

**FINANCIAL SERVICES FOR POOR SOUTH AFRICANS:
AN ANALYSIS OF
FINANCIAL SERVICES COOPERATIVES**

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DECLARATION

I the undersigned, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in part submitted is at any university for a degree.

Signature:

Date:

SUMMARY

South Africans earning less than R1 440 per month (18 million adults) and less than R2 880 per month (29 million adults) are regarded as poor and relatively poor respectively. Of the relatively poor, 78% are unbanked, i.e. do not have access to a formal bank account, while 86% of the poor are unbanked.

These figures show clearly that commercial banks do not meet the financial needs of many people, especially the poor for savings, credit, transmission and insurance services. Therefore the importance of those institutions that do not form part of the formal financial sector and provide micro savings and micro credit services, generally referred to as micro finance, to the poor at the local level on a sustainable basis.

The objective of this research is twofold.

Firstly, a review of the literature on micro finance in general to establish the financial needs of the poor, the constraints formal financial institutions face in providing micro financial services and to identify best practice regarding the provision of financial services to the poor in order to be in the position to form an opinion on institutional success.

Secondly, to analyse a specific South African micro finance initiative, Financial Services Cooperatives (FSCs), to identify how FSCs relate to the international best practice and to establish whether they are successful in addressing the financial needs of the poor.

A FSC is a financial institution through which micro finance services (savings, credit, transmission and insurance) are extended to unbanked households in a rural village. It utilises a community's rules, customs, relationships, knowledge, solidarity and resources combined with formal financial methods and concepts. The FSC is initiated, owned, financed and managed by the villagers

themselves. FSCs are registered cooperatives under the Cooperative Act of 1981 and may accept deposits from their members in terms of an exemption from the Bank Act of 1990. Currently, FSCs experience problems in providing credit, transmission and insurance services, preventing them from intermediating between borrowers and savers.

After reviewing the above-mentioned international best practice the conclusion reached with regard to FSCs includes the following:

FSCs only provide savings services and therefore do not intermediate between borrowers and savers as required for a financial institution. This in turn prevents them from being sustainable. FSCs' failure can be ascribed to the restrictive legislation, unsuccessful regulation and supervision. New legislation is currently under review that will change the landscape for micro finance and specifically for FSCs.

OPSOMMING

Suid-Afrikaners wat minder as R1 440 per maand (18 miljoen volwassenes) en minder as R2 880 per maand verdien (29 miljoen volwassenes) word onderskeidelik as arm and relatief arm bestempel. Agt-en-sewentig persent van dié wat relatief arm is, het nie toegang tot 'n formele bankrekening nie, terwyl 86% van dié wat arm is, geen toegang het nie.

Hierdie syfers toon duidelik dat kommersiële banke nie aan die finansiële behoeftes, met betrekking tot spaar-, krediet-, transmissie- en versekeringsdienste van baie mense voldoen nie, veral nie die armes nie. Daarom dat instellings wat nie deel vorm van die formele finansiële sektor nie en mikro-besparings en mikro-krediet, algemeen bekend as mikro-finansies, in 'n plaaslike gebied en op 'n volhoubare basis verleen, belangrik is.

Die doel van hierdie navorsing is tweeledig:

Eerstens, bied dit 'n oorsig oor die mikro-finansiering literatuur ten einde die finansiële behoeftes van die armes te ondersoek en die beperkings wat formele finansiële instellings ondervind om mikro-finansiële dienste te verskaf, aan te stip. Beste praktyk rakende die voorsiening van finansiële dienste aan die armes word geïdentifiseer, om sodoende in 'n posisie te wees om 'n opinie te kan vorm oor institusionele suksesfaktore.

Tweedens, om a spesifieke Suid-Afrikaanse mikro-finansiële inisiatief, Financial Services Cooperatives (FSCs) te ondersoek, ten einde vas te stel hoe hierdie inisiatief vergelyk met internasionale beste praktyk en hoe suksesvol dit is in die voorsiening van finansiële dienste aan die armes.

'n FSC is 'n finansiële instelling waardeur mikro-finansiële dienste (spaar-, krediet-, transmissie- en versekeringsdienste) verskaf word aan diegene in 'n plattelandse nedersetting wat nie toegang tot

formele bankdienste het nie. FSCs maak gebruik van 'n gemeenskap se reëls, gebruike, verhoudings, kennis, solidariteit en hulpbronne en kombineer dit met formele finansiële metodes en konsepte. Dit is 'n inisiatief van die gemeenskap en word deur die inwoners van die nedersetting besit, finansier en bestuur. FSCs is geregistreerde koöperasies in terme van die Ko-operatiewe Wet van 1981, en mag ook deposito's van hulle lede aanvaar op grond van 'n vrystelling van die Bankwet van 1990. Tans ondervind FSCs probleme in die verskaffing van krediet-, transmissie- en versekeringsdienste wat hulle verhoed om as tussenganger tussen leners en spaarders op te tree.

Na die oorweging van die internasionale beste-praktyk, kan die volgende gevolgtrekking rakende FSCs gemaak word:

FSCs tree nie op as tussenganger tussen leners en spaarders nie, soos vereis word van 'n finansiële instelling nie. Dit beperk gevolglik volhoubaarheid. Die mislukking kan toegeskryf word aan beperkte wetgewing, onsuksesvolle regulering en supervisie. Nuwe wetgewing is tans onder oorweging wat die landskap vir mikro finansiering en veral vir FSCs sal verander.

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LIST OF ACRONYMS

AFRACA	African Agricultural Association
AROA	Adjusted return on assets
BancoSol	Bank for Solidarity
BRI	Bank Rakyat Indonesia
CGAP	Consultive Group to Assist the Poorest
DGRV	Deutscher Genossenschafts und Raiffeisenverband (German Cooperative and Raiffeisen Confederation)
DSD	Department of Social Development
DTI	Department of Trade and Industry
ECA	Eastern Europe and Central Asia
FFS	Formal financial sector
FINASOL	Financial Solutions for Cooperating People
FSA	Financial Services Association
FSC	Financial Services Cooperative
FSS	Financial self-sufficiency
GDP	Gross Domestic Product
GNP	Gross National Product
IFAD	International Fund for Agricultural Development
IFS	Informal financial sector
LSM	Living Standard Measure
MBB	Micro Banking Bulletin
MENA	Middle East and North Africa
MFI	Micro Finance Institution
NDA	National Department of Agriculture
NGO	Non-government organisations
OSS	Operational self-sufficiency
PAR	Portfolio at risk
ROSCAS	Rotating and Savings Associations
SA	South Africa
SACCO	Savings and credit cooperative
SARB	South African Reserve Bank
SDI	Subsidy Dependence Index

SFS Semi-formal financial sector
SHG Self-help group
USAID United States Agency for International Development

CHAPTER 1

INTRODUCTION

A person is defined as poor or relatively poor if the person earns an income of \$1 or \$2 per day respectively. Internationally 1.3 billion people live on less than \$1 a day (one out of every four people). More than a half of the world's population, 3.2 billion, survive on less than \$400 per year (FINCA, 2003:6). Importantly, it is estimated that of the world's 4.5 billion people living in low and lower-middle income countries, 80% (3.66 billion) do not have access to formal financial services, and that 360 million households have a demand for but no access to commercial savings and credit services from financial institutions (Robinson, 2001).

South African statistics show similar results. In accordance with the international criteria, persons earning less than R1 440 per month (18 million adults) and less than R2 880 per month (29 million adults) are classified poor and relatively poor respectively. Of the relatively poor, 78% are unbanked, i.e. do not have access to a formal bank account, while 86% of the poor are unbanked (Porteous, 2003b:3).

These figures emphasise the importance of those institutions that do not form part of the formal financial sector (FFS) and provide mainly micro savings and micro credit services to the poor at the local level on a sustainable basis. These micro savings and credit services make up what is generally referred to as micro finance.

From the above it is clear that commercial banks do not meet the financial demands of many people, both locally and internationally, for savings, credit, transmission and insurance services. Why is this the case? The answer can firstly be traced to the environment of the poor and secondly

to the influence this has on the operations and activities of commercial banks (Straus Commission, 1996a; b; Bonti-Ankomah and Chamba, 2000).

The poor generally operate in an environment associated with poor infrastructure, low population density, high levels of illiteracy, limited business activities, high levels of insecurity and risk. In addition, income and expenditure flows do not usually coincide. Production, consumption, trade and exchange, saving, borrowing or income earning activities are also often in small quantities. As a result, the transaction with a commercial bank is usually very small and the transaction cost for a commercial bank is therefore high. Furthermore, the income derived from providing the services to the poor does not warrant the cost of provision due to the limited extent of services and the remoteness of most of the rural villages. The poor, on the other hand, face high transaction costs in travelling to the nearest bank and often do not adhere to the minimum requirements set by the bank for either opening a savings account or obtaining a loan. However, despite the above-mentioned problems, micro finance institutions (MFIs) over time developed financial services tailored to the demands of the poor.

During the 1970s, governments emphasised the importance of the agricultural sector and its contribution to economic growth and development. This gave rise to the development of agricultural credit institutions. Interventions included providing agricultural credit and reducing the interest rate and thus the interest repayment burden on farmers. Donors supported these policies by providing substantial financial resources for on-lending to boost growth in the sector. However, the outcome was not as positive. Credit institutions were highly subsidised, interest rates artificially low and repayment rates extremely low. Yaron *et al.* (1997) point out that the failure of this kind of policy can be ascribed to the misconceptions about the real problems in financial markets, i.e. asymmetric information, high transaction cost, poor management of rural financial institutions and the lack of an appropriate legal and regulatory framework. Traditional intervention was often based

on misconceptions about the challenges rural areas face, and therefore directed policy at the symptoms rather than the causes of inadequate financial intermediation. For example, it was often argued that the poor could not participate in the formal financial sector because of their inability to save, while the poor, on the contrary, can and want to save (Rutherford, 1999).

Developments in Bolivia, Indonesia and Bangladesh during the 1980s gave rise to what Morduch (2000) and Robinson (2001) refer to as “The Microfinance Revolution” and paved the way for the development of the micro financial sector. Government played an active role in this “revolution” by establishing a favourable economic environment with market-related interest rates, a stable political environment, and a sound legal and regulatory framework to facilitate the functioning of MFIs. MFIs provided demand-orientated financial services that not only involved credit services but also savings services. They developed operating procedures and methods according to socio-economic circumstances. These institutions also sought to achieve financial sustainability, redefining the role of donors as developmental. Finally, given the legal and regulatory framework set by government, MFIs moved into the formal financial sector.

As stated before, poor South Africans, despite their demand for financial services, find that commercial banks are unwilling to provide them with these services. Consequently, the poor turn to more informal savings and credit methods (friends and family members), as well as member-based financial institutions. The latter are institutions that rely on their members to contribute to the capital of the institutions and the power of collective actions. These institutions include rotating savings and credit associations (ROSCAs), burial societies, credit unions (also known as savings and credit cooperatives (SACCOs) and financial services cooperatives (FSCs).

This research focuses on the development and analysis of FSCs in South Africa. The International Fund for Agricultural Development (IFAD) and the African Agricultural Association (AFRACA)

launched the first FSC in 1994. Initially, there were three pilot projects in the North West Province with one regulator, the Financial Services Association (FSA), approved by the Registrar of Banks in 1996. A second regulator, Financial Solutions for Co-operating People (FinaSol) was established in 1999. In June 2003, 62 FSCs still operated in six provinces and, a year later, 53 in eight provinces (ECI Africa, 2003a:33; FSC Information, 2004). In 2001, both regulators collapsed leaving FSCs in the dark. Currently FSCs fall under the supervision of the National Department of Agriculture (NDA).

The basis for the analysis of South Africa's FSCs is a review of the literature on micro finance with the following objectives:

- To identify the financial needs of the poor;
- To identify and explain the constraints formal financial institutions face in providing micro financial services; and
- To identify international best practice regarding the provision of financial services to the poor.

The objectives of the analysis of South African FSCs are to identify how FSCs relate to the international best practice and to establish whether they are successful in addressing the financial needs of the poor.

Information includes a review of the literature and documentation provided by personnel who are directly and indirectly involved in the FSC programme. Interviews with personnel were supplemented by e-mails and telephone conversations. In addition, the author participated in seminars on member-based self-help organisations to obtain further information and insight.

This study is organised as follows: Chapter 2 examines relevant international literature on micro finance. Firstly, reference is made to the financial needs of the poor, i.e. savings, credit and

transmission services, with emphasis on savings. The financial sector is then discussed with reference to its functioning, its importance for economic growth and development, and the reasons why the formal financial sector fails in addressing the financial needs of the poor, as well as why the sector needs to be regulated and supervised. The focus then falls on the preconditions for delivering financial services to the poor on a sustainable basis. These include delivering appropriate services within the correct institutional structure while improving institutional capacity, and the need for services to be regulated and supervised in order to prevent failure. Important measurement benchmarks are then discussed, which assist in analysing the success of institutions.

Chapter 3 focuses on FSCs. It starts with information on the supply and unmet demand for financial services in South Africa, with the emphasis on the poor, after which the development of FSCs is explained. In order to draw lessons from international programmes, cooperative banking, which originated in Germany in 1864 and is also known as Raiffeisen Banks, and village banking concepts founded in 1989 are discussed. Since FSCs accept deposits from their members, these institutions need to operate under the Banks Act of 1990. However, the high cost of registration allowed for the development of exemption notices from the Banks Act and FSCs have been exempted from the Banks Act. Problems, especially the collapse of FSA and FinaSol, as well as the limitation on growth due to the exemption notice, led to the development of appropriate legislation to regulate FSCs. The chapter concludes by using specific benchmarks to summarise their current situation.

Chapter 4 concludes the research. It interprets the results in terms of the literature reviewed, comparing FSCs to international best practice.

CHAPTER 2

PROVIDING MICRO FINANCIAL SERVICES TO THE POOR ON A SUSTAINABLE BASIS

2.1 Introduction

Micro finance refers to small-scale financial services, primarily savings and credit, provided to the poor whose savings are small, who have no collateral and whose loan demands are small, and who therefore do not have access to formal financial institutions (institutions registered under the financial laws of a country) and are excluded from their benefits. MFIs operate either as informal (unregistered) or semi-formal (institutions registered under special laws or exclusions to the financial laws) institutions, and have developed unique operating procedures and enforcement contracts that enable them to provide the necessary financial services to the poor. Micro finance has one vision, namely, to supply financial services to poor people excluded from the formal financial sector (FFS). Some provide only loans and make use of group solidarity as collateral; others require mandatory savings as collateral for loans, while others provide voluntary savings and credit services.

This chapter investigates international best practices as identified in the literature in delivering micro financial services to the poor. Section 2.2 explains that the poor need access to savings and credit services, amongst others, to improve their living conditions. Savings afford them smooth consumption and storing liquidity for future emergencies, while credit provides them with the necessary funds for investments and unforeseen emergencies (Rutherford, 1999; 2003; Robinson, 1994; 2001; Matin *et al.*, 1999; 2002). Unfortunately, the high risk and transaction costs involved prevent commercial banks from serving this segment of the market (Hoff and Stiglitz, 1990; Germidis *et al.*, 1991).

Section 2.3 focuses on the financial sector. The section starts by defining the main function of the financial sector, namely, the mobilisation and allocation of financial resources between deficit and surplus units. A well functioning financial sector will improve the savings and investment rates of an economy, which should have a positive impact on economic growth. Studies by, for example, King and Levine (1993a; 1993b), Eschenbach (2004) and Berger *et al.* (2004) explain this relationship in more detail, emphasising the positive contribution a well functioning financial sector makes to economic growth and development. Unfortunately, the FFS fails to serve all segments of the population, especially the poor. This can be ascribed to market imperfections (Hoff and Stiglitz, 1990). By addressing the causes of the market failure, particularly asymmetric information and moral hazard, it is possible to increase access to financial services for the poor. To prevent financial system instability and thus protecting the financial system as a whole, prudential regulation and supervision are also important (Carmichael and Pomerleano, 2002; Chaves and Gonzalez-Vega, 1994; Brownbridge and Kirkpatrick, 2000). This section ends by defining each subsection of the financial sector, namely, the formal, informal and semi-formal financial sector (Ghate, 1992a; 1992b).

The main body of this chapter, section 2.4, explains the preconditions for delivering sustainable financial services to the poor. Implementing what is considered best practices in micro finance and carefully adapting those to local socioeconomic conditions and cultural settings to achieve this. It entails providing the appropriate services (savings, unsubsidised credit and transmission services) and building institutional capacity (Rhyne and Otero, 1994a; CGAP, 2001; Robinson, 2001; Ledgerwood, 1999; Yaron, 1994a; 1994b; Yaron *et al.*, 1997). To assist MFIs in serving the poor, Ghate (1992a), Schoombee (1998), and Seibel and Parhusip (2003) advocate the importance of linking MFIs with formal financial institutions (commercial banks). This linkage provides MFIs with access to commercial funds and training, increasing competition and serving the poor more successfully. In contrast to the traditional approach of serving the poor, micro finance moved out of

the heavily donor dependent arena of subsidised operations into one where they operate in a business manner as part of the regulated financial system – integrated into the financial system as entities that offer micro finance services. Therefore, institutions rely on deposits to finance lending operations. If, however, an institution such as this cannot repay its depositors because it became insolvent, its failure, if it is a large institution, could undermine public confidence to such an extent that the banking sector will suffer a run on deposits. Therefore, institutions need to be regulated and supervised, protecting the safety of small deposits in small financial institutions. Christen *et al.* (2003), Chaves and Gonzalez-Vega (1994), and CGAP (2000) explain different possibilities for regulating and supervising MFIs.

Section 2.5 provides performance criteria (benchmarks) for certain indicators according to which the success of MFIs can be assessed and compared. These indicators include institutional characteristics, financing structure indicators, outreach, macroeconomic conditions, sustainability, operating income and expense, efficiency, productivity, and risk and liquidity indicators (MBB, 2003). This research focuses on both outreach and sustainability indicators. While breadth of outreach refers to the number of poor being reached by micro finance, depth of outreach indicates how deep in the pool of poverty an institution serves the poor. Sustainability indicators refer to operational self-sufficiency (OSS) and financial self-sufficiency (FSS). Institutions are OSS if they are able to generate enough operating revenue from credit and savings operations as well as investments, to cover operating expenses, financing costs and provision for loan losses. FSS institutions in addition generate enough revenue to cover all costs mentioned before, but also the cost of capital; i.e. these institutions could cover all their costs if they were unsubsidised. This is especially helpful within the new revolution due to the emphasis placed on less donor support.

This chapter concludes by summarising the main findings. Throughout this chapter, the emphasis is placed on ways in which micro financial services can be delivered to the poor in a sustainable way.

It defines and characterises good micro financial service products, which in turn help to define the kind of institution that will be required to deliver these products, as well as the legal, regulatory and economic environment that will best promote the growth of such institutions, reaching as many people as possible, while maintaining high levels of sustainability.

2.2 The financial needs of the poor

Poor people demand a portfolio of financial services, primarily savings, credit and transmission services, tailored to their liquidity needs. These services are used to finance life-cycle events (burial, weddings, childbirth, home building and old age), emergencies (sickness, injuries, loss of employment) and investment opportunities (to invest in a new enterprise, purchase land, housing construction or children's education). Apart from the above-mentioned services, other services include insurance, grant and equity funding.¹

Often a person's disposable income determines his or her propensity to save. An increase in disposable income often leads to an increase in the willingness and capacity to save. In the past, the belief was that low-income people, especially the poor, have a low propensity to save and are thus less able to contribute to an economy's savings. In other words, the common belief is that the poor cannot save. Experience has shown the contrary; the poor can and want to save. Rutherford explains that "the poor can save, do save, and want to save money. Only those so poor that they have left the cash economy altogether – elderly disabled, for example, who live begging food from neighbours – cannot save money" (1999:6).

That the poor do not have large amounts of money is a fact, and since expenditure is not always in small amounts, large sums of money are often needed. Therefore, money available must be

¹ This research does not explore these options. Brown (2003) cautions MFIs to provide micro insurance, despite poor people's vulnerability towards a wide variety of risks. Not only do these institutions lack the basic skills and resources to provide insurance services, such services will not necessarily benefit the poor since savings and credit services are more essential to address their financial needs. He opts for MFIs to rather collaborate with existing insurers in order to provide the benefits involved without taking the insurance risk.

managed in ways that allow for unforeseen consumption expenditures, namely, smoothing consumption. Rutherford (2003) indicates that poor people do indeed obtain large amounts of money when needed. He identifies three patterns through which savings are converted into useful large sums of money. These include, firstly, a “savings up” pattern, where savings are stored in small consecutive units (usually weekly instalments) until accumulated into a large enough sum to finance the large expenditure. A second pattern, “savings down”, allows the saver to have immediate access to the lump sum of money, i.e. borrowing the money, and repaying the loan in consecutive instalments. Thirdly, the “savings through” pattern is a mix of the first two patterns and the lump sum becomes available at some time during a series of savings. It is thus not that the poor cannot save, but rather that they cannot find a safe place (institution) where they can save the money, i.e. formal opportunities such as banks and the like are rarely accessible. As a result, the poor often turn to informal ways of saving their money.

Common forms of savings methods among the poor include cash, animals, gold and other valuables, land, construction material, membership of rotating and savings associations (ROSCAs), labour obligations and deposits with saving collectors. At a first glance, these methods of saving seem reasonable given poor people’s circumstances; however, a number of advantages and disadvantages can be listed. Advantages include convenience, liquidity (cash and gold), animal by-products (animals) and mechanisms for encouraging regular savings and possible returns (ROSCAs, labour obligations and deposits with saving collectors). Some of the disadvantages often associated with informal savings methods include security problems (safe keeping of gold and cash), storage problems (animals), high risk of theft or death (animals, gold), low returns if any and a decline in the value of money given inflation (Rutherford, 1999; Robinson, 1994; 2001).

A study by Robinson (1994) indicates that the poor want financial services with characteristics of security, convenience, liquidity, confidentiality, access to loans and returns. Above-mentioned

savings mechanisms cannot provide this combination of features, whereas formal financial savings products can. For example, demand deposits (liquid accounts) with no restrictions on withdrawals are more appropriate than, for instance, grain and cash crops since the funds in such accounts are secure, liquid and earn some return. Disadvantages are also associated with formal financial savings products and include taxed interest, transaction costs to the savers, no returns on small accounts, a decline in the real value of savings due to inflation or currency devaluation, and the risk of institutions failing and going bankrupt. However, the advantages outweigh the disadvantages and therefore the emphasis should be placed on formal financial savings mechanisms for the poor.

As stated above, conventional theory (that favours subsidised credit institutions) believed that poor people cannot and do not want to save due to their low-income levels and high propensity to consume. This myth is criticised in recent development finance literature, which indicates that the poor have the ability and willingness to save. The fact that the poor save their money has considerable implications for financial policies and resource mobilisation (Otero, 2003; Robinson, 2001; Rutherford, 1999; 2003; Yaron *et al.*, 1997).

Apart from savings opportunities, the poor want access to credit. This will enable them to use future income for current consumption and investment purposes, i.e. to have immediate access to a lump sum of money. As discussed above, large sums of money are needed for unforeseen consumption expenses, fuelling the demand for credit services.

Poor people use transmission services to transfer money in order to purchase items, pay school and examination fees, or to support family members. On the supply side, these transmission services allow people to receive salaries and pension payments. In many cases, poor households rely on either pension grants from the government or on money the husband earns in the urban areas while the household remains in the rural area. Some people make use of formal institutions, such as

commercial banks, while others rely on more informal means, such as friends and relatives. Informal transmission methods pose some risk of the money being stolen or misused by friends or relatives. Transmission services via formal financial institutions also have its share of problems that include delays, long queues, network limitations, insolvency of branches and unreliable communication.

In conclusion, this section indicated that the poor demand a portfolio of financial services. The problem, however, is that formal financial institutions do not address these financial needs due to the high risk and transaction costs and low returns involved when serving this segment of the market (section 2.3.5.1). This led to the development of informal and semi-formal financial institutions to fulfil these needs.

Jalilian and Kirkpatrick (2001) rightly point out that improved access to financial services strengthens the productive assets of the poor and thereby improves their productivity. Therefore, economists generally believe that financial development (better access to financial services and the proper functioning of the financial system) can make a positive contribution to economic growth and thus poverty reduction. More particularly, it is has led to efforts explaining the relationship between financial development, economic growth and poverty reduction. As the next section will explain, despite the evidence that financial development contributes to economic growth and therefore also poverty reduction, financial market failures, particularly asymmetric information and the high cost of small-scale lending, limit the access of the poor to formal financial services.

2.3 The financial sector

Entrepreneurs often lack enough capital to undertake their investment opportunities while savers want to earn high returns on their investments. However, the latter may not have the time, capacity or means to collect and process information on the best possible investment opportunities and as a result will experience high transaction costs. On the other hand, entrepreneurs, lacking enough

capital, will have to search for savers willing to provide capital for investment purposes. Similarly, they experience high transaction cost due to the lack of information. It is therefore this cost of acquiring information and bringing together those who have funds to lend (savers) and those who wish to borrow (entrepreneurs) that create incentives for the emergence of financial markets. As Demetriades and Andianova (2003:1) rightly point out, the absence of a financial system will require that all consumption be financed by current income. Firms will not be able to raise capital for investment purposes unless they accumulated enough profits from previous years, and the creation of new firms and innovations will not be possible.

2.3.1 The functions of the financial sector

Given the above, the primary function of the financial system is to allocate resources between deficit (lenders) and surplus (savers) units. To explain this function better, it can be broken down into the mobilisation and allocation of financial resources, diversifying risk and monitoring managers. Note that these functions each affect economic growth. This is done via capital accumulation and technological innovation. The former affects growth by either altering the savings rate or by reallocating savings among different capital-producing technologies, while the latter focuses on the invention of new production processes and goods.

The financial system undertakes the following:

- i. Mobilising resources from savers for investment purposes. Mobilising savings from savers is, however, costly. It involves the transaction cost associated with collecting savings as well as overcoming information problems in making savers feel comfortable in handing over control of their savings.² It is essential that financial systems effectively pool savings in order to contribute to economic development. Besides the direct affect of better savings mobilisation on capital accumulation, pooled savings can also be allocated to projects and

² Information problems relate to asymmetric information (Section 2.3.3). Costs are covered by means of bank charges and high interest rates.

investment opportunities that might lead to the adoption of better technologies and boost technological innovation.

- ii. Allocating and transferring resources from lenders to borrowers. Financial markets intermediate between borrowers and lenders, providing the former with loanable funds (savings) for investment purposes. However, the allocation of resources is associated with problems of asymmetric information (section 2.3.3). Consequently, high information costs may keep capital from flowing to its highest value use and therefore impede on economic growth. It is therefore important that the financial system address the information problems experienced in order to identify the best possible investment opportunities and induce a more efficient allocation of capital, leading to economic growth. Apart from identifying the best production technologies, financial markets may also boost the rate of technological innovation by identifying those entrepreneurs with the best chances of successfully initiating new goods and production processes.
- iii. Reducing risk by spreading savings across many different investment opportunities. This spreading of households' savings also diversifies their risk and reduces their exposure to the uncertainty associated with individual projects. On the other hand, financial institutions with diversified portfolios of innovative projects also reduce risk and promote investment in growth-enhancing innovative activities, improving technological change and economic growth.
- iv. Monitoring managers and exercising corporate control. Managers and entrepreneurs have better knowledge of their businesses' performance than creditors and shareholders do. As a result, managers might engage in opportunistic behaviour and thus discourage savings. Therefore, banks need to monitor borrowers, while equity markets allow shareholders to discipline managers by voting out poor management. In order to lower monitoring costs, banks need to have a well-diversified portfolio and develop a long run relationship with

firms. This will also lower information acquisition costs and in turn facilitate better resource allocation (Levine 1997; 2004; Carmichael and Pomerleano, 2002)

Taking the above into account, a well functioning financial system should improve the savings and investment rates within an economy and should therefore theoretically improve economic growth.

2.3.2 The financial sector and economic growth

There has been a widespread interest among economists in the relationship between finance and economic growth. The empirical literature has for some time indicated that a positive association between finance and growth does exist. However, at the centre of this debate is the causality between finance and economic growth. Specifically, does financial development cause economic growth or does it merely follow growth generated elsewhere in the economy?

As early as 1911, Joseph Schumpeter argued that banks play an important role in economic development. This is not because they alter the savings rate, but because they can allocate savings resources to industries that have good growth opportunities. These industries will require large sums of money. Thus, by providing the necessary funds, banks can improve productivity, technical change and the rate of economic growth. Schumpeter also argued that industries with good growth potential should grow relatively more in countries with higher financial development than in less financially developed countries.

However, the consensus view during the 1950s to 1960s was that financial development followed growth. Stated differently, the degree of economic development determines the role and size of the banking sector (Eschenbach, 2004:2). A 1952 study by Joan Robinson (Levine, 1997:688) argued that economic development creates demands for particular financial products to which the financial system automatically responds. This perspective, in other words, believes that finance does not

cause growth. Robert Lucas (Levine 1997:688) also stressed that the role of the financial system in economic growth was overemphasised.

As a result, governments did not focus on the development of viable financial systems. During this period (1950 to 1970), they used the financial system to finance key industrial sectors, in a manner that inhibited the development of the financial sector. This approach mainly focused on providing cheap credit via controlled and subsidised interest rates, and high reserve requirements (financial repression policies) to finance budget deficits. As a result, these countries' financial systems, instead of showing increased growth, contracted. The inability to capture savings and provide credit services to a majority of the economically active population hampered the financial system to mobilise domestic resources. Dependent on external aid and debt, banks were undercapitalised and lacked commercial orientation, inflation rates were high and economic growth low and volatile.

In 1973, studies by Ronald McKinnon and Edward Shaw argued for the liberalisation of interest rates and the abolishment of financial repression policies. Others that followed include Kapur (1976) and Galbis (1977).³ All these authors recommended that the deposit rate that maximises growth is the one that results from free market equilibrium; interest rate ceilings need to be abolished; selective or directive credit programmes must be given up; reserve requirements need to be reduced; and in the financial sector competitive conditions must be ensured (Eschenbach, 2004: 8). This would increase economic growth and development.

In a pioneering 1969 study by Raymond Goldsmith (Levine; 1997:702), he examined the relationship between finance and growth using the value of financial intermediary assets, relative to

³ For a more detailed discussion see:

McKinnon, R.I. 1973. *Money and Capital in Economic Development*. Washington D.C.: Brooking Institution.

Shaw, E.S. (1973) . *Finance Deepening in Economic Development*. New York: Oxford University Press.

Kapur, B.K. (1976. Alternative Stabilization Policies for Less-Developed Economies. *Journal of Political Economy*. 85(4): 777-95.

Galbis, V. 1977. Financial Intermediation and Economic Growth in Less-Developed Countries: A Theoretical Approach. *Journal of Development Studies*. 13(2): 58-72.

gross domestic product (GDP). Using data across 35 countries over 103 years (1860 to 1963), he found that financial intermediation was positively related to economic growth and postulated that this was due to the increased efficiency and volume of investments. However, his work did have some weaknesses in that it involved a limited number of observations (35 countries); the measure of financial development did not take into account the quality of financial services; it did not investigate whether financial development is associated with productivity growth and capital accumulation; and the direction of causality was not identified. He furthermore did not take into account the many other factors that contribute to economic growth, including the propensity to save, the supply of human capital, fiscal and monetary policy, political and economic stability, the rate of population growth and the initial level of GDP. Yet, he was the first to provide significant empirical evidence on the positive correlation between finance and growth. He also broke the ground for later empirical research conducted in this field.

Others that followed on Goldsmith's research include King and Levine (1993a and 1993b); Hermes and Lensink (1996); Levine (1997); Stiglitz (1998); Levine *et al.* (1999); Levine and Loayza (2000); Jalilian and Kirkpatrick (2001); Carmichael and Pomerleano (2002); Fisman and Love (2003); Demetriades and Andrianova (2003); Honohan (2004); Berger *et al.* (2004); Eschenbach (2004); Levine (2004).

Certainly one of the most influential of these is the research by King and Levine (1993a and 1993b) who took steps to overcome some of Goldsmith's weaknesses. Their study included 80 countries over the period 1960 to 1989. They took into account other factors affecting economic growth (per capita growth rates of GDP, growth in the capital stock and total factor productivity); examined the capital growth and productivity growth channels; analysed whether the level of financial development predicts long run economic growth, capital accumulation and productivity growth; and constructed additional measures for financial development. They rightly state at the end of their

study that “higher levels of financial development are significantly and robustly correlated with faster current and future rates of economic growth, physical capital accumulation and economic efficiency improvements . . . [and] . . . finance does not only follow growth: finance seems importantly to lead economic growth” (King and Levine, 1993a:717; 730).

The four indicators of overall financial development for more precise measurement of the functioning of the financial system proposed by them include the following:

- i. The liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries) as percentage of GDP. This is an indicator of “financial depth” and thus the relative size of the financial system.
- ii. The ratio of commercial bank domestic assets divided by commercial bank plus central bank assets. It measures the degree to which the banks versus the central bank allocate society’s savings. It does not directly measure the effectiveness of banks in researching firms, exerting corporate control, mobilising savings, easing transactions and providing risk management facilities to clients. It is thus not a direct measure of the quality and quantity of financial services provided by financial intermediaries. The reasoning behind this measure is that commercial banks have a definite advantage over the central bank concerning risk diversification services, the management of liquidity risks, information monitoring, identifying profitable investments, and mobilising and allocating savings, i.e. performing the financial functions as noted before.
- iii. The credit allocated to private enterprises as percentage of total domestic credit (credit issued to central and local governments plus credit issued to public and private enterprises). This ratio reflects the redistribution of credit from public enterprises and government to the private firms.

- iv. The amount of credit by financial intermediaries to the private sector as percentage of GDP. Both ratios (iii) and (iv) address concerns about the allocation of credit. Systems that allocate more credit to private enterprises are more engaged in researching firms, exerting corporate control, providing risk management services, mobilising savings and facilitating transactions than systems that favour government enterprises. Higher levels of both these ratios indicate good interaction with the private sector, and are indicative of a financial system that provides productivity enhancing financial services, thus greater financial sector development.

King and Levine found that there is a strong positive relationship between each of the four financial development indicators and the three growth indicators (per capita GDP, growth in the capital stock and total factor productivity). In other words, improvements in the provision of financial services will promote economic growth and technological innovation. After taking into account other factors associated with growth (for example, income per capita, education, political stability, indicators of exchange rate, and trade, fiscal and monetary policies), they found that the initial level of financial development is a good predictor of subsequent rates of economic growth over the next 30 years, i.e. that there is a significantly large empirical relationship between the initial level of financial development and future long run economic growth. Furthermore, insufficient financial development has sometimes created a poverty trap and therefore became a severe obstacle to growth, even though countries have established other conditions favouring growth, for example macroeconomic stability, trade openness and educational attainment.

Other researchers, such as Levine et al. (1999), Beck et al. (2000), and Carmichael and Pomerleano (2002), used the above indicators on different cross-country data over different time periods and obtained correlating results.⁴ In addition, these researchers settled the issue of causality, i.e. that

⁴ For more detailed discussion on the econometric models and variables used, see King and Levine (1993a and b), Beck *et al.* (2000) and Levine *et al.* (1999).

better functioning financial intermediaries accelerate economic growth. Carmichael and Pomerleano (2002) confirm this by stating that a doubling of the ratio of private credit is associated with an average long-term growth rate of almost two percentage points higher. On the other hand, countries experiencing negative growth rates also show problems within the financial system. Problems include, for example, state owned banks, massive official intervention in credit allocation, high level of non-performing loans and interest rate controls – all restrictions that impede the ability of the financial system to mobilising and allocating capital funds efficiently. It is also worth mentioning that studies by Levine (1997) and Khan (2000) refer to other factors that need to be taken into account, namely, the differences in political systems and legal traditions because these factors also influence financial development and economic growth. Nevertheless, the body of evidence would tend to push sceptics towards the view that well-functioning financial systems have improved economic growth. As King and Levine (1993b:540) conclude:

[F]inancial systems affect the entrepreneurial activities that lead to productivity improvements in four ways. First, financial systems evaluate prospective entrepreneurs and choose the most promising projects. Second, financial systems mobilise resources to finance promising projects. Third, financial systems allow investors to diversify the risk associated with uncertain innovative activities. Fourth, financial systems reveal the potential rewards to engaging in innovation, relative to continuing to make existing products with existing techniques. Thus, a more developed financial system fosters productivity improvements by choosing higher quality entrepreneurs and projects, by more effectively mobilising external financing for these entrepreneurs, by providing superior vehicles for diversifying the risk of innovative activities, and by revealing more accurately the potentially large profits associated with the uncertain business of innovation. In these ways, better financial systems stimulate economic growth by accelerating the rate of productivity enhancement.

In general, the view that finance causes growth prevails, although it is also accepted that the reverse causal relationship may also hold. Despite the positive contribution the financial system makes to

economic growth, market failures are intrinsic to financial markets preventing the poor access to formal financial services. By addressing the causes for these market failures, it is possible to increase the access to financial services for the poor.

2.3.3 The imperfections of the financial sector

It has been argued in section 2.3.1 that the primary function of the financial system is to facilitate the mobilisation and allocation of economic resources in an uncertain environment. However, the financial system does not work perfectly, causing the market to fail to efficiently mobilise and allocate financial resources (discussed below) and, as a result, it needs to be regulated accordingly (section 2.3.4).

Carmichael and Pomerleano (2002:24) provide four reasons why financial markets fail:

Firstly, due to anticompetitive behaviour such as mergers and collusions, financial markets prevent economic participants to enjoy the benefits from this sector. Benefits from competition include improved access to capital for business, cheaper credit and housing loans to consumers, a better match between the financing needs of deficit and surplus units, cheaper transactions and greater ability to manage risks.

A second reason, market misconduct, includes unfair or fraudulent conduct by market participants and inadequate disclosure of information on which to base investment decisions. This might lead to a lack of confidence in the efficiency and fairness of markets by participants.

Thirdly, systemic instability arises when the failure of one financial institution to honour its promises, i.e. to fulfil its primary functions, leads to a general panic, as individuals fear that other financial institutions cannot honour their promises as well. In other words, when savers withdraw large amounts of deposits, a crisis of confidence in one institution can spread to others leading to a

run on the bank. The risk of instability is especially high amongst deposit taking institutions. These institutions can only meet their promise of transforming illiquid assets into liquid liabilities if they have sufficient amounts of reserves available. Any such failure could lead to lack of confidence amongst clients.

The fourth reason, particularly relevant in serving the poor, is that of asymmetric information. This refers to the characteristics of the parties involved in a credit transaction where one party has more information about the transaction than the other does. Put differently, the risk profile of borrowers, i.e. their investment choices, honesty, risk tolerance capacity and willingness to repay loans, is unknown to banks. This lack of information between institutions and clients leads to problems of adverse selection, moral hazard and credit rationing. As a result, formal financial institutions do not provide financial services to low-income customers, discussed forthwith.

Adverse selection arises because lenders do not have perfect information on borrowers' characteristics. Since individuals have information regarding their likelihood of default, risky borrowers have an incentive to pose as safe borrowers. Banks' screening mechanisms, however, cannot effectively distinguish between risky and safe borrowers. Banks therefore either charge higher interest rates or demand collateral in order to offset the risk and ensure that only safe borrowers enter the market. Unfortunately, these options prevent low-risk borrowers from applying for the high-cost loans, leaving the bank with riskier loans. High-risk clients are thus adversely selected because of the presence of asymmetric information. Poor people furthermore do not possess sufficient wealth to provide collateral and therefore would be denied access to credit.

Moral hazard refers to clients' actions. In a credit contract, the lender (also referred to as the principal) often cannot observe the actions of the borrower (agent) and the borrower's action can affect the returns to both parties. Stated differently, a lender might stipulate that the borrowers must

extend the necessary actions and efforts and/or that the loan must be used for a prescribed purpose. However, the borrower may deviate from the terms of the contract or actually use the loan for purposes other than those approved by the lender. As a result, lenders' risk increases with extending credit. To address this problem, lenders can monitor borrowers' actions. The difficulty with this approach is that it is costly to undertake. Therefore, lenders would rather demand collateral. Poor borrowers are again excluded from the credit market.

According to Hoff and Stiglitz (1990), adverse selection and moral hazard could prevent interest rates from equilibrating the supply and demand for credit. Furthermore, to compensate for above-mentioned problems, banks increase their interest rates, increasing the average potential risk of loan applicants and decreasing expected returns. They therefore deny loans to those they do not know well or whose reputation cannot be vouched for and therefore may prevent worthwhile activities from being undertaken. This will reduce investment, output and welfare development. However, the poor are again denied access to credit. According to Robinson, banks deny "credit to prospective borrowers not because of lack of funds but because of perceived risk related to asymmetric information and moral hazard" (2001:156).

Thus, the financial sector contributes to economic growth and development, but due to reasons discussed above, it sometimes fails to fulfil its functions. To address the market failure, regulation is prescribed.

2.3.4 The regulation and supervision of the financial sector

Government has three important functions within the financial system (Stiglitz, 1998:1): firstly, to ensure the existence of financial markets and positive economic conditions as part of the macro-economic policy (low inflation levels, low prevailing interest rates and monetary policy that allow for liquid financial markets); secondly, to set the ground rules for institutions allowing them to

pursue financial feasibility; and lastly, to ensure that financial resources entrusted to them are well managed. It is especially these last two functions that are important and need further discussion.

Financial regulation can be defined as rules that govern the commercial behaviour in the financial system; in other words, to establish a legal framework in which commerce can flourish. Without any rules, or if the rules are not enforced, businesses will lack confidence and trust in the financial system, corruption will become endemic and the functioning of the financial system will be inefficient. The primary function of the system is to mobilise and allocate financial resources. Any failure to do so will result in the failure of these objectives and therefore adversely affect economic efficiency and development. To prevent any such failure requires financial institutions to be monitored in order to detect possible problems, i.e. to be effectively regulated and supervised. This will ensure the stability and soundness of all financial intermediaries, and thus the economy, institutional efficiency, and it will protect consumers against undue risks that may result from failures, fraud or opportunistic behaviour in the financial system. Carmichael and Pomerleano (2002:24) explain that regulation must take place if the cost of failure is greater than the cost of regulation, and furthermore that the regulating measure must address the cause of the market failure.

The above section identified four reasons why financial markets fail, namely, anticompetitive behaviour, market misconduct, systemic instability and asymmetric information. Regulation addressing each of the above (in the same order) can be summarised as follow:

- Anti-collusion rules, rules to prevent anticompetitive behaviour and contestability rules to ensure free entry and exit within markets;
- Business standards to promote confidence in the efficiency and fairness of markets, entry requirements via licensing and capital requirements, and the disclosure of financial statistics and information;

- Macroeconomic stability, entry and capital requirements; and
- Prudential regulation and supervision.

Above-mentioned regulatory options not only aim at correcting the market imperfections present, but also protect the consumer. Although it seems that there is minimal overlap between the options available to resolve the different market failures, some degree of overlap is inevitable. The most obvious overlap is between prudential and systemic instability regulation. While the former is aimed at addressing information constraints, it is complementary to correcting systemic instability.

Prudential regulation can be defined as “legal rules that aim to contribute to the stable and efficient performance of financial institutions and markets . . . [and] represent constraints placed on the actions of financial intermediaries to ensure the safety and soundness of the system” (Chaves and Gonzalez-Vega, 1994:56). Stated differently, they ensure that the promises made by suppliers of financial services have an acceptably high probability of being met.

The problem with asymmetric information is that the two parties involved in a financial transaction do not have the same information, increasing risk and leading to adverse selection, moral hazard and the rationing of credit. Prudential regulation therefore attempts to shift the risk away from financial institutions to the regulator, allowing institutions to take greater risk than they otherwise would. Such regulation is thus preventive rules that attempt to control the risk, reduce the probability of failure, avoid financial promises from being broken, focus on the safety and soundness of financial institutions and safeguard the stability of the financial system. Preventive regulation includes the following instruments:

- The licensing of financial intermediaries. This provides customers with a minimum assurance that the institution will not take advantage of them through false or misleading information. Licensing requirements may include requiring professional qualification or

accreditation of staff and management, a comprehensive business plan and the submission of the license holder to various forms of regulation.

- Minimum capital requirements that are intended to absorb unexpected losses. It allows regulators leeway to resolve situations of distress before a financial institution cannot honour its promises and ensures prudent management by owners. It is therefore commonly used for deposit-taking institutions since prudential regulation is involved. However, increases in the capital requirements increase entry barriers into the banking industry. The minimum capital requirement is 8% as set out in the Basle Capital Accord of 1997.
- Limiting the amount of loans granted to staff.
- Balance sheet restrictions aim at diversifying risk. This is done by preventing institutions' loan portfolios to be concentrated around individuals or groups that face similar economic risk.
- Liquidity requirements ensure that financial institutions have the necessary funds to meet any promises made, i.e. to pay out deposits when withdrawn.
- Customer support schemes that are employed by institutions in the event that the other preventive measures fail, for example deposit insurance and guarantees (Brownbridge, 2002; Brownbridge and Kirpatrick, 2000; Chaves and Gonzalez-Vega, 1994; Carmichael and Pomerleano, 2002).

In addition to reducing the risk, i.e. establishing rules of behaviour, regulators also need to monitor institutions' compliance with the rules. Supervision thus determines the risk faced by intermediaries, monitors and analyses the performance of financial markets and intermediaries, and ensures that intermediaries comply with regulations. In short, the objective therefore is to detect any problems that may result in institutions becoming illiquid and/or insolvent. Three basic methods for monitoring compliance include the following:

- Complaints by consumers to the regulating authorities, which are the least disturbing and costly approach to supervision;
- Off-site data analysis to determine the financial position of an institution, i.e. to detect any deterioration in an institution's financial position by comparing its current position to its historical experience and to that of its competitors; and
- On-site visits to determine the accuracy of the off-site data analysed and the areas in which reported information is inadequate or misleading, which is furthermore helpful to determine the extent to which an institution implements the regulating rules.

Financial markets do fail, which is to the disadvantage of the consumers, be it the depositor or borrower. In addressing the various sources of market failure through regulation and supervision, consumers are protected and markets become efficient. However, despite the measures that are in place, many formal financial institutions are unwilling to serve poor households. This leaves room in the financial market for the development of semi-formal and informal financial institutions to serve primarily the poor.

2.3.5 The continuum of the financial sector

Many studies indicate that financial markets of developing countries are characterised by the coexistence and cooperation of the formal financial sector (FFS) (financial institutions registered under the financial laws of a country that engage in financial intermediation) and the informal financial sector (IFS) (unregistered institutions providing savings and credit services), forming a continuum in terms of degree of formality. The semi-formal financial sector (SFS) (institutions or MFIs registered under special laws or exclusions to the financial laws) forms a grey area in between. Within this continuum, different types of institutions serve different types of market niches. It has been shown and will be shown further that the poor cannot fully rely on the FFS to

provide them with financial services. Therefore, both the SFS and IFS play an important role in addressing the financial needs of the poor. Furthermore, regulations within the FFS relating to capital, reserve, liquidity and auditing and reporting requirements, prevent informal and semi-formal institutions from entering the FFS.

2.3.5.1 The formal financial sector

Within the FFS, the scale of operations of individual lenders is large, transactions are at arms length and loan terms are standardised, with regulations relating to capital, reserve, liquidity, and auditing and reporting requirements. This sector accommodates large and long-term loans due to its pooling of deposits and enjoys economies of scale and scope. It is primarily organised to address the financial needs of large and medium scale industry, organised trade and commerce. These institutions are urban based, serving upper-income households with low outreach levels in rural areas, excluding from the outset the rural section of the population – denying a large part of the population access to financial services. The FFS covers a wide variety of institutions: central, commercial, merchant, development and savings banks, insurance companies, social and security schemes, mutual building and loan associations.

Ghate (1992a) argues that the FFS has a comparative advantage in mobilising savings, but still neglects the mobilisation of savings from the poor. Despite substantial evidence to the contrary, formal institutions still believe that the poor cannot save. However, the poor can save. It is not the absence of demand, but rather the lack of supply that prevent poor people access to savings services. In many instances, the demand for saving facilities is greater than that for credit. Even in least developed countries, the savings capacity is often neglected, since either informal institutions are forbidden to collect savings or formal institutional regulation makes savings mobilisation unprofitable.

Small loans are associated with high interest rates. This is the result of increased transaction costs for the institution when serving smaller loans. For example, Goodwin-Groen (2002) reports that if the actual cost of a loan is \$25, the percentage cost is 0.25% for a \$10 000 loan, but 25% for a \$100 loan. This transaction cost, the cost of transferring funds from a saver to a borrower and the cost to ensure repayment are influenced by, for example, the availability and extent of communication and the infrastructure. Institutions serving the poor are too small to reach economies of scale and scope. Mismanagement and the lack of cost-reducing technologies further influence transaction costs. In order to cover the risk involved, commercial banks ask for collateral. However, the absence of collateral not only prevents the poor access to financial services, but also results in higher interest rates. Thus, the commercial banks transfer the high transaction costs onto the client, who cannot afford the high costs involved. Apart from these, the client also often carries the cost of travelling to the nearest financial institutions.

2.3.5.2 The informal financial sector

Institutions and households not served by the FFS often turn to the IFS for their financial needs, allowing the poor access to financial services. Borrowers with no collateral, for example, may obtain a loan from institutions operating in this sector based on first-hand information on the borrower. Another example would be if the loan amount is too small or the duration too short, increasing the transaction cost for the formal sector, which places the loan beyond the profitable reach of the formal institution. Thus, for these reasons the informal sector is better suited to the requirements of small and poor borrowers, rural households, low-income urban-based households, small farmers and micro entrepreneurs. Institutions in the IFS specialise in specific areas or niche markets and function outside the regulating framework of the formal sector, for example, interest rate and credit allocation policies, tax payments and reserve requirements. Institutions are thus uncontrolled and unregulated.

Personalised loan transactions, face-to-face dealings with borrowers, easy access to financial services, speedy loan approvals, willingness to serve small accounts and flexibility in respect of interest rates, collateral requirements and maturity periods, characterise the IFS. The flexibility found within this sector gives it its comparative advantage and economic rationale, with lower transaction costs than found in the FFS. As a result, informal institutions can deliver small loans to poor borrowers better than formal institutions can. However, often these institutions charge interest rates higher than commercial banks would. Goodwin-Groen (2002) explains that clients live in remote areas, have no credit history and no collateral, and are frequently illiterate. This results in higher costs involved and thus higher interest rates. However, these institutions are willing to provide these services to clients who are willing to pay (Germidis *et al.*, 1991; Ghate, 1992a; 1992b; Robinson, 2001).

This spectrum includes friends and relatives, moneylenders (pawnbrokers, finance companies and landlords) and organised groups (ROSCAs and self-help groups).

- Friends and relatives borrow from one another. These loans are small amounts with no interest charged, no collateral required (although the relationship between the parties act as substitute for collateral) and open-ended repayment terms.
- Moneylenders lend to clients based on good information about them and earn interest on the information possessed. Moneylenders serve those borrowers with no access to credit from friends and relatives, or who do not have collateral to turn to collateral-based sources for credit.
- Organised groups are mutually organised groups of individuals subject to the rules and regulations they themselves have laid down and agreed to. Organised groups are divided into two types of arrangements: savings and credit arrangements combined, e.g. ROSCAs, and savings and credit arrangements only, e.g. self-help groups. ROSCAs are found in a

variety of forms in rural and urban areas throughout developing countries. Each member in the group contributes a specific amount on a regular basis, e.g. monthly or weekly, to a common pool. This pool of money goes by turn to every member of the group according to the payment period. Thus, each member obtains the pooled savings at some time. Self-help groups (SHGs) provide members with savings and credit facilities. Small groups of about twenty members are formed where each member contributes money to a common fund. They are based primarily on the principle of lending their members' savings, although external funding is also sought to expand these resources. Accumulated funds are used for specific purposes as decided by the group. SHGs also ensure members and their family access to funds in case of emergencies.

Although the formal and informal financial sector each operates where they have a comparative advantage and thus serve different borrowers for different purposes, there is interaction between the two sectors. Funds flow from the FFS to the IFS and vice versa. Ghate (1992a; 1992b), for example, indicates that in Asian countries, credit distributed by informal institutions originated from formal institutions, usually commercial banks. He also indicates that often savings mobilised within the IFS are deposited with formal institutions. Germidis *et al.* (1991) showed this to be true for some African countries as well. Therefore, there is a movement of funds between these sectors; stated differently, a linkage exists between the formal and informal financial sector. Thus, given the above, the IFS contributes indirectly to financial and economic development.

2.3.5.3 The semi-formal financial sector

In the middle of the financial continuum, a grey area is found where neither the FFS nor the IFS enjoy comparative advantages. This grey area between the two sectors can be regarded as semi-formal (registered entities under special financial laws or exemptions to these laws), serving those clients excluded from the formal financial institutions, and includes institutions such as credit

unions, savings and credit co-operatives (SACCOS) and village banks. These institutions, or MFIs, are usually licensed and operate under particular laws and regulations, and are supervised by government agencies not regulated by banking authorities. These institutions found innovative risk reducing strategies to serve the poor, provide both savings and credit services, and strive to be independent of government and donor agencies in order to reach self-sufficiency.

Credit unions and SACCOS (also referred to as financial cooperatives) provide financial services to members only and these institutions are characterised by voluntary participation; the accumulation of savings that allow members access to credit, and some common link between members, which may be residential, occupational or professional. Loans may not exceed a fixed percentage of members' accumulated savings and sometimes a minimum membership period is required before a member can apply for a loan. Depending on the country, these institutions may have different legal status. They are rural or urban based and membership fees and funds mobilised allow for savings and credit services to members.

Village banks provide savings and credit services to poor women (groups of about 30 to 50 members). An implementing agency organises the village bank and provides a loan for on-lending to individual members. The loan term of typically four months consists of 16 weekly instalments, which are collected at regular meetings. At the end of the loan cycle, the village bank repays the entire loan plus interest to the implementing agency. Loan amounts increase after each successful repayment period. Savings are also used to finance loans and thus result in peer monitoring. Although the village-banking model originated during the 1980s, many adaptations and innovations have been made to the original model (discussed further in section 3.3.2).

In conclusion, the financial system plays an important role in transferring surplus funds to deficit units within the economy. This contributes to economic growth and development. However, the

mobilisation and allocation of financial resources in an uncertain environment prevent formal financial institutions from serving the poor efficiently; leaving them without access to formal financial services. This in turn led to the development of semi-formal and informal financial institutions to address the financial needs of the poor. The next section will argue that these institutions need to deliver the appropriate financial services, build strong institutional capacity and operate under appropriate regulation and supervision. This will result in high levels of outreach and sustainability.

2.4 Preconditions for delivering sustainable financial services to the poor

The function of the financial system is to intermediate between savers and borrowers. This is true for any financial institution. However, to do this sustainably is no easy task and therefore financial institutions, MFIs in particular, must meet certain requirements. For example, it is essential to provide financial services on both sides of the balance sheet, as will be evident, with the emphasis on voluntary savings mobilisation instead of credit delivery. Institutional sustainability and adequate regulation and supervision of institutions are also important requirements. In discussing the above-mentioned requirements, consideration will be given to two opposing views, namely the traditional and financial systems approach to microfinance.

The traditional approach to microfinance argues for institutions that make credit available to poor households and are funded by government and donor subsidies. The primary goal is to reach the poor with credit. Savings is not a significant part of this approach. In terms of this approach it was believed that developing countries could not generate sufficient internal savings for investment purposes; rural areas could contribute to economic growth and development through the agricultural sector; and households could exit poverty and improve their living condition with access to cheap credit. Therefore, the injection of external funds was important. In addition, to obtain high agricultural yields, farmers had to adopt new improved technologies and this required substantial

credit. Governments established highly subsidised institutions to finance agricultural and non-agricultural activities.

During the period of subsidised lending activities, the financial sector failed to efficiently mobilise and allocate financial resources between surplus and deficit holders. Jackelen and Rhyne (2003) report that interest rate policies often remunerated savings, while interest rates on loans were below the annual inflation rate. Development institutions were required to lend money to institutions and people regardless of the risk involved, but according to government policies. This direct government intervention was an ineffective way of allocating scarce financial and economic resources and exacerbated instability in the financial sector. It further led to the development of government-owned institutions which were largely insolvent and hampered competition. Macroeconomic theory teaches that domestic private savings are an important source for providing the necessary funds for investment purposes. Without savings, investments cannot be made from domestic funds, which in turn hamper economic growth unless alternative sources of investment finance could be obtained. As a result, the financial systems of countries following this approach contracted instead of showing increased growth. Institutions experienced low repayment rates, which forced them to rely on donor subsidies. Together with interest rate ceilings, low savings mobilisation and institutional mismanagement, this led to the limited impact this policy had on the poor (Rhyne and Otero, 1994; Robinson, 2001; Schoombee, 1998; Yaron *et al.*, 1997).

The solution thus was to move in the direction of more realistic interest rates, i.e. liberalised interest rates and exchange rate policies, and a more market-orientated approach to banking. In short, allowing the financial sector to operate efficiently.

During the 1970s, institutions in Bolivia, Indonesia and Bangladesh, owing to the failure of existing policies, developed lending methodologies suitable for low income clients and demonstrated that

micro credit can be provided at interest rates that enable institutions to cover all costs and generate profits. Both the Grameen Bank in Bangladesh with its group-lending methodology and the Unit Desa System of Bank Rakyat Indonesia (BRI) showed that MFIs could reach more than 1 million borrowers with very high repayment rates during the 1980s. The BRI also showed that it could operate its micro banking system without subsidy. Bolivia's Banco Solidario – translated as the Bank for Solidarity (groups) (BancoSol) – became financially sustainable in the 1990s, less than two years after it was founded, and pioneered the access of microfinance institutions to domestic and international financial markets. Both BancoSol's and BRI's success paved the way for a new approach to micro finance with the result that more poor people have access to financial services than before. Many refer to this new view on successful financial service delivery to the poor as the micro finance revolution (Graham, 1995; McGuire and Conroy, 2000; CGAP, 2001; Matin *et al.*, 1999).

The financial systems approach, in contrast to the traditional approach, focuses on commercial financial intermediation among poor borrowers and savers with the emphasis on sustainable financial institutions. The assumption is that the poor can save and are capable of repaying loans at commercial rates of interest. It is thus accepted that demand exists for services on both sides of the balance sheet, but at the same time recognised that the demand for savings services far exceeds that for credit services. To achieve success, the following three principles need to be adhered to (Rhyne and Otero, 1994; Robinson, 2001):

- Institutions must know their markets. The poor are willing to pay for access and convenience, thus interest rates must be market determined and lending outlets located near the clients, application procedures simple and loan disbursement quickly.
- Institutions must use special techniques to reduce administrative costs. Simple procedures are needed and approvals should be decentralised.

- Institutions must use special techniques to ensure repayment, for example, have self-selected groups in which members guarantee each other's loans, borrowers are motivated and supervised, lending is progressive and savings compulsory.

2.4.1 Appropriate financial services

It was indicated above that the poor demand access to savings, credit and transmission services. It is therefore important to incorporate these needs into financial products and design techniques to deliver these services on a sustainable basis. When delivering these services, the financial system will perform its most important function, namely, intermediating between surplus and deficit units.

2.4.1.1 Savings products

Traditional theorists neglected savings mobilisation. This can be attributed, firstly, to the misconception that poor people cannot save because their income is too low and is subject to too many shocks of nature. If they do save, it is usually in the form of non-financial assets. Secondly, policies of cheap credit to institutions eliminated the need to mobilise savings to finance lending activities; and, thirdly, institutional inefficiencies to develop suitable savings instruments furthermore reduced savings mobilisation.

As a result, many different types of MFIs developed over time (Robinson, 2001). For example, in some countries MFIs (usually non-government organisations (NGOs)) are found that are not permitted to mobilise voluntary savings. Another example would be institutions that believe the poor has no demand for savings and therefore neglect voluntary savings, but that the demand for credit is very high. The third example includes institutions that mobilise high amounts of savings, but lack credit services.

Robinson (2001) argues that all these institutions cannot and will not be effective in meeting the demand for micro finance, savings and credit services. The reason is that they do not have a large enough interest rate spread to cover the operating and financial costs required to provide both services profitably. Morduch (2000) also points out that institutions that rely on government and donor funds have very little incentive to mobilise savings. Deposit mobilisation is costly to undertake and re-lending deposits results in greater losses. As a result, interest rates on deposits experience downward pressure to levels far below the rates charged on loans, giving depositors little or no incentive to save.

Those who subscribe to the opposing view, however, believe that savings mobilisation has a two-fold objective: firstly, to meet the demand of large numbers of poor people by providing secure savings services (discussed below); and, secondly, to build and improve the sustainability of institutions that provide both savings and credit to the poor by building a relatively stable means to finance their portfolios (discussed in section 2.4.2).

Concerning the first objective, savings mobilisation enjoys high priority at the local level. Institutions can either mobilise voluntary or mandatory (also known as compulsory or forced) savings. Mandatory savings require borrowers to deposit a portion of their loan amount as savings along with each loan repayment. This amount can either be a percentage of the loan amount or a nominal amount. Therefore, compulsory savings are sometimes viewed as part of the loan product rather than an actual savings product. Apart from being used as guarantee to ensure repayment of loans, these savings help institutions to build up their asset base, demonstrate clients' ability to manage cash flows and make periodic contributions, as well as demonstrate the value of saving practices to borrowers. While institutions utilising compulsory savings assume that the poor must be taught to save and learn financial discipline, institutions utilising voluntary savings assume that the poor can save. Voluntary savings products allow savers to determine the amount and timing of

deposit and withdrawals and they are either interest bearing liquid savings accounts (demand deposits), higher interest semi-liquid savings accounts (contractual savings), or time deposits (fixed deposit accounts).

With demand deposits (interest bearing savings accounts), the amount and timing of the deposit and withdrawals are not set in advance. These accounts allow savers rapid access to their financial savings at any time the institution is open. Such services enable depositors to smooth consumption, cope with emergencies, take advantage of unexpected investment opportunities and store excess cash. It also allows for transmission services. Liquid savings accounts are essential for mobilising voluntary savings from those segments of the market that previously had no access to savings services. The volume and unpredictability of transactions require more complex internal control, liquidity management and management information systems, requiring sophisticated and costly management that result in high administration costs. It is therefore the most challenging savings service to offer on a sustainable basis. These services are also associated with high liquidity and low interest rates due to rapid withdrawals and deposits.

Contractual savings (semi-liquid) accounts require depositors to regularly deposit a set amount for a set period after which the entire amount plus interest can be withdrawn. It allows depositors to build a lump sum out of small frequent repayments that is not vulnerable to day-to-day demands and to collect returns while storing savings in a safe place. It serves those that save for longer periods and for expected needs. The maturity is therefore between six and twelve months, with competitive interest rates almost market related. These services are less administratively demanding because predictable cash flows are involved and easier to offer on a sustainable basis despite the higher financial costs. The interest rate on these accounts is higher than on demand deposits.

With fixed deposit accounts (time deposits), depositors must deposit a relatively large amount for a set period. These accounts pay interest on all deposits, while restricting withdrawals; they allow savers high returns and depositors, who favour high returns instead of liquidity because they want to save for expected needs, utilise them. There is often a lower demand for fixed deposit accounts since very few of the poor have large sums of money to deposit for set periods. Costs and management requirements are lower than for liquid and semi-liquid accounts, but the interest rate is higher.

If institutions provide these savings services, the poor will be supplied with a range of deposit instruments offering different proportions of liquidity to meet their demands with reference to security, convenience, liquidity and returns. Savers are encouraged to choose an account or a combination of accounts that meet their needs. These services are provided to households as well as to local institutions, for example schools, religious institutions and local organisations such as sports and neighbourhood groups (CGAP, 2001; Ledgerwood, 1999; Robinson, 1994; 2001).

2.4.1.2 Unsubsidised credit products

Those who are amenable to the traditional view assumed that the poor, especially farmers, cannot pay the commercial costs of credit for the inputs needed and that they needed complementary technical assistance to teach them how to productively utilise the credit, since credit alone is not sufficient for productive use. Commercial banks avoided lending in rural areas as they viewed the sector as risky and unprofitable, and because borrowers often lacked the necessary collateral. Therefore, governments intervened and established highly subsidised financial institutions. Financial institutions during the late 1960s and 1970s were specifically set up by government, using their own resources, foreign grants or soft loans, and took the form of agricultural banks or agricultural credit cooperatives. These institutions were characterised by supply-led subsidised credit programmes for agricultural and non-agricultural activities that provided loans at below-

market interest rates and far below the cost of operations. Loan officials neglected the proper screening of potential borrowers to ensure repayment, while subsidised credit discouraged financial discipline, with borrowers that took advantage of institutions' lack of commitment to ensure repayment and thus encouraged corruption. These programmes often reached the better-off segments of the market, i.e. the wealthy and politically connected individuals, but reaching very few poor households (Ledgerwood, 1999; Yaron, 1994b; Yaron *et al.*, 1997; Robinson, 2001).

Supporters of the financial systems approach argue that donor and government funds are not enough to meet the unmet demand for credit evident worldwide. Only sustainable institutions can meet this demand. In contrast to the traditional approach where credit was delivered at below-market rates of interest, the new paradigm places more emphasis on commercially obtained credit and locally generated funds, i.e. voluntary savings to finance loans without external subsidies. As a result, interest rates are market related.

Rhyne and Otero (1994) and Robinson (2001) further explain that institutions need to develop new loan products. For example, small loans that increase as borrowers prove both willingness and capacity to repay; relatively short-term loans; frequent payment instalments; and loans offered to any creditworthy borrower for any viable business or household investment purpose. Concerning collateral requirements and reducing risk, character reference and joint liability through group lending are favoured. On average, group lending (34 million borrowers) is still preferred compared to individual lending (16 million borrowers) (MBB, 2003). However, according to Drake and Rhyne (2002), group-lending methodologies may begin to change over time as borrowers with strong repayment records prefer to borrow directly from the institution using individual credit products. To reduce operating costs, short and simple loan applications are used and approvals decentralised.

2.4.1.3 Transmission services

Linked to the perception that the poor cannot save is the belief that almost none, if any, funds transferred by the poor are saved, or that those who do utilise transmission services do not belong to the target group of MFIs. Amounts sent can vary between \$5 to as much as \$150 for family support, while school fees can be between \$25 and \$500. Generally, commercial banks do not operate within rural areas due to the high cost involved, excluding the poor from utilising these services. It is thus inaccessible and, when available, costly to use. For example, fees charged could reach up to 35% of the transfer value, which can easily exceed the value of the amount sent for very small transactions (Sander, 2001:8).

MFIs increasingly recognise the need for transmission services because poor families are the recipients of remittances. Global attention has been drawn to the subject as the World Bank reports on the economic importance of remittances, funding agencies explore options of funding MFIs to offer these services and new banks developed that focus primarily on the business of money transfers (Fernando, 2003:5).⁵ In addition, Sander (2001:11) reports the profitability of providing such services. As a result, more attention is given to the possibilities of providing micro finance clients with transfer facilities (institutional requirements discussed in section 2.4.2.4).

The financial system approach thus promotes institutions that deliver both savings and credit products to the poor on a sustainable basis. Of the 124 institutions reported by the Micro Banking Bulletin (MBB), 37 (30%) are engaged in providing both credit and savings services, while the remaining 87 (70%) only provide credit services. This approach also promotes MFIs with a large enough interest rate spread to cover all costs and risk, that have strong incentives to provide deposit instruments that are appropriate for the poor and to approve small loans, and to provide other financial services such as money transfers, and salary and pension payments.

⁵ In 2001, the ACLEDA Bank in Cambodia transferred \$7 million in remittance, which increased to \$28 million in 2002 (Fernando, 2003:6)

2.4.2 Institutional capacity

Financially, institutions developed during the 1950s to 1970s showed very little success (Ledgerwood, 1999; Yaron, 1994a; 1994b; 1998; Robinson, 2001; Rhyne, 2003). Inadequate planning, credit evaluation, management, monitoring and inefficient operations are some of the reasons these programmes incurred huge losses. As Graham (1995) indicates, despite near perfect loan recovery, the high costs involved prevented institutions from reaching financial sustainability. Most institutions thus remained highly subsidy dependent. The World Bank, for example, forwarded \$16.5 billion in agricultural credit to MFIs before 1992 (Yaron, 1998). Policy makers, instead of focusing on financial sector objectives, rather focused on production objectives. Directed credit improved agricultural production in the short-run, while the long-term rural development objectives were neglected. Yaron *et al.* conclude that “[t]his approach . . . constrained long-term economic growth. Only by emphasizing the quality of lending can the quantity of lending be expanded in a rapid, efficient and sustainable manner” (1997:27-8).

The financial systems approach emphasises that it is possible to develop financially successful institutions that provide financial intermediation for the economically active poor. These institutions have low or no subsidy dependence, low government involvement, tailored financial products and repayment rates above 95% (Matin *et al.*, 1999; Morduch, 2000; Robinson, 2001; Rhyne and Otero, 1994).

Nevertheless, MFIs face common problems that prevent them from reaching a high level of sustainability. These include, for example, a lack of strong management teams to communicate the objectives of the institution, a lack of appropriate services, unmotivated skilled staff, ineffective savings mobilisation, weak loan administration and ineffective loan collection procedures (Graham, 1995; Ledgerwood, 1999; Morduch, 2000; Robinson, 2001; Yaron *et al.*, 1997; Yaron, 1994 and 1994b).

What exactly are self-sufficient institutions? Initially, three levels of self-sufficiency were advocated (Rhyne and Otero, 1994). The first level includes institutions that are heavily subsidised, and revenues from interest and fees do not cover operating costs, including loan loss provision. The spread between the lending interest rate and the cost of funds is too low to cover operating costs. Institutions, which cover operating costs but not the commercial costs of loanable funds, are grouped together at level two. Although donor support is still required, institutions obtain funds on terms that are near market rates. The third level includes those institutions that are financially sustainable, implying that their revenues cover all costs (including the costs to lower the high risk) calculated on a commercial basis, thus generating profits.

As the micro finance industry grew and came of age, the above-mentioned three levels were reduced to two, namely, operational self-sufficiency (OSS) and financial self-sufficiency (FSS) (Ledgerwood, 1999). For comparison purposes, the MBB provides benchmarks on these and other relevant indicators (section 2.5).⁶

Of the 124 institutions that reported to the MBB in 2002, 66 were sustainable. Institutions that have reached OSS are able to generate enough operating revenue from credit and savings operations and investments to cover operating expenses, financing costs and provision for loan losses. The international benchmark for OSS (the average) is 140% for the 66 sustainable institutions and 153% for those targeting the lower end of the market (clients with an average loan balance of less than US\$150⁷) (MBB, 2003). Institutions that have reached OSS and generate enough revenue to also cover their cost of capital, i.e. institutions that could cover all their costs if they were unsubsidised,

⁶ The MBB collects financial and portfolio data provided voluntarily by MFIs, organise the data according to certain criteria (summarised in Table 2.1) and publish the results. This method of standardisation allows donors, investors, micro finance practitioners and other service providers to facilitate greater standardisation and a better understanding of the development of the micro finance sector. Initially, only 28 MFIs from 17 countries provided information for building a resource base in 1997. Since then, the number increased by 425% to 147 institutions from 53 countries in 2002, but decreased to 124 in 2003 due to MFIs whose data had not been updated being excluded from the 2003 publication. These institutions represent Latin America (40%), Asia (18%), Africa (17%) Eastern Europe (18%), the Middle East and North Africa (7%) (MBB, 2003).

⁷ These clients will also be referred to as the poor.

have attained FSS. The 66 institutions that reported FSS to the MBB in 2002 had an average FSS ratio of 128% and those targeting the poor 136%. The adjusted return on assets (AROA) for FSS institutions – a proxy for profitability or how well an institution uses its total assets to generate returns – was 5.7%. (MBB, 2003).

McGuire and Conroy (2000) are of the opinion that MFIs should be able to achieve FSS within five to ten years. High costs and too low interest rates to cover these costs might prevent institutions from reaching these levels of sustainability. Barrès (2002:28) reports that the age of the MFI influences profitability. According to his calculations, an increase of one year in the age of a MFI is associated with a 0.3 percentage point increase in the AROA. Added benefits are the productivity and efficiency of the institutions due to the increase in the number of borrowers per staff member and the reduced cost per borrower.

In order for institutions to reach high levels of sustainability, they need to build strong institutional capacity. This refers to “the degree to which an organization’s objectives and procedures are embedded in its day-to-day activities” (Yaron et al., 1997:100). Mobilising voluntary savings, effective loan administration, high loan repayments and the appropriate institutional structure assist in strengthening the institutional capacity.

2.4.2.1 Mobilise voluntary savings

Mobilising voluntary savings plays an important role in reaching sustainability. It not only enables clients to build good reputations and help institutions in the screening of borrowers, but also develops a sense of ownership among clients and therefore increases their willingness to repay their loans. Savings furthermore provide a source of funds to capitalise loan portfolios. All of this will in effect improve loan outreach, reduce the dependency on external sources from government and donors and increase sustainability. It furthermore serves as a mechanism for establishing a closer

relationship with a commercial bank and thus the formal financial sector. The worldwide pattern supports the view that savings are more in demand than loan products, for example, MFIs reached 29 million savers and 9 million borrowers during 2002. The total amount of voluntary savings amounted to US\$2.4 billion, compared to the US\$1.9 billion loans outstanding for the same year (Barrès, 2002:25).

To deliver savings services more effectively to clients, institutions must deliver them at positive real interest rates (a benchmark of 4.1% is reported by the MBB (2003)), provide different savings and deposit instruments (discussed above), and train staff to effectively mobilise savings (internationally the average is 104 voluntary savers per staff member for large institutions and 163 for small institutions).⁸ Staff could, for instance, collect savings on payday from local employees of factories, businesses or schools. Mobile banking is also an option in regions with low crime and high social stability. Institutions must also provide for good security, quick service and effective cash management. Access to liquid savings accounts provides savers with the opportunity to withdraw cash when the institution is open, therefore institutions must have sufficient cash on hand during opening hours. An enabling environment with an appropriate legal and regulating framework and adequate and effective supervision to protect depositors is also required. If institutions utilising savings to finance loan activities fail, it moves the responsibility away from the original funding sources, i.e. the government and donors, to the savers. The repercussions will be felt throughout the economy, which could adversely affect attitudes towards the financial system. It may also prevent the success of future projects. Thus, a dual defence against such possible failure is, firstly, strong institutional capacity and, secondly, external control in the form of prudential regulation and supervision.⁹

⁸ Large institutions have a loan portfolio size greater than \$8 million, while small institutions have a loan portfolio less than \$2 million.

⁹ Indicators to establish benchmarks on savings are still in the infant stage. A great deal of effort was put into developing indicators for credit-led institutions. The increased interest in savings has led the MBB to develop indicators to evaluate savings mobilisation along the same line as credit institutions. However, MFIs need to adjust

2.4.2.2 Effective loan administration

Loan administration includes the screening of borrowers and the processing and monitoring of loans. Screening borrowers is a costly operation due to the presence of information constraints and the absence of traditional collateral to secure loans. The adjusted cost per borrower for FSS institutions (the cost of maintaining an active borrower or client) was US\$123. The longer institutions operate, the lower the adjusted cost per borrower - for new institutions is was 108% compared to the 85% for mature institutions (MBB, 2003). Institutions use characterised lending and must train their staff to evaluate the character of borrowers by using existing social structures, for example, the official leadership structures within a village, and incorporate into the lending process social or peer groups, which are collectively responsible for the loan amount. These innovations will address some of the moral hazard and adverse selection problems experienced in credit transactions. First-time borrowers could receive loan amounts within one to two weeks from submitting the application, while repeat borrowers can expect payment within one or two days. Loan applications must be uncomplicated. This will contribute to timely loan disbursements and lower transaction costs for the client as repeat visits to the institution will not be necessary. Loan amounts should be determined according to borrowers' projected cash flow or repayment abilities. This will help institutions to avoid potential losses and encourage clients to manage their funds and build up an asset base.

2.4.2.3 High loan repayments

Continued loan losses are often the cause of institutional insolvency or persistent donor support. Institutions must therefore ensure high loan repayments. Institutions may want to create financial discipline with first-time borrowers and might require mandatory savings, which also reduces some of the risk involved. Other institutions rather use progressive loans, i.e. borrowers are allowed to

their reporting information accordingly and this process will take time. Definitions applied should thus be uniform and will gradually be added to the Bulletin's reports until all indicators have been reported. For a detailed discussion on proposed indicators, see Rhyne (2003).

re-borrow larger amounts given good repayment records. It is also necessary that institutions adjust loan terms according to the variety of financed activities and cash flow patterns among borrowers. Frequent payments (weekly, monthly and, in extreme situations, daily) ensure that borrowers do not use their accumulated cash for other purposes than to repay their loans. Staff efficiency also contributes to high loan repayment rates. Therefore, the same staff that screens potential borrowers must also be responsible to collect loan instalments, allowing more effective loan monitoring. The borrower per staff member is 132 on average and the borrowers to loan officers 359 for those institutions reporting to the MBB (MBB, 2003).

To improve the monitoring of performance of clients and even institutions, institutions need to implement management information systems. Management information systems, whether manual or through computerised spreadsheet or advanced software, enable institutions to determine their overall financial performance, track the performance of staff and financial services, especially loan repayments; and develop profiles on clients that could assist in improving existing products and developing new ones. Developing and implementing innovative techniques to make loans available and position themselves favourably in products and techniques also include credit cards, smart cards, ATMs, credit scoring, pawn loan payments through post offices or retail outlets of chain stores, hand-held personal computers, biometrics for identifying individuals and satellite-based communications (Drake and Rhyne, 2002).

2.4.2.4 Transmission services

It was stated above that there is a demand for transmission services, while on the supply side the micro finance industry is changing its view regarding the possibilities of providing such services. It is evident that transmission services can only be provided if the following requirements are met:

- The MFI needs to operate under regulatory requirements that allow for money transfers (section 2.4.3).

- Institutional capacity to manage cash. The institutions must thus have cash on hand since pay-in and payout of money transfers differ. In addition, strong monitoring and control systems must be in place.
- A business agreement with either a commercial bank or other financial institutions specifically designed for money transfers. This allows for better products, for example domestic and international transfers. The World Council of Credit Unions has, for example, gone into a partnership agreement with the New York based VIGO Remittance Corporation in order to provide credit union members with a safe, relatively cost effective and rapid transmission service.
- A management information system needs to be in operation in order to increase speed and reliability of transferring money (Fernando, 2003:7; IDB, 2004; Sander, 2001:12; Kabbucho *et al.*, 2003:28).

This service not only benefits the clients but also the MFI. IDB (2004) reports that the cost for clients can range between \$6 and \$45, depending on the amount transferred and the partnership agreement (with \$45 being extremely expensive). Kabbucho *et al.* (2003) report that in Kenya credit union members only pay a \$10 flat rate for transferring up to \$1 500. Money is sent and received within a few hours, can be deposited directly into the recipient's deposit account or used to pay the recipient's school fees or electricity provider. Pensions can be received, thus increasing safety and reducing the time pensioners need to stand in long queues. For MFIs transmission services could be complementary to the existing services provided. The increase in the number of products provided will thus attract new clients. As a result, new accounts are opened, increasing the amount of savings available for on-lending. The expansion of the MFI's business increases economies of scope, efficiency and eventually outreach and sustainability. Thus, the improvement on both the demand and supply side of money transfers can make a significant contribution to increase the welfare of the poor and low-income households. Kabbucho *et al.* (2003:29) also

suggest that MFIs could target specific niches within the sector, such as the payment of school fees, thereby ensuring a competitive service and an increased outreach in addition.

2.4.2.5 Appropriate institutional structure

In order to expand the provision of micro finance, a number of institutional structures can be considered (Germidis *et al.*, 1991; Ghate, 1992a; Ledgerwood, 1999; Rhyne and Otero, 1994; Schoombee, 1998; Lapenu, 2002). One option would be to create a new institution, which focuses on micro finance clients, for example the Grameen Bank in Bangladesh.

Another option would be to transform semi-formal institutions (NGOs and MFIs) into formal institutions. The former are more flexible than the latter in respect of interest rates, repayment schedules and loan durations, which is to the client's benefit. If, however, they move into the formal sector, they will often have to undergo several structural changes, and the regulatory policies that often prevent them from mobilising deposits, will need to be revisited. This will allow them to provide both savings and credit services. BancoSol, which transformed from a NGO, serves as a good example.

A third option involves creating specialised divisions and programmes aimed exclusively at serving micro clients in formal sector commercial banks. Banks have the infrastructure to serve micro clients successfully, for example communication networks, and access to liquidity, branch networks and the commercial orientation. However, special operating techniques are required to serve this segment of the market. Standard principles will not succeed. BRI followed this approach and obtained great success.

A fourth option is to promote links between the informal or semi-formal financial sector and the formal financial sector, i.e. using existing formal and informal institutions to facilitate financial

services rather than establishing new ones. The advantages include, firstly, that the FFS will take advantage of the lower costs the IFS and SFS experience in order to reach more poor clients profitably. Secondly, informal institutions very often experience a shortage of funds. Linkages will provide these institutions with access to commercial funds, which in turn will promote competition within the IFS. Thirdly, mobilised savings can be more efficiently used for productive investments. Fourthly, institutions will have the opportunity to provide their clients with better financial services, such as different deposit options and transmission services, and, fifthly, MFIs will have access to bank training facilities increasing the financial skills of their staff. Ghate (1992a:178) concludes that each sector has some comparative advantage and linking the sectors combine these advantages to complement each other and serve the poor more successfully, i.e. increasing outreach and sustainability.

Within the linkage literature, four models are found (Schoombee, 1998; Seibel and Parhusip, 2003). Banks may deal with informal institutions indirectly, with NGOs as financial intermediaries. With this model, NGOs are responsible for repaying the loans advanced by banks to informal institutions. Banks may also deal with informal institutions indirectly, with NGOs as intermediaries. The informal institutions are responsible for repaying the loan received from the bank, while the NGOs assist the banks in establishing new informal intermediaries and assist the latter with training and administration of credit received from banks. According to the third model, banks directly link with the individual members of informal institutions, while the latter and NGOs assist the banks in, for example, the monitoring, supervision and recovery of loans. In the fourth model, banks deal with informal institutions with no NGO involvement. This requires either that the informal institutions must be sophisticated or that the banks are willing to provide the necessary training.¹⁰

¹⁰ For a more detailed discussion on linkage strategies, see Seibel and Parhusip (2003); Schoombee (1998) and Ghate (1992a).

Thus, by establishing the appropriate institutional structure, institutions can successfully function as intermediaries between poor and/or small savers and borrowers and thereby contribute to economic development and growth. It is, however, essential that institutions providing these services be regulated and supervised.

2.4.3 Prudential regulation and supervision

Section 2.3.4 explained that within the financial sector the government plays an important role to ensure macroeconomic stability. It furthermore provides a regulatory framework in which financial institutions operate. The primary objective of regulation is to protect the solvency of the financial system, i.e. protecting the stability of the payments system on a macro level. At the micro level, it protects depositors against undue risk of losses that might arise from the failure of the institution, and it promotes the efficient performance of institutions and markets. Furthermore, supervision ensures that regulations are adhered to, risk minimised and troubled institutions improved or closed.

Proper regulation and supervision of MFIs hold benefits for both institutions and their clients. For institutions, benefits include increased access to diversified funding sources, increased speed of reaching sustainability, increased profitability and the ability to be more innovative in product offerings, increased competition amongst institutions that lead to efficiency and greater focus on clients' needs, and decreased cost of credit to clients (Christen et al., 2003; CGAP, 2001; Chaves and Gonzalez-Vega, 1994; Ledgerwood, 1999; Wright, 2000; Rosenberg, 2003; Yaron et al., 1997).

MFIs are different from conventional commercial banks and, as a result, regulations as applied to formal institutions are difficult and costly to apply to MFIs.¹¹ Although both commercial banks and MFIs are vulnerable to liquidity problems, the risk features of MFIs differ from commercial banks. This results from the client base of MFIs, which is low income and without assets, and loans that

¹¹ Christen *et al.* (2003) report that the cost of supervision of a decentralised MFI of 10 000 clients can be from 1% to 5% of assets, which is relatively high compared to the 0.1% in the case of commercial banks.

are small, unsecured, short-term and based on character. Mergers between MFIs are also unlikely. It is also difficult to apply formal monitoring procedures to MFIs because of the unsecured loan portfolios and the remoteness of institutions and clients. Therefore, no general framework exists to apply directly to the regulation of any MFI, but there is also no reason to ignore regulating MFIs. Despite the above-mentioned problems, consensus has been reached that deposit-taking MFIs need to be regulated, especially when they use deposits to finance loans and are therefore engaged in financial intermediation. This will avoid systemic risk, reduce asymmetric information and protect depositors.

In order to move MFIs into a regulated framework, either new legislation is needed or existing laws altered. Christen *et al.* (2003) explain that not enough evidence exists to justify the former since those institutions that followed this route were already very profitable when the new legislation became available to them. Therefore, it is generally accepted that existing laws need to be altered, which include the following options:

- Use the existing legal and regulatory framework. MFIs could thus apply for a standard banking license if they meet all the requirements for a commercial bank. However, the high capital requirements associated with commercial banks will prevent many MFI from following this option.
- Use an existing framework but regulate by exception. In other words, MFIs use license structures which were not specifically created for them. A government would thus give legal authorisation to grant regulatory exceptions to MFIs whose assets would fall under a modest amount that could not affect the financial system. Many MFIs followed this path in becoming a commercial bank, non-bank finance company or a financial cooperative.
- Unlicensed MFIs must use the license of licensed institutions to increase their financial services to clients. This option needs further investigation since, from a supervisor's

point of view, it is easier to supervise than to supervise an institution doing only micro finance.

- MFIs may mobilise savings on condition it is deposited in a licensed bank as soon as possible. This option would be a good way to assist institutions to first operate successfully in managing deposits and gain experience for a few years, after which it can apply for a licence to intermediate between saving and credit. It also allows supervisory authorities to regulate these deposits and to get to know the institutions better. Thus, institutions following this route may not use the savings to finance any lending activities or any other activity, except to pay out savings withdrawals, and depositors would have a priority claim on the bank accounts if the MFI failed.
- Self-regulation in which institutions develop their own supervisory and governing bodies. Requirements include an independent board with the technical expertise and authority to hold management accountable, well formulated and properly implemented internal controls and risk management policies, and high-quality auditors who are educated about micro finance. Only if these elements are combined with transparent disclosure will self-regulation be successful.
- Contracting third parties to perform the supervising functions while regulating authorities regulate the MFIs.

While regulation refers to a set of rules governing the intermediation of financial resources between savers and borrowers, supervision refers to the monitoring and compliance of these rules. Some approaches to supervision suggested by CGAP (2001), Christen *et al.* (2003) and Rosenberg (2003) include the following:

- Supervision within the existing supervisory authority, i.e. the supervisory authority responsible for commercial banks. This might include that a separate department within the agency or that bank supervisors are also responsible for MFIs. It is however

important that specially trained supervisory staff are needed given the differing risk characteristics and supervisory techniques of MFIs.

- Self-supervision, an alternative to the above, relates to the regulation and/or supervision by any body that is effectively controlled by the regulated entities. In other words, the responsibility for monitoring and compliance lies with the people who manage the institution. Christen *et al.* (2003) report that this route to supervision “has been tried many times, and has virtually never been effective in protecting the soundness of the regulated organisations” . This does not mean that self-supervision cannot be effective, but it can be asserted that self-supervision is usually unwise, especially when regulation and supervision must enforce financial discipline and conservative risk management. The reason for failure lies in the obvious fact that the supervisory institution is controlled by the parties to be supervised, which results in a conflict of interest.
- Delegated supervision, which is where the responsibilities are delegated to a third party while the supervisory agent maintains its legal authority over the supervised institution as well as monitoring and controlling the third party’s work. It must be clear that if such a third party fails, somebody must have the authority and ability to clean up the situation by intervention, liquidation or merger.
- Apexes provide MFIs with wholesale funding and is by nature of agreement the supervisory agency in order to ensure repayment of the loan.
- Rating agencies that rate MFIs also supervise the institutions.

2.5 Measuring the success of micro finance institutions

Delivering financial services sustainably to the poor requires meeting the preconditions discussed in the above section. These preconditions can be summarised as follow:

- Mobilise savings and use it to finance loans, i.e. truly intermediate between borrowers and savers;

- Develop an effective client methodology, i.e. use special lending and savings techniques adapted from the informal sector, for example, simple paperwork, small volumes per staff member, and keeping administrative costs as low as possible;
- Interest rates that will reflect the true cost of funds as well as finance a viable lending operation;
- Accountability of managers and staff, as well as operating the institution as a business not a charity;
- Building institutional capacity;
- An enabling policy environment with appropriate prudential regulation and supervision;
- Motivating all participating parties – banks, government, MFIs and clients; and
- A systematic project design towards financial sustainability, taking into account social and cultural factors and adjusting for local community conditions.

In this section, the focus turns to identifying quantitative measures needed to express the level of success of institutions active in this market. Traditionally, financial ratios – profit figures presented in standard financial statements, return on equity and return on assets – were used to measure institutions' performance. However, such analyses do not take the various subsidies involved into account. Yaron *et al.* (1997) point out that the financial ratios may increase due to increased subsidies, while the true performance of institutions deteriorates. Therefore, a new method of analysing the performance of MFI involves what the MBB refers to as international benchmarks for micro finance.

The MBB classifies MFIs according to the characteristics summarised in Table 2.1.

Table 2.1 Institutional characteristics

Age of the MFI	New: Young: Mature:	1 to 3 years 4 to 7 years over 7 years	
Scale of Operations (Gross Loan Portfolio, in US\$ ¹²)	Large:	Africa, Asia, ECA, MENA: Latin America:	> 8 million > 15 million
	Medium:	Africa, Asia, ECA, MENA: Latin America:	2 million to 8 million 4 million to 15 million
	Small:	Africa, Asia, ECA, MENA: Latin America:	< 2 million < 4 million
Lending Methodology	Individual: Solidarity Group: Village Banking:	1 borrower groups of 3 to 9 borrowers groups of ≥ 10 borrowers	
Target Market (*Depth = Average Loan Balance per Borrower / GNP per Capita)	Low-end: Broad: High-end Small Business:	depth* < 20% OR average loan size < US\$150 depth* between 20% and 149% depth* between 150% and 249% depth* ≥ 250%	
Level of Country Income	Lower and Middle Income Upper Income	GNP per capita < 3 000 US\$ GNP per capita ≥ 3 000 US\$	
Level of Retail Financial Intermediation	Financial Intermediary: Other:	passbook and time deposits ≥ 20 % of total assets passbook and time deposits < 20 % of total assets	

Source: MBB, 2003.

In order to compare findings and determine the success of institutions, benchmark indicators were developed by the MBB for institutional characteristics, financing structure, outreach, macroeconomic conditions, sustainability, operating income and expenses, efficiency, productivity, and risk and liquidity (MBB, 2003). Although traditional criteria are not emphasised, institutions still need to adhere to generally accepted accounting principles. Table 2.2 summarises two benchmark indicators.¹³

¹² The measure is regionalised to reflect differences in income levels across regions.

¹³ For a detailed summary of all the indicators see MBB (2003).

Table 2.2: International benchmark indicators

INDICATORS AND RATIOS
Outreach indicators
<u>Breadth of outreach</u>
Number of active borrowers
Number of voluntary savers
Gross loan portfolio
Voluntary savings
<u>Depth of outreach</u>
Average loan balance per borrower / GNP per Capita
Percent of women borrowers
Average savings balance per saver
Average loan per borrower
Sustainability
Unadjusted return on assets
Adjusted return on assets (AROA)
Adjusted return on equity (AROE)
Operational self-sufficiency (OSS)
Financial self-sufficiency (FSS)

Source: MBB, 2003

While reference to some indicators has already been made in section 2.3, this section is interested in the outreach and sustainability indicators, as they will be utilised in the analysis of domestic FSCs in chapter 3.

2.5.1 Outreach indicators

Outreach, a hybrid measure, refers to institutions' ability to extend financial services to as many people as possible within a given area. In other words, it is used to analyse whether an institution has reached its target clientele's demand for financial services and to what extent this had been done. Therefore, the focus is on the clients – the poor – that utilise the financial services of MFIs. This measure allows institutions to better understand their market, i.e. the needs and preferences of clients, helping them to improve existing services and develop new ones. These benchmarks also need to be considered in the context of the stated objectives of each institution, which define the target clientele. As the objectives differ, comparisons between institutions become complicated.

Information on the potential market within an area also allows institutions to gain better knowledge of their target market and furthermore allows for comparisons in relation to the general population of the area covered by the institution. This assists the institution to alter current services or develop new service products. If, for instance, the number of pensioners served relative to the service area is low, products need to be developed, or existing products altered, to reach more pensioners (Rhyne, 1994; Yaron, 1998, MBB, 2002 and 2003).

To determine how successful institutions are in reaching the poor, both the breadth (extent) and depth of outreach can be calculated (Yaron *et al*, 1997:91; Fruman and Paxton, 1998:8). The former refers to the absolute number of households or enterprises reached by the institution with different kinds of instruments, while the latter refers to the type of client reached, i.e. how deep in the pool of under-served (the poor, women, rural inhabitants and the uneducated) has the institution been able to reach. Table 2.3 summarises benchmarks for the MFIs that reported to the MBB.

Table 2.3: Outreach benchmarks for the year ending 2002Stellenbosch University <http://scholar.sun.ac.za>

INDICATORS AND RATIOS	ALL MFIs	FSS MFIs
Number of institutions	124	66
Breadth of outreach (averages)		
No. of active borrowers	15 553	22 841
Number of voluntary savers	3 345	6 019
Gross loan portfolio	US\$ 5 347 516	US\$ 10 154 579
Voluntary savings	US\$ 1 197 475	US\$ 3 282 583
Depth of outreach (averages)		
Percentage women borrowers	62.9%	61.9%
Loan per borrower	US\$ 532	US\$ 621
Loan balance per borrower / GNP per Capita	54.3%	66.4%
Savings balance per saver	US\$ 269	US\$ 258

INDICATORS AND RATIOS	SCALE: SMALL*		TARGET MARKET: LOW-END°		REGION: AFRICA ⁺	
	ALL MFIs	FSS MFIs	ALL MFIs	FSS MFIs	ALL MFIs	FSS MFIs
Number of institutions	24	8	49	18	17	8
Breadth of outreach (averages)						
No. of active borrowers	5 344	4 485	24 108	43 739	21 974	21 813
Number of voluntary savers	1 135	3 900	5 940	35 321	27 082	49 998
Gross loan portfolio	US\$ 655 893	US\$ 813 350	US\$ 3 447 287	US\$ 9 844 004	US\$ 5 273 209	US\$ 10 698 044
Voluntary savings	US\$ 22 621	US\$ 155 802	US\$ 204 132	US\$ 1 519 351	US\$ 1 308 311	US\$ 6 845 184
Depth of outreach (averages)						
Percentage women borrowers	81.7%	73.3%	78.3%	76.8%	70.8%	60.1%
Loan per borrower	US\$ 204	US\$ 270	US\$ 182	US\$ 188	US\$ 228	US\$ 398
Loan balance per borrower / GNP per Capita	23.1%	40.1%	17.6%	15.7%	69.1%	109.9%
Savings balance per saver	US\$ 33	US\$ 45	US\$ 68	US\$ 103	US\$ 105	US\$ 86

* Benchmarks for small MFIs are included because South African FSCs fall into this category.

° Benchmarks for MFIs serving the low-end of the market are included because South African FSCs fall into this category

⁺ Benchmarks for MFIs in Africa are included because FSCs fall into this category

Source: MBB, 2003

The above table indicates an average clientele of 18 898¹⁴ of which 82% are borrowers and 62.9% are women borrowers for the 124 MFIs that reported to the MBB. The 66 FSS institutions show similar results. It is important to note that institutions that are small, targeting the poor and in Africa have on average more than 70% female borrowers. In addition, these institutions have more voluntary savers than the average 18% calculated for the 124 institutions that reported to the MBB. African MFIs have on average more savers than borrowers, which shows the importance of savings services in this region.

Paxton and Cuevas (2002) have developed useful and easy to use depth of outreach indicators. They compare the average income of MFI clients, the proportion of female clients, the proportion of rural clients and uneducated clients with country averages for these variables. If a MFI serve clientele that is poorer, more female, more rural and less educated than the national averages, such an institution has a positive outreach index. Information on these variables are widely available for any programme and make their use appealing, aided by the lack of any alternatives. Unfortunately, there are limitations in this method (Zeller and Meyer, 2002). These indicators only consider clients' average income rather than the full distribution of incomes in an MFI's portfolio. It also does not relate average income to absolute poverty indicators in a country and is therefore not used by the MBB.

While the aim of micro finance is to improve the access to financial services for the poor and in so doing improve living conditions, the poor experience problems not only related to access to financial services but also access to other markets and services, such as labour, health and education. Savings and credit services will only assist the poor served by allowing them a greater range of choices to survive within their situation, given their abilities and hard work. Financial services can only be a complement to existing or future development projects, which seek to

¹⁴ The sum of borrowers and savers. The assumption is that a client is either a borrower or a saver.

remove basic constraints, and can never be seen as the only way to address poverty. Government and NGOs need to provide complementary services independently from financial services.

Apart from reaching high levels of outreach, section 2.4 indicated that high levels of sustainability are also important in order to efficiently intermediate between savers and borrowers.

2.5.2 Financial sustainability

Traditionally, MFIs relied heavily on subsidies to finance operations. However, as indicated above, such programmes had low levels of outreach and success in achieving the goals of poverty reduction and improved living conditions. Thus, the need exists to build sustainable MFIs to serve the poor.

For institutions to be sustainable, they have to be both operationally self-sufficient and financially self-sufficient (section 2.4.2). While the OSS and FSS benchmarks are generally used, Yaron (1994a) also used the Subsidy Dependence Index (SDI), which indicates the percentage increase necessary in the lending rate to eliminate all subsidies received in a given year. Stated differently, the SDI measures to what extent an institution relies on subsidies.¹⁵ The SDI thus provides a method to determine the total cost involved in supporting a MFI, allows for comparisons between similar institutions, and serves as a long-term monitoring and performance instrument.

To interpret the SDI, the following apply: The SDI has a lower bound of -100 with no upper bound. A negative figure indicates that an institution has reached sustainability, that annual profits exceed the total annual value of any subsidies received and that the lending rate could have been lowered; a SDI of zero indicates sustainability has been reached; while a SDI of 100 indicates that a doubling of the interest rate will eliminate subsidies (Yaron, 1994a; Yaron *et al.*, 1997:94).

¹⁵ The index assumes that an increase in the interest rate is the only change made to compensate for loss of subsidy (Yaron, 1994).

Although it was indicated above (section 2.4) that improved institutional efficiency contributes to sustainable micro finance delivery, Yaron (1994a; 1997) highlights four specific factors that contribute to reduced subsidy dependence.

- i. An institution must have high positive on-lending interest rates, which are high enough to cover all operating costs;
- ii. High loan collection is required, implying sound financial management;
- iii. Deposit interest rates high enough to stimulate voluntary savings mobilisation; and
- iv. Contain administrative costs.

Note that it is not the financial assistance by donors and governments that is being criticised, but the continuing thereof. MFIs need government and donor support especially during the formative stages, i.e. for start-up capital and the development of innovations. Government and donors thus need to be realistic in their approach to support the development of MFIs. It should be an incentive rather than an ongoing financial subsidy, which creates dependence. Subsidies and donor funds should be used for development and start-up purposes and not to finance artificially low interest rates as before.

Table 2.4: Sustainability benchmarks for the year ending 2002Stellenbosch University <http://scholar.sun.ac.za>

INDICATORS AND RATIOS[*]	ALL MFIs	FSS MFIs
Number of institutions	124	66
Adjusted return on assets (AROA)	0.1%	5.7%
Adjusted return on equity (AROE)	2.3%	14.6%
Operational self-sufficiency (OSS)	115%	140%
Financial self-sufficiency (FSS)	104%	128%

INDICATORS AND RATIOS[*]	SCALE: SMALL[*]		TARGET MARKET: LOW-END[°]		REGION: AFRICA⁺	
	ALL MFIs	FSS MFIs	ALL MFIs	FSS MFIs	ALL MFIs	FSS MFIs
Number of institutions	22	8	45	18	18	8
Adjusted return on assets (AROA)	-9.5%	7.2%	-3.7%	7.7%	-1.9%	4%
Adjusted return on equity (AROE)	-15.2%	19.9%	-6.7%	16.6%	-3.1%	14.5%
Operational self-sufficiency (OSS)	99%	152%	108%	153%	110%	140%
Financial self-sufficiency (FSS)	88%	137%	97%	136%	100%	131%

^{*} Averages^{*} Benchmarks for small MFIs are included because South African FSCs fall into this category.[°] Benchmarks for MFIs serving the low-end of the market are included because South African FSCs fall into this category⁺ Benchmarks for MFIs in Africa are included because FSCs fall into this category

Source: MBB, 2003

Internationally, 53% of MFIs reported to be FSS, i.e. after adjusting for subsidies, the erosion of capital and provision for portfolio at risk, they still generated enough income to cover operational costs (see Table 2.4). Of the 66 FSS MFIs, 39 were operating for longer than seven years, 56 were found in low/middle income countries, and 24 provided both savings and credit services. All the MFIs targeting the poor and in Africa have reported to be operationally self-sufficient and close to reaching FSS levels (MBB, 2003).

It is often argued that a trade-off exists between outreach and sustainability, i.e. achieving the former makes it harder to reach the latter, *ceteris paribus*. Traditionally, it was assumed that institutions serving the poor can only obtain high levels of outreach with the aid of subsidies because of a high risk of failure and low expected returns (due to absence of physical collateral, underdeveloped infrastructure, the poor being situated in rural areas increasing monitoring and administrative costs). However, the contrary has been indicated above and has been argued by scholars in the field (Yaron, 1992; Yaron *et al.*, 1997; Fruman and Paxton, 1998; Paxton and Cuevas, 2002). Institutions can serve the poor with increased outreach while maintaining and improving their sustainability, i.e. complimenting one another. Gibbons and Meehan support this line of argument when they state, “it is not the clientele served that determines an MFI’s . . . [sustainability] . . . but the degree to which its financial services program is well designed and managed” (2000:4).

The most recent research by the MBB (2005) also supports this view. They used data from 60 MFIs who submitted data sets for a minimum of four consecutive years, 1999 – 2002. Although some institutions had information for more than the required four years, this new analysis ensures that trend lines could be established in order to better analyse the micro finance industry.

Table 2.5 summarises some of the results. Sustainable MFIs reach more clients on average (both in relative and absolute terms) than unsustainable institutions. In addition, MFIs that provide smaller loans on a sustainable basis had a higher average (59 501) and total (892 517) clientele than non-sustainable institutions with 19 017 and 95 085 respectively. In other words, sustainable MFIs reach on average three times as many clients. A comparison of the average growth rate in outreach over the 4 years shows similar results. Non FSS institutions, targeting the low end of the market, had an average growth in outreach of 23% compared to the 117% of FSS institutions.

Table 2.5: Sustainability versus outreach

MFI sustainability	Number of institutions	Average number of borrowers over the period
Non sustainable institutions	11	13 364
Institutions that became sustainable	17	25 551
Sustainable institutions	32	33 398

Source: MBB, 2005.

The MBB's research also confirms previous research (section 2.4.2) which indicates that reducing costs improves sustainability. This is possible by better portfolio management, improved portfolio quality, economies of scale and institutional efficiency. Another interesting and important result from this research is that on average, clients of sustainable institutions paid five percentage points less for financial services in 2002 than in 1999.

Thus, achieving both high levels of outreach and sustainability is possible if institutions provide appropriate services, build capacity and function within well-defined regulatory and supervisory borders.

2.6 Concluding remarks

The function of the financial system is to mobilise and allocate financial resources from surplus units (depositors) to deficit units (borrowers). In doing so, it will improve the savings and investment rates of the economy and contribute to economic growth and development. However, the poor are excluded from the formal financial sector due to the information imperfections within the market. This relates to asymmetric information, adverse selection, moral hazard and credit rationing. To participate within the financial sector, the poor turn to MFIs for help.

The micro finance sector moved away from previous policies that included highly subsidised interest rates and high degrees of donor involvement to a stage where institutions strive towards financial sustainability and less donor involvement. This chapter discussed ways in which this can be achieved. The best practice could be summarised as (i) appropriate services, (ii) strong institutional capacity, (iii) appropriate institutional structure, and (iv) appropriate prudential regulation and supervision.

- i. Services focus on the needs of the poor, i.e. voluntary savings, commercially obtained credit and transmission services. Emphasis is placed on savings as a source to finance the loan portfolio, as well as interest rates that will reflect the true cost of funds and will finance a viable lending operation. While some MFIs require mandatory savings as collateral from clients before approving a loan, some offer voluntary savings services. If a MFI provides services on both sides of the balance sheet, such an institution operates as a true financial intermediary.
- ii. To provide these services, strong institutional capacity is required. These include effective deposit and loan administration, high loan repayment rates, improved operating procedures or the development of new ones, increased staff productivity and effective management information systems.

- iii. To strengthen the industry further, institutions need to consider an appropriate institutional structure. From the four possibilities identified, linking informal and semi-formal financial institutions with the formal financial sector is supported. Linkages will allow informal and semi-formal institutions access to commercial funds and training services, should improve their financial services and as a result increase outreach and sustainability.

- iv. The primary objective of the regulation of financial institutions is to protect the solvency of the financial system, i.e. the stability of the payments system on a macro level and to protect depositors at the micro level. Therefore, as with commercial banks, MFIs need to be regulated. Options available include regulation by exception or self-regulation. Apart from being regulated, institutions need to be supervised to ensure that they adhere to the regulating rules and regulations. Options available include supervision within the existing supervisory authority, delegated supervision or an apex body that provides wholesale funding and is therefore by nature the supervisory agency. Self-supervision is not suggested at all.

In order to measure the success of institutions, international benchmarks are available. Both outreach and sustainability indicators were emphasised. Those excluded from the formal financial sector are usually the poor, women, uneducated and rural clients whom MFIs need to serve, i.e. increasing the depth of outreach. As stated before, MFIs moved away from an era of highly subsidised operations and work towards reaching financial sustainability – to operate without continuing financial support from donors and government. This in turn is a precondition for the stability and permanence of the micro finance sector.

In conclusion, the poor do not always have access to formal financial services. MFIs thus face the challenge of supplying the poor with financial services that are demanded on a sustainable basis. Given the preconditions for successful delivery of these services, it can be concluded that a crucial nexus between institutional and product design, type of clientele served, loan sizes and sustainability exists – the more efficient the design, the greater the demand and prospects of financial sustainability.

Using the above-mentioned success criteria, Chapter 3 discusses financial services cooperatives (FSCs). It investigates the success or failure of this initiative to serve the poor on a sustainable basis.

CHAPTER 3

AN ANALYSIS OF FINANCIAL SERVICES COOPERATIVES

3.1 Introduction

South Africa's formal financial sector, comprising of the banking sector, securities firms and insurers, is regarded as highly sophisticated by world standards; it is highly developed, well regulated by appropriate financial laws, has access to adequate capital resources, infrastructure and technology, and is well supervised. However, the services this sector provides are often unsuited to the needs of the poor (those earning less than R2 195 per month), preventing them from accessing the benefits these financial services include.

This worrisome fact led to a declaration by the Nedlac financial summit in 2002, which stated that "every South African resident should have access to affordable and convenient payments and savings facilities" (Financial Sector Summit, 2002). In addition, the Financial Sector Charter was released in October 2003 with the objective to "substantially increase effective access to . . . financial services to a greater segment of the population"(Financial Sector Charter, 2003:9), especially to the poor and very poor. The Charter reflects the commitment of the financial sector to address economic inequities and inequalities and skills development, and to be in partnership with government and other stakeholders. This will make the economy and the financial sector inclusive without adversely affecting standards or the stability of the financial sector.

The Bank Supervision Department estimates the size of the micro finance industry in South Africa to be R14 billion (R1 046 billion for the FFS) and the value of loans written per annum to be R25.8 billion (R17 490 billion for the FFS). The micro finance sector is thus relatively small compared to the formal financial sector and contributes approximately 2% of the overall financial sector in Rand terms (Bank Supervision, 2002:4). As will be indicated below, poor households utilise these micro

financial services to finance life-cycle events, emergencies and investment opportunities due to the lack of access to formal financial services.

This chapter aims at analysing financial services cooperatives (FSC), also known as village banks. The first section (section 3.2) discusses the demand and supply of financial services within the South African financial sector. It indicates that especially the poor, those earning less than R2 195 per month (67% of the population) struggle to obtain access to financial services (78% of these are unbanked). The more impoverished, the more difficult it becomes to obtain access to financial services. The section also indicates the limited amount of financial services provided within rural areas, but concludes that institutions such as FSCs and SACCOs show much potential in serving the poor.

Before discussing the FSC model in detail, attention is given to the lessons learned from the very successful German cooperative movement, as well as to the principles of village banking (section 3.3). The reason for addressing these initiatives is the success they have had in reaching the poor on a sustainable basis and to compare them with the FSC movement. Attention is then given to the FSC model. The important issues within the FSC context are the legal framework under which FSCs operate (section 3.4), the financial services FSCs provide (section 3.5), their relationship with commercial banks (section 3.6) and their regulation and supervision (section 3.7).

Current legislation prevents FSCs from reaching more people. Yet, as section 3.4 and 3.8 will indicate, a new proposal has been tabled before parliament that is in accordance with international findings. In addition, section 3.7 argues that with better regulation and supervision FSCs will be able to reach more people than is currently the situation. Too often FSCs were left to their own devices. To conclude this chapter, FSCs' results are compared with international outreach and sustainability benchmarks (section 3.9).

3.2 The South African financial sector

The financial sector comprises of formal financial institutions (e.g. securities firms, insurers and banks), semi-formal institutions (e.g. FSCs, SACCOs) and informal institutions (e.g. moneylenders, ROSCAs). Of these, the banking sector is the largest. Their total funds (capital, reserves, deposits and loans) were R1 046 billion at the end of 2001, increased to R1 100,8 billion during 2002 and reached R1 377,6 billion at the end of 2003. Of the 22 banks in operation, the four biggest banks represent 81% of the banking sector, while the five biggest represent 86% (Bank Supervision, 2002:4; 2003:4; 2004:4).¹ A 2001 analysis estimates the size of the IFS to be R14 billion and the value of loans written per annum to be R25.8 billion (HSRC, 2001:96). Despite this sector being relatively small, i.e. approximately 2% of the FFS, it plays an important role in providing financial services to those not having access to formal financial services.

Despite the size of the banking sector, 35% of the adult population is unbanked (FinScope, 2003). The most important challenges this sector faces include responding to the demand for access to financial services and the limited credit extension to entrepreneurs. By addressing these issues, the banking sector will contribute towards higher savings mobilisation and credit allocation that will spill over into enterprise creation, stimulate higher demand for goods and services in the economy as a whole and thus boost economic growth. It has been argued before that the financial sector positively contributes to economic growth and development. It further leads to the reduction of inequalities and poverty. Requirements to successfully address the above-mentioned issues, for example, include continued financial stability, increased access to financial services for a greater segment of the population, developing a savings culture, directing pooled savings towards growth stimulating investments, and skills development within the sector (Financial Sector Charter, 2003:5).

¹ The five banks are Standard Bank, Nedbank, ABSA, First Rand and Investec Bank (Bank Supervision, 2004:83).

When looking at the banking sector more closely, it is evident that the demand for banking services differs between different income groups. As a result, different categories of banking institutions were created and banking legislation and regulation tiered according to institutional features and different market niches. On the first level, 22 banks operate that are registered under the Banks Act of 1990. These institutions meet the minimum capital registration requirements of R250 million and serve government, businesses and individuals that meet the requirements set out by the banks. The second level comprises of two banks registered under the Mutual Banks Act of 1993, as well as narrow and core banks (none registered yet as legislation are still under review). The two mutual banks meet the capital requirement of R50 million and supposedly serve those excluded from the commercial banks.² However, provision must be made for those institutions operating at the third level of banking. Third-tier banks can be defined as “community deposit-taking institutions, with full acknowledgement of the contribution these institutions can make in providing needed financial services to members of the community not served adequately or served at all by the first and second tier banks” (ECI Africa, 2003a:21). These deposit-taking institutions, i.e. FSCs, SACCOSs, stokvels (a type of ROSCA) and burial societies are currently regulated in terms of exemptions from one or more of the relevant acts that regulate the banking sector.

It will be indicated below (section 3.2.2) that given the unmet demand for financial services, institutions operating at the third tier show important potential to address the supply constraints commercial banks experience.

3.2.1 The demand for financial services

In order to analyse the utilisation of financial services, the Living Standard Measure (LSM), which measures the standard of living of people according to particular variables and divides the population into ten distinct groups (LSM 1-10), is used.³ During 2002, FinScope (2002) used a

² Section 3.4.2 will indicate that unfortunately, mutual banks do not show much success in South Africa.

³ Variables include possession of durables such as television sets, radios, type of house etc.

sample of 875 households to examine and report on the number of people utilising financial services. Unfortunately, the survey excluded those living in rural areas. The report states that

- Twenty-two per cent of the urban and peri-urban population is banked, i.e. have access to an ATM card or savings account, and in addition a current or cheque account and/or a credit card. These people at least completed secondary education and in many cases also tertiary education, are 35 years or older and can be grouped in LSM 8-10.
- Thirty-seven per cent is partially banked, i.e. have only access to an ATM card or savings account. They are between 25 and 34 years of age, live in informal or township areas and are mostly in LSM 3-8.
- Thirty-seven per cent of the non-rural population is unbanked, i.e. do not even have an ATM card or savings account. This group is less educated, than the banked and the partially banked groups, requires assistance in their own language to access financial services, lack steady cash flow and is in LSM 3-5.
- Four per cent of the population is not segmented.

The 2003 FinScope survey included rural areas and represents 26 928 806 South African adults who are 18 years and older. Some of the characteristics of the population identified by this survey are summarised in Table 3.1 below:

Table 3.1 Population according to LSM indicators⁴

LSM groups	1	2	3	4	5	6	7	8	9	10
% of population	67%					18%		15%		
Population (million)	5.3	6.5	6.1	6.1	5.8	5.5	2.4	2.3	2.2	2.1
Adults (million)	3.0	4.1	4.2	4.0	3.6	3.6	1.7	1.7	1.6	1.5
Av. Monthly household income (R)	770	879	1104	1534	2195	3575	5504	7427	10561	21591
% Working full time	17	17	19	20	20	27	31	38	35	49
% Working part-time	9	9	13	9	8	6	9	6	6	9

Source: Porteous, 2003b :6; FinScope, 2003.

⁴ The table excludes those people earning social transfers, which amounts to 5.5 million people.

The table indicates that 67% of adults earn an average income of R2 195 or less per month.⁵ They are regarded as the relatively poor and fall in LSM 1-5. Seventy-eight per cent of them are unbanked, i.e. do not have access to a formal bank account, while 86% of those in LSM 1-3 (the poor) are unbanked (Porteous, 2003b:3). According to international criteria, a person is defined as poor or relatively poor if the income is less than \$1 or \$2 per person per day respectively. In accordance with the international criteria, persons earning less than R1 440 (18 million adults and roughly in LSM 1-3) and R2 880 (29 million adults and roughly in LSM 1-5) per month are classified poor and relatively poor respectively. Porteous (2003b:3) furthermore reports that the majority of the wealthier urban people (LSM 6-10) tend to be banked, while the rural and peri-urban population who are mainly poor (LSM 1-5) tend to be unbanked.

Overall, 51% of the population is banked. They are mostly wealthy (almost four fifths of LSM 6-10 are banked), live in urban areas and 85% are employed. Thirty-six per cent of the population were previously banked. Poverty and unemployment are the main reasons why these people no longer use their bank accounts. The 13% that are unbanked comprise of young (33%), black (88%), rural (52%), poor (86% in LSM 1 – 5) and unemployed (52%) people. South Africa, in this regard, compares fairly well to Mexico (43% banked) and Brazil (48% banked), both middle-income countries (Porteous and Hazelhurst, 2004:21-29).

Table 3.2 provides further information on the banking status of the relatively poor in South Africa. Of the 17.8 million relatively poor within urban and rural areas, 67% are unbanked. According to FinMark (Porteous, 2003b), the numbers relating to percentage working and household monthly income (Table 3.1) influence access to financial services since some income is necessary to afford these services (78% unemployed are unbanked). For example, the ISRDS (2000:9) reports that rural households' sources of income include reliable remittances (9.9%), unreliable remittances

⁵ Those who receive income from not working, for example, social transfers and pensions, are excluded.

(16.2%), pensions (11.4%), wages (58.2%), and some households have no income and are totally marginalised (4.3%)

Table 3.2 Classification of population earning less than R3 000 per month

Segment	Size	Urban	Rural	Banked	Unbanked
Employed/partially employed	5.2m	67%	33%	48%	52%
Unemployed/unsupported	5.0m	90%	10%	22%	78%
Township youth	3.0m	100%		30%	70%
Supported family	2.4m	5%	95%	33%	67%
Pension/grant	2.2m	55%	45%	27%	73%
Totals	17.8m	12.3m	5.5m	5.9m	11.9m

Source: ECI Africa, 2003a:33

The fact that the rural population is unbanked, does not imply that they do not want financial services. Local studies (Strauss Commission, 1996a; 1996b; Spio *et al.*, 1995) indicated that it is not the lack of demand that prevents the poor from access to financial services, but rather the limited supply. The international literature (Rutherford, 1999; Robinson, 2001) shows conclusively that they demand a variety of financial services, of which savings and credit services are the most important. Apart from these, the demand for better electronic transmission services also exists because of the poors' extended family networks and extensive rural-rural and urban-rural migration. Such services will allow transmission between urban and rural areas as well as within and between rural areas. Of the 45% pensioners and grant recipients in the rural areas of South Africa and 55% in urban areas, only 27% in total are banked (ECI Africa, 2003a:33). Schoeman (1996a:5) further indicates that approximately a third of net earnings earned in urban areas throughout South Africa

are remitted toward rural areas. Social transfers or pensions are also an important, if not the only source of income for many rural households.

The rural poor in South Africa face many constraints in obtaining financial services. The most important problems, which correspond to the international findings (section 2.3.5.1), include:

- High transaction costs. These include the costs of travelling to the nearest town, which is estimated between 30 to 80 km with costs between R10 to R50, plus a day or two on the road; frequent visits to the bank; and long time lapses between application and approval of loans. Often these costs are so high clients prefer informal methods of savings and borrowing.
- The lack of appropriate collateral. Formal financial institutions evaluate rural applications in terms of traditional asset-based security requirements. Land title is most commonly accepted despite rural people living on communal land. Rural communities are furthermore forced to build up economic reserves in the form of livestock as an alternative means of investment. However, financial investments provided by banks have a wider usage than livestock (Bonti-Ankomah and Chamba, 2000; Schoeman, 1996a; HSRC, 2001).

In conclusion, there is a low utilisation of financial services in rural areas. Although there are some constraints in accessing financial services, the limited supply of these services is also a contributing factor.

3.2.2 The supply of financial services

The supply of micro finance services is summarised in Table 3.3, which considers both savings and credit services. The estimated rural coverage by each institution is also given.

Table 3.3 Supply of micro finance services (1999/2000)

Retail Institutions	Loans Rm	Savings Rm	Outlets	Estimated % Rural	Loan Accounts	Savings Accounts
Public Sector	330	1 646	2 440	36	78 000	2 840 000
Land Bank	30		25	80	43 000	
Provincial Parastatals	300	600	50	80	35 000	840 000
Post Office Outlets		1 046	2 365	35		2 000 000
Private Sector	12 599	4 661	17 132	38	7 951 580	4 740 100
NGO's	108	5	30	35	66 000	
FSCs (Village Banks)		1	10	100		1 100
Credit Unions	9	10				6 000
Cooperatives			1 200	80		
Commercial Banks	12	4 000	4 000	33		4 000 000
Retail Stores	5 000		1 000	35	2 173 913	
TEBA Cash	130	600	172	40	86 667	700 000
Private Sector						
Agricultural firms	40	45	20	100	25 000	33 000
Registered Small Loans	7 000		5 700	35	5 600 000	
Industry						
Pawnbrokers	300		5000	35		
Informal Sector	400	1 760	1 150 000	35	0	14 750 000
Mashonisias / loan sharks	150		25 000	35		
Burial Societies		1 560	325 000	35		6 500 000
Stokvels	250	200	800 000	35		8 25 000
Total	13 329	8 067	1 169 572	35	8 029 580	22 330 100

Source: HSRC, 2001:98

It is estimated that of the 19 572 formal retail outlets 37% are in rural areas, while an estimated 35% of the 1 150 000 informal outlets operate in rural areas. Both FSCs and private sector agricultural firms operate exclusively in rural areas (100% coverage), followed by the Land Bank, provincial parastatals and cooperatives (all with an 80% rural coverage). Commercial banks have the lowest coverage of only 33%.⁶ It is further reported that at the end of 2002 total micro loans and micro advances granted by banks amounted to R13.6 billion (Bank Supervision, 2003:33).

⁶ See HSRC (2001:98-111) for a more detailed discussion of each Retail Institution.

As mentioned earlier (section 2.3.3 and 2.3.5), financial intermediation involving the poor is costly and difficult given certain constraints and problems. These include the following:

- Inadequate policies: These policies created a dualism within the financial sector because the FFS caters for the needs of higher income people and the IFS caters for the lower income groups. Legislation like the Banks Act with excessive capital requirements, prevents third-tier institutions from registering as banks and thereby intermediate more successfully between borrowers and savers (section 3.4).
- High transaction costs: Bonti-Ankomah and Chamba (2000:43) indicate that transaction costs for formal institutions are higher than that of informal institutions because of the maturity of the financial system, the nature and extent of transport and communication facilities available, the nature and extent of financial regulation, difficulties of specialised institutions in reaching economies of scale and economies of scope, information asymmetries and mismanagement. Porteous and Hazelhurst (2004:38) report that on average the monthly cost of serving a lower income customer is R32, compared to Brazil's R10.30, Mexico's R118.00 and Kenya's R1 047.50.⁷
- High interest rates: Institutions need to compensate for borrowers' lack of collateral and cover operating costs, and therefore charge high rates of interest.
- The lack of or inadequate savings mobilisation: Low savings rates are associated with poor access to services and not to the rural people's inability to save. As has been argued before, the poor can save and want to save money. The Strauss Commission (1996a; 1996b) also emphasised that financial intermediation is more successful if institutions operate on both sides of the balance sheet. However, as will be discussed in section 3.4, institutions are restricted from mobilising savings if they are not registered under the Banks Act of 1990 constraining access to funds for on-lending.

⁷ The transactions include withdrawals, deposits and statement requests.

- Lack of competition: Commercial banks cater for the higher end of the financial market while MFIs cater for the lower end. Meagher and Wilkinson (2001) are of the opinion that competition, entry and innovation are significantly constrained at the lower end of the banking and financial services market.
- Collateral problems: Rural people live on communal land, which banks do not accept as collateral. These people often also do not have sufficient savings and no credit records.

The previous section indicated that it is mostly those in LSM 1-5, which include the rural population, that struggle to obtain access to appropriate financial services (78% unbanked). To address this serious problem, the FFS is, in terms of the Financial Sector Charter (2003:9), committed to increase access to financial services effectively for people earning an average monthly income of R2 195 or less.⁸ By 2008, the charter aims to improve the situation for these people in such a way that:

- Eighty per cent will have effective access to services to access and transfer cash for day-to-day purposes;
- Eighty per cent will have access to bank savings products and services, for example savings accounts and contractual savings products;
- Six per cent will have access to short-term risk insurance products and services, for example funeral, house and health insurance; and
- A percentage (still to be finalised) will have effective access to life insurance industry products and services.

If these objectives are met, the financial services landscape will definitely change for the better.

The first annual report ending 31 December 2004 only needs to be submitted by 31 March 2005.

That report will provide some indication of what can be expected in the future.

⁸ The Charter defines financial services to include access and transfer of cash for day-to-day purposes; savings products; credit for low income housing, agricultural development, insurance products and establishing or expanding black SMEs.

In the meantime, the unmet demand still exists. The HSRC states that “[u]nless rural communities expand their own initiatives; access to micro-finance . . . can be expected to deteriorate rather than improve in the foreseeable future” (2001:123). This is why it is important to focus on institutions that operate within the rural communities, utilising the community’s resources combined with formal financial methods to serve the poor. These institutions are referred to as member-based financial institutions because they rely on their members to contribute to the capital of the institution and the power of collective actions. Examples include ROSCAs, burial societies, FSCs, and SACCOs. Estimations with regard to number of members and amount of savings in these institutions are summarised in Table 3.4.

Table 3.4 The supply side of member-based financial institutions

Institution	Number	Members	Savings
Stokvels (ROSCAs)	800 000	8.25m	R400 m/month
Burial societies	250 000	8m	R200m/month
FSCs	62	80 000	R40 m
SACCOs	28	13 000	R20 m

Source: ECI Africa, 2003a:33

Figures on the amount of credit are unfortunately not available. The savings of SACCOs and FSCs together amount to 0.005% of the total deposits in the banking sector.⁹ ECI Africa states that “a conservative estimate of the market potential of membership-based financial institutions is 1 500, with a potential membership base of 2.25 million and a savings portfolio of R1.125 billion” (2003a:34). There is thus still more potential within this segment of the market, and member-based financial institutions can play an important role in providing financial services to the poor. However, success cannot be reached within the short-term. The latest information (as at June 2004)

⁹ The deposit base of the banking sector amounted to R795 billion at the end of 2003 (Bank Supervision, 2004).

shows that only 53 FSCs are registered with 32 909 members in total and a portfolio size of R5.5 million. This is much lower than the estimated results in Table 3.4 and will be discussed in section 3.8 (FSC information, 2004).

In conclusion, with only 51% of South Africans being banked, much still needs to be done to improve access to financial services especially for the poor. The Financial Charter aims at improving the situation by focusing on first- and second-tier institutions. However, third-tier institutions have the potential to serve more poor people than is currently the situation.

3.3 Financial services cooperatives

It was argued above that third-tier institutions can contribute to successfully deliver financial services to the poor. Many of the poor are situated in rural areas and, as section 3.2.1 indicated, it is primarily they who struggle to obtain access to appropriate financial services. Amongst those institutions mentioned, it is only FSCs that operate exclusively in rural areas.

A FSC is a financial institution through which micro finance services are extended to unbanked rural households, i.e. creating access to basic banking services on a sustainable basis. It utilises a community's rules, customs, relationships, knowledge, solidarity and resources combined with formal financial methods and concepts. The FSC is initiated, owned, financed and managed by the villagers themselves, who buy shares in the FSC. Therefore, members of the FSC are jointly responsible for its success. The shareholding structure of the FSC allows for easy entry for new members, thus not only increasing the FSC's outreach but also resulting in the villagers' commitment to the success of the FSC. It targets both the poor and better-off segments within the community and in this manner further increases outreach (Jazayeri, 1996; Pearce and Helms, 2001; FSA, 2001).

Schoeman (1996a) reports that IFAD and AFRACA launched the first FSC during November 1994. Five villages in the North West province showed interest and during 1994 and 1996 three of these established a FSC, namely, Kraaipan, Lotlhakane and Motswedi.¹⁰ Other stakeholders were mobilised to form a consultative group, which included First National Bank, ABSA, Bophuthatswana Building Society, the Community Bank, the regional Reconstruction and Development Programme office in that province, Agricolor SA, the Development Bank of Southern Africa, the Rural Finance Facility, Shade, and Income Generation Projects for South Africa (Schoeman, 1996a; 1996c; ECI Africa, 2003a:12).

The purpose of these FSCs was to create financial institutions that will allow rural people access to financial services by reducing the transaction costs of services, increasing the amount of savings mobilised, reducing information cost and providing loans. This will allow for the circulation of resources within the community since available funds will be reinvested within the community. Membership could be obtained through the buying of shares, which will allow members access to the financial services provided by the FSC. Members include pensioners, families of migrant workers, farmers, traders and shop owners, informal and formal businesses, schools and churches.

The FSC concept was new to South Africa and the purpose of the above pilot project was to develop the concept and products to such an extent that it could be replicated in other areas. Attention had to be given to the legal framework in which they operated, as well as to the involvement of the commercial banks. As a result, more FSCs were developed and established in villages throughout SA. From the outset, the FSC project was a joint venture between the rural communities, the private sector (commercial banks) and the government. In order to understand the underlying principles of FSCs (registered as cooperatives), it is essential to discuss briefly the principles of both cooperatives (with special attention to German cooperative banks) and village

¹⁰ These FSC are still in operation. Kraaipan has 1 575 members and a portfolio of R864 774, Lotlhakane has 904 members and a portfolio totalling R382 523, with Motswedi having the most members, 1 892, and a portfolio worth R1. 8 million (FSC information, 2004).

banks. German cooperative banks show great success in serving a vast majority of the German population, while the more informal village banks focus on serving the poor.

3.3.1 Cooperatives as banking institutions

A cooperative is usually defined as “an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise” (De Lange, 2003:2). In other words, it is an association with emphasis on voluntary participation, focused on serving its members and in the process the community as a whole, and improving their lives. Initially, cooperatives were widely used for agricultural purposes, but now also include other services such as housing and medical assistance. As a result, the interest in and membership of cooperatives grew and 800 million people internationally are members of cooperatives (Phadu, 2003:2).

The first cooperative as a business entity originated in Rochdale, England, in 1844 when weavers in England experienced terrible living conditions. Twenty-eight workers of the textile industry, under leadership of Charles Howarth, established the Rochdale Society of Equitable Pioneers on 24 October 1844. The objectives of this cooperative were to address the needs of better housing, employment, food, education and other social needs of the members by means of cooperation of all the members of the cooperative (Spaul and Kay, 1947:17-22).

In Germany during the late 1800s, farmers started to change production from subsistence farming to production for the markets, and therefore the importance of money and capital increased. However, farmers had limited access to credit services and often lacked the necessary collateral requirements to obtain a loan. Many had to rely on credit from shopkeepers, agricultural dealers and moneylenders. Responding to these conditions, Herman Schulze-Delitzsch founded several credit cooperatives, focusing on urban areas, during the 1840s and 1850s. In 1864, Friederich-Wilhelm

Raiffeisen set up the first credit cooperative, modelled along the lines of its predecessor, to operate in rural areas – the so-called Raiffeisen Bank.

The objective of the Raiffeisen and Schulze-Delitzsch cooperatives was to provide savings and credit services in urban and rural areas by developing the idea of self-help. Since then, German cooperatives have shown great success in addressing the needs of its members, contributed to the development of the German economy and especially addressed the financial and social needs in rural areas.¹¹ For example, Germany had 80 cooperatives in 1870, which increased to 21 000 by 1925. In 1999, 9 500 cooperatives operated in Germany in five sectors, namely agriculture, banking, small-scale industry/service sector, housing and consumption, with 20 million members; that is roughly every fifth German.¹² Of the 9 500 cooperatives, 21% (2 037) operate as cooperative banks serving 14.9 million members with a balance sheet of 900 billion Euro (DGRV, 2001). These cooperative banks are organised into three tiers. Local cooperative banks (2 034) operate at the first tier, while two regional banks operate at the second. Local banks established these two banks mainly for managing their surplus liquidity and for refinancing purposes. The national cooperative bank operates at the third tier. It provides a wide range of banking services to both the cooperative banks and domestic and foreign companies (Harms, 2001; Guinnane, 2001; DGRV, 2002).¹³

Legally, German cooperative banks are registered under the Cooperative Act, which regulates the organisation and structure of the banks. As banks, they are furthermore registered under the Banking Act, which regulates their activities, for example, liquidity requirements and capital

¹¹ Cooperative banks also operate in the United States of America, Bolivia, Chile, Colombia, Argentina and Brazil (DGRV, 2003).

¹² In South Africa, three forms of cooperatives can be legally established, namely agricultural, special farming and trading cooperatives. Trading cooperatives include home industry, buying, mutual aid, transport, financial services and housing cooperatives (De Lange, 2003:4).

¹³ Ramesha (2003:3) reports similar findings for the cooperative movement in India. Ninety-two thousand cooperatives (Primary Agricultural Credit Societies) serve rural areas. Three hundred and seventy-six District Central Cooperative Banks operate at the second level, overseeing the operations of those at the first level. At the top 29 State Cooperative Banks serve all member cooperatives.

structure. This act contains a broad definition of banking, distinguishes 12 broad types of banking services, and prescribes different capital and prudential requirements to each type of bank, depending on the banking services provided. Cooperative banks are not registered under any exemption to the Banking Act. Bezuidenhout and Delpont (2001) advocate this as a key factor in the success of cooperative banks.

Regional cooperative audit federations under the authority of the Deutscher Genossenschafts- und Raiffeisenverband (DGRV – German Cooperative and Raiffeisen Confederation) conduct banking supervision of cooperative banks. This supervision includes traditional audits that include a financial and managerial assessment. The regional audits are submitted to the Bundesbank, the German central bank. If an audit report indicates anything suspicious, the Bundesbank will conduct an on-site inspection. In turn, the Bundesbank submit regional summaries to the Federal Banking Supervisory Office (BAKred), which reviews the audits and if necessary set corrective actions. One problem with this approach to supervision is that, if a cooperative bank does experience any problems, the corrective measure might reach the bank too late since the BAKred receives audited information too late.

The experience of German cooperative banks supports the widespread view that carefully designed MFIs can take advantage of local community ties and provide banking services to the poor on a sustainable basis.

As mentioned above, cooperatives developed from the idea of people joining hands to solve their economic problems together, i.e. the principle of self-help. To become a member of a cooperative, a person must buy a share, which is redeemable at par. Shares allow a member voting rights (one member, one vote), contribute to the cooperative's capital and allow members to benefit from the services provided. Members are thus jointly responsible for the performance of their cooperative.

Decisions and policies are made democratically by the members, thus all decisions have the backing of the members; they can influence the type of services to be delivered and thus have a sense of loyalty to their cooperative.

Success factors of cooperative banks relate to their ability to provide their members with both savings and credit services and follow a savings first strategy. Graham (1995) and Harms (2001) explain that this approach allows institutions to better train financial managers since savings services are easier to manage than credit services, thereby improving the managerial capacity. Membership helps members to feel they are contributing to the development of their cooperative since their own contribution (shares) to the capital fund prevent them from developing a perception that loans do not have to be paid back; it also helps the cooperative to become financially sustainable. Members also learn that it is sometimes better to postpone current expenditure if possible until the required amount has been saved than it is to borrow the money and pay interest (following a savings up approach).

Once a cooperative bank shows success in managing its savings, it can start providing credit services. Credit services are often associated with problems of asymmetric information (adverse selection and moral hazard) and therefore require enforcement contracts. However, Guinnane (2001:370) and Graham (1995) explain that cooperative banks as savings first institutions can overcome these problems. Cooperatives are limited to a specific small geographical area where people enjoy considerable knowledge of each other's character and abilities. This access to low cost information affords cooperatives the benefit of screening potential members as well as monitoring existing borrowers. To further address above-mentioned problems, co-signers can secure loans. This implies that the cooperative has substantial information and enforcement capabilities.

It has been argued before that credit alone is an inappropriate tool for solving the financial problems of the poor and that subsidised credit prevents institutions from becoming financially sustainable. Cooperatives deliver credit services at commercial rates of interest and provide their services in ways that keep operating costs low. They follow a policy of slower growth, but more sustainability by not letting members borrow beyond their proven means of payment. The objective of a cooperative is to address the needs of its members; therefore, savings and credit services need to be tailored to the members' needs. Thereby, members are self-responsible for their cooperative and their commitment determines the success and sustainability of the service provided.

3.3.2 The methodology of village banks

The village-banking concept originated in Bolivia during 1984 when John Hatch established the Foundation for International Community Assistance (FINCA). By 2002, twenty countries worldwide implemented the same model with the main goal of reducing poverty by providing credit to 227 388 women in more than 15 000 groups and thereby increasing their income.¹⁴ To meet this objective, village banks act as self-help organisations and empower the poor by building local capacity.

According to the original model, a village bank works with groups of thirty to fifty members, usually women. Membership is based on self-selection. These members are jointly the owners of the bank and responsible for its governance. The bank provides both savings and credit services to its members. The amount a member saves, determines the size of the loan amount. According to Kasi (2003), the requirement can be between 10% to 20% of the loan amount. Therefore, each subsequent loan increases proportionately with the amount of savings mobilised by the bank from each individual member. If the member reaches a loan ceiling of US\$300, which usually occurs

¹⁴ FINCA aims at serving 450 000 clients by the end of 2005 (FINCA, 2003:6). By 2002 more than 300 programmes in 60 countries implemented the same or adapted model, for example, Freedom from Hunger, Save the Children and the Catholic Relief Services (FINCA, 2003:4)

after approximately three years, such members must turn to other institutions, i.e. the formal financial institutions, for their financial needs. Savings earn no interest, but members receive a share of the profits generated from the bank's re-lending activities or other investments.

Although members' savings can be used to finance loans, the implementing agency (USAID) provides the necessary funds. These funds must be repaid with interest after a four-month period (internal loans also have a four month cycle). This makes up the external account of the village bank. The internal account consists of members' weekly loan repayments, which are charged at commercial rates of interest; interest from loans made with member savings, fines charged; and member savings (Holt, 1994).

Problems associated with village banks include inflexible loan maturity; formal limits on the size of loans; the unwillingness of banks to adapt to the growing demand and wealth of members providing that larger loans can be backed by acceptable collateral; and reductions in the breadth of outreach since the banks serve people of the same village. Furthermore, the small amounts of voluntary savings are withdrawn at the end of each loan cycle, reducing the bank's chances of becoming financially sustainable, thus making the bank too dependent on the external account and therefore on donor involvement. Furthermore, linking savings to loans reduces the value of the service for clients and attract few savers. Village banks also experience high drop out rates due to the limited services provided, members reaching the loan ceiling, and in Africa due to HIV/AIDS. Village banks need to attract more deposits from members. Even more worrisome is the fact that village banks are not linked to the formal financial sector and this needs to be investigated. Although the basic principle was that after three years the internal account would be sufficient to provide for the financial needs of the members, resulting in the graduation of the village bank, this is very seldom the case. Uganda's village bank only reached this level after eight years from inception (Kasi, 2003:7). This factor prevents village banks from becoming financially sustainable.

Despite the above-mentioned problems, village banks have many benefits. For members, these include simple procedures, access to savings and credit services, the absence of stringent collateral requirements, additional income and learning to have financial discipline. Members also enjoy a joint liability and are therefore jointly responsible for the performance of the bank. For village banks, benefits include comparative advantages in collecting information about borrowers since they are located near their members, which in turn reduces the cost of screening potential members and monitoring existing borrowers. Peer pressure is also used to monitor borrowers, and members who default on their loans are excluded from the bank's services. For implementing agencies, benefits include minimised transaction costs over the long term, as well as relatively low capital requirements. The local economy also benefits from the village bank due to improved health, increased labour productivity, consumption, investments and better education of children and members.

One question about village banks remains: Can they operate at levels of self-sufficiency? Originally, Holt (1994) argued that management costs would threaten sustainability. However, FINCA's answer is in the affirmative. The global loan repayment rate is 97% (FINCA, 2003:3). Woller (2000:4) supports this view when he indicates that village banks can reach levels of operational and financial self-sufficiency. Factors that can contribute include higher interest rates and increased productivity (by utilising improved information systems), which drive down operating costs. This all leads to the attractiveness of products and services. As a result, improved efficiency will lead to reduced interest rates. It must be remembered that the aim is to serve the very poor and higher interest rates may negatively affect this objective.

Apart from increased efficiency, village banks need to encourage voluntary savings by paying positive real interest rates on deposits, since liquid savings are better instruments to address the financial needs of the poor. When voluntary savings are provided from the outset, savers will

become interested in the performance and sustainability of the bank. However, administrating such savings accounts might be beyond the administrative capacity of the banks. It is further advocated that village banks use commercial funds to finance loans and therefore be less donor dependent. These funds can then be on lent to borrowers at commercial rates of interest. Village banks are then linked with the FFS. This linkage can be expanded by depositing the internal account with commercial banks. Given extensive training, village banks will experience high repayment rates and success, although training will increase costs. The original model allows banks to rely on self-supervision by members. However, internal accounts need to be externally supervised to prevent any financial problems and protect borrowers.

Thus, given the international experience of cooperatives and village banks, what lessons can be learnt and comparisons drawn from their experience?

Both the German cooperative movement and the village bank model emphasise the importance of joint liability. They also rely on members' knowledge about one another to overcome the information constraints common to financial markets. Another important feature is the idea of self-help, the community helping themselves to overcome the constraints they face in obtaining financial services, but also in addressing their socio-economic problems by reinvesting their money within the community. Emphasis is thus on the participation of the members. With regard to cooperatives, the word itself is derived from the word cooperation. Therefore, the cooperative idea is one of people working together to satisfy their own economic needs in accordance with specific rules and principles.

Both cooperatives and village banks operate using the savings first principles. This improves clients' financial discipline and creditworthiness, builds the capital base of the institutions and

assists in better management. On the negative side, deposits require good record keeping and documentation of daily deposits and withdrawals, which increase operational costs.

Unlike village banks that operate in the IFS, cooperatives are registered entities that operate within the FFS and are regulated and supervised by leading authorities. If any institution experiences any difficulties that might adversely affect the financial system or any other related problems, action can immediately be taken. Regulated institutions also create trust amongst members, which increases their participation and sense of ownership, and in turn contributes to the sustainability of cooperatives.

3.4 The legal framework of FSCs

Although registered as cooperatives (section 3.4.1), FSCs may accept deposits from members and they are therefore registered in terms of the Banks Act (section 3.4.2). However, current legislation prevents FSCs from reaching their full potential and must be revisited (section 3.4.3).

3.4.1 Registration under the Cooperative Act of 1981

In 1996, with the registering of the pilot FSCs, a submission to the Registrar of Banks by EFK Tucker Inc. (1996) suggested that these institutions must rather register under the Cooperative Act of 1981 than under the Companies Act of 1973. Some of the benefits involved when registered as a cooperative would include lower registration costs, a simpler framework, a more suitable share capital structure with statutory provision for easy cancellation of shares and greater flexibility with the structuring of voting rights, and the provision to do business with members only rather than with the general public. Therefore, it would be a more suitable structure to operate in rural areas. It was approved and these institutions were registered as financial services cooperatives under the Cooperative Act of 1981 (Act No. 91 of 1981).

The first cooperative in South Africa, a consumers' cooperative, was established in 1892 in terms of the Companies Act. No cooperative act existed at that time. Since then many more cooperatives, especially agricultural cooperatives have been registered under the same act. In 1908, the first Cooperative Act was passed followed by the Cooperative Societies Act of 1922 (Act No. 28 of 1922). After recommendations by the Commission of Inquiry into Cooperatives and Agricultural Credit of 1934, the Cooperative Societies Act of 1939 (Act No. 29 of 1939) came into operation on 1 September 1939. The focus was still on agricultural and farming activities. This act was repealed by the Cooperative Act of 1981 (Act No. 91 of 1981), which makes provision for three types of cooperatives, namely, agricultural cooperatives with objectives related to agriculture, special farming cooperatives with the objective of agriculture and trading in agricultural products, and trading cooperatives that could have any lawful objective without limitation on membership. The Act of 1981 only addresses the needs of agricultural cooperatives. This is the result of the cooperative legislation being situated in the National Department of Agriculture (NDA). The current Act did contribute to the development of successful agricultural cooperatives; however, cooperatives serving other segments of the market came into existence and necessitates changing the Act (De Lange, 2003; Du Toit, 2003; Phadu, 2003).

Proposed changes include the following:

- The Department of Trade and Industry (DTI) will take over the responsibility of developing and administrating cooperatives; a Cooperative Enterprise Division will be established within the DTI and the Registrar of Cooperatives, instead of being located in the NDA, will rather be located in DTI's Corporate and Intellectual Property Registration Office (CIPRO).
- Government's commitment to support the cooperative movement and recognise FSCs and other cooperatives is reiterated in the Draft Cooperative Bill published in the Government Gazette Number 257656 on 27 November 2003 (RSA, 2003a).

If this Bill is passed, the new Cooperative Act will replace that of 1981, and will be more in line with international standards. It will make the formation of cooperatives more accessible to all communities, provide for an enabling legal framework that does not hinder the establishment, growth and development of sustainable cooperatives, and cater for all types of cooperatives. For example, whereas the current Act provides for only three types of cooperatives, the Bill makes provision for six different types of cooperatives, which include agricultural and farming cooperatives, financial services cooperatives, housing cooperatives, workers' cooperatives, transport cooperatives and medical services cooperatives (Du Toit, 2003:11; RSA, 2003a). Cooperatives will empower people to join hands and address the economic problems they face within the community, i.e. following a bottom up approach to economic development. Cooperatives are seen as an instrument of change, able to address the inequities of the past and to integrate the previously less privileged groups of the population into the market economy. Yet, these institutions will under the Cooperative Act remain independent legal entities that are business orientated and commercially competitive. Du Toit (2003:11) goes further in explaining that other benefits of cooperatives include economic empowerment, job creation, social reform, human development, access to markets, entrepreneurial development and increased savings and investment and thus economic growth.

Given the German experience and principles dating back to the 1840s, it is expected that cooperatives will be successful in addressing the financial and economic needs of their members. The principles of self-help, self-responsibility, self-administration and self-management contribute to their success. The South African government believes that these principles fit in well with the socio-economic needs of communities. The NEDLAC financial sector summit supported this view and proposed the development of enabling legislation to further strengthen the cooperative movement. As a result, a Draft Cooperative Banks Bill was drawn up and is currently under review by government (section 3.8).

3.4.2 Registration under an exemption to the Banks Act of 1990

Neither the current Cooperative Act nor the proposed act provides for FSCs to accept deposits from their members, yet they do. This relates to the “business of a bank”, which is defined as “accepting and soliciting deposits from the general public, and using the funds for a range of lending and investment activities” (Meagher and Wilkinson, 2001:16). As soon as this is the case, FSCs need to be registered either under the Banks Act of 1990 or the Mutual Banks Act of 1993.¹⁵ However, the high registration cost of R250 million for a bank and R50 million for a mutual bank (previously R50 million and R10 million respectively) is far beyond the reach of a FSC. A FSC will thus only be able to provide deposit services if it is exempted from the Banks Act, which is currently the case.

The notice serves as a specific exemption from the Banks Act that makes provision for FSCs to provide banking-related financial services to its members, which include accepting deposits, funds against the issue of shares, advancing loans and/or providing for members to share in profits and nominate management.¹⁶ Conditions set out by the exemption include that an FSC

- must enter into an agreed business arrangement with a commercial bank (section 3.6);
- must be a member of any approved self-regulatory body approved by the Registrar of Banks or the Financial Services Association (FSA) approved by the Registrar of Cooperatives (section 3.7); and
- may hold a maximum of R10 million in deposits.

¹⁵ The Mutual Banks Act aims at filling the gap between the formal and informal financial sector since minimum capital requirements are less for mutual banks than for banks. The former are however subject to the same principles of accountability and risk management as banks.

¹⁶ Former exemptions from the Banks Act are not appropriate for FSCs. The first exemption (Government Notice R2509 of 28 December 1993) allows cooperatives to take deposits from members on the condition that it must not be less than R1 000 and that it remains with the cooperative for a minimum of twelve months. The second exemption (Government Notice 2173 of 14 December 1994) relates to a group of persons where a common bond exists among the members and applies to “stokvels” and credit and saving unions. However, the operations of a FSC fall outside the scope of this exemption. For example, transfer facilities provided by FSCs fall beyond the scope of services provided by the bodies covered under the exemption. Members’ deposits with the FSC are furthermore not the same as the ‘pooling’ of money found with “stokvels” and allowed under the exemption (EFK Tucker Inc., 1996).

Initially, the exemption would have expired on 31 December 2000, but the Minister of Finance extended the expiry date by a further notice on 28 December 2000 in Government Gazette no 24291 to 31 December 2003 (RSA, 2000). Again, the exemption was extended until 31 December 2005 (RSA, 2003c). It is hoped that this exemption will be replaced by new legislation before having to be extended again (section 3.8).

3.4.3 Future options for registration

Current legislation (including the exemption notice) prevents FSCs and other third-tier financial institutions from reaching their potential, inter alia by capping the deposit base at R10 million (R9, 9 million for other institutions, e.g. SACCOs) and the requirement that a FSC has to be a member of a self-regulatory body. Not only has self-regulation not worked internationally, it also proves to be a problem locally (section 3.7). Willemse rightly pointed out that “regulation by exemption does not work – the time is right for new legislation” (2003:1). Options include the rewriting of the current Banks Act and Mutual Banks Act or the formulation of new legislation.

3.4.3.1 Changing of the Banks Act and Mutual Banks Act

The success of German cooperative banks could be ascribed to the fact that they are registered under the Cooperative Act as well as the Banking Act. These banks are not registered under any exemptions. Therefore, one possibility within the South African context would be to rewrite the current Banks Act or Mutual Banks Act and to include FSCs under one of these Acts. However, rewriting the Acts is not an easy task and since the Banks Act complies with international standards and principles, this would not be a good route to follow. After consultation with the DGRV, Bezuidenhout and Delport (2001) are of opinion that a revision of the Mutual Banks Act might be a possibility. However, the Mutual Banks Act did not prove to be very successful in filling the gap between the first- and third-tier financial institutions. The Mutual Banks Act was mainly

introduced to facilitate the gradual development of development lenders. However, only two mutual banks are currently registered, namely, VBS Mutual bank and GBS Mutual bank. Problems associated with mutual banks include the lack of mobilising venture or external capital, shares cannot be traded on the stock exchange, and excessive equity requirements (ECI Africa, 2003a:19). The other option to consider is to develop new legislation.

3.4.3.2 New legislation

The development of new legislation is no easy task, but if properly done should contribute positively towards the growth and success of third-tier financial institutions. Given the number of people without access to financial services, the banking sector needs to create an enabling legislative framework. Options include the development of narrow and core banks, or the development of cooperative banks. Both sets of legislation are currently under review.

Narrow and Core Banking

One option for FSCs would be to register as either narrow or core banks. The objective of this legislation is to increase competition within the banking sector and to increase access to financial services.

Narrow banks will be allowed to provide deposit facilities and credit payment activities. The latter refers to irrevocable transactions, for example, paid beneficiaries are assured of payment the moment the transaction takes place. No revocable transaction, for example, using cheques or debit orders, are allowed, resulting in the prohibition of lending to the private sector. Instead, these banks need to invest in highly liquid assets, for example, risk-free central government paper. Some of the most important advantages include the safekeeping of money for the public, reducing moral hazard and discrimination between well-informed and uninformed depositors, and requiring less

regulation. Compared to commercial banks, disadvantages include limited supply of credit and less successful intermediation between depositors and investors due to the limited services available.

It is proposed that core banks, on the other hand, will be allowed to specialise in deposit-taking activities, but restricted in the lending side. Their services will include deposit-taking, provision for payment services, cheque accounts, and loans to individuals and small and medium enterprises (SMEs). However, the scope of lending would be carefully defined in order to exclude large, risky transactions. A core bank is therefore more restricted in its activities than a commercial bank, but less so than a narrow bank. Core banks enjoy similar advantages as narrow banks do and in addition promote competition within the banking sector. A core bank can thus operate as a small to medium sized bank with investments in central government paper and small loans to the public and the SME sector (Falkena *et al.*, 2002).

As mentioned above, the purpose of narrow and core banks is to increase competition within the banking sector, as well as to increase access to financial services for the public by lowering entry requirements and limiting their business scope. Since the products of narrow banks are highly standardised and operations depend on economies of scale, it would be a good start to increase access to financial services. However, only a financial institution with a large geographical presence and sufficient economies of scale will survive in the long run. Therefore Falkena *et al.* (2002:4) propose the upgrading of the existing Postbank to a narrow bank. The Postbank will be able to provide deposit facilities and be a full credit payment member of the national payment system. Such a transition will level the playing field and since it will not operate under a special Act or exclusion by the Registrar of Banks, distortions in the banking sector will be reduced and

competition increased.¹⁷ It can also be used for the payment of pensions, unemployment insurance benefits, disability grants or any other welfare grants by government.

The core banking dispensation, on the other hand, will allow the entry of micro lenders, money-market unit trusts, supermarkets, retail stores and telephone companies to the banking field due to lower entry requirements. This will contribute to broader access to savings facilities and allow new entrants to offer transaction facilities. Furthermore, micro lenders will have access to a retail deposit base, which could contribute to a reduction in on-lending interest rates.

Falkena *et. al.* (2002:18) identify a number of institutions that might qualify for a core bank license. Of the 34 non-bank institutions registered with the MFRC, only ten micro lenders might qualify for the license.¹⁸ Yet, the initial capital requirement of R50 million to register as a core or narrow bank again places them in the same category as mutual banks. This barrier to entry prevents FSCs and many other third-tier institutions from entering the second tier. That is why the Cooperative Bank Bill is currently under discussion (see section 3.8)

3.5 Financial services provided by FSCs

The objective of a FSC is to provide an institutional structure through which the mobilisation and allocation of financial resources can be achieved; in other words, providing a comprehensive range of financial services such as savings, loans, transmission facilities and insurance. Community members who are not members of a FSC do not have access to these services. When asking the poor why it is important to have access to financial services, they often identify security, convenience, liquidity, confidentiality and access to savings and loans. Financial services, therefore, need to be tailored to these needs. Delivering appropriate services will result in increased

¹⁷ The Postbank is currently registered under an exemption to the Banks Act, Government Notice Number 13744 of 24 January 1992 with an indefinite expiry date (Bank Supervision, 2002). During 2003, the deposits increased with 27% to a total of R1 242 million (SARB, 2004:S-15).

¹⁸ The figures provided are limited to existing micro lenders and exclude an unknown number of entities that may be interested in providing core-banking services.

participation and outreach, and should contribute to the success of the institution. The discussion that follows will indicate the financial services FSCs provided to their members before the collapse of the two regulating bodies, Financial Services Association (FSA) and Financial Solutions for Co-operating People (FinaSol).

3.5.1 Shares

For FSC membership at least one share needs to be bought. This not only gives the shareholder or member voting rights, but also access to the financial services of the FSC. It furthermore creates a sense of ownership amongst members, which should contribute to the success of the institution. The shares need to be affordable and within reach of the poor. Share prices vary between FSCs. For FSA FSCs, shares were priced at R10 per share, while FinaSol FSCs were R50 per share. The latter also had a membership fee of R30, while an additional R20 was necessary to open the bank account (Africa, 2001). Currently, the situation has not changed and FSC shares vary according to the original implementing agency, FSA or FinaSol. Shares do play an important role in the operation of the FSC since the members accept full ownership and responsibility for the FSC. The proposed cooperative banks will sell shares at R10 each (section 3.8).

3.5.2 Savings

Mobilising savings has a twofold objective, namely, to meet the demand of a large number of poor people by providing them with secure savings services and, secondly, to build and improve the sustainability of institutions. FSCs therefore primarily mobilise local savings from members. Saving products are available to individuals as well as to groups. Two types of accounts are available:

- i) An open account, which earns no interest on the deposits and is used for the safekeeping of money. This facility allows members to store the money while rationally deciding on consumption spending.
- i) A fixed deposit account provides members with a medium-term investment opportunity. In 1996, members received a fixed deposit certificate and earned 11% interest on an investment of three months, 11.5% on a six months and 12% on a 12 months investment (Schoeman, 1996b:5).

FSCs follow a savings first approach and savings are thus used as a source for loanable funds. Members are encouraged to use the saving facilities of the FSC since members' future lending depends on their savings track record. On 20 June 2002, FinaSol reported estimated savings at R5.3 million and the average savings per member (excluding shares) at R482 (Baumann, 2002:41).¹⁹ Different rates are charged for withdrawals, depending on the FSC. Some FSCs limit their withdrawals to a R1 000 per day and charge a service fee that varies from R0.75 to R4 per transaction, depending on the amount withdrawn (Motlounge, 2004; Noxolo, 2004). Another FSC reports that withdrawals are charged at 1.5% on the amount being withdrawn (Lothlakane, 2004) or that a fee equal to R5 per R100 withdrawn is charged (Ngobese, 2004).

Information available limits the analysis of the savings portfolio of FSCs, since the reported portfolio makes no distinction between the amount of shares and savings. The total savings reported by the 53 FSCs still in operation amount to R5.5 million as at June 2004 (FSC information, 2004). Given that FSCs must deposit their portfolio at a commercial bank, the expectation would be that such a link bank (section 3.6) would provide the FSC with additional services or at least better than normal interest rates on savings. However, none of the FSCs interviewed reported this to be the case.

¹⁹ No information is available on FSA's FSCs.

3.5.3 Loans

The credit market is associated with information constraints, leading to adverse selection and moral hazard. Both the German banking cooperatives and FINCA village banks successfully overcome these constraints as they are situated close to their members and utilise local knowledge to ensure good borrower selection (reducing adverse selection) and the identification of borrowers through the share-holding mechanism (reducing moral hazard). Local pressures via other shareholders also reinforce repayment discipline. FSCs apply the same mechanisms.

Loans obtained by FSC members are used for a variety of reasons, for example, to finance life-cycle events, emergencies, and investment opportunities. FSCs should focus on the financing of bankable activities and projects within the community. Such lending will result in the creation and development of SMEs and thus increased employment, development and the overall improvement of the community. In this way the success of the FSCs could spill over to non-members (the community) who should be enticed to become members.

Lending activities are only possible once sufficient savings have been accumulated. In the previous dispensation, a FSA FSC member must have savings equal to two instalments of the loan amount to obtain a loan. FinaSol FSCs was required a savings collateral equal to 30% of the loan amount and physical collateral for additional amounts. In both instances, the credit committee of the FSC screen potential borrowers. Lending is thus a mix of collateral-based lending and individual relational lending. In 2002, FinaSol reported a total of R1.45 million of loans still outstanding (Baumann, 2002:41). The interest rate also varies between FSCs, between 2.5% and 5% per month. The maximum loan amount is R1 000.²⁰ Interest accrued from loans is reinvested or paid out to the members as dividends (Moore, 2002). However, the FSCs interviewed all expressed their concern

²⁰ One FSC reports that members had access to three different types of loan products, depending on their needs. These include a long-term loan at 3% per month with a period between 3 to 12 months, a short-term loan for 30 days at 14% and a speed loan at 1% per day for 7 days (Motloun, 2004).

that the income received from providing the services are not sufficient to cover operational costs (section 3.9.2). FSCs experience problems increasing the number of loans not because of the collateral requirements or the lack of demand, but merely because of limited skills and lack of institutional capacity.

3.5.4 Transmission services

South Africa's extended family networks as well as the number of pensioners living in rural areas – an estimated 40% of rural families have a pensioner living with them (Strauss Commission, 1996b) – call for greater attention to be given to better electronic transmission facilities, i.e. to integrate the rural areas into the financial system of the country. FinaSol (2000) reports that 50% of the South African population has no access to efficient electronic transmission services and that in a country with a highly developed financial system.

FSCs, however, are well positioned to utilise transmission facilities effectively, specifically for pension payments within rural areas. Originally, some FinaSol FSCs made use of transmission facilities for their clients to provide services such as pension payments, money transfers and bill payments. Although all the FSCs interviewed expressed their interest in having transmission services available to their members, none reported currently having this service available.

FSC members have individual account numbers at the FSC, which is linked to the electronic funds transfer system, while the FSC has one account at the link bank, covering all members. Although it is reported that some FSCs receive almost 300 electronic transfers a day to individual accounts, the Department of Social Development (DSD) insists that grant recipients have their own commercial bank account number for the department to transfer the payments. The department therefore does not recognise the FSC transfer system. If, however, FSCs could provide this service to their members, it would provide an essential financial service within the rural communities, which could

increase membership, and ensure an income for FSCs in the form of fees paid by the DSD as they do with banks and other private cash management institutions. In other words, the same department providing funds for the development of FSCs prevents them from developing and reaching their full potential (Baumann, 2002).²¹

FSCs thus provide mainly savings services and have not fully explored the potential of savings as a source to finance the loan portfolio.

3.6 Linking FSCs with the formal financial sector

The exemption to the current Banking Act granted to FSCs requires that a FSC secure a business arrangement with a commercial bank, called the link bank (of the FSC's own choice), before operations can commence (RSA, 1998). The link bank provides the FSC with an account for deposit purposes. Initially, the amount of deposits by the FSC members does not justify the costs involved for the link bank in providing the deposit facility to the FSC. However, as the FSC's volume of operations increases and more deposits are made, the incentive for a bank increases. For example, FSC savings was an estimated R40 million up to mid 2003 (ECI Africa, 2003a:33). By depositing these funds with commercial banks, it provides banks with funds for on-lending and thus increases investment opportunities. Linkage therefore integrates third-tier institutions into the FFS, contributes to increased savings and investments and therefore also to financial development, economic growth and development.

Linking first- and third-tier institutions furthermore combines each institution's comparative advantages, and should result in increased outreach and sustainability for the third-tier institutions. Commercial banks experience advantages in the services they provide and being able to provide commercial funds at market-related interest rates. FSCs, on the other hand, being situated within

²¹ Section 3.7 indicates that the DSD is responsible for assisting in the development of FSCs.

the rural communities, can overcome information constraints. Functions of the link bank can be summarised as follow:

- deposit taking and any additional services according to the needs of the members of the FSC on a commercially viable basis, for example, a loan agreement that will secure a credit line to be used by the FSC to make loans to individual members;
- setting lower interest rates and charge lower transaction fees;
- provide support and advice where necessary as well as training, for example, to tellers; and
- evaluate the FSC's risk position by having access to the FSC's financial records and therefore be able to evaluate the loan portfolio and risk management skills to determine the FSC's debt capacity.

FSCs will experience the following benefits:

- access to a deposit account;
- access to commercial funds at a market related interest rate;
- as the linkage continues, access to a wider range of financial services to its members, for example, term deposits (the interest rate the FSC will pay on term deposits to members will be lower than the interest rate the FSC receives on the deposits at the link bank), transfer services to receive pensions and salaries and access to insurance; and
- access to support, advice and training services (Schoeman, 1996a; 1996c).

A well functioning partnership with a commercial bank is an essential element in the success of FSCs. However, experience indicates that FSCs unfortunately do not get the necessary training and support services from their link banks (ECI Africa, 2003a:11). FSCs indicate the commercial banks are not willing to assist them with any advice or training (Informal conversations, 2003). Reasons include the lack of and capacity constraints bank staff experience at branch level to train new FSC staff, increasing the training cost and consequently putting pressure on the profitability of the

branch. If, however, head office provides the banks at branch level with specific directives and therefore with the necessary funding, banks would be in a better position to assist FSCs.

This situation is about to change, given the directive of the Financial Sector Charter to “[support] the establishment of third tier community based financial institutions” (2003:10). This will be done through human resource development. For example, a financial institution needs to spend 1.5% of total basic payroll per annum on training of black employees, introduce training programmes and establish undergraduate and postgraduate diplomas and degrees in financial services. Banks therefore need to invest in human capital development and appropriate mentorship programmes. Apart from training staff, financial institutions also need to invest a minimum of 0.2% of post-tax operating profits in consumer education. This will empower consumers with knowledge and enable them to make informed decisions about their finances. These kinds of commitments will positively contribute to the success of FSCs and other member-based financial institutions by improving the management skills of staff. In turn, it will affect the administration of savings and loans, increase outreach and also sustainability.

3.7 Regulation and supervision of FSCs

The primary objective of regulating a financial institution is to protect the solvency of the financial system; in other words, to protect the stability of the payments system at a macro level, and at the micro level protect the depositors against undue risk of losses that might arise from the failure of the institution, and to promote the efficient performance of institutions and markets. Supervision furthermore ensures that regulations are adhered to, risk minimised and troubled institutions improved or closed. Given the appropriate regulation and supervision, institutions will experience increased access to diversified funding sources, increased speed of reaching sustainability, increased profitability and the ability to be more innovative in product offerings. Increased competition amongst institutions should also follow, leading to efficiency and greater focus on

clients' needs, decreased costs of credit to clients, as well as protected institutions and clients, which should in turn open the financial system to the poor.

As financial institutions, FSCs must also be regulated to ensure standards and protect the financial industry. Jazayeri (2000:14) states that commercial banks involved with village banks are not the appropriate external body for regulatory purposes. The reason is that the commercial bank's interest is primarily to collect savings and lend to the village bank. However, provision has been made by the Registrar of Banks under the exemption notice for external regulators other than commercial banks to undertake this task. An apex body, FSA, and a franchiser, FinaSol, regulated FSCs until 2001 after which the NDA took over the responsibility. The following section will explain the development of these two regulating institutions as well as the problems that led to their closure.

3.7.1 The regulating bodies FSA and FinaSol

The three FSC pilot projects introduced between 1994 and 1996 needed support services, training and direct financial contributions, and had to be registered with the Registrar of Banks. This resulted in the formation of FSA by the three existing FSCs in February 1996. After a project analysis was handed to the Registrar of Banks, recognition was given to the FSCs under an exemption to the Banks Act (discussed in section 3.4.2).²² Due to the self-regulating provisions within the exemption, FSA was appointed to regulate its member FSCs. It must be noted that from the start the initial purpose of FSA was the development of FSCs and not their regulation. Below it will be indicated that this additional function of FSA was one of the main reasons FSA did not reach its stated main objective, which was developing and supporting FSCs. At the institutional structure of FSA, all registered FSCs had equal representation at the board level and the FSA

²² This project analysis was done under the supervision of J.H. Schoeman. For more detail on this analysis, see Schoeman 1996a; 1996b; 1996c.

formed the overall controlling body for all FSCs as well as the mechanism through which the individual FSCs could interact on a macro level (FSA, 2001; ECI Africa, 2003a:13).

FinaSol, on the other hand, a not-for-profit association under Section 21 of the South African Companies Act, was an initiative in January 1999 of the South African Sugar Association with donor support from the United States Agency for International Development (USAID) to support the development of communities in sugar farming areas. The FinaSol model was based on a franchising system utilising the same principles as developed for the pilot project. According to the franchising agreement, FinaSol (the franchiser) would provide the necessary start-up assistance to the FSC (the franchisee). The FSC did not have to buy the franchise, but would receive the necessary support and standardised services (ECI Africa, 2003a:14; FinaSol, 2000).

Despite FSA's concerns about the existence of a second regulator and developer within the sector, the Registrar of Banks allowed for the entry of FinaSol. FSA's argument relates to the fact that within the village bank concept, "the service providers [the FSCs] and the clients [the members] are the same entities (the communities)", which is different from the commercial bank environment where "the service providers (the banks) and the clients (depositors) are different entities . . . [so that] competition relates to competition between the service providers" (FAS, 2000: 1). Thus, applying this principle to the village bank concept results in putting the communities in competition with themselves. "This situation is counter productive and very confusing for the rural communities" (FSA, 2000:2).

3.7.2 The collapse of FSA and FinaSol

Both FinaSol and FSA had to perform three different (or conflicting) roles at the same time, that of developer, trainer and regulator. These functions can be summarised as follows:

- The development of FSCs, which includes pre-launching support to interested communities, the registration of FSCs, start-up capital to be paid back over a three year period,²³ information systems, technical support, the development and marketing of products, the mobilisation of funds nationally and internationally, to secure strategic partnerships and to enhance good business relations;
- The training of FSC members through capacity building; and
- The regulation of FSCs, which includes protecting FSC members, auditing and consolidating financial statements for presentation to the Registrar of Banks, to ensure financial sustainability and prudent operating conditions, arbitration of disputes between member FSCs and remedial actions to under performers.

For developing and training FSC members, FSA and FinaSol received funding from donor agencies. In 1999, the National Department of Welfare (now Department of Social Development (DSD)) granted R7 million from the poverty alleviation portfolio of this department to the FSA for capacity building, the replication of the FSC and the development of specific products. FinaSol, on the other hand, received funding to the value of £1 million from the DFID. At the same time, the SARB required FinaSol to operate as regulator, stretching operational income over increased operational costs. Thus, although in principle the SARB (via the exemption to the Banks Act) and the government (via the DSD) supported the FSC concept, neither of the institutions was willing to assist in any other means possible.

Both FSA and FinaSol had to close down all operations due to the lack of funding or the withdrawal of donor support. The DSD requirements were that FSA had to establish seventy FSCs in seven provinces by 2002. Although FSA targeted to have 66 FSCs registered by the end of 2001, the DSD found that only 29 communities were assisted in the development of a FSC at the end of

²³ Start-up capital to the amount of R40 000 to cover initial operating expenses as well as a grant of R8 000 to purchase a safe and to use for the initial set up of the FSC office was provided by FinaSol to its member FSCs. This was done only once; the FSC had to have an approved business plan (ECI Africa, 2003:13; FinaSol, 2000).

February 2002. The DSD therefore refused to honour their funding agreement with FSA. A project review by the DSD showed that FSA lacked management abilities and was inexperienced in micro finance. Another problem was FSA's lack of capacity to develop a proper social transfer system (section 3.4.5 indicated that the DSD, ironically, had just as much part in this problem).

FinaSol experienced more or less the same kind of problems. According to them (Discussion groups 2001a; 2001b), poor management skills of Board Members and problems with computer systems, which were often down, were some of the limitations preventing them from reaching their targets. By the end of 2001, FinaSol was not on track with its targets as determined by the donors involved and, even though new management had been appointed, USAID and DFID withdrew all funding. This forced FinaSol to close down non-viable FSCs (FinaSol, 2000; Baumann, 2002:39; ECI Africa, 2003a:15).

Currently all FSCs are under supervision of the NDA, but receive no additional assistance with product development, training and support.²⁴ At the South African Cooperative Banking Conference (Informal conversations, 2003) many FSC managers stressed their concern since they desperately need training and support. Some of them experience administrative problems, a shortage of stationary and even the mismanagement of funds. When asked where the NDA is in this matter, their response is "They avoid us" and "They don't return our telephone calls", opinions echoed by ECI Africa (2003:15), Lothlakane (2004), Mahlangu (2004), Motloun (2004) and Noxolo (2004).

²⁴ It is calculated that 17 FSCs discontinued their operations since the collapse of FSA and FinaSol. Of these, eight had not yet had any members (FSC information, 2004).

3.7.3 The way forward

The NDA, SARB and National Treasury are currently investigating the necessary actions that must be taken to assist FSCs. It is clear that FSCs do not have the capacity or ability to represent themselves at the national level and that they need to be supported and regulated. Specific structures are necessary to fulfil this role. The problems experienced by FSA and FinaSol clearly indicate the following:

- i) Self-regulation does not work. It requires continued funding as well as capacity and expertise. The rationale behind self-regulation is that regulation becomes member driven, which reduces regulatory costs. The international experience indicates that although self-regulation has been tried a number of times, it was never a success (section 2.4.3). Regulation and supervision cannot enforce financial discipline and conservative management at the same time, since the parties to be supervised control the supervisory institutions (FSA and FinaSol), which results in conflict of interest.
- ii) The roles of developer and regulator need to be separated since they have conflicting objectives. As ECI Africa clearly points out, “The regulatory function requires a measure of distance in order to discipline effectively without the fear of member entities moving over to another self-regulator or simply going their own way” (2003a:30). The additional lack of statutory powers and funding to deal effectively with delinquent members raise questions about the appropriateness of a self-regulating model.

Taking cognisance of the above, Schoeman (2003:4) rightly points out that FSCs need to be recognised as an integral part of the financial system, i.e. recognised as banks in their own right and not be exempted from any Act. This will allow them to reach sustainability and to compete effectively with other financial institutions. However, as long as FSCs are exempted from the Banks Act, they are required to be members of a self-regulatory body approved by the Registrar of Banks.

It has been argued that the main reason for FSA's and FinaSol's failure is their combined responsibilities as developer and regulator. The new proposed Cooperative Banks Act moves in the right direction by suggesting (as ECI Africa (2003b) did) that two separate bodies should undertake these tasks.

3.8 Cooperative Banking

As has been previously argued (section 3.4), current legislation, including the exemption notices, prevents FSCs and other third-tier financial institutions from reaching their potential. Registering as narrow or core banks in terms of the proposed new legislation, is also not feasible for FSCs (section 3.4.3.2).

To eliminate the number of exemptions as well as address the entry requirements to move from the third to the second tier, emphasis is placed on the importance of the proposed legislation pertaining to cooperative banks (Delpont, 2002; 2003; Schoeman, 2003; ECI Africa, 2003a; 2003b; Hawkins, 2004; Banking Council, 2004). At the NEDLAC financial sector summit, parties agreed on the importance of enabling legislation for cooperative banking in order to expand financial services to the poor. Suggestions were that these banks operate as provisional cooperative banks with a limited range of financial services to their members, namely, shares, savings, fully secured loans and group schemes. Requirements would include no minimum initial capital requirements, unimpaired reserves equal to 10% of total assets and maintaining a positive net worth. As the banks grow, unsecured loans and transfer services would be added. The final stage will be when a bank registers as (converts into) a mutual bank, competing directly with commercial banks. It is important that cooperative banks must not be seen as "interim or second class service providers that are only providing a service in the absence of commercial banks . . . [as this] is most definitely a recipe for disaster" (Schoeman, 2003:4).

On 10 November 2004, the Minister of Finance released a Draft Cooperative Banks Bill for public comment. The objective of this bill is to make “provision for the regulation and development of existing community banks and the promotion of the establishment of new co-operative banks. [It will] create an enabling environment for co-operative banks to be integrated into the formal banking system . . . [and] will assist the banking industry and the nation with improving access to financial services for a broader market” (RSA, 2004:1). Institutions are still member based, managed and controlled by their members, and they apply cooperative principals and provide a wide range of financial services. This Act will incorporate best practices from the Banks Act but will be more flexible according to the needs of such institutions.

For institutions to register as cooperative banks, registration under the Cooperative Act as well as a cooperative bank license under the Cooperative Banks Act is a prerequisite. Applications will have to be forwarded to the Supervisor of Cooperative Banks (hereafter the Supervisor), appointed under the authority of the Registrar of Banks. After the approval of the management plan, business plan and the constitution of the bank by both the Minister of Finance and Supervisor, an applicant will receive a cooperative bank license. This license is valid for one year after which renewal is required. Renewal depends on, inter alia, the financial and operational success in accordance to the initial business and management plan as well as a detailed projection of the way forward.

The license allows for the registration of two different types of banks. A Savings Cooperative Bank will only be allowed to take deposits and provide transmission services, while a Savings and Loans Cooperative Bank will also be allowed to advance loans to members or provide any additional services prescribed or approved by the Minister of Finance.

It is clear that legislation regarding the opening up of access to financial services, and more specifically the role and place of FSCs in this, is moving in the right direction. Firstly, the new

Cooperative Act is drawn up in accordance with international standards. This will make the formation of cooperatives more accessible to all communities and will cater for all types of cooperatives.

Secondly, doing away with the current exemption notices will bring third-tier institutions, also FSCs, in reach of the second tier. Given the German experience, this is a move in the right direction. The Bank Supervision Department (2003:31) rightly points out that legislation should “provide for ensuring that the business of such institutions is conducted in a safe and sound manner, conducive to the orderly growth of the financial sector, whilst contributing to poverty reduction in both rural and urban areas” (Bank Supervision, 2003:31).

Thirdly, it will provide for the establishment of a support organisation responsible for the promotion and development of new cooperative banks, assist existing banks with training, support management, and serve as the accounting officer of the banks. The projected cost of supporting a new bank is calculated to be R16 600 initially; while continued support thereafter is calculated at R16 500 per annum (ECI Africa, 2003b:12-17). Apart from donor support, each cooperative needs to pay a 2% membership fee, which will be enough to cover the costs of the supporting institution. Given this provision for a support organisation, FSCs will establish the Financial Services Cooperative of South Africa (FICOSA). It will be a cooperative owned by FSCs regulated in terms of the proposed Act (Mohlmonyane, 2004).

Fourthly, the National Treasury will be responsible for the regulation of the banks. The Supervisor will be responsible for the supervision of these banks. This includes inspections, keeping register of the banks, ensuring compliance with the Act, annual reports to the Treasury and assembling accounting records. If any bank fails to comply with these requirements, it must report the situation in writing to the Supervisor.

Thus, problems experienced during the previous dispensation will be overcome by the new Act and is therefore the appropriate legislation for FSCs.

Section 2.4.2.5 advocates for strong linkages between formal and informal financial institutions. The initial FSC model also supported this view. However, its failure and the international support for cooperative banking emphasise the importance of supportive legislation specifically for third-tier financial institutions.

3.9 FSCs: Successful?

Although a variety of indicators can be used to determine the success of MFIs, as indicated in section 2.5, the lack of recorded audits by both FSA and FinaSol largely prevents such an analysis. However, this section will, where information allows, discuss the success of FSCs in terms of their outreach and sustainability.

3.9.1 Outreach indicators

Outreach refers to an FSC's success in serving that segment of the market that had no access to the financial services they need and for which they are prepared to pay. Section 2.5.1 identified that the breadth of outreach refers to the absolute number of households or enterprises reached by the institution with different kinds of instruments, while the depth of outreach refers to the type of client reached, i.e. how deep in the pool of under-served (the poor, women, rural inhabitants and the uneducated) has the institution been able to reach.

ECI Africa (2003a:34) estimated the market potential for member-based financial institutions to be 1 500 institutions with a potential membership base of 2.25 million and a savings portfolio of R1 125 million. However, FSCs did not even reach 0.5% of their potential savings portfolio in 2003 (see Table 3.5).

Table 3.5 FSCs: Location, membership and portfolio

Province	No. of FSC registered (June 2004)	Members	Portfolio (R)	Portfolio (US\$)*	Portfolio as % of total portfolio
Eastern Cape	11	4987	70 739	10 967	1.28%
Free State	2	846	73 329	11 369	1.33%
Gauteng	1	150	11 982	1858	0.21%
Kwa-Zulu Natal	14	11 123	920 140	142 658	16.71%
Limpopo	6	2 472	341 614	52 963	6.21%
Mpumalanga	12	7 324	874 831	135 633	15.89%
North West	6	5 907	3 208 783	497 486	58.3%
Northern Cape	1	100	3 729	578	0.07%
Western Cape	0	0	0	0	0%
Total	53	32 909	5 505 147	853 511	

* Exchange rate R6.45 : US\$ 1 (SARB, 2005:S110)

Source: FSC information, 2004

According to the above table, 53 FSCs served 32 909 members in total with a portfolio of shares and savings of R5.5 million (US\$ 853 511),²⁵ on average thus 620 members/savers per FSC, savings and shares of R167 (US\$ 26) per member and a portfolio of R103 870 (US\$ 16 104) per FSC. When comparing FSC outreach to international benchmarks, cognisance has to be taken of the fact that FSCs fall into three different sub-categories, i.e. they are small, they are located in Africa, and they target the poor (Table 2.3).

FSCs' breadth of outreach in terms of number of savers and total savings portfolio is not in line with the international benchmarks for either small or African MFIs. An individual FSC has on average 620 savers and a savings portfolio of US\$ 16 104. A small MFI has on average 1 135 savers and a

²⁵ FSCs did not make a distinction between shares and savings in their portfolio.

savings portfolio of US\$ 22 621, while a small FSS MFI has on average 3 900 savers and a savings portfolio of US\$ 155 802 (Table 2.3). An African MFI has on average 27 082 savers and a savings portfolio of US\$ 1 308 311, while an African FSS MFI has on average 49 998 savers and a savings portfolio of US\$ 6 845 184 (Table 2.3).

FSCs perform better than both small and African MFIs in regard to depth of outreach when the latter is measured by the amount of savings per saver (the assumption is that the lower the amount of savings, the poorer the customer). FSCs have on average US\$ 26 savings per saver, which is lower for both small and African MFIs, whether all MFIs or only FSS MFIs are included (Table 2.3).

Before the collapse of FSA and FinaSol, 70 FSC were registered but 17 discontinued operations afterwards. These 17 FSCs represented 2 7966 members with a portfolio of R146 858. In July 2001, 60 FSCs were registered with 11 400 members (Nigrini, 2002:385). Comparing these numbers to those in table 3.5, it is evident that despite the decrease in number of FSCs registered, membership increased.

Section 3.7 indicated that both FSA and FinaSol experienced problems, which directly resulted in fewer communities being reached. It is therefore not the failure of communities and FSCs' lack of compliance with the necessary specifications of the project, but rather the inability of FSA and FinaSol to fulfil their task as developers that caused FSCs not to reach their potential market successfully.²⁶

FSC members' monthly income is between R500 and R2 500 per month and the majority earn an income of less than R1 000 per month. In terms of depth of outreach, FSC members (on average

²⁶ According to many FSCs, both FSA and FinaSol only did the minimum to assist them in developing. One FSC manager reports that FSA only gave them a safe (Informal conversations, 2003; Ngobese, 2004).

620 per FSC) are all relatively poor (an average income of R2 880 per month and in LSM 1-5), with the majority falling into the poor category (an average income of R1 440 per month and in LSM 1-3). Unfortunately how many pensioners, women and other unbanked people are served, cannot be established (ECI Africa, 2003a; Baumann 2002).

International benchmarks indicate that MFIs targeting the poor have on average reached 5 940 savers (Table 2.3). For FSS MFIs targeting the poor, the average number of savers increases to 35 321 (Table 2.3). It is apparent that FSCs' breadth of outreach does not compare favourably to these international benchmarks. However, FSCs' US\$ 26 average savings per saver, indicates that greater depth of outreach is attained than the international benchmarks (Table 2.3) for both all MFIs targeting the poor (US\$ 68) and for FSS MFIs targeting the poor (US\$ 103).

The FSC is also a community project, aiming to contribute towards community development. Therefore, if a FSC provides financial services to the community successfully and if these services are utilised satisfactorily, it will contribute to social and economic development at the local level, in which case the FSC can be considered successful in its outreach. As Schoeman (2003:1) rightly points out, capacity building and empowerment are complementary to the financial services a FSC provide. Capacity building includes:

- Equipping people with knowledge and skills, for example, training community members as staff of the FSC as well as teaching members how to manage their income;
- collectively managing the FSC, which in nature is part of the cooperative principles, i.e. jointly being responsible to ensure the success of the cooperative; and
- institutional development which entails the legal and regulatory changes that must be made to help the FSC improve its capacity.

Economic empowerment is the integration of previously disadvantaged and poor communities into the economy by helping them to help themselves. It is the process of joining hands and start initiatives that will address their economic needs. Nigrini (2001, 2002) argued that FSCs do empower their people since having access to financial services and resources enable them to increase their earnings and obtain the goods and services they need. It furthermore allows them to participate in the development of their community.

3.9.2 Financial sustainability

Chapter 2 emphasised how financial services can be delivered to the poor on a sustainable basis. Although it involves a number of aspects as discussed, emphasis is placed on less donor dependency, lending at commercial rates of interest and using savings as the source of loanable funds. In order to measure sustainability, section 2.4.2 introduced both an operational (OSS) as well as a financial (FSS) indicator. The former determines whether an institution can generate enough operating revenue from credit and savings operations and investment to cover operating expenses, financing cost and provision for loan losses. The latter indicator determines whether institutions can generate enough revenue to also cover their cost of capital. Table 2.4 indicated that on average African MFIs (110%) and those institutions targeting the poor (108%) have reached OSS, furthermore that on average African MFIs (140%) have reached FSS while those targeting the poor are close to reaching FSS (97% on average). Small MFIs are close to reaching OSS (on average 99%), but not yet close to FSS (88% on average).

Due to the lack of proper accounting records for FSCs, these indicators cannot be calculated. Nevertheless, there is no doubt that the FSCs have not reached operational or financial sustainability. Given the available data, problem areas in this regard were identified, i.e. capacity , financial (cost, income) and donor dependency problems.

The lack of capacity at the local level is a major constraint in the development of sustainable FSCs (Discussion Groups, 2001a; 2001b). Community members often have no formal qualifications and lack the necessary skills to run and manage the FSC. Therefore, there is a need for subsidies to provide training tailored to the community's needs and time constraints. It is then essential to ensure that the people trained remain in the community. During interviews with FSCs the view was expressed that training is the most important need. Neither the commercial banks, nor the NDA (or the regulating bodies when involved) provided the promised training. One FSC states, "No training, no savings, no loans, no income, no services to our members!" (Isaiah, 2004).

The financial problems FSCs generally experience can be ascribed firstly to the limited assistance from FSA and FinaSol, secondly their collapse and thirdly to the passive manner in which the NDA is currently overseeing the operations of the FSCs (Isaiah, 2004; Motlounge, 2004; Ngobese, 2004; Molali, 2004; Lothlakane, 2004 Noxolo, 2004). The specific constraints FSCs face therefore relate to their costs, income and donor dependency.

Establishing a FSC in a rural area is difficult and expensive. Given the proposed legislation pertaining to the development of cooperative banks, ECI Africa (2003b:7,12) calculated the establishment cost per new bank to be R42 468. This includes a grant of R44 352 (a capital grant of R8 000 and an operational grant of R36 352) and initial establishment support of R16 600; excluded is the cost of training. The objective is to reach sustainability within one year, which requires 500 members with a portfolio of R200 000 and a product range that will generate enough income to cover costs. This is an over optimistic view. Internationally it takes on average 8 years to reach sustainability (MBB, 2005).

It can be argued that the benefits for members, i.e. the access to financial services and reduced transaction costs (banking costs, transport costs, bank charges), outweigh the establishment costs involved. Furthermore, a community's effective participation can to a large extent determine the

sustainability of the FSC. It is thus essential that the community buys into the project and that it is not forced on them. They must understand that it is their project, their responsibility and their institution. If only the DSD supported these institutions. As mentioned before, 37,5% of income in rural areas is in the form of remittances and pensions, while 45% of the rural population are pensioners and grant recipients, placing FSCs in the ideal position to act as an intermediary for the DSD to pay pensions and grants within the villages and earn an income for this service. However, government is not willing to explore this possibility to improve access to financial services within the rural areas (section 3.5). Thus, if members mainly utilise the savings facilities offered, FSCs would experience sustainability problems due to the lack of income generating opportunities.

At the operational level, FSCs also experience problems. All FSCs interviewed expressed their concern about the high operation costs of almost R4 000 per month (paying the teller, manager and rent). Another worrying fact is that neither FSA nor FinaSol assisted FSCs financially with the initial start-up, as they had undertaken to do (section 3.7). As Baumann (2002) rightly points out, continued subsidies will be necessary to cover operating costs and reduce the cost of loans granted to members. This is not in line with the financial systems approach to microfinance (section 2.4), which emphasises the importance of non-subsidisation and mobilising voluntary savings as a source of funds to capitalise loan portfolios.

In conclusion, FSCs experience problems in reaching sustainability because of their clients' profile, low income levels and no need for credit facilities; lack of capacity to manage FSCs; and lack of support from the regulating bodies, FSA and FinaSol in the past, and currently the NDA. The main reason for FSA and FinaSol's collapse was the withdrawal of donor funds (section 3.7.2). In other words, the lack of FSA and FinaSol in reaching sustainability prevented FSCs from reaching sustainability. Thus, FSCs find themselves in a catch-22 situation. Their sustainability has an

impact on the regulating bodies' sustainability, but at the same time, the regulating bodies' sustainability has an impact on that of FSCs.

3.10 Concluding remarks

FSCs operate in a financial market where 35% of the adult population, 78% of the poor and 86% of the very poor is unbanked. Given the potential demand for financial services (which include savings, credit, transmission and insurance services) as well as the limited supply by formal financial institutions in rural areas, FSCs have the potential to contribute extensively to open up access to financial services to the poor in these areas. For the reasons discussed in this chapter, they have to date not succeeded in this.

This chapter concludes by summarising the main determinants identified for FSCs to succeed in this regard. Firstly, for FSCs to succeed in opening up access to financial services to the rural poor, appropriate banking services should be provided. The most important of these are savings facilities. The poor demand this for safe-keeping of their savings, but at the same time allowing members access to their funds on a day-to-day basis. Savings services will also provide FSCs with the necessary funding for on-lending, which in turn will generate income and thus promote less donor dependency.

Credit services should only be provided once the institutions have grown and have built institutional capacity, have overcome the information constraints present, have costs under control and are able to offer loans at commercial rates of interest. Transmission services, although much in demand, are not provided since FSCs lack appropriate infrastructure. Requirements include appropriate information systems, institutional capacity and legal recognition.

The second determinant is access to the formal banking sector in order to ensure access to (i) training and advice that could improve the capacity of FSCs and (ii) a wider range of financial

services for their members. The required linkage to a commercial bank ought to have ensured this. However, the expected advantages did not flow from FSCs' linkage with the formal banking sector.

Thirdly, FSCs need to operate under an appropriate legal framework. This requires that they need to register under the Cooperative Act, currently under review. As cooperatives, FSCs rely on principles dating back to the 1850s, which include self-help, self-administration and collective ownership. The current Cooperative Act is limited in its approach to provide for different cooperative institutions and is biased towards agricultural cooperatives. However, the new Cooperative Bill is more in line with international standards and makes the formation of cooperatives more accessible to all communities. It will provide for an enabling environment that will stimulate the establishment and growth of sustainable cooperatives.

In addition, FSCs as banking institutions provide deposit services to members and therefore are required to be registered in terms of the Banks Act. Unfortunately, the current high restrictive requirements forces FSCs to register under an exemption to the Banks Act. This exemption notice has been extended twice since 2000 and expires at the end of 2005. Experience indicates that more enabling legislation is a precondition for increased success as a deposit-taking institution. The new Draft Cooperative Banks Bill, if implemented, will repeal the exemption notices and create an enabling legal framework. It provides for FSCs to register as cooperative banks, the registration of a support organisation overseeing the development and capacity building of FSCs, the Minister of Finance to be responsible as regulator, and for the appointment of a Supervisor of Cooperative Banks.

CHAPTER 4

CONCLUSION

The vast majority of the poor throughout the world do not have access to basic banking services. Internationally MFIs have succeeded in substantially opening up financial services to the poor. Local institutions show similar potential in reaching these people. Therefore, the objective of this research is twofold. It firstly identifies international best practice with regard to micro finance and, secondly, it discusses how FSC operations relate to these practices in order to reach a conclusion whether FSCs are successful in addressing the financial needs of the poor.

Services provided should focus on the needs of the poor, i.e. voluntary savings, commercially obtained credit and transmission services. Emphasis is placed on savings as a source to finance the loan portfolio and interest rates that will reflect the true cost of funds and will finance a viable lending operation. While some MFIs require mandatory savings as collateral from clients before approving a loan, some offer voluntary savings services. If an MFI provides services on both sides of the balance sheet, such an institution operates as a true financial intermediary between clients. The only services FSCs provide, apart from the shares that allow membership, are savings services and, to a very limited extent, credit services. The mere existence of these services clearly indicates that there is a demand for them and that FSCs are providing in this need. However, the lack of institutional capacity prevent FSCs from fully utilising accumulated savings as a source for on-lending.

FSCs interviewed expressed their eagerness to be able to provide their members with transmission facilities. Fortunately, the proposed Cooperative Bank legislation makes provision for the

establishment of a Savings Cooperative Bank which may provide transmission services. This will benefit many pensioners and grant recipients situated in the rural areas.

To provide financial services, institutions need strong institutional capacity. This includes effective deposit and loan administration, high loan repayment rates, improved operating procedures or the development of new ones, increased staff productivity and effective management information systems. FSC managers complain that staff members have no knowledge of how to effectively run their institution because of the absence of training. Manually updated records are used instead of the proposed information system. As a result, effective record keeping is hampered and restricts financial analyses.

To strengthen FSCs' institutional capacity, FSCs had to secure a business arrangement with a commercial bank. Linkages would have allowed institutions access to commercial funds, training services, improved financial services and as a result increased outreach and sustainability. FSC, however, did not experience these benefits from their link banks. Under the new proposed Cooperative Bank legislation, FSCs will not have to secure a business arrangement with a commercial bank, since they will operate as a registered bank. In addition they will receive support from a registered support organisation, which will provide training, support management and serve as the accounting officer.

The primary objective of the regulation of financial institutions is to protect the stability of the payments system at a macro level and, at a micro level, protect depositors. As FSCs accept deposits, they need to be regulated. Options available include regulations by a tailor made act, or self-regulation. Apart from being regulated, institutions need to be supervised to ensure that they adhere to the regulations. Options available include supervision within the existing supervisory authority, delegated supervision or an apex body that provides wholesale funding and is therefore by nature the supervisory

agency. Currently, the exemption notice makes provision for FSCs to be regulated by self-regulating bodies. However, the failure of these institutions, i.e. FSA and FinaSol, indicates that self-regulation is not successful. These institutions had to perform conflicting tasks, both developing and regulating FSCs at the same time. As a result, problems arose and led to the withdrawal of donor support and the closure of both FSA and FinaSol. The responsibility now lies with the NDA, SARB and National Treasury. The proposed Cooperative Banks Act makes provision for the Minister of Finance to be responsible as regulator and a supervisor for the supervision of FSCs is also provided for.

The literature is unambiguous about the fact that MFIs need to register in terms of the financial laws of the country applicable in order to effectively provide financial services to the poor. Internationally, cooperative banking institutions are registered in terms of a country's Cooperative Act, as well as either a Cooperative Banks Act, or the Banks Act. Advantages of such a dispensation include operating at the second- instead of the third-tier, appropriate regulation and supervision, remedial actions when experiencing financial difficulties and increased participation due to increased confidence amongst members of the cooperative.

Locally, optimism for the future of FSCs stems from both the proposed Cooperative Act as well as the proposed Cooperative Banks Act. The new Cooperative Act is in line with international standards and makes the formation of cooperatives accessible to all communities. It will provide for an enabling environment that stimulates the establishment and growth of sustainable cooperatives.

As deposit taking institutions, FSCs currently operate under an exemption to the Banks Act. This has been shown not to be conducive for the proper functioning of FSCs. The proposed Cooperative Banks Act will repeal the exemption notice. This proposed legislation will create an enabling legal framework. It provides for FSCs to register as cooperative banks, the registration of a support

organisation overseeing the development and capacity building of FSCs, and a supervisor responsible for the supervision of FSCs. This route allows FSCs to be more transparent in their operations.

To measure the success of MFIs, international benchmarks are available. Both outreach (breadth and depth) and sustainability (OSS and FSS) indicators are emphasised. 53 FSCs are still in operation, reaching 39 202 members and with a savings portfolio worth R5.5 million. FSCs' breadth of outreach in terms of number of savers and total savings portfolio is not in line with the international benchmarks for either small or African MFIs. How many pensioners and women are reached is not possible to calculate. The absence of well-recorded information limits the extent of analysis. However, FSCs perform better than small, African MFIs and MFIs targeting the poor in regard to depth of outreach.

FSC are not financially sustainable. Without donor support capacity training remains a problem. This, combined with low usage of credit services, limits operational income to cover expenses. Many of the factors leading to this unsatisfactory result will be addressed when FSCs register under the proposed Cooperative Banks Act. .

Other problem areas that require serious attention include the following:

- FSCs desperately need training. Neither the regulating bodies nor the NDA train FSC staff. Once trained, the staff will improve the efficiency and effectiveness of the FSC. The NDA needs to take up the responsibility while legislation is prepared and discussed. The people need the services, but the unwillingness of the NDA to intervene will cause many FSCs to discontinue operations. This will leave members without access to savings services.
- FSCs need financial assistance. The initial start-up amount of R40 000 never reached the FSCs, while the R8 000 towards buying a safe and some stationery is not sufficient to start and run a FSC. Government needs to intervene by supporting the establishment (start-up) and

development (technical assistance) of FSCs with the clear understanding that financial support is temporary.

- FSCs are well positioned to provide rural communities with transmission services. However, the problems identified first need to be addressed.

In conclusion, given the international experience, FSCs do not successfully intermediate between borrowers and savers. In addition, they do not show any success in reaching sustainability. The reason for their failure is not because of the unwillingness of communities to participate. Communities in fact show high levels of interest and FSC managers a willingness to serve and empower them. The failure can be explained by restrictive legislation, inappropriate regulation and supervision.

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