required to leave her village bank. As noted above, many village bank members value very highly the non-credit benefits of village banking and are very reluctant to give these up in order to access a group or individual loan. In Compartamos, a different factor explains the limited number of group and individual loans: perverse pay incentives for branch managers. Branch managers in Compartamos receive about one-quarter of their total income in the form of incentive bonuses. These bonuses are linked to the size and performance of their village bank loan portfolios and are not linked at all to the size and performance of their group and individual loan portfolios. The result is hardly surprising: branch managers focus their attention and that of their staffs almost exclusively on promoting and attending to their village bank loan portfolios.

The first of these two problems is shared by FINCA Nicaragua's group and individual loan clients as well. As a possible remedy to this problem, both Pro Mujer Bolivia and FINCA Nicaragua should seriously consider providing group and individual loans not only as *replacements* for village bank loans (as they do now) but also as *supplements* to village bank loans (as Compartamos does, for example). In this way, clients are not forced to give up all of the supports and other non-credit benefits of village banks that many members value so highly. The incremental cost of allowing a member to remain in her village bank and of continuing to supply her with a village bank loan (beyond the cost of providing her a group or individual loan) is deemed to be quite small by all three of the VBIs. Therefore, this arrangement should not increase VBI operating costs very much. In any case, each type of loan should be priced to at least cover its costs, and hopefully return the VBI a profit as well. Permitting VBI clients simultaneous access to two loans follows in the tradition of larger banking institutions, which are normally only too happy to have clients take out an additional loan. The remedy to the second of the two problems described in the preceding paragraph is apparent. Compartamos must achieve at least a rough balance in how its incentive pay system treats indi- vidual, group, and village bank loans—as FINCA Nicaragua and Pro Mujer Bolivia have done.

The Issue of Mission Drift

One way for VBIs to increase the uptake of a group or individual loan product is to offer such loans to all clients in the VBI's service area, not just to those who have been part of its village banking program. This practice is followed by Compartamos and FINCA Nicaragua, but not by Pro Mujer Bolivia (Table 2.8, line 9). Pro Mujer Bolivia limits its individual loan product to village bank graduates as a way to avoid mission drift. That is, Pro Mujer Bolivia aims to direct its available loan and human resources to serving the very poor with village bank loans, and reserves its larger, individual loans (minimum loan size $500) only for those who have outgrown their village bank loans—and who, therefore, were once presumably very poor. Pro Mujer Bolivia prefers not to offer these larger, individual loans to any others in its service area, as a way to avoid as much as possible directing its resources to the less poor or even nonpoor.

While Pro Mujer Bolivia's social goals are laudable, it is not clear that their clientele restriction best serves these goals. It is true that in the shorter run offering larger, individual loans to completely new clients may well reduce Pro Mujer Bolivia's poverty

impact by reducing the amount of funds available to serve new, very poor village bank clients. However, in the longer run, the opposite may be true. The larger, individual loans may generate significant profits for Pro Mujer Bolivia, providing it funds to expand its village banking operations to large numbers of very poor clients in new areas. And by removing the clientele restriction, profits may be further increased because of the dramatic increase in the density of individual loan client prospects (that is, in the number of individual loan client prospects in a given neighborhood or area), which could lead to substantial increases in loan officer productivity. In addition to allowing Pro Mujer Bolivia to expand its outreach to the very poor, the profits generated by an expanded program of individual lending could also be used to reduce the interest rate charged on all Pro Mujer Bolivia loans. This would increase the competitiveness of Pro Mujer Bolivia's village banking program and cross-subsidize the poorer village bank clients and their smaller size loans. In the same way, many credit unions in Latin America have long served a diverse clientele of poor and middle class borrowers ignored by the traditional banking system. In many cases, these credit unions have been able to keep the interest rate charged to their poor borrowers far below what other microfinance institutions charge because of this pooling of heterogeneous clients. If VBIs really wish to maximize the help they can offer to the very poor, they might consider the maxim that the very poor deserve to be served by a financial institution with a heterogeneous clientele, so that they don't have to pay so much for their tiny loans.

Further Expanding Client Choice

One of the key benefits of solidarity group and individual loans is the flexibility these loans have to be tailored to meet individual client needs. VBIs offering group or individual loans can increase these benefits by widening the range of loan repayment options available to their group and individual borrowers, for example, to include loan maturity (term) and repayment frequency options not available with their village banking product. Compartamos and Pro Mujer Bolivia offer group and individual loans with both biweekly and monthly repayments and a much wider range of loan maturities than is offered with their village banking products (Table 2.8, lines 5 and 6). On the other hand, FINCA Nicaragua offers exactly the same repayment frequency and loan maturity for its group and individual loans as it does for its village banking loans. This misses an important opportunity to diversify its product offerings in a way that meets a greater range of client needs.

Loan Officer Specialization

In analyzing their group and individual loan applicants, all three VBIs utilize loan officers who are completely separate from the village bank loan officers (Table 2.8, line 3). This separation of functions recognizes that a different loan methodology and a different set of skills are required when underwriting group or individual loans, as opposed to village bank loans. All three VBIs try to emulate the best practices utilized by leading group and individual lenders. For example, in the case of individual loans, this includes an examination of a client's character, cash flow, collateral, and credit history, as well as the stability of the client's business. As discussed in the preceding section, both Compartamos and Pro Mujer Bolivia (but not FINCA Nicaragua) track each individual's loan payments in the village banks, providing an excellent source of credit history information on clients desiring a group or individual loan.

Replacing Internal Account Loans

Since March 2003, Compartamos has been pilot testing an interesting individual loan product, called a "parallel loan." This product is meant to at least partly replace internal account loans, which were discontinued by Compartamos in the year 2000. Parallel loans have been quite popular in pilot tests, with about one-quarter of village bank

members taking one out in any given cycle. Compartamos expects to have 20,000 parallel loan clients by December 2004, after full product rollout.

Parallel loans are designed to meet short-term credit needs, such as those that merchants often have in advance of a holiday or other peak selling period. They may also be used to meet short-term consumption or emergency needs. In Compartamos' village bank loan cycle, which consists of 16 weekly meetings, parallel loans may be started in week four or afterwards, and must be repaid by week 15.

While the village bank does not guarantee the repayment of parallel loans to Compartamos, it recommends both whether a member should be granted such a loan as well as the size of the loan to be granted. The village bank has a strong incentive to make these choices well since no additional parallel loans can be granted to any member of the village bank while even one of these loans is in arrears.

Compartamos is beginning conservatively with the new loan product, allowing parallel loans only in village banks that have repaid their village bank loans well over at least six cycles. Parallel loans are also limited in size to a maximum of 30 percent of the borrower's loan from Compartamos. Compartamos expects this product to bring it significant additional profits since pilot tests indicate that parallel loans can be offered by the existing village bank loan officers with little increase in meeting time and, thus, with little or no increase in staff. Compartamos charges its usual village bank loan rate for the parallel loans.

Parallel loans appear to be a promising product, which could be of interest to the growing number of VBIs that have either closed up their internal account or started new programs without one. A possible problem with this product, at least as it is currently implemented by Compartamos, is its potential for imposing heavy transactions costs on borrowers. This is because each individual with a parallel loan must go to the bank each week to deposit her weekly parallel loan installment payment (the receipt from which must be shown at the next village bank meeting as proof of payment). The burden of these weekly journeys could be particularly heavy for clients who live far from the receiving bank branch and cannot combine trips with other parallel loan recipients (a practice that is, sensibly, allowed by Compartamos). Given the limited size of these loans, it would not seem overly burdensome to have the village bank take charge of depositing the parallel loan payments along with the village bank loan payments each week, thus potentially saving the parallel loan clients significant transportation costs and time.

Forced Savings

VBIs typically require each village bank member to save. This section makes four recommendations about these forced savings:

- Less forced savings. VBIs with good repayment performance—for example, delinquency rates of under five percent—should strongly consider capping client forced savings balances at no more than 10-20 percent of the amount the client has borrowed from the VBI in the current loan cycle.

- Varying rates of forced savings. VBIs can usefully recognize that some village banks are riskier than others by varying the following ratio:

  $$\frac{\text{Client forced savings balance}}{\text{Amount the client has borrowed from the VBI in the current loan cycle}}$$

  This ratio would be set lower for all clients of village banks with good repayment records and higher for all clients of village banks with poor repayment records. In this way, cash collateral is in-

creased where it is needed and decreased where it is not.[38]

- Greater access to forced savings (increased liquidity). VBIs should strongly consider following the lead of Compartamos and CRECER and offering their clients a village banking product in which forced savings are freely available at the end of every loan cycle without having to leave the village bank.

- Illiquidity options. For clients who prefer their savings to be illiquid, VBIs can offer products from a range of options, including traditional village banks (with forced savings that are available only when the client leaves the village bank or in an emergency), contractual savings products, and certificates of deposit. For VBIs that do not mobilize savings themselves, these last two products would be offered through a partner financial institution that is licensed to accept deposits.

Like many VBIs, the four VBIs surveyed here have instituted forced savings for two main reasons: cash collateral and client savings accumulation.[39] As noted in the earlier section on delinquency control, all four VBIs utilize forced savings as cash collateral to deter the complete failure of village banks and lessen the effects of such failures on the VBI. With varying degrees of compulsion, the four VBIs also use forced savings balances to cover the more routine cases of individual loan delinquency that do not threaten the village bank's existence. The second main reason the four VBIs force their clients to save is to introduce them to the discipline and habit of saving and to the possibilities that having a sizable savings balance could open up for them. For example, a sizable pool of savings could be used for emergencies, to pay school fees and other large household expenditures, to buy tools or machinery, or to start another business.

The four VBIs clearly differ in the emphasis they place on the two major reasons for instituting forced savings, and interestingly, this difference is clearly reflected in the nature of their forced savings programs. The main purpose for forced savings reported by Compartamos and CRECER is cash collateral while for FINCA Nicaragua and Pro Mujer Bolivia it is client savings accumulation (Table 2.9). Reflecting this distinction, Compartamos and CRECER also mandate lower client forced savings balances (as a percentage of the amount the client has borrowed from the VBI in the current loan cycle), return all forced savings at the end of each loan cycle, and require that all forced savings be constituted before the loan is disbursed.[40]

[38] This is the same ratio that the first bullet suggests capping at 10-20 percent. Taking these two suggestions together, this ratio might be set at five percent for all clients of village banks with very good repayment records, 10 percent for all clients of village banks with reasonably good repayment records, and 15-20 percent for all clients of village banks with weaker repayment records.

[39] For VBIs that offer internal account loans, another possible reason for instituting forced savings is to provide funding for these loans. However, internal account loans could instead be funded with a program of liquid, voluntary savings—and perhaps more successfully, given the high returns savers earn on internal account loans. Of the four VBIs surveyed here, CRECER and Pro Mujer Bolivia still maintain an internal account, but neither cited its funding as a major reason for their forced savings program.

[40] It might seem difficult for a client to constitute her forced savings all in one lump sum, before receiving her loan. However, this lump sum can be saved up a little at a time, as voluntary savings during the previous loan cycle. Moreover, these voluntary savings can be added to the lump sum of forced savings that is returned to the client at the end of the previous loan cycle. For a client's first loan, the required lump sum may be saved up either before entering the village banking program at all or during the several-week period prior to the first loan, a time that is used for training the members of a new village bank and for saving.

On the other hand, FINCA Nicaragua and Pro Mujer Bolivia set higher forced savings balances (as a percentage of the amount the client has borrowed from the VBI in the current loan cycle), do not return forced savings at the end of the loan cycle, and have clients meet their forced savings obligations by paying equal size installments at every village bank meeting during the loan cycle. Moreover, in both FINCA Nicaragua and Pro Mujer Bolivia, clients can obtain access to their forced savings only if they leave the village bank or in case of an emergency (such as a hospitalization). In both of these VBIs, clients are permitted to leave the village bank, obtain their savings, and rejoin the village bank the next day without missing a single loan cycle. However, there is no guarantee that such clients will be accepted back into the village bank, particularly if they are seen as conflictive. In addition, Pro Mujer Bolivia (but not FINCA Nicaragua) requires such clients to start over with entry-level loan amounts—adding to the penalties of accessing forced savings and thus increasing the illiquidity of these savings. With this as background, we now discuss each of the four major conclusions in turn.

The Size of Forced Savings Balances

During their first loan cycle, all of Pro Mujer Bolivia's village bank members are required to save 20 percent of the amount they have borrowed from Pro Mujer Bolivia in that loan cycle. During subsequent loan cycles, they must continue to save 20 percent of the amount they have borrowed in

Table 2.9
Forced Savings

	Compartamos	**CRECER**	**FINCA Nicaragua**	**Pro Mujer Bolivia**
Main purpose of forced savings	Cash collateral	Cash collateral	Savings accumulation	Savings accumulation
The *amount* of client forced savings in the current loan cycle as a % of the amount the client has borrowed from the VBI in the current loan cycle	10%	10-20%[1]	32%	Generally 20%, but may be reduced in later cycles[2]
Minimum client forced savings *balance* as a % of the amount the client has borrowed from the VBI in the current loan cycle	10%[3]	10-20%[3]	Minimum 32%. No maximum.	For village bank: minimum 20%, target of at least 30%
Forced savings: Accumulated or Returned at the end of each cycle?	Returned	Returned	Accumulated	Accumulated
Forced savings: paid in by client Before loan is granted or During loan repayment?	Before loan is granted	Before loan is granted	During loan repayment[4]	During loan repayment[4]

[1] CRECER's forced savings rate is 10 percent in rural areas and 10-20 percent in peri-urban areas. CRECER believes that there is a higher default risk in peri-urban areas due to fewer social controls and greater competition from other financial institutions, and so often sets the forced savings rate in these areas at 15 or 20 percent.
[2] As explained in text.
[3] These percentages for Compartamos and CRECER are the same as those in the line above because forced savings are always returned at the end of every loan cycle. Therefore, a client's forced savings balance equals the amount of his or her forced savings in the current loan cycle.
[4] Forced savings are paid in equal installments at each village bank meeting during the loan cycle.

Source: Survey of these four VBIs, carried out in August-September 2003.

that cycle, with these savings accumulating until the *village bank* can reach a savings *balance* of at least 30 percent of the amount it has borrowed from Pro Mujer Bolivia in the current loan cycle. Once the 30 percent target is in reach during the current loan cycle, the 20 percent savings requirement can be reduced to as little as five percent. However, village banks can also decide that all members should save a higher percentage than this, for example, 10 or 20 percent of the amount each member has borrowed. In summary, the target for Pro Mujer Bolivia's *village banks* is to have forced savings *balances* of at least 30 percent of the amount the village bank has borrowed from Pro Mujer Bolivia in the current loan cycle. The program design ensures that village bank forced savings balances will never be below 20 percent of the amount they have borrowed from Pro Mujer Bolivia in the current loan cycle. This means that, on average, client forced savings balances will be targeted at 30 percent (and have a minimum of 20 percent) of the amount the client has borrowed from Pro Mujer Bolivia in the current loan cycle.

FINCA Nicaragua's forced savings program requires clients to save 32 percent of the amount they have borrowed from FINCA Nicaragua in the current loan cycle, and places no cap on the size of the resulting forced savings balance. Thus, the forced savings balances of FINCA Nicaragua clients are always at least 32 percent of the amount they have borrowed and can rise to 100 percent or more.

Forced savings balances of 30 percent or more of the current loan amount would appear to be excessive cash collateral for VBIs with such outstanding client repayment records as those of FINCA Nicaragua and Pro Mujer Bolivia. Compartamos and CRECER have maintained equally outstanding client repayment records (Table 2.2) with much lower forced savings balances: Compartamos with 10 percent of the current loan amount and CRECER with 10 percent of the current loan amount in rural areas and 10-20 percent in peri-urban areas.

While both FINCA Nicaragua and Pro Mujer Bolivia agree that such high forced savings balances are probably not needed for cash collateral purposes, they justify these balances on the grounds that they help clients accumulate a substantial pool of savings that clients can later use for emergencies, to start another business, to buy tools or machinery, or for any other of the many good purposes to which savings can be put. The question is not whether savings are useful; they most certainly are. The question is whether VBIs should force all of their clients to save at such high rates.

Many clients are likely to be hurt by high forced savings requirements, such as those set by Pro Mujer Bolivia and FINCA Nicaragua. These clients could more quickly increase their incomes and escape poverty if they were allowed to take some or all of their forced savings contributions and invest them in their own businesses, for example, as additional working capital or to buy tools and equipment. This is not to say that there aren't many clients who wouldn't be helped by saving—because they need larger amounts to invest, for example. The critical question is: will these clients save voluntarily when it is in their own best interests to do so, or must they be forced to save because they do not have the willpower to save even when it is in their own best interests? Considering these possibilities, the question can be stated more explicitly: how many clients are harmed by high forced savings requirements (because the clients do not need so much savings and would be better off if allowed to save less or nothing at all) and how many are helped by high forced savings requirements (because the clients need at least this much savings but lack the willpower to save)?

While this question is very difficult to answer directly, there *is* ample evidence that the old belief that the poor do not save on their own is clearly false. In fact, there is a growing consensus around a new view that the poor may be too poor and vulnerable *not* to save. The poor, like all people, face the

possibility of both individual emergencies (such as illness, accidents, death, fire, theft, increased business competition, and job loss) and systemic emergencies (such as recessions, inflation, floods, earthquakes, and hurricanes). These events can exert large downward economic pressures on households. Therefore, poor households, which may already exist on the margins of subsistence, have strong motivations to save, so that they and their families are not pushed by such events into states of even graver deprivation such as severe food insufficiency or starvation. The poor, like other people, also save for important life cycle events such as marriages, funerals, childbirth, festivals, education, and establishing a household.

There is a wealth of empirical evidence that even the poor save on their own. We do not attempt to review all of this evidence here, but cite only a few examples. Wright (2000, p. 72) notes that there are five savers for every borrower in the renowned Bank Rakyat Indonesia (BRI), a microfinance institution that has long offered both credit and voluntary savings services to many poor people. Another set of institutions that have also offered both credit and voluntary savings services to poor clients for a long time are the Latin American credit unions. Judging from the available survey evidence on client income levels, the poverty rate of credit union clients in Latin America appears to be roughly equal to the poverty rate of the clients of other microfinance institutions in the region, approximately 20-50 percent (Westley, 2001). In a recent IDB/CGAP inventory of 273 of the largest and most important credit unions in 11 Latin American countries with major microfinance markets, there were 2.64 savers for every borrower.[41] Both this and the BRI data show that voluntary savings is a much more widespread activity than borrowing. Data on the average size of savings accounts in Latin American credit unions corroborates the survey evidence showing that many credit union savers are poor, thus reinforcing the point that the poor save on their own in large numbers. For example, Branch and Klaehn (2002, p. 9) find that 94 percent of the 120,000 savings accounts in 15 leading Bolivian credit unions are under $500, and have an average balance of $47. Branch (2002a) finds that of the 782,000 savings accounts in 22 leading Ecuadorean credit unions, 81 percent are under $100 and 94 percent are under $300. Richardson (2002) finds that 89 percent of the 116,000 savings accounts in 4 leading Guatemalan credit unions are under $300, with an average balance of $29. Finally, Richardson (2002) shows that of the 2.44 million savings accounts in 85 credit unions in Bolivia, Ecuador, Guatemala, Romania, and the Philippines, 94 percent are under $300, with an average balance of $33.

In light of this new view that the poor have strong reasons to save and that large numbers of them do in fact save voluntarily, VBIs with high forced savings requirements should reconsider the wisdom of these requirements. These VBIs may well be depriving many of their clients of capital they need to expand their businesses now and grow their way out of poverty. For this reason, we suggest that VBIs with good repayment performance should strongly consider capping forced savings balances at no more than 10-20 percent of the amount the client has borrowed from the VBI in the current loan cycle, which would likely suffice for cash collateral purposes. Such a reduction would follow a trend toward falling forced savings requirements among Latin American VBIs. For instance, both Pro Mujer Bolivia and Compartamos have made large reductions in these requirements in recent years, with Compartamos dropping requirements from 20-40 percent of loan amount to 10 percent, for example.

[41] The 11 countries are Bolivia, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, and Peru. There were 3.37 million savers versus 1.28 million borrowers. The data generally refer to December 2001.

Even forced savings balances of 10-20 percent of the loan amount may still prove to be excessive. In fact, it is not at all out of the question that forced savings could be discarded entirely by Latin American VBIs, just as Latin American solidarity group lenders largely abandoned this element of their loan methodology in the 1990s. Instead of utilizing forced savings as cash collateral, VBIs could follow the group lenders and rely on their clients' desires to access high quality financial services and the VBI's provision of such services as the fundamental motivator of loan repayment. Offering savings services on a completely voluntary basis would also be based on the non-patronizing idea that poor clients are normally rational and generally act in their own self interest—saving when it is best for them to do so. As Wright (2000) discusses, programs of voluntary, liquid savings can lead to larger savings balances than programs of forced, illiquid savings such as those maintained by FINCA Nicaragua and Pro Mujer Bolivia.

Varying Rates of Forced Saving

VBIs that continue to rely on forced savings for cash collateral can usefully recognize that some village banks are riskier than others by allowing the following ratio to vary:[42]

$$\frac{\text{Client forced savings balance}}{\text{Amount the client has borrowed from the VBI in the current loan cycle}}$$

This ratio would be set lower for all clients in village banks with good repayment records and higher for all clients in village banks with poor repayment records. In this way, cash collateral is increased where it is needed and decreased where it is not. For example, all clients in all village banks might start out with this ratio set at 10 percent. The ratio could then be reduced to five percent for all clients of village banks that compile very good repayment records and increased to 15 or 20 percent for all clients of village banks with weak records. It is suggested that the same ratio be set for all clients in a given village bank, rather than setting different ratios for different clients according to their individual repayment performance. This is done in order to reinforce group solidarity and create incentives for village bank members to help those members having repayment difficulties, thus hopefully minimizing loan delinquency at the village bank level.

Greater Access to Forced Savings

VBIs should strongly consider following the lead of Compartamos and CRECER and offering their clients a village banking product in which forced savings are freely available at the end of each loan cycle without having to leave the village bank. The reason for this is simple. Most low-income people who save prefer to be able to access their savings as often as they wish in order to meet emergencies, business needs and opportunities, and household and other demands that arise—rather than having these savings locked up in an illiquid account. As Branch (2002) notes, when given the choice, most small savers prefer liquid deposit instruments such as savings accounts to less liquid deposit instruments such as certificates of deposit, even though the savings accounts normally pay a lower rate of interest. The following data from 23 leading credit unions in Ecuador (as of December 2000) and eight leading credit unions in Bolivia (as of September 2003)—where savers face exactly this choice—corroborate this assertion.[43] In Ecuador, there are 745,992 savings accounts versus 19,565 certificates of deposit. Of the savings accounts, 85 percent are under $100, 94 percent are under $300, and the average size of all savings accounts is $71. In Bolivia, there are 119,742 savings accounts versus 5250 certif-

[42] This is the same ratio that we have suggested capping at 10-20 percent for all clients.

[43] The Ecuador data are from WOCCU (2000) and the Bolivia data are from tabulations provided by WOCCU staff in Bolivia.

icates of deposit. Of the savings accounts, 80 percent are under $100, 90 percent are under $300, and the average size of all savings accounts is $198. This evidence clearly shows that small savers prefer to save in liquid accounts, even though such accounts pay less.[44] It should follow even more strongly, then, that village bank clients would prefer liquid savings to illiquid savings if the two are equally remunerated. VBIs can certainly offer clients access to their forced savings at the end of each loan cycle without harming the role these savings play as cash collateral.

If the VBI does not allow clients free access to their forced savings at the end of each loan cycle without having to leave the village bank, it should strongly consider at least reducing the penalties on those who do leave the village bank and withdraw their forced savings. As noted earlier, Pro Mujer Bolivia (but not FINCA Nicaragua) requires that such clients must start over with entry-level loan amounts if they subsequently return to the village bank. Pro Mujer Bolivia has indicated that it is strongly considering reducing this penalty. Under Pro Mujer's proposal, a client who had worked up to a $500 loan, for example, would not be forced to start over with an entry-level ($100) loan, but could start with an intermediate-size loan of perhaps $300-350. FINCA Nicaragua's policy is even more client friendly than this: no restrictions are placed on the size of the returning client's loan. However, two barriers to clients' accessing their forced savings still remain in both Pro Mujer Bolivia and FINCA Nicaragua. First, some clients may not even be aware of the possibility that they can leave the village bank, withdraw their forced savings, and immediately rejoin the village bank without missing any loan cycles. Second, clients who leave the village bank have no guarantee that they will be accepted back into the village bank, particularly if they are seen as conflictive.

Illiquidity Options

Village banking experience suggests that some clients prefer their savings to be illiquid. Clients may prefer illiquid savings so that they are less tempted to use them for relatively trivial consumption purposes and can more easily resist requests for assistance from friends and relatives.[45] Judging from the above credit union data, where clients are free to opt for deposit accounts with more or less liquidity, clients preferring less liquidity may be a distinct minority. Nonetheless, if there are a sufficient number of such clients to make the effort worthwhile, they can be offered the possibility of placing their savings in a certificate of deposit or a contractual savings product.[46] For VBIs that do not mobilize savings themselves, these products would be offered through a partner financial institution that is licensed to accept deposits. Another alternative would be to offer a choice of village banks to all clients living in a given village or geographic area. Clients could choose to join either a traditional village bank, with forced savings that

[44] Some readers might wonder whether minimum deposit sizes might not be larger for certificates of deposit than for savings accounts, and thus help to explain the apparent overwhelming preference for savings accounts. This suspicion is correct, but the effect does not appear to be all that important since both types of accounts generally have low minimum sizes. The minimum deposit size prevalent in the Ecuadorean credit unions at the time these data were collected was approximately $5 for savings accounts and $20-40 for certificates of deposit. In Bolivia, these minimum sizes were $5-10 and $50, respectively.

[45] Some VBIs, such as Compartamos and FINCA Nicaragua, induce an artificial client preference for illiquid forced savings over liquid voluntary savings by covering village bank loan arrearages using voluntary savings before forced savings (Table 2.3). In such a situation, a client preference for forced over voluntary savings may not represent a preference for illiquidity so much as a preference for reducing their chances of loss.

[46] In contractual savings, clients make deposits on a regular basis (e.g., every week or month) for a specific time period (e.g., one year). Clients face significant penalties for missing deposits and for early withdrawal.

are available only when the client leaves the village bank or in an emergency, or else a village bank with forced savings that are available at the end of every loan cycle. Provided that there are enough clients in the area to constitute two or more village banks, both models could exist side by side, representing yet another way in which village banking can be made more flexible and demand driven.

Voluntary Savings

VBIs normally provide village bank members an opportunity to save voluntarily, over and above the amounts the members are forced to save. This section makes four recommendations about these voluntary savings:

- Voluntary savings through the village bank account. VBIs should allow village bank members to save as much as they want by making voluntary deposits in the village bank savings account. This deposit service should be maintained even if internal account loans are discontinued.

- Access to voluntary savings (liquidity). VBIs should allow a village bank member to make withdrawals from her voluntary savings at all village bank meetings unless her savings are tied up funding internal account loans. In this case, the member may have to wait to withdraw her savings until the internal account loans are repaid, possibly until the end of the loan cycle.

- Earmarking. VBIs that allow internal account loans should also allow village bank members to designate whether their voluntary savings are to be used for such loans or should only be deposited in a financial institution. The same choice should be allowed for forced savings.

- Individual voluntary savings accounts. If it is possible to arrange, the VBI should consider offering its clients individual savings accounts for their voluntary savings.

These recommendations are now discussed in turn. While they may seem straightforward, only the first recommendation is implemented by all four VBIs surveyed here.

Providing and Maintaining Voluntary Savings Services

One of the great advantages of village banking is that it provides a way not only to offer its clients credit, but also savings services. By pooling all of their forced and voluntary savings together in a single deposit account, members of a village bank can often overcome the deposit minimums and low balance fees that are frequently imposed by banks and other deposit-taking financial institutions. This may allow village bank members to access formal savings services for the first time in their lives. When members are located some distance from the financial institution, use of this village bank savings account mechanism can also drastically reduce their transactions costs. One or two village bank members can make the trip for many, combining deposits and withdrawal requests along with loan repayments to the VBI in a single journey.

VBIs that permit internal account lending provide savers with the added possibility of earning much higher interest rates than those normally paid by banks. For the four VBIs surveyed here, typical bank interest rates paid to village bank depositors are in the range of 2-4 percent per year. These low deposit rates primarily reflect the very low inflation rates now prevalent in these countries. In contrast, internal account loans are normally priced at or above the VBI's loan rate, which is at least 2.5 percent per *month* in the case of the VBIs surveyed here. These much higher interest rates are one of the significant benefits to clients of being served by a VBI that has retained the internal ac-

count. However, these increased interest earnings generally come at the cost of increased risk and decreased liquidity. The increased risk reflects the fact that internal account loans may not be repaid, and that this risk to members' savings is normally greater than the risk that members will not get their deposits back from a bank or other financial institution. The decreased liquidity reflects the fact that internal account loans are often not repaid until the end of the loan cycle, so that depositors may not be able to withdraw their savings until then.

All the VBIs surveyed here permit members to save as much as they like by making voluntary deposits in the village bank savings account. All four combine voluntary and forced savings in this account, which is placed in a licensed, deposit-taking financial institution. Two of the four—CRECER and Pro Mujer Bolivia—allow some or all of these combined savings to be channelled instead to internal account loans. To their credit, the two VBIs that closed their internal accounts a few years ago—Compartamos and FINCA Nicaragua—continue to offer their members a way to save voluntarily, with all village bank savings held in a partner commercial bank. While the interest earnings are modest, these village bank savings accounts afford members a relatively safe, liquid way to save that avoids or attenuates some of the pitfalls of saving money at home in the form of cash (such as the temptation to spend the money or lend it to friends or relatives in need) or in the form of jewelry, livestock, building materials, or other goods (such as theft, physical deterioration, difficulty in selling the goods, indivisibility problems, and possible losses if the goods must be sold quickly).[47]

Access

All four VBIs surveyed here except CRECER allow members to withdraw any of their voluntary savings at any village bank meeting. In this way, village bank members in the three VBIs have reasonably frequent access to these savings—every week or two, depending on the frequency of their meetings. The one exception to this good practice, CRECER, does not permit members to withdraw their voluntary savings until the end of the loan cycle. This is a clear disincentive to save voluntarily and also seems to be an unnecessary restriction that may harm some CRECER clients who need access to their voluntary savings sooner. CRECER could instead follow the practice of the other three VBIs and permit voluntary savings withdrawals at all meetings.[48]

An exception to the general rule that voluntary savings requests should be honored during all village bank meetings can arise in VBIs, such as CRECER and Pro Mujer Bolivia, that permit internal account loans. If a member's voluntary savings are tied up funding internal account loans, she will have to wait for her money until some of these loans are repaid, possibly until the end of the loan cycle, by which time all internal account loans normally must be paid off.

Earmarking

Of the two VBIs surveyed here that allow internal account loans, CRECER and Pro Mujer Bolivia, only the latter permits clients to designate whether their voluntary savings should only be deposited in a financial institution or can also be used to make internal account loans. This choice usefully allows clients to decide whether they prefer the greater liquidity and safety of a bank ac-

[47] These problems are discussed further, for example, by Rutherford (2000) and Westley (2001a).

[48] Savings withdrawals can be paid directly out of member loan repayments, any savings contributions made during the meeting, and any unused funds in the internal account. If these funds are insufficient to cover the requested withdrawals, members seeking withdrawals can be given the option of waiting until the next meeting for their money or taking a signed withdrawal slip to the bank and obtaining the remainder of their funds as soon as they wish (assuming the required funds are available there).

count or the greater returns associated with funding internal account loans. Such earmarking represents another relatively easy way to break down the inflexibilities of village banking and increase client satisfaction, all at little cost to the VBI. The same choice could also usefully be granted in the case of client forced savings, something that neither CRECER nor Pro Mujer Bolivia does at present. Permitting these choices is somewhat akin to giving savers the choice between a more liquid savings account and a less liquid, but higher return, certificate of deposit.

Individual Accounts

If it is possible to arrange, a VBI should consider offering its clients individual savings accounts for their voluntary savings. Such accounts may be of particular interest to the more prosperous village bank members, whose higher savings balances are more likely to satisfy minimum deposit requirements and escape low balance fees. Individual accounts allow those who hold them complete control over their savings, including daily access, and a way to establish their own financial track record. Since only a few VBIs in Latin America are allowed to mobilize deposits, most VBIs would offer these individual savings accounts by establishing an alliance with a licensed, deposit-taking financial institution. For example, Pro Mujer Bolivia has established such a relationship with FIE, which offers individual village bank members savings accounts and billpaying services, and is considering whether to offer remittance services in the future. A second example is Freedom from Hunger, which has been working with selected credit unions in Ecuador and other countries to enable the credit unions to offer a village banking product. Village bank clients are permitted to become full credit union members—and thus open individual savings accounts in the credit unions and use other credit union services—after five loan cycles (about 20 months).

Internal Account Loans

The question of whether to permit internal account loans has generated a great amount of controversy in the village banking field. The reason for this is that allowing these loans has many strong advantages and disadvantages. Two different VBIs may come to opposite conclusions on this issue simply because they place very different weights on the importance of the various pros and cons. In light of this, the purpose of this section is not to arrive at a one-size-fits-all conclusion about the desirability of permitting internal account loans. Inevitably, some VBIs will believe that the weight of the evidence favors eliminating these loans and other VBIs will believe the opposite. Rather, this section aims to increase our understanding of some of the key advantages and disadvantages of permitting internal account loans, in order to help VBIs make a more informed choice. Partly, this is done by applying data to test key hypotheses, an important contribution of the section. The four VBIs surveyed here provide fertile ground for this section's discussion since two of the four VBIs (Compartamos and FINCA Nicaragua) have chosen to eliminate internal account loans and the other two have not.

While the discussion of the pros and cons of permitting internal account loans occupies most of this section, three other points can be made much more briefly, the last two of which are only stated since they are discussed elsewhere in the paper:

- As a general rule, internal account loans should only be granted to those who are members of a village bank.[49] The four VBIs surveyed here all agree that it is too risky to lend to non-members, for at

[49] By "members," we mean those who actively participate in the village bank by coming regularly to meetings, borrowing jointly from the VBI along with the other village bank members, and perhaps saving. Members, as the term is used here, include those who occasionally sit out a loan cycle because of a business downturn or for other reasons.

least three reasons. First, since non-members generally receive fewer financial and non-financial services from the village bank than members, non-members are normally less committed to repaying their loans in order to ensure the continued, healthy functioning of the village bank. Second, since internal account loans are usually repaid in bullet form (a single payment of principal and interest at the end of the loan), non-members are typically not required to attend most village bank meetings. Therefore, non-members receive less indoctrination and training than members on the importance of timely repayment; that is, they are not as imbued with the repayment culture as are members. Finally, village bank members often have less information about the businesses, character, and creditworthiness of non-members than they have about each other. All of these factors make the risk of internal account lending to non-members significantly higher than it is to members. As an example, CRECER allowed its village banks to make internal account loans to non-members until 1998, when the practice was discontinued due to excessive internal account loan losses.

- VBIs that do not permit internal account loans should still retain voluntary savings services for all village bank members. This point is discussed in the section on voluntary savings, above.

- VBIs that do not permit internal account loans should *consider* offering a product along the lines of Compartamos' parallel loans, to at least partly replace the function served by internal account loans. Parallel loans and the needs they fill are discussed in the section on solidarity group and individual loans, above.

These last two points both relate to the issue of retaining important services even if internal account loans are eliminated.

Pros and Cons of Eliminating Internal Account Loans

The pros and cons of eliminating internal account loans are summarized in Box 2.1. These pros and cons address the question of whether to *eliminate* internal account loans, rather than whether to *permit* internal account loans to be offered. This is because the former characterizes the operational decision faced by many VBIs who have followed a traditional village banking model and still permit these loans to be offered. The same set of pros and cons would come into play under the other characterization of the question, but the pros and cons would simply be reversed.

The two advantages. The two advantages of eliminating internal account loans accrue to both the VBI and most of its clients. That is, both groups enjoy the benefits of shorter meeting times and fewer problems with internal account loan delinquency, favoritism in the granting of internal account loans, and the misuse of internal account funds by village bank officers and others. The impact of these two factors on clients (leaving aside for the moment all of the other pros and cons of eliminating internal account loans) is that client satisfaction should increase. Therefore, client retention rates should rise, which, in turn, should increase VGI sustainability and scale. In addition, in theory at least, shorter meeting times could result in higher loan officer productivity (more borrowers per loan officer), which would also tend to increase VGI sustainability. In regard to this last effect, it is interesting to look at the story the data tell in the case of Compartamos and FINCA Nicaragua, two VBIs that eliminated internal account loans a few years ago.

Compartamos, which eliminated internal account loans in early 2000, estimates that this reduced village bank meeting times by about one-third and claims that loan officer productivity increased substantially as a result. The data show that the number of borrowers per loan officer increased from 339 in December 1999 to 390 in December

2001, a 15 percent increase (Table 2.7). While this suggests that there was an important increase in productivity, such a conclusion must be regarded as tentative. This is so because it is impossible to know to what degree the 15 percent increase is attributable to the elimination of internal account loans and to what degree it may be due to other factors operating at the same time that also affected loan officer productivity.

FINCA Nicaragua eliminated internal account loans in mid 2001. In this case, however, the number of borrowers per loan officer dropped from 315 in December 2000 to 294 in December 2002, a 7 percent decline (Table 2.7). This highlights the possibility that eliminating internal account loans might yield no increases in loan officer productivity and VBI sustainability. This might occur, for example, if loan officers did not take advantage of shorter meeting times to squeeze in more meetings per week, but rather spent a little more time on other topics or on going from one meeting to the next, or simply shortened their workday. The policy conclusion from this is that not all of the theoretical benefits of eliminating internal account loans may be realized, and that strong management oversight may be critical to ensuring that they are.

The two disadvantages. Of the two disadvantages of eliminating internal account loans, the first (loss of empowerment, business skills, and solidarity—see Box 2.1, item 3) falls directly on the clients. Logically, this effect should also worsen VBI performance since, with less satisfied clients, client retention rates and the VBI's sustainability and scale should all be harmed as well. Proponents of retaining internal account lending often emphasize these effects. It is certainly true that by lending their own money, village bank members can obtain significant empowerment, business skills, and solidarity. However, they already obtain a good measure of these benefits from the process of deciding how much each village bank member can borrow from the VBI. This last decision is one that all village bank members also have a substantial stake in

Box 2.1 **Advantages and Disadvantages of Eliminating Internal Account Loans**
Advantages of eliminating internal account loans
1. Reduces meeting time.
2. Eliminates a number of problems associated with the internal account: internal account loan delinquency, issues of favoritism in granting internal account loans, and mismanagement/ fraud/theft problems.
Disadvantages of eliminating internal account loans
3. Village bank members lose some of the empowerment, business skills, and solidarity that come from managing and investing their own money.
4. Loan delinquency rates on the VBI's loans to the village bank may rise due to a slackening of repayment discipline and reduced information flows.
Mixed – Eliminating a client benefit that came at the expense of the VBI
5. Clients lose a source of supplemental loans and no longer receive such large interest earnings on their savings (which come from the high interest rates paid on internal account loans). On the other hand, client demand for the VBI's loans and, therefore, the interest earnings on these loans, are likely to increase—increasing VBI revenue and sustainability if the VBI has the funds available to meet this demand.

making well because all members are held responsible for any loan defaults. It is not clear how much additional benefit is obtained by repeating this decisionmaking process for internal account loans since in both cases each village bank member faces the very real prospect of losing her own money.

The second disadvantage of eliminating internal account loans (increased VBI delinquency rates—see Box 2.1, item 4) operates through two channels. The first channel is summed up, for example, in the firm conviction of Pro Mujer Bolivia that, "when the women lend their own money [from the internal account], it teaches them the importance of repaying in the most forceful way possible, and this lesson carries over to the repayment of their loan with Pro Mujer." Illustrating the second channel, Compartamos notes that when it offered internal account loans, it had the following advantage: "by observing village bank members discussing internal account loan requests and by seeing how well members repaid these loans, Compartamos loan officers gained a great deal of insight into each village bank member's business, character, and loan repayment capacity." Using this information, Compartamos loan officers could better monitor and sometimes guide village bank decisions on how much members could safely borrow from Compartamos. Through both of these channels, internal account lending should help reduce VBI delinquency rates and also help clients to avoid developing a bad credit history.

We find no clear empirical evidence of the importance of this second disadvantage of eliminating internal account loans. Comparing VBI delinquency rates just before Compartamos and FINCA Nicaragua eliminated their internal account loans (in early 2000 and mid 2001, respectively) versus afterwards, there is no sign of any substantial increase in delinquency (Table 2.2). Delinquency rates are extremely low both before and afterwards. This certainly leads one to question whether these effects are real and substantial. On the other hand, it may be that eliminating the internal account does tend to increase the delinquency rate, but that other factors operated in the case of Compartamos and FINCA Nicaragua to keep delinquency rates low. For example, it may be that loan officers worked harder to keep these rates down after the internal account was eliminated because loan officer pay is tied to loan delinquency. Under this scenario, eliminating the internal account may have increased VBI operating costs, or at least cut into the operating costs savings derived from shorter village bank meetings.[50]

The mixed effect. Finally, item 5 in Box 2.1 can be viewed as the elimination of a subsidy from the VBI to its clients. We have already noted that VBIs often must devote substantial loan officer time to helping the village bank manage its internal account lending (Box 2.1, item 1). Yet, the VBI earns no interest income from this activity since all interest accrues to the village bank members themselves. Moreover, the availability of internal account loans often reduces the demand for VBI loans, particularly since village bank members often prefer internal account loans to VBI loans.[51] In all four of the VBIs surveyed here, two mechanisms operate (or operated, in the case of the two VBIs that no longer permit internal account loans) to limit this reduction in VBI loan demand. First, the interest rate charged on internal account loans is/was at least equal to the rate charged by the VBI on its loans to the village bank. Second, quantitative restrictions have been employed by three of the four VBIs, all except Compartamos. For example, FINCA Nicaragua limited a member's internal account loan to be no more than 10 percent of her loan with FINCA. This limit is set at 30 percent for Pro Mujer

[50] It would be an interesting future exercise to try to track the impact on operating costs from reduced information flows and a possible slackening of repayment discipline. However, so many factors affect operating costs that this relationship is difficult to analyze without much more detailed data than are presently available.

[51] Internal account loans are often preferred because of their greater flexibility; see Box 1.2.

Bolivia and 150 percent for CRECER. However, CRECER loan officers have discretion to reduce this limit and often set it at 75-100 percent. While Compartamos set no quantitative limit, internal account borrowing was often severely rationed because of the scarcity of loanable funds relative to demand. CRECER's continuing generous internal account lending limit reflects their strongly-held belief that these loans are an important source of client satisfaction and benefits, and one that enhances CRECER's competitive position in Bolivia's increasingly competitive microfinance market.

Overall assessment. Taking all of these effects together, most clients probably lose when internal account loans are eliminated. Clients lose: a) a source of flexible, supplemental loans, b) a way to earn high interest rates on their savings, and c) a source of empowerment, business skills training, and solidarity. In most VBIs, these losses probably outweigh client gains from shorter meetings and from the elimination of conflicts and other problems associated with internal account loans. Therefore, eliminating internal account loans is likely to reduce client satisfaction and retention rates, which, in turn, exerts downward pressure on VBI sustainability and scale.

On the other hand, other factors are likely to push VBI sustainability and scale upward when internal account loans are eliminated. Without competition from the internal account, VBI lending is likely to increase. Shorter meetings may translate into higher loan officer productivity, particularly if management actively tries to ensure that this happens. VBI loan delinquency rates need not rise, though this may come at some additional cost (which would tend to *decrease* VBI sustainability and scale).

On balance, considering all of the factors in the last two paragraphs, it is unclear whether eliminating internal account loans will increase or decrease VBI sustainability and scale. There are important pulls in both directions, and VBIs will have to evaluate how important each of these factors is likely to be in their particular situation. In addition, VBIs that believe eliminating the internal account would increase their own sustainability and scale must weigh these benefits against the various client impacts in order to decide whether discontinuing internal account lending would exact too high a price on clients, and therefore on the VBI's development mission, to be worthwhile.

3. Policy Recommendations and the Role of Governments and Donors

This chapter begins by examining the role of non-financial services in village banking. It finds, contrary to the minimalist model of microfinance, that the provision of non-financial services should not necessarily disqualify a VBI from being regarded as a best practice VBI, or from becoming a licensed, deposit-taking financial institution. This chapter also briefly discusses the special role that village banking can play in rural finance and the role of governments and donors in fostering the development of village banking.

Non-Financial Services and the Issue of Licensing

This section comes to two major conclusions. First, the provision of non-financial services (NFS) by village banking institutions may, under certain circumstances, constitute an exception to the widely-held principle that best practice calls for microfinance institutions to provide financial services only (the minimalist model of microfinance). That is, the provision of NFS should not necessarily disqualify a VBI from being considered a best-practice VBI or result in the recommendation that these services be spun off or eliminated. Second, bank superintendencies should not disqualify VBIs from becoming licensed, deposit-taking institutions simply because they provide NFS. Other factors should be considered—including the cost and quality of the NFS and the VBI's performance—in order to make that determination. In summary, we find that, under certain circumstances, VBIs offering non-financial services can be considered best practice VBIs and should be allowed to become licensed and mobilize deposits from the public.

Village banking is singled out as a possible exception to the minimalist model of microfinance for two reasons. First, because VBIs regularly bring sizable groups of clients together to receive financial services, they can secure significant cost economies for both themselves and their clients in the delivery of NFS. Second, VBIs often aim to serve very poor clients, who may not be able to make very effective use of financial services without complementary NFS. Thus, the delivery of at least a basic level of NFS may significantly improve the VBI's return on its provision of financial services. Both of these reasons will be expanded on below.

The case of CRECER is utilized to illustrate the proposition that the provision of NFS should not necessarily disqualify a VBI from being regarded as a best practice VBI or from becoming a licensed, deposit-taking financial institution. In Chapters 1 and 2, we showed that CRECER has many of the hallmarks of best practice, including: very low loan delinquency rates, high levels of efficiency (low operating costs as a share of average loan portfolio), a large number of clients, and rapid growth. Four characteristics of CRECER's NFS are key in explaining at least some of these excellent results. Moreover, these four characteristics are the basis on which we argue that CRECER's NFS should not disqualify it from being regarded as a best practice VBI or from becoming a licensed, deposit-taking financial institution if it wanted to do this. The four characteristics are as follows:

- CRECER's costs of providing NFS are very low, only 5-10 percent of its total operating costs (where total operating costs consist of the costs of providing both financial and non-financial services). This helps CRECER keep up its efficiency and sustainability levels.

- CRECER's NFS are highly valued by its village bank members and are provided at low cost to these clients. The only

cost to clients of receiving CRECER's NFS is that they must stay an additional 20 minutes at each village bank meeting. Both of these factors help to improve CRECER's client satisfaction and retention and therefore its own scale and sustainability.

- CRECER does not attempt to create a profitable commercial venture out of the sale of its NFS. Rather, CRECER only tries to deliver some very basic training in 20 minutes, while the whole village bank is assembled and the loan officer is already present.

- The provision of NFS does not distract CRECER from the difficult job of maintaining high levels of portfolio quality. In fact, it has maintained exceptionally low loan delinquency rates: 0.1-0.2 percent during the last several years (Table 2.2).

Pro Mujer Bolivia, the other one of the four VBIs surveyed here that offers NFS, provides an interesting variant on the CRECER case. Pro Mujer Bolivia's NFS may not disqualify it from being considered a best practice VBI but are likely to present much more of an obstacle to it becoming a licensed, deposit-taking financial institution. The major reason for the difference in outcomes between the CRECER and Pro Mujer Bolivia cases is that Pro Mujer Bolivia's NFS are much more costly than CRECER's, averaging 25 percent of total operating costs. We now discuss whether the provision of NFS should disqualify a VBI from being regarded as a best practice VBI or from becoming a licensed, deposit-taking financial institution—centering the discussion first around the case of CRECER and then around the case of Pro Mujer Bolivia.

The Case of CRECER

CRECER is a good example of a VBI whose NFS should not disqualify it from being regarded as a best practice VBI or from becoming a licensed, deposit-taking financial institution. Employing the "Credit with Education" methodology furnished by its long-time sponsor, Freedom from Hunger (a U.S.-based NGO), CRECER provides all of its village bank members with education in basic business skills (such as how to calculate one's profits and improve one's business) and in a number of basic health areas (including diarrhea prevention and treatment; child immunization, health, and nutrition; family planning; and HIV/AIDS prevention). One or two of these topics is normally covered over the course of each loan cycle. The training is imparted during a 20 minute segment of each village bank meeting by the same single loan officer who delivers the credit and savings services and helps manage all other aspects of the village bank for CRECER. The education modules follow modern practices of adult education, building on what participants already know and actively engaging them in their own learning. The costs of developing the education modules are borne by Freedom from Hunger, which uses these modules for its programs worldwide. Thus, CRECER need only pay for the costs of adapting the modules to local conditions.

This dual use of loan officers, to deliver both financial and non-financial services, has proven to be a very economical way for CRECER to provide basic NFS. The loan officer has already incurred all the time and money costs of making the sometimes quite lengthy trip to the village bank to deliver financial services anyway. And the village bank members have already gathered to receive these services. So, for both the loan officer and the village bank members, it is relatively inexpensive to then devote an additional 20 minutes to cover the educational material.

Vor der Bruegge, Dickey, and Dunford (1999) carry out a very detailed costing exercise in order to determine the extra costs of the education component for CRECER and for three other VBIs sponsored by Freedom from Hunger that utilize the same credit with education methodology. The exercise

covers several years and consistently finds that the education component is responsible for 5-10 percent of each VBI's total operating expenses (for delivering all financial and non-financial services). This 5-10 percent includes: the costs of adapting the education modules to local conditions and training loan officers, the extra time of both loan officers and management in delivering the education component, and the costs of all other activities that would be eliminated if CRECER delivered only financial services. Such low costs are the result of the dual use of loan officers, the fact that the education modules are originally developed by Freedom from Hunger, and CRECER's own careful efforts to control costs.

In addition to being cheap to deliver, CRECER's education modules are highly valued by clients. For example, Dunford (2001) reviews numerous surveys of the clients of CRECER and of other VBIs sponsored by Freedom from Hunger (FFH) that utilize the same credit with education methodology. Most of the clients surveyed cite the education component as one of the aspects of the FFH village banking program that they most appreciate, with over 90 percent typically rating it "useful" or "very useful." In fact, many clients report that they remain with the FFH program because of the education component. In Bolivia, while the clients of some financial institutions joined in the mass movement of the last few years to form "debtor syndicates" and renounce their debts, CRECER's clients continued to be extremely loyal. CRECER's 30-day delinquency rate has remained a vanishingly low 0.1-0.2 percent (Table 2.2). When asked why they have remained so loyal, many clients told CRECER staff, "CRECER cares about us. They are not just here to collect our loans. They talk with us and give us education" (Dunford 2001, p. 11). Finally, Dunford (2001) summarizes some of the large number of studies that show that FFH's credit with education methodology has very substantial impacts in many areas targeted by the education modules. For example, important positive changes are reported in such areas as breastfeeding practices, treatment of diarrhea, immunization of children, children's diet and nutritional status (weight for age, height for age, and malnourishment), and women's empower-ment.

As noted in Chapter 1, village banking has long been associated with the particular focus of trying to serve very poor microentrepreneurs. These clients face a great many constraints to increasing their income levels and escaping poverty. For example, they may not know how to improve the management of their business or increase its profitability. They may lack the courage or skills to leave a market that is saturated with competitors and find a better alternative. A woman microentrepreneur and her children may suffer from diseases that could have been prevented, reducing the time she can devote to her business.

Because the very poor are likely to suffer to a greater degree from these deficits than the moderate poor and non-poor served by many other microfinance institutions, some VBIs feel a special need to complement the financial services they offer with NFS. These VBIs reason that if they only provide credit and other financial services, many of their very poor clients would not be able to increase their incomes very much before they would run into another constraint or obstacle and have their progress stopped. For example, these very poor clients might not know how to refocus, diversify, or otherwise improve their businesses in ways that would make better use of the credit they receive and lead to more substantial income increases. Or health problems might prevent these clients from spending enough time with their businesses to utilize the credit to best advantage and make large income gains. Though one could certainly argue the point, such phenomena may be less severe for clients who are not so poor. In any case, some VBIs, such as CRECER and Pro Mujer Bolivia, believe that they must provide certain basic NFS in order to ensure the effectiveness of their financial services. The following questions then arise: Could this be best

practice? Should such VBIs be prohibited from mobilizing deposits?

Offering NFS in the way that CRECER does should not disqualify a VBI from being considered a best practice VBI or from becoming a licensed, deposit-taking financial institution. This is less of an exception to the minimalist model of microfinance than it might, at first, seem. CRECER's NFS comprise a relatively small share of total costs (5-10 percent) and are provided free of charge. CRECER has not tried to create a profitable commercial venture out of the sale of its NFS. Had it done so, professional trainers with a more sophisticated command of training methods and more knowledge of public health might be required to compete with other commercial training providers. Instead, CRECER only attempts to deliver some very basic training in 20 minutes while the whole village bank is assembled and the loan officer is already present.

Still, those favoring the minimalist model of microfinance might offer several objections to what CRECER is doing. These objections are grouped and discussed under the following three headings: professionalization, cost, and portfolio quality.

- Professionalization. One of the key reasons that many believe in minimalist microfinance is that it is hard enough to professionalize the delivery of financial services alone, and make this into a profitable business. It may be too demanding of the talents of the board of directors and management to try to deliver both financial and non-financial services with a high enough level of competence to make both services profitable. While this certainly *would* be a challenge, VBIs such as CRECER do not try to sell their NFS, much less make them into profitable commercial ventures. They only try to deliver some very basic training, while keeping the costs of doing so low. Judging from the many studies undertaken of CRECER and other, similar Freedom from Hunger programs, clients very much value and benefit from these learning opportunities.

- Cost. Offering both financial and non-financial services and charging only (or mainly) for financial services can drive up costs and undermine sustainability. This is serious concern and no doubt many microfinance institutions (MFIs) have fallen into this trap. CRECER overcomes this objection by utilizing its loan officers to deliver both types of services at the same village bank meeting, by using the education modules already developed by Freedom for Hunger for its programs worldwide, and through its own careful efforts to control costs. These factors keep the additional costs of the education program to a very low 5-10 percent of total costs. Such a small expenditure may be more than compensated for by the cost reductions associated with lower client dropout rates, thus enhancing, rather than diminishing, CRECER's sustainability.

- Portfolio quality. Microfinance minimalists worry that MFIs that offer NFS will be distracted from the difficult job of maintaining high levels of portfolio quality. Moreover, the fact that an MFI offers it clients training or other help in addition to credit may render the MFI overly involved with its clients and too sympathetic to the plight of clients in difficulty. This may make the MFI more reluctant to aggressively pursue such clients when their loans turn delinquent. Finally, borrowers who receive advice from the MFI may feel less compulsion to repay their loans if the advice turns out to be bad. Clearly rebutting all three of these concerns, CRECER, like Pro Mujer Bolivia, has maintained extremely low loan delinquency rates (Table 2.2). CRECER has adopted a philosophy of "tough love," meaning that while it is very supportive of its clients, it also insists that they meet their financial obligations in a timely manner. Further, CRECER's education modules, like

those of Pro Mujer Bolivia, impart information about basic health practices and general business skills. They do not try to teach organic farming, handicrafts production, or other technical skills. Thus, clients would rarely be in a position to blame CRECER for teaching them a new business that did not go well, and refuse to repay their loan on this basis.

In summary, CRECER's NFS should not disqualify it from being regarded as a best practice VBI or from becoming a licensed, deposit-taking financial institution. The extra costs of its education program are not enough to render CRECER uncompetitive; such small cost differences can be easily made up in other areas of operations. In fact, CRECER has a very low ratio of total operating costs to average loan portfolio (Table 1.4), well below the average for other VBIs in Latin America, even though all of CRECER's NFS are included in its costs. And, as noted above, these NFS are highly valued by clients, so that the additional NFS costs may be offset or more than offset by the cost savings and other benefits of higher client retention rates. CRECER does not present significant credit quality risks, a major factor superintendencies must be concerned with before granting a license to mobilize deposits. The high quality and professionalism of CRECER's products and operations are further demonstrated by its large client base and rapid growth. For example, as of December 2002, CRECER had 40,142 borrowers, and CRECER's loan portfolio (in U.S. dollar terms) and number of borrowers had each increased by an average of 28 percent per year over the 1999-2002 period. Perhaps CRECER's single greatest weakness is that it narrowly misses full financial sustainability (Table 1.3). This calls into question whether CRECER is a financially-viable business that could be licensed and would thrive in the marketplace. Nonetheless, it would be hard to argue that CRECER's failure to earn profits is caused by its NFS offerings, as the preceding arguments and the three bullets above demonstrate. At worst, CRECER's NFS raise its operating costs and damage its sustainability only a little. It is much more likely that CRECER's NFS actually increase its sustainability—by improving CRECER's village banking product and thus its competitive position in the market. Although this analysis has not examined all of the indicators a superintendency could review before licensing a VBI to mobilize deposits, it has reviewed many of the most important ones. We find no evidence that CRECER's NFS should stand in the way of such licensing or from classifying CRECER as a best practice VBI.[52]

The Case of Pro Mujer Bolivia

Pro Mujer Bolivia, the other one of the four VBIs surveyed here that offers NFS, provides an interesting variant on the CRECER case. Pro Mujer Bolivia's NFS may not disqualify it from being considered a best practice VBI, but are likely to present much more of an obstacle to it becoming a licensed, deposit-taking financial institution. The basic reason for the difference in results between the CRECER and Pro Mujer Bolivia cases is that Pro Mujer Bolivia's NFS are much more costly than CRECER's, averaging 25 percent of total operating costs over the 2000-02 period.[53] We first explain why Pro Mujer Bolivia may well be considered a best practice VBI and then why the high costs of its NFS create problems for its licensing as a deposit-taking financial institution. A possible solution to these licensing problems is also suggested.

Pro Mujer Bolivia's delivery of NFS, like CRECER's, takes advantage of the fact that

[52] This is not to say that CRECER is ready to receive a license from the superintendency, but only that CRECER's NFS do not stand in the way of achieving this. For example, the superintendency might want to see a better track record of profitability before granting a license.

[53] According to data provided by Pro Mujer, NFS costs equal 25, 29, and 21 percent of total operating costs in the years 2000-2002, respectively, where total operating costs consist of the costs of providing both financial and non-financial services.

a group of approximately 20 generally very poor women is already assembled to receive financial services. Thus, Pro Mujer Bolivia can achieve substantial cost economies for both itself and its clients by extending the village bank meeting a little longer (by 30 minutes on average in Pro Mujer Bolivia's case) in order to deliver the general business training and health services that it provides. As with CRECER, these NFS may be particularly valuable in eliminating some of the key obstacles that Pro Mujer Bolivia's generally very poor clients face when trying to increase their incomes. Unlike CRECER, however, Pro Mujer Bolivia not only provides education but also makes extensive use of paid professionals such as nurses and family planning counsellors to help deliver its NFS. For example, women receive breast examinations, children under five years old are vaccinated, and nurses provide other forms of primary health care. As a result, Pro Mujer Bolivia's NFS are much more costly than CRECER's.

Although Pro Mujer Bolivia has had fewer client satisfaction and impact studies done of its NFS than CRECER and other Freedom from Hunger programs, the available results indicate that the Pro Mujer Bolivia clients value the NFS they receive quite highly. For example, Claure (2000, p. 53) finds that 96 percent of the Pro Mujer Bolivia clients consider the NFS useful. FINRURAL (2003, p. 70) reports that 30 percent of the 315 Pro Mujer Bolivia clients surveyed rank the NFS as the most appreciated program element, ahead of both credit and forced savings. Despite the apparently high quality of its NFS, Pro Mujer Bolivia, like CRECER, does not try to make these services into a profitable commercial venture, and, in fact, charges only nominal amounts for its NFS. Thus, it does not run afoul of the minimalist microfinance criticism that it may be too demanding of the talents of the board of directors and management to try to deliver both financial and non-financial services with a high enough level of competence to make both services profitable.

The financial performance of Pro Mujer Bolivia indicates that it has not fallen victim to other key concerns of microfinance minimalists. Pro Mujer Bolivia's consistently low delinquency rates (Table 2.2) clearly demonstrate that it has not been distracted from the job of maintaining high levels of portfolio quality and does not have significant credit risk. The high quality and professionalism of Pro Mujer Bolivia's products and operations are further corroborated by its large client base and rapid growth. As of December 2002, Pro Mujer Bolivia had 41,609 active clients (31,535 borrowers and 10,074 clients who only save). Pro Mujer Bolivia's loan portfolio (in U.S. dollar terms) and number of borrowers grew at average annual rates of 27 and 19 percent, respectively, over the 1999-2002 period.

As one of the prerequisites for becoming a licensed, deposit-taking financial institution, bank superintendencies properly require a feasibility study showing the commercial viability of the applicant. Pro Mujer Bolivia would be open to legitimate question in this area. While the *Microbanking Bulletin* calculations put Pro Mujer Bolivia's adjusted return on assets (AROA) at the very healthy levels of 1.3, 7.3, and 5.1 percent in the years 2000-2002, respectively, these calculations do not include the cost of providing NFS.[54] Once this additional cost is factored in, the AROA drops to –5.0, -0.1, and 0.9 percent, respectively, for these same three years, a far more anemic performance. The very substantial cost burden of Pro Mujer Bolivia's NFS (25 percent of total costs) raises legitimate questions about Pro Mujer Bolivia's long-term competitiveness, that is, whether it is a financially-viable business

[54] AROA is the same as the traditional return-on-assets (ROA) calculation, except that a series of adjustments is made to eliminate the effect of subsidies and inflation and to standardize loan loss provisioning and loan writeoff policies. For example, subsidies are factored out by removing grants and repricing subsidized loans to market rates. See the *Microbanking Bulletin* for further details.

that could be licensed and would thrive in the marketplace.

Here and in Chapter 1, we have shown that Pro Mujer Bolivia has many of the hallmarks of best practice, including: very low loan delinquency rates, high levels of efficiency (large number of borrowers per loan officer and low ratio of financial services operating costs to average loan portfolio), a large number of clients, and rapid growth. Its marginal levels of profitability are the one area in which it demonstrates some weakness. Despite this weakness, Pro Mujer Bolivia's NFS may not disqualify it from being considered a best practice VBI. The reason for this is partly that Pro Mujer Bolivia does so many other things well and partly that, while Pro Mujer Bolivia spends substantial sums to deliver NFS, it appears that clients value these services very highly. Pro Mujer's marginal levels of profitability may be seen as stemming from the choice it has made to benefit its clients by delivering valuable NFS to them and charging relatively little for these services.

This suggests a way for Pro Mujer Bolivia to answer the legitimate question about its long-term competitiveness, thus eliminating this obstacle to its licensing. If clients really do value Pro Mujer Bolivia's NFS, then they should be willing to pay more for them, either by paying increased amounts directly for the services themselves or by paying indirectly through increased interest rates on Pro Mujer Bolivia's loans. This additional income might allow Pro Mujer Bolivia to establish a track record of true profitability. In this way, Pro Mujer Bolivia could demonstrate that it is capable of delivering financial services, with some complementary NFS, sufficiently well as to be commercially viable.

Even if Pro Mujer Bolivia were to follow this suggestion and establish a track record of true profitability, it may still face obstacles to becoming a licensed, deposit-taking financial institution. This is because, with Pro Mujer Bolivia devoting one-quarter of its operating budget to NFS, the bank superintendency may consider that it is overly involved in the provision of NFS, instead of being totally or almost totally specialized in the provision of financial services—thus exposing depositors to excessive risk. In this case, Pro Mujer Bolivia could elect one of at least three alternative courses of action. First, its NFS provision could be spun off as a separate commercial venture, and Pro Mujer Bolivia could specialize in the provision of financial services only. Second, NFS expenditures could be reduced so that they represent a much smaller share of total costs (as they do for CRECER). Then it could be argued that NFS costs represented less than the normal variation among financial institutions in operating cost efficiency and could be reasonably ignored. A final alternative would be to establish a permanent source of funding for the NFS (e.g., an endowment), so that the provision of these services on a subsidized basis could be assured into the forseeable future.

The Role of Village Banking in Rural Finance

Governments and donors looking to strengthen rural financial systems should consider the role that VBIs can play, given that many VBIs already have a strong rural presence. As noted in Chapter 1, the percentage of borrowers residing in rural areas is higher for village banking clients (29 percent) than for solidarity group clients (17 percent) or individual loan clients (8 percent).

Strengthening and expanding the operations of rural VBIs (as well as other types of MFIs already located in the rural areas) may work better than trying to lure urban commercial banks out to rural areas. The lack of rural lending experience of these banks may constitute a formidable barrier to their entry into rural markets. Because VBIs generally also have a strong poverty focus, strengthening and expanding VBIs will help to alleviate social problems at the same time that it extends the reach of the rural finance system.

VBIs that also offer larger size solidarity group and individual loans may usefully complement this poverty focus by serving a broader cross-section of microentrepreneurs, including perhaps some who are moderately poor and non-poor.

Although many VBIs provide little or no credit to farm families, some do. For example, CRECER estimates that 40 percent of its clients engage in at least some agricultural activities and that 20-30 percent engage exclusively in these activities. Credit that is provided to a woman village bank member is often shared with other members of her family, and, thus, in the case of farm families, may be used to support all of the family's agricultural activities. Hence, VBIs may reach both farm as well as non-farm rural families.

The Role of Governments and Donors

Governments have an important role to play in implementing the policies and strategies recommended in this chapter. Donors can play a constructive role in facilitating policy and strategy changes by using a variety of tools at their disposal, including dialogue with the countries, technical assistance operations, and adjustment and other lending programs. Donors can also help to strengthen individual VBIs—both rural and urban—as a means of extending the reach of financial systems to some of the neediest microentrepreneurs. They may do this through the provision of technical assistance support or by helping to expand VBI lending portfolios by making loans to these institutions. However, donors should avoid making loans to VBIs that can mobilize deposits or borrow commercially in amounts sufficient to meet their funding needs. On the other hand, most VBIs in Latin America are still NGOs whose biggest constraint on expansion is generally the lack of loanable funds. This makes portfolio funding an important role for donors in the case of promising NGO village banking institutions.

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Annex A

The Structure of the Village Banking Industry in Latin America

Recently, the IDB and CGAP surveyed 193 microfinance institutions (MFIs) in 17 Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, Uruguay, and Venezuela). Of these 193 MFIs, 176 provided the requested data, a very high 91 percent response rate. The following table presents data on all 47 MFIs in Latin America that were found to offer village bank loans. Some of the salient characteristics of these 47 village banking institutions (VBIs) are discussed in Chapter 1. The data generally refer to mid 2001. A borrower is considered to be rural if (s)he lives in a locality with a population of 5000 or less. Average loan size is measured as the average outstanding loan balance, in U.S. dollars.

Table A1
The Village Banking Industry in Latin America

Country	Microfinance Institution	Individual Loans			Group Loans			Village Bank Loans			
		No. of Clients	Portfolio (US$)	Average Loan Size	No. of Clients	Portfolio (US$)	Average Loan Size	No. of Clients	Portfolio (US$)	Average Loan Size	% Rural Clients
I. Bolivia	1. Pro Mujer							26,427	3,297,017	125	21.6
	2. CRECER							25,350	3,700,000	146	67.3
	3. FONDECO	2,426	3,544,969	1,461				6,537	622,919	95	69.0
	4. ANED	2,454	1,956,210	797	17,411	5,003,597	287	6,040	535,198	89	100.0
II. Colombia	5. AGAPE	320	164,572	514	777	121,328	156	6,795	290,970	43	0.0
	6. ADEMCOL							3,100	260,586	84	0.0
III. Costa Rica	7. ADAPTE	50	75,000	1,500	340	160,000	471	550	100,000	182	0.0
IV. Dom. Repub.	8. ASPIRE	980	934,314	953				1,939	224,548	116	0.0
V. Ecuador	9. Project Hope	261	38,522	148				8,629	739,109	86	34.4
	10. CEPESIU	730	157,820	216	738	110,700	150	965	38,600	40	50.4
	11. CRS							13,194	690,671	52	84.0
	12. FINCA							6,239	1,214,100	195	39.1
VI. El Salvador	13. Enlace (CRS)							8,494	1,206,958	142	0.0
	14. ASEI							4,300	350,000	81	64.2
	15. CAM (FINCA)	95	109,000	1,147				21,222	2,903,340	137	77.0
VII. Guatemala	**16. Banrural	14,586	24,260,484	1,663	4,344	6,133,712	1,412	950	1,129,828	1,189	73.7
	**17. Bancafé							5,231	719,491	138	50.0
	18. CADISOGUA				502	54,654	109	569	72,683	128	100.0
	19. FAFIDESS	7	9,491	1,356	11	8,619	784	4,780	1,487,411	311	57.7
	20. FUNDEA	7,827	4,841,009	619	560	111,767	200	102	13,060	128	29.4
	21. FUNDAP	7,899	5,724,081	725	2,162	605,076	280	4,041	670,843	166	0.0
	22. FAPE	160	88,456	553	288	49,002	170	1,181	85,861	73	3.2
	23. FUNDESPE	2,354	1,987,886	844				3,223	1,280,410	397	100.0
	24. Génesis Empresarial	6,250	4,283,433	685	12,014	4,495,962	374	8,581	2,253,869	263	100.0
VIII. Honduras	25. ODEF	1,163	2,011,384	1,729	6,408	1,122,768	175	1,594	488,551	306	65.1
	26. IDH	660	341,619	518				5,288	1,253,387	237	27.8
	27. Project Hope							2,717	589,104	217	0.0
	28. World Relief	338	566,662	1,677	2,124	1,079,508	508	16,228	1,727,768	106	23.4

Country	Microfinance Institution	Individual Loans			Group Loans			Village Bank Loans			
		No. of Clients	Portfolio (US$)	Average Loan Size	No. of Clients	Portfolio (US$)	Average Loan Size	No. of Clients	Portfolio (US$)	Average Loan Size	% Rural Clients
IX. Mexico	*29. Financiera Compartamos	153	157,043	1,026	3,604	1,211,823	336	68,546	14,751,301	215	1.8
	30. CAME/Los Emprendedores	1,000	552,486	552				17,000	2,320,442	136	0.0
	31. FINCA							8,306	1,344,096	162	61.6
X. Nicaragua	32. CEPRODEL	4,317	3,497,491	810				850	364,966	429	0.0
	33. FUNDECAP				2,626	190,000	72	1,600	310,000	194	62.5
	34. Pro Mujer							8,422	381,097	45	33.0
	35. ASODENIC	2,611	1,269,713	486	5,124	700,720	137	12,398	929,810	75	0.0
	36. FINCA							23,279	2,090,023	90	13.6
XI. Peru	*37. EDYPME Edyficar	10,354	11,227,505	1,084	3,468	1,062,981	307	4,004	669,776	167	36.4
	*38. EDPYME Solidaridad	374	699,313	1,870	297	106,539	359	324	119,045	367	0.0
	39. FINCA	48	65,341	1,361				6,313	774,946	123	3.0
	40. GCOD	477	216,300	453				3,091	521,150	169	29.5
	41. Manuela Ramos	733	432,196	590				7,918	749,074	95	70.0
	42. CESS Solidaridad	330	681,897	2,066	634	262,960	415	1,030	203,705	198	38.2
	43. RASUHILLCA	927	347,912	375	1,458	135,524	93	25	2,615	105	100.0
	44. PRISMA MicroCredit	143	114,846	803	3,068	669,484	218	31,434	5,728,543	182	0.0
	45. PROMUC (rest of consortium)							14,593	1,447,123	99	10.2
	46. CRS				4,381	917,048	209	6,886	726,162	105	42.8
	47. MIDE (Fondecap Cuzco)	50	6,659	133	2,385	199,494	84	67	5,656	84	100.0
	OVERALL - 47 VBIs	70,077	70,363,615	1,004	74,724	24,513,265	328	410,352	61,385,814	150	29.4

Key: * = upgrade (a regulated financial institution that began as an NGO).
** = downscale (a commercial bank or *financiera* that offers loans to microenterprises).