ASSESSING THE SUSTAINABILITY OF SAVING AND MICRO-CREDIT PROGRAMME (SMCP), ERITREA

By

Berhane Ghebreslasie Tesfamariam

AN ASSIGNMENT SUBMITTED TO THE
UNIVERSITY OF STELLENBOSCH
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE
MPHIL IN SUSTAINABLE DEVELOPMENT PLANNING AND MANAGEMENT

Supervisor

Prof. Mark Swilling

December 2004
Declaration

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

Signature

Date 18-03-2004
Abstract

For a long time now micro credit has been as a central poverty alleviation strategy and a means of promoting economic growth and employment. Decision makers and development planners recognized that the provision of micro credit to those with no previous access to credit facilities can serve as a tool to combat poverty.

The Saving and Micro Credit Programme (SMCP) is one of such micro credit institutions that was established and is working in Eritrea to attain this aim. It is clear that micro credit should be sustainable if it is to have institutional permanence in lending, have a wider outreach and be focused and efficient. However, this is not so simple. The imperative to develop a viable and sustainable institution has also to be balanced against social objectives for which the sustainability objective is a means.

Assessing the factors underlying the success or failure is essential to make a planned intervention that can help to enhance sustainability of such a micro credit institution. This study is thus carried out to assess and examine the sustainability of the SMCP. In an attempt to make such an assessment forty respondent clients and four key informants namely the General Manager, a regional Manager and two promoters were consulted. The forty interviewees were selected from seven sites in two regions out of the six regions in the country. The selection was based on purposeful and convenience sampling. Mostly qualitative and to some extent quantitative methodology was used to analyze and interpret the data.

The findings of the study indicated that the legal status and legal framework governing the microfinance sector is yet to be established.
It was found out that the government limits the interest rate. This limits SMCP’s ability to price its product on a full cost recovery basis while maintaining competitive product prices.

Despite its importance to clients as well as to the programme, SMCP experienced slow growth of voluntary savings. It has been applying mostly obligatory savings serving as a guarantee fund characterized by locked-in or group accounts.

It was also found out that clients express their dislike of the mutual guarantee which means having to pay for group members' default.

On the other hand, it has been identified that SMCP’s work is decentralized and brings the service to a doorstep level, rendering it efficient and cost effective.

It has been found that SMCP is making an effort to develop a product mix that is tailored to meet the needs of the target market.

Taking into consideration the hostile environment under which SMCP was forced to work and the young age of SMCP, what is revealed by the sustainability indicators Operational Self Sustainability Indexes and Financial Self-sustainability indicates remarkable achievements.

Finally the study has made some recommendations which can help develop a sustainable institution. These include establishing a legal base; pricing products on a full cost recovery basis; introducing a good and planned remuneration packages and an incentive scheme.

The findings of the study reveal the problems and the short comings identified by the study provide an opportunity for a planned intervention to enhance the sustainability of the programme.
Opsomming

Mikrokrediet word al lank beskou as 'n belangrike strategie om armoede te verlig en om ekonomiese groei en werkverskaffing te bevorder. Besluitnemers en en die beplanners van ontwikkeling besef dat die verskaffing van mikrokrediet aan diegene wat voorheen nie toegang gehad het tot kredietfasilitate nie, kan dien as instument om armoede te bestry.

Die Besparing en Mikrokrediet Programme (Saving and Micro Credit Programme SMCP) is 'n voorbeeld van 'n mikrokrediet genootskap wat gestig is en wat in Eritrea poog om hierdie doelwit te verwesenlik. 'n Mikrokrediet instansie moet volhoubaar wees sodat dit permanent kan uitleen, wyer kan uitreik en meer gefokus en effektief kan fokus soek. Dit is egter nie so eenvoudig nie. Dit is belangrik om 'n lewensvatbare en volhoubare instansie te stig maar dit moet opgeweeg word teen die sosiale doelwit, naamlik dat die volhoubaarheid om sosiale redes belangrik is.

Die faktore wat tot sukses of mislukking lei moet in ag geneem word voordat daar 'n beplande ingryping kan plaasvind wat die volhoubaarheid van die mikrokrediet genootskap sal bevorder. Hierdie studie is dus onderneem om die volhoubaarheid van die SMCP te ondersoek. Tydens die studietydperk is veertig respondente (kliënte) en vier sleutel informante naamlik die algemene bestuurder, 'n streeksbestuurder en twee promoters ondervra. Die veertig respondente is gekies uit sewe dorpe in twee van die sewe streke van die land. Die keuring is gedoen gebaseer op doelgerigte en gerieflikheids monstering. Meestal kwalitatiewe en tot 'n sekere mate kwantitatiewe metodologie is gebruik om die data te ontleed en te interpreteer.
Die bevindinge van die studie dui aan dat die wettige status en die wettige raamwerk wat die mikrofinansies sektor moet onderlê, nog nie tot stand gebring is nie.

Die regering beperk die rentekoers. Dit beteken dat SMCP se vermoë om sy produk te beprys op die basis van volle koste verhaling terwyl kompeterende pryse gehandhaaf word, ook beperk is.

Ten spyte van die feit dat besparing belangrik is vir die klient en vir die programme, het dievrywillige besparing stadig gegroei. Die programme het meestal gedwonge besparing toegepas as 'n waarborgfonds wat gekenmerk is deur groeprekening.

Daar is gevind dat die klënte hulle ontevredenheid uitspreek met die beginsel van onderlinge waarborg wat beteken dat hulle moet inbetaal as 'n lid van die groep versuim om te betaal. Aan die ander kant is daar gevind dat die SMCP gedesentraliseerd te werk gaan en en diens tot by die deur van die klient bring, wat die diens effektief en koste effektief maak. Die SMCP doen moeite om 'n produkmandjie te ontwikkel wat geskoei is op die behoefte van die teikenmark.

As ons die vyandige omgewing in ag neem waarin die SMCP moes werk en die feit dat dit 'n baie jong genootskap is, het die genootskap verbasend goed gevaar. Dit word aangedui deur die volhoubaarheids indikators: Operational Self Sustainable Indexes and Financial Self-Sustainability.

Aanbevelings word gemaak wat kan bydra tot tot die ontwikkeling van 'n volhoubare instansie. Dit sluit in die tot stand bring van 'n wettige basis: die beprysing van produkte op die basis van volle verhalings kostes; en die invoer van 'n beplande vergoedingspaket en 'n aansporingskema.
Die bevinding van die studie is dat die probleme en tekortkominge die geleenheid bied vir beplande ingryping om die volhoubaarheid van die programme te verbeter.
Dedication

This work is respectfully dedicated to the Eritrean martyrs who have sacrificed their precious lives to defend the mother land in the border conflict of 1990-2000.
Acknowledgements

It is a great honour and privilege for me to have studied at the University of Stellenbosch. I thank God for granting me such an opportunity and believe that all the good in me is His gift. My indebtedness and gratitude to the Eritrean Ministry of Local Government and the University of Asmara for giving me this opportunity for further study and sponsorship is great. My indebtedness and gratitude to the University of Stellenbosch is also immense and unforgettable for providing me sponsorship to finish my studies when my sponsorship terminated.

My profound gratitude goes to Prof. Mark Swilling, my supervisor, for his guidance, valuable inputs and encouragement throughout this work. His devotion and enthusiasm to help in hard times of the study period has been very impressive and unforgettable. These are behaviours by which I am deeply moved and which I value. My sincere thanks also go to Ms. Anneke Muller for her help, advice and concern during the writing of this paper. I thank Mrs. Eve Annecke, Dr. Piet Classen, Prof. Johan Burger and my other teachers. I am glad that part of them lives in me.

My special thanks go to my intimate friend, Mr. Menghestebab Afewerki, the manager of SMCP, for all the valuable information, and the relevant materials with which he provided me and for his kind help in facilitating my fieldwork for data collection. I thank the staff of SMCP for their data. I am also indebted to the SMCP Manager of Debub Region, the promoters of the Saganeiti, Dekamare, Debarwa and Galianefhi Sub-regions for their commitment of travelling to the different sites with me, arranging the interviews and sharing their knowledge and experience on the programme. I am equally grateful to all my respondent-clients.
of SMCP whose cooperation and knowledge has contributed much to the shaping of this paper.

I would also like to express my heartfelt thanks to my wife Mrs. Zega Oqbamicael and my children Selam, Selomon, Yordanos, Yohannes, Merhawit and Alexander for their perseverance and patience during my absence.

I thank my cousin, Mr. Tesfamicael Ghiorgis; my brother in-law, Fr. Teclu Oqbamicael; my nephews, Mr. Efrem Isayas and Mr. Solomon Tewelde; my friends, Mr. Micael Tcellemarium, Mr. Zeray Gheremedhn, Mr. Sultan Tesfay, Mr. Franco Nino, Mr. Azmera Tesfazghi, Mr. Ghermay Tesfazion; and other loved ones for their moral and material help to my family and myself while I was studying. May God reward you all for your kind acts!
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>General Introduction</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>1.0 General Introduction</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>1.1 Background of the problem</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>1.2 Problem Statement</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>1.3 Objectives of the study</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>1.4 The Research Questions</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>1.5 Significance of the Study</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>1.6 Scope and Limitation of the Study</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>1.7 Research Methodology</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>1.8 Organization of the Study</td>
<td>13</td>
</tr>
<tr>
<td>2</td>
<td>The Concept of Sustainability with regard to Microfinance, the Factors Influencing it and its Implication to Poverty</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>2.1 Poverty and how it is affected by financial services</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>2.1.1 Poverty and its dimensions</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>2.1.2 The effect of financial services on poverty</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>2.2 Microfinance and its various aspects as related to sustainability</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>2.2.1 The meaning of microfinance and the evolution it underwent</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>2.2.2 Objectives of the microfinance institution</td>
<td>23</td>
</tr>
<tr>
<td></td>
<td>2.2.3 Microfinance as an institution</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>2.2.5 Literature on different models of microfinance and the paradigm shift it underwent</td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>2.3 Sustainability concept and microfinance factors affecting it</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>2.3.1 The meaning of sustainability</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>2.3.2 Financial service products and their delivery mechanisms and procedures</td>
<td>36</td>
</tr>
</tbody>
</table>
2.4 Outreach.................................................................................................................. 48
2.5 The implication of sustainability for poverty alleviation .................................... 49
2.6 Summary.................................................................................................................... 52

CHAPTER THREE: ASSESSING THE SUSTAINABILITY OF SAVING AND MICRO-CREDIT PROGRAMME (SMCP) ERITREA .......................................................... 54
3.1 Overview of Erirtean................................................................................................. 54
3.2 Saving and Micro Credit Programme Erirtean.......................................................... 58
   3.2.1 Background of SMCP ...................................................................................... 58
   3.2.2 Objectives and Strategies of SMCP ................................................................. 60
   3.2.3 Organizational Structure .............................................................................. 61
   3.2.4 SMCP's legal base, political and economic environment ............................... 63
3.3 SMCP's working policies and procedures and their implication to sustainability ... 65
   3.3.1 Loan products, and their use ......................................................................... 65
   3.3.2 The programme model .................................................................................. 72
   3.3.3 Security, loan term and repayment method .................................................... 73
   3.3.4 Group formation ............................................................................................ 74
   3.3.5 Loan processing and approval procedure ...................................................... 74
3.4 Organizational and financial sustainability of SMCP ............................................ 76
   3.4.1 Organizational structure and governance ....................................................... 76
   3.4.3 Interest rate .................................................................................................... 78
   3.4.4 Repayment ..................................................................................................... 79
   3.4.5 MIS ................................................................................................................ 83
   3.4.6 Outreach ........................................................................................................ 84
   3.4.7 Staff productivity ............................................................................................ 89
   3.4.8 Financial performance .................................................................................... 92

CHAPTER FOUR: SUMMARY OF MAIN FINDINGS, RECOMMENDATIONS AND CONCLUSION .............................................................................................................. 97
4.1 Main findings of the study ...................................................................................... 97
4.2 Recommendations ............................................................................................... 101
4.3 Conclusion .......................................................................................................... 104

BIBLIOGRAPHY ........................................................................................................ 108
LIST OF TABLES

Table 3.1: SMCP's loan products ..........................................................64
Table 3.2: Tier Ia products .................................................................65
Table 3.3: Tier Iib products .................................................................67
Table 3.4: Tier II products .................................................................69
Table 3.5: SMCP's outreach performance ...........................................83
Table 3.6: SMCP's efficiency indicators ..............................................88
Table 3.7: SMCP's staff productivity compared ...................................90
Table 3.8: SMCP's financial performance ratios ..................................91
LIST OF FIGURES

Figure 2.1: Credit, investment, income and savings cycle..............................36
Figure 3.1: SMCP’s organization chart..........................................................60
Figure 3.2: Loan use in percentage................................................................68
Figure 3.3: Loan loss and delinquency rate......................................................79
Figure 3.4: SMCP’s number of active loans......................................................84
Figure 3.5: SMCP’s outstanding loan portfolio................................................85
Figure 3.6: SMCP’s self sufficiency ratios.......................................................87
Figure 3.7: Trend of SMCP profitability indicators.........................................94
LIST OF ABBREVIATIONS

ACCIION  Americans for Community Cooperation in Other Nations
ACORD   Agency for Co-operation and Research Development
BAAC    Bank for Agriculture and Agricultural Cooperatives
BKK     Badan Kredit Kecamalan
BUD     Bank Rakyat Indonesia Unit Desa
CGAP    Consultant Group to Assist the Poor
ECDF    Eritrean Community Development Fund
FINCA   Foundation for International Community Assistance
FSSI    Financial Self-Sufficiency Index
GB      Grameen Bank
ICC     International Capital Corporation
IDP     Internally Displaced Person
MFI     Microfinance Institution
MIS     Management Information System
MOLG    Ministry of Local Government
NGO     Non Governmental Organizations
NSC     National Steering Committee
OSSI    Operational Self Sufficiency Index
ROSCA   Rotating Savings and Credit Associations
RRPE    Recovery and Rehabilitation Programme of Eritrea
SMCP    Saving and Micro Credit Programme
SMME    Small, Micro and Medium Enterprises
UNDP    United Nation Development Programme
USAID   United States Agency for International Development
VBC     Village Bank Committee
CHAPTER ONE: INTRODUCTION

1.0 General Introduction

It has been around thirty years since policy makers and planners began to consider micro-credit as one of the important development interventions that can be used to help families move out of poverty. It is regarded as a central poverty alleviation strategy and a means of promoting economic growth and employment through small micro, and medium enterprises. As such, the realization of the Micro-credit Summit Campaign's target of reaching 100 million of the world's poorest families with credit for self-employment and other financial and business services offers a significant contribution to the Millennium Development Goals, one of which is halving absolute poverty in the world by 2015 (Daley-Harris, 2002:4).

It is clear that micro credit should be sustainable if it is to have institutional permanence in lending, have wider outreach, and be focused and efficient. However, there is an ongoing debate about the compatibility of poverty alleviation goals and institutional sustainability (Morduch, Rhyne, cited in Ruit, 2002:6).

According to Simanowitz and Walter (2002:4), to achieve these goals practitioners have had to make many compromises and trade-offs. The imperative to develop viable and sustainable institutions has placed great pressure on organizational productivity and efficiency but this has had to be balanced against social objectives for which the sustainability objective is a means. The goal of combating poverty in the most effective way has also necessarily been compromised, as it is clear that micro credit institution, seeking to become financially sustainable, cannot spend the time and resources with clients that more holistic development organizations might.
Maintaining the appropriate balance between meeting the social objectives and developing a viable and sustainable institution is a challenge. Maintaining a balance between excellent financial performance, outreach to the poorest people and significant positive impacts on the lives of their clients, is difficult. To date there has been inadequate exploration of financial products and low-cost service delivery mechanisms that would allow microfinance institutions to include extremely poor households without compromising their sustainability objectives (Hickson, cited in Sam Daley-Harris, 2002:18).

Innovative financing with the vision and ability to reach the very poor while maintaining strong financial performance is crucial and needs be explored. It is likely that the process of striving towards these goals will involve trade-offs between the social and financial objectives. It can be expected that the nature of these trade-offs will vary in different contexts.

Case study material has been drawn from Eritrea to explore how this initiative has fared. Eritrea, a newly established and one of the poorest countries in the world, tests the assertion made about microfinance being sustainable and a poverty alleviation strategy. An assessment of the factors underlying the success or failure of a micro credit institution is timely because development agencies and developing country governments including Eritrea have been involved intensely in the promotion of such micro credit institutions.

The development of such an institution in a newly established country such as Eritrea hopefully presents a genuine opportunity to build on the more positive aspects of recent experience elsewhere and to seek to avoid repeating the mistakes which have been made in the past.
1.1 Background of the problem

As equity concerns emerged in the early 1970s, the focus on poverty gained in importance (Owens and Show, 1972). In this period decision makers and development planners recognized that provision of micro credit to those with no previous access to credit facilities can serve as a tool to combat poverty. At this time government agencies were the predominant method of providing productive credit to these disadvantaged people. Government and international donors assumed that the poor required cheap credit and saw this as a way of promoting agricultural production by small landholders (Ledgerwood, 1992:2). Such government programmes – normally based on a social welfare, subsidy approach – nearly always end in being used as vehicles for political patronage, extremely low repayments, market distortions and eventually truncation of services (Women’s World Banking, 2002:272).

The inadequacies of rural finance and the policies and instruments on which their operations depend have been well documented (Adams and Vogel 1986, Braverman and Guasch 1986, Von Pischke 1991). As Wilson puts it:

"Analysts and practitioners alike have been united in declaiming the limitations of supply-led credit provision and the inefficiencies of processes which have been applied to the appraisal, delivery and management of targeted loan programmes. Credit need has too often been misunderstood and we have neglected (and even discouraged) savings through our emphasis on "cheap credit". Too little attention has been paid to the quality (as opposed to the quantity) of credit." (Wilson, 1995:1)

Wilson (1995:1) points out that in consequence to what has been mentioned here above, with few exceptions and across a wide range of countries, the performance of micro-credit institutions has been disappointing.

In line with this, Women’s World Banking (2002:264) points out that during the 1980s
and 1990s, particularly in Asia, Africa and Latin America thousands of microfinance NGOs were established to provide micro-loans, using individual and group lending methodologies. However, the measures and models considered to be best practice were regarded by many as too costly for the very poor. Solidarity groups naturally select individuals of a similar economic and social position. Micro finance institutions seeking institutional and financial sustainability are required to charge interest rates which cover the costs of the capital and operational expenses, these being too costly for the very poor. Such institutions believed that the focus should be on poverty where specific targeting strategies and support measures are required which will prolong dependency on donor support.

Beginning in the mid-1980s the subsidized, targeted credit model supported by many donors was the object of steady criticism, because most programmes accumulated large loan losses to the extent of failing basic challenges like controlling loan delinquency and covering costs. They required frequent recapitalization to continue operating. Such necessity of continued subsidization drained budgets and deprived other sectors of the economy of funds. In general, they have not mobilized savings effectively. They have been characterized by poor financial reporting, a lack of or inadequate provisions for bad debts, and legal ceilings on interest rates, wrong financial policies and delivery mechanisms and replications of methods and models that are not suitable for local conditions.

Thus it became more evident that adjustments should be made and particularly that market based solutions were required. This led to a new approach that considered microfinance as an integral part of the overall financial system. Most recently microfinance institutions have recognized the need to achieve financial sustainability which has led to the current “financial systems” approach characterized by the
following beliefs:

- Subsidized credit undermines development

- Poor people can pay interest rates high enough to cover transaction costs and the consequences of the imperfect information markets in which lenders operate.

- The goal of sustainability (cost recovery and eventually profit) is the key not only for institutional permanence/continuity in lending, but also to making the lending institution more focused and efficient.

- Because loan sizes to people are small, microfinance institutions must achieve sufficient scale if they are to become sustainable.

- Measurable enterprise growth, as well as impacts on poverty, cannot be demonstrated easily or accurately; outreach and repayment rates can be proxies for impact. (Ledgerwood, 1999:2)

According to Women's World Banking (2002:270), broad consensus now exists that microfinance needs to work for poor people and to be financially sustainable. It is also recognized that microfinance is not the answer for all the world's poorest families; some will need support other than microfinance, if they are to move away of poverty. Experience demonstrates that the financial needs of poor people are best served by encouraging a broad range of institutional types to provide efficient and responsive lending, savings, insurance, and other financial services that poor people need to build their business, increase income and assets, and reduce risks. Poor people need sustained access to an evolving set of financial products and services. These can only be provided by financially sustainable institutions, dealing with diverse segments and products, each in the position to increase outreach and grow
with their clients.

1.2 Problem Statement

As mentioned earlier, it has been a couple of decades since provision of micro credit services to poor people was first seen as key strategy in the poverty alleviation effort. Government and donor agencies were actively involved and much resource was being used aiming at the betterment of the living conditions of these poor people. Implementation of the programme is the process of transforming these resources to achieve that objective.

Implementation normally takes place within organizational settings. The tasks done by microfinance/ micro credit, are proof that these organizations are needed to facilitate and manage the implementation process. It is a fact that these institutions should be sustainable for on-running and lasting benefit.

Unfortunately, however, micro credit institutions have frequently failed in the past. Sometimes the attempt to replicate and technically imitate the mode of operations of successful institutions without adjusting them to existing local conditions was the cause. A solution that was found adequate in one socio-economic environment, where a specific set of social values exists, is not necessarily the right approach in tackling the complex issue of providing financial services to the rural poor in a different socio-economic environment.

Some other factors also hamper the sustainability of micro credit institutions. Yaron (1992:3) mentions a number of them, some of which are the following:

- The programmes have reached a minority of the poor population, often resulting in benefits in the form of negative on-lending interest rates which
become an unintended grant element captured by wealthy and influential farmers. The maintenance and continued operation of many of the credit programmes has turned into an extremely costly drain on government budgets, which support these efforts.

- Generally, adequate provisions for bad debts have not been made and a proper assessment of the institution’s sustainability has often been impossible. The financial results disclosed by such institutions have often been too rosy, as loan losses have not been accounted for properly. The actual miserable financial position would only be disclosed when the institution had lost its liquidity. Information on the value of the loan portfolio contaminated by arrears (at least one overdue instalment) has almost always been missing. Consequently, instead of remedial actions that could have been carried out at an earlier stage, more costly measures have been necessary.

- Control of on-lending interest rates, a widespread practice in developing countries, has not allowed compensation for the high level of risk involved in lending to risky operations such as agricultural operations, given their exposure to the vagaries of nature. To maximize the return on these institutions’ loan portfolios, which are constrained by legally imposed ceiling interest rates, large borrowers often have been favoured in an attempt to minimize risk and administrative costs per dollar lent, therefore crowding out small-scale entrepreneurs.

Finally there are the exogenous factors. Micro credit institutions operate within the context of existing political, economic and cultural environments. Instabilities in such areas greatly impede proper functioning, hence the sustainability of micro credit institutions.
1.3 Objectives of the study

Based on the problems enumerated above, the aim of the study is to assess the sustainability of the Saving and Micro-Credit Programme in Eritrea (SMCP) and explore or investigate the factors for its success or failure.

The specific objectives are:

1. To review the international literature on saving and micro-credit and their sustainability
2. To explore successful experiences in the field and evaluate to what level they can be replicated or adapted in the Eritrean situation.
3. To explain the need of saving and micro-credit services in the poor rural and marginalized communities and the pertaining lack of resources to address this need in Eritrea.
4. To explain how such service can serve as a tool in poverty alleviation.
5. To assess its approaches and activities from a sustainability point of view
6. To explain how the Saving and Micro-Credit Programme (SMCP) is established aiming at bridging the gap.
7. To approve or disprove traditional assumptions and beliefs about the poor with regard to saving and credit or to test the compatibility of the programme as a poverty strategy and the need for its sustainability.
8. To assess the implication or effects of current approaches towards sustainability and come up with useful suggestions and recommendations.
1.4 The Research Questions

Drawing from the objectives of the study specified above, some research questions have been formulated to guide the study. The main focus of the study constitutes research to answer these questions. These are:

1. What is the aim of SMCP and the type of services provided to the people?

2. What are the financial policies and delivery mechanisms applied?

3. To what extent do these policies, delivery mechanisms and the activities ensure the sustainability of the programme and what is its implication to poverty alleviation?

4. How far does the Eritrean experience substantiate assertions made about micro credit or microfinance?

5. What challenges are faced by the programme and what are the efforts made to tackle them?

6. What can be done to ensure that such programme be sustained without neglecting its poverty alleviation aim?

1.5 Significance of the Study

The Saving and Micro-Credit Programme in Eritrea forms part of the poverty alleviation strategy package. Largely this also falls under the rehabilitation and reconstruction programme to which the government is highly engaged and committed at present.

The government and donor agencies are involving big amounts of resources for the success of the programme. The performance of many micro-credit institutions which
have been sponsored by state and international donors has often fallen short of their stated goals. This necessitates an analysis of the methods and ways of operation of such institutions to enable corrective measures to be taken to avoid possible failures and to ensure success.

Hopefully this paper can make a small contribution to the ways and means of seeking to avoid a re-run of past inadequacies and mistakes in the field and help deepen and widen the achievements of SMCP. It may also help identify policy and operational constraints which have relevance elsewhere.

1.6 Scope and Limitation of the Study

The study deals with assessing the sustainability of Saving and Micro-Credit Programme in Eritrea. A study of this nature, evaluating sustainability, involves extensive data collection and analysis. The cost being high in terms of labour and time, some details which would have been appreciated by experts in the field could not be dealt with.

This paper does not deal with the economic benefits to the ultimate borrowers of the programme. The effectiveness of the individual loans and their contribution to increasing incomes and economic development are complex and measuring them is beyond the scope of this paper.

Lastly, I acknowledge the fact that my own values, beliefs and judgments as well as those of whom I interviewed can affect the data in my research study. This, together with the resource constraints, affect my research findings although I did my best to ensure that they will not be affected to a significant degree.
1.7 Research Methodology

This study is a case study that focuses on content and analysis of the system and activities of SMCP Eritrea. The main sources of data will be both primary and secondary. The research methodology for collecting data is qualitative with some relevant statistical data relating to performance and policy issues of SMCP.

Data for this study were collected from two main sources – secondary and primary. The sources for secondary data included books, journals, the internet, regular work reports, operational manuals and a number of credit related studies conducted by SMCP and other institutions.

In primary data collection the methodological strategies employed by the researcher to address the basic research questions are semi-structured interviews with SMCP clients from Tier I and Tier II, Village Bank Committees and the SMCP officials, documentary analysis of guidelines/manuals, reports and an overview observation of the activities conducted by the institution. The focus of the interviews was on the type of service products offered, the methods and mechanisms applied, problems encountered, and the flexibility of SMCP to address the clients’ needs.

The study was conducted in Debub and Maekel, two of the six regions in Eritrea. The reason why the researcher chose these regions was that it was here where the programme was first implemented, where the number of village banks and clients are more numerous than elsewhere in the regions, also where the most diversified use of the loans exists. In view of time, financial and labour constraints, it was also for the researcher’s convenience because relatively these regions are not remote.

Against the above backgrounds, seven sites were identified. These are Asmara, Hemberti, Dekemhare, Segheneiti, Ala, Adifelesti, Adinehabay and Mendefera. Of these, four are villages, two towns and one a city. From these seven sites forty
respondents were selected. Out of these forty respondents, twenty eight, including four Village Bank committees, were from Tier I. The remaining twelve were from Tier II. The selection of the respondents was based on their accessibility, their length of experience as clients, the position they occupy and knowledge they have of the solidarity groups, village banks and Tier II. Gender was also given consideration. The promoters were very cooperative and helped in identifying these clients and they helped to introduce the researcher to the clients and asked them to share their experience and knowledge about the financial service with the researcher. In two instances, the promoters of Dekemhare and Galanefhi sub-zones travelled to the specific sites outside the towns with the researcher for hours explaining all his questions about the programme and discussing freely different issues relevant to the programme on the way.

Beside these client-respondents, the Manager of SMCP, the Regional Manager of SMCP of the Debub Region, two promoters one of Dekamare Sub-zone, another of Galanefhi Sub-zone, were approached as key informants whom the researcher viewed as knowledgeable to supply him with rich information. Before the interview, participants were told of the aims and purposes of the research study. Further, they were also informed that confidentiality and anonymity would be maintained, and that the names of individuals would not be disclosed.

The researcher decided on using interview for his study because an interview offers a very flexible and accessible means of information gathering. The researcher also decided to apply semi-structured interviews because he believed that this would enable him to structure the responses of the interviewees so as to gain information on the required areas and raise necessary questions, which might occur during the interview period. The value of semi-structure is to enable researchers to probe the
responses made by the interviewees while at the same time controlling the tendency to deviate from the topic in question.

During the fieldwork done in one month's time from July 18 to August 20, 2003 the intended face-to-face interviews with the interviewees was completed. In addition, the researcher attempted to observe first hand the activities conducted by the clients with the loans they take. In the data analysis both qualitative description and quantitative such as percentages, tables, graphs etc. will be used.

1.8 Organization of the Study

The study is divided into four chapters. Chapter one presents the introductory part. It touches upon the general background to the study, objectives, research questions, significance of the study, scope and limitations and the research methodology.

After giving a short and general description of what is meant by micro-credit, microfinance and financial microenterprise and the way they are used in the study, chapter two discusses the concept of sustainability with regard to microfinance, its implication for poverty eradication and the factors which influence it.

Chapter three, after giving an overview of Eritrea, the study area, deals with assessing the sustainability of Saving and Micro Credit Programme in Eritrea. The analysis of the data mostly focuses on the objectives and research questions specified earlier in this chapter.

Chapter four presents a summary of the main findings and recommendations.
CHAPTER TWO: THE CONCEPT OF SUSTAINABILITY WITH REGARD TO
MICROFINANCE, THE FACTORS INFLUENCING IT AND ITS IMPLICATION TO
POVERTY

2.1 Poverty and how it is affected by financial services.

2.1.1 Poverty and its dimensions

The Declaration of the World Summit for Social Development, Copenhagen, 1995,
(as cited in Taylor Committee, 2000) points out:

"Poverty has various manifestations, including lack of income and productive
resources sufficient to ensure sustainable livelihoods; hunger and malnutrition;
ill health; limited or lack of access to education and other basic services;
increased morbidity and mortality from illness; homelessness and inadequate
housing; unsafe environments; and social discrimination and exclusion..."

In line with this Statistics South Africa (as cited in Ackron, 2000:1) describes poverty:

"Poverty is seen in all its manifestations as the denial of opportunities and choices
most basic to human development, to lead a long, healthy, creative life and to enjoy a
decent standard of living, freedom, dignity, self-esteem and respect from others".

This indicates that poverty is a multidimensional phenomenon. It encompasses the
inability to satisfy basic needs; lack of control over resources; lack of education and
skills; poor health; malnutrition; lack of shelter; poor access to water and sanitation;
vulnerability to shocks, violence and crime; and the lack of political freedom and
voice. Simanowitz and Walter (2002:20) suggest that in order to understand poverty
holistically, it is important to move beyond the economic and include the fulfillment of
basic needs (food, shelter, clothing, health, education, and psychological well-being),
the means to achieve welfare in the present and future, social networks and
empowerment, and vulnerability to risk.
Poverty is usually defined in either absolute or relative terms. According to Taylor (2002:6) an inability to afford an adequate standard of consumption is absolute poverty. In this event, one would use a poverty line, reflecting an income level sufficient to afford adequate consumption, as a point to determine who is poor and who is not.

This definition overlooks the distribution of resources in society that often underpins absolute poverty. Thus relative poverty refers to an individual's or group's lack of resources when compared to that of other members of that society. Bringing these absolute and relative concepts together, Taylor (2002:7) points out that poverty can be defined as the inability of individuals, households or entire communities to command sufficient resources to satisfy a socially acceptable minimum standard of living.

With regard to these two dimensions of poverty May (2001) also indicates that in the absolute sense of poverty, the poor are materially deprived to the extent that their survival is at risk. In the relative sense, they are also deprived in relation to other social groups in the society in which they live and whose situation is less constraining. Relative deprivation in this sense is a universal and permanent feature of human society.

The World Bank (as cited in Arckon, 2002) describes absolute poverty or extreme poverty as the deprivation of individuals relative to some absolute and predetermined norm(s) or standard taken as the minimum necessities of life or minimally acceptable standard of human existence. Some norms and standards do not necessarily relate only to income or to wealth, but also to other aspects of the quality of human existence. In fact, a distinction has increasingly come to be made between income poverty and other aspects of socio-economic deprivation.
Sebastad and Cohen (2000) separate those living above and below the poverty line - poor and non-poor. The category of poor are further divided into destitute (bottom 10% below the poverty line), extreme poor (those in the bottom 10 to 50% of households below the poverty line), and moderate poor (the top 50% of households living below the poverty line). A further category of vulnerable non-poor is also recognized. The extreme poor and destitute is defined by the Micro-Credit Summit as the poorest and by the Consultative Group to Assist the Poor (CGAP) as very poor.

Poverty is not a static condition; individuals, households or communities may be vulnerable to poverty as a result of shocks and crises (uncontrollable events which harm livelihoods and food security) and long-term trends (such as racial and gender discrimination, environmental degradation and macroeconomic trends). Vulnerability to poverty is therefore characterised by an inability to devise an appropriate coping or management strategy in times of crisis (May, 2000). To put it in Fransman (2002) words "...Whatever one's station in life is, no person is above the risk of falling within the social security net" of course due to poverty.

As long as eradication of poverty remains as one of the major challenges of the world, the complex roots and causes of absolute poverty must be studied and a comprehensive development strategy for its reduction or eradication must be formulated. Often there appears a tendency based on emotion or political motive, of addressing the symptom of poverty by means of poverty reduction or poverty relief. However, it is evident that a poverty alleviation strategy of any time range will be effective only if the roots and causes of poverty are correctly identified and addressed.

Ackron (2002:5) indicates that assets and the return on them can serve as a basis for rational understanding of the roots of poverty. Individuals and communities have
access to these assets in different forms and ways. It is the returns that individuals and communities acquire by using these assets that determine their well-being. Where such assets are absent or deficient or where low returns are achieved, extreme poverty is the result.

Sebstad and Cohen (cited in Simanowitz & Walter, 2002:20) define these assets as financial, human, physical and social. Financial includes income size, regularity and security, savings, loans or gifts. Human includes skills and knowledge, ability to labour, good health, self-esteem, bargaining power, autonomy, and control over decisions. Physical includes housing, land, productive and non-productive possessions, and so on. Social includes networks, group membership, relations of trust, access to wider institutions of society, freedom from violence.

This triggers a thought that anything that creates an entitlement to resources can play a significant role in poverty eradication. Provision of financial services – primarily saving and credit services - can greatly help in this aspect as poverty alleviation is in part a process of increasing income and economic stability, which leads to improved fulfilment of basic needs and access to services. For such an objective we need to look at how best to provide financial services to both poor and very poor clients in a sustainable way.

2.1.2 The effect of financial services on poverty.

In order to understand the role that financial services can play in reducing poverty more effectively, it is important to understand conceptually the mechanisms by which financial services can affect poor people's lives. Poor people live in a high risk and changeable environment. They need to be able to take advantage of opportunities that lead to improving income or economic status, to protect themselves against the risks of crises or shocks, and to cope with these when they arise (MkNelly & Stack,
cited in Simanowitz & Walter, 2002:20). Financial services can contribute towards this by helping stabilize, diversify, smooth, and increase incomes and build them into the society in a very fundamental way, that the poor can become genuine economic participants.

Rutherford (cited in Simanowitz & Walter, 2002:20) outlines how the biggest financial need of people (poor or otherwise) is to accumulate lump sums of money that can be used to cope with opportunities or demands. “Despite their small incomes, the poor are often faced with expenditure needs which are large in relation to the sums of money they have. These lump sums can be acquired either through credit or through saving.

According to Simanowitz & Walter (2002:22), there are four areas where the need for lump sums may create hardship and where a poor person’s livelihood may be strengthened by credit, savings, or other financial services:

Opportunities: Poor people need lump sums in order to invest in opportunities – economic or social - for income generating.

Consumption: There is often a difference between people’s consumption patterns and their income. This may lead to inefficient management of household finances.

Life cycle needs: All people have major predictable occurrences throughout their lives, such as birth, marriage, death, school fees, retirement, and so forth. These all require relatively large sums of money.

Crisis and Emergencies: Unpredictable events such as illness, death, accident, fire, weather, and crime are common for all people, and more common for the very poor, who are also more vulnerable to their negative impacts.

There is a crude but conservative assumption that some 80 percent of the world’s 4.5 billion people living in low and lower-middle economies do not have access to formal sector financial services. An estimate of 1.8 billion people have unmet demands for
commercial savings or credit services from financial institutions either for credit or savings. This indicates that the demand for commercial microfinance is rarely met by the formal financial sector. One reason is that the demand is generally not perceived. Another is that many actors in the formal sector believe, wrongly, that microfinance cannot be profitable for banking institutions (Robinson, 2001:6).

CGAP (S.a.) points out that financial services can be provided to the poor. What were being provided so far, have proved to be a powerful instrument for poverty reduction that enables the poor to build assets, increase incomes, and reduce their vulnerability to economic stress. Such a tool can be used to help low-income people improve household and enterprise management, increase productivity, smooth income flows and consumption costs, enlarge and diversify their micro businesses and increase their incomes (Robinson, 2001:6).

It is a powerful socio economic weapon that needs to be promoted as a human right and a system should be designed to ensure it for all people (Yunus and Jolis, 1999:235). However, with more than a billion people still lacking access to basic financial services, especially the very poor, the challenge of providing financial services to them remains. Convenient, safe, and secure deposit services are a particularly crucial need.

Such financial services provided at small scale level to low income people, both rural and urban, is known as micro-finance. But this is a recently coined term which developed from terms such as rural finance, local finance, etc (Rhobinson, 2001:126).

It is, however, important to be realistic about the changes that can be brought about by financial services alone. We should not expect microfinance to eliminate poverty by itself. If we are to push the frontiers of the effectiveness of microfinance then we need to explore and innovate and find where the limitations are in each context.
2.2 Microfinance and its various aspects as related to sustainability

2.2.1 The meaning of microfinance and the evolution it underwent

Micro credit, microenterprise finance, rural finance, local finance, etc. are terms which involve the distribution of small scale loans to entrepreneurs and the low-income segment of the population. Such activities have a number of roots that go far back in history. For hundreds of years, poor people in Africa and Asia have formed savings and lending groups. Moneylenders and the informal market used to provide quick services, at very high costs, to people who had no access to mainstream financial institutions. In the last century, cooperatives and credit unions in developing countries have been active on savings mobilization and lending. Over the years, governments have created lending programmes for poor entrepreneurs and producers although most of these programmes have suffered from subsidized interest rates, political patronage, and low repayments (Women’s World Banking, 2002:264).

Microfinance replaced the earlier terms micro-credit and microenterprise finance at about the time the movement began to notice the importance of savings. According to Hanning & Katimbo-Mugwanya (2000), the concepts and the perceptions of its provision are said to have evolved greatly over the past two decades. While it was initially seen as an informal fragmented activity, now there is an increasing realisation of its importance as a component of the overall financial system, serving a huge portion of a country’s population. From providing micro credit to microentrepreneurs, microfinance entities are expanding into other high-demand services such as micro saving facilities.
In fact, the change of terms indicated several shifts in perspective, including not only the value of savings but also a broadening of scope from micro enterprises to low income clients generally (households, farms, individuals), and a concern with building financial institutions free of donor dependence. The term micro credit has since become associated with the Micro Credit Summit and the Grameen Bank philosophy, while the term microfinance is more closely associated with the financial systems approach (Rhyne, 2001:6). But still the Micro Credit Summit defines the micro credit institution as an institution which offers savings and other financial services to the poor and the poorest for self-employment projects that generate income, allowing them to care for themselves and their families (Micro Credit Summit, s.a.).

This shows that the terms microfinance, microenterprise finance and micro credit are often used interchangeably throughout the debates, though generally microfinance is used to refer to the field as a whole and to the development of financial institutions, while the other terms refer more narrowly to the provision of credit (Rhyne, 2001:6). The terms are used interchangeably also in this paper.

According to Ruit (2002:5), microfinance services entail the broad range of financial products while micro credit schemes target a single financial product. The microfinance literature has largely been situated in the context of SMME development, where access to credit, savings and other financial products are a vital component to enterprise promotion, employment creation, and poverty alleviation.

According to Ledgerwood (1999:1) many microfinance institutions (MFI) provide social intermediation services such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group. Thus the definition of microfinance includes both financial intermediation and social intermediation. He expresses this saying that microfinance
is not simply banking, but a development tool too. The activities usually involve:

- Small loans, typically for working capital
- Informal appraisal of borrowers and investments
- Collateral substitutes, such as group guarantees or compulsory savings
- Access to repeat and larger loans, based on repayment performance
- Streamlined loan disbursement and monitoring
- Secure savings products. (Ledgerwood, 1999:1)

2.2.1.1 Microfinance paradigms
Microfinance is said to have undergone different paradigm shifts. According to Mayoux (2002:246) these are the following:

i) Financial self sustainability paradigm: this is currently dominant by most donor agencies, underlying the models of microfinance promoted in publications by USAID and CGAP. It was the dominant inspiration behind many presentations at the 1997 Micro-Credit Summit in Washington, DC. The main policy focus is to set up financially self-sustainable microfinance programmes that increase access to microfinance services for large numbers of poor people.

ii) Poverty alleviation paradigm: The main origins and inspiration of this is the integrated poverty-targeted community development programmes. As main policy focus, microfinance is taken as part of an integrated programme to alleviate poverty and vulnerability and increase the well-being of the poorest households.

iii) Feminist empowerment paradigm: It arises from the international women’s movement and underlies the gender policies of many NGOs and the perspectives of some of the consultants and researchers looking at the gender impact of
microfinance programmes. This paradigm is rooted in the development of some of the earliest microfinance programmes in the South. As main policy focus microfinance is taken as an entry point for women's economic, social and political empowerment.

2.2.2 Objectives of the microfinance institution

Selecting a target market depends on the objectives of the microfinance service provider and the perceived demand for financial services. MFIs need to supply services that fill the gaps and integrate the unserved groups into the market. Thus the goal of MFIs as development organizations is to service the financial needs of unserved or underserved markets as a means of meeting development objectives which generally include:

- To reduce poverty
- To empower women or other disadvantaged population groups
- To create employment
- To help existing business grow or diversify their activities
- To encourage the development of new businesses

Other than these three objectives most frequently cited are:

- To create employment
- To increase the productivity and incomes of vulnerable groups
- To reduce rural families’ dependence on drought-prone crops.

Every organizational decision on what target market to serve varies with the context in which it is going to operate. The decision making process, however, must keep in
mind the two long-term goals of microfinance which are *outreach* and *sustainability* (Webster, Riopelle & Chidzero: 1996)

2.2.3 Microfinance as an institution

According to Ledgerwood (1994:93), an institution is a collection of assets – human, financial, and others – combined to perform activities such as granting loans and taking deposits overtime. Thus by its very nature an institution has a function and a certain permanence. Real institutions have a well-defined function and are set up and run to perform their function on a permanent basis. Clearly, permanence is important. Poor men and women need permanent and reliable access to savings and credit facilities, and only sustainable institutions can assure permanence.

a) Attributes of a good institution

Ledgerwood (1999:94) points out that a good institution has three attributes:

1. It provides services to the relevant target group.

   - *Appropriate services* include the offering of loans that match client demand and ones that will enable quality services to be designed and distributed so that they are attractive and accessible to the target group.

   - *The scope of services* must be consistent with situation of the clientele. At times different loan types may be necessary.

   - *Prices*: The provision of low transaction costs for the client, a high degree of deposit liquidity, and rapid availability of loans are extremely important features for a target-group-oriented institution to provide.

2. Its activities and offered services are not only demanded but also have some identifiable positive impact on the lives of the customers.
3. It is strong, financially sound, and stable enough to provide a reliable supply of financial services.

b) Institutional types

Institutions can be classified as formal institutions, informal institutions and informal providers (generally not referred to as institutions). Formal institutions are defined as those that are subject not only to general laws and regulations but also to specific banking regulation and supervision. Semiformal institutions are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial law, but with few exceptions, not under bank regulation and supervision. Informal providers are those to which neither special bank law nor general commercial law applies. Disputes arising from contact with them often cannot be settled by recourse to the legal system. (Ledgerwood, 1999:97)

2.2.4 Ownership structures

Ownership of MFIs can be of almost any type. They can be government-owned, like the Bank Rakyat Indonesia that serves low-income clients; member-owned, like the credit unions in West Africa; socially minded shareholders, like many transformed NGOs in Latin America; and profit-maximizing shareholders, like the microfinance banks in Eastern Europe (CGAP, s.a.)

Regarding the involvement of government in the provision of microfinance, some people argue that the government's role is to create an enabling environment for the success of both microenterprises and private sector microfinance organizations and that governments should not run microfinance. Others say government should
provide microfinance but must do so on a commercial basis to provide continued access to microfinance and to avoid distorting the financial markets.

2.2.5 Literature on different models of microfinance and the paradigm shift it underwent

2.2.5.1 Financial systems approach vs poverty lending approach

Microfinance in the 1990s was marked by a major debate between two leading views: the financial systems approach and the poverty lending approach. The financial systems approach emphasizes large-scale outreach to the economically active poor. It focuses on institutional self-sufficiency. Given the scale of the demand for microfinance worldwide, it believes that this is the only means to meet it. The poverty lending approach concentrates on reducing poverty through credit, often provided together with complementary services such as skills. With the exception of some mandatory savings as a condition for acquiring loans, often savings service is not provided. Under this approach donor and government funded credit is provided to poor borrowers, typically at below market interest rates. The goal is to reach the extremely poor.

Discussing the debate, Rhyne (cited by Robinson, 2001:22) points out that both camps wants to reach the poor and each believes sustainability is important. The debate is regarding the means not on the goals. It is ultimately about whether to subsidize interest rates or not. The objective is outreach and sustainability is the only means.

In relevance with this Robinson (2001:46) indicates that microfinance has made a shift from the old paradigm of subsidized credit delivery to the new paradigm of sustainable commercial microfinance. In the old paradigm, loans are subsidy
dependent, limiting the number of borrowers who can be served. Here, wide outreach is not possible because the lending interest rates of such institutions are too low to cover the costs and risks of large-scale financial intermediations. Whereas the new paradigm emphasizes the idea that, given enabling macroeconomic, political, legal regulatory, and demographic conditions, micro-finance institutions can be developed to provide financial services at the local level profitably, sustainable, without subsidy and with wide coverage.

Robinson (2001:126) points out further those four main streams of literature about local finance which impeded the development of such sustainable, commercial microfinance. These are the supply-leading finance theory, the imperfect information paradigm, informal credit markets and the saving of the poor. The Supply-leading finance theory refers to the provision of loans in advance of the demand for credit, for the purpose of inducing economic growth. The imperfect information paradigm concerns the behaviour of rational actors in an environment where information is imperfect and costly. Under informal credit markets the role of informal commercial moneylenders in local financial markets is dealt with. The literature on the saving of the poor discusses savings and its role in commercial microfinance institutions (Robinson: 2001:126).

2.2.5.2 Institutional models of microfinance – Minimalist vs Integrated

There is much debate in the field of microfinance as to whether MFIs should be minimalist – that is, offering only financial intermediation – or integrated – offering both financial intermediation and other services. Most MFIs offer social intermediation to some extent. The decision to offer nonfinancial services determines whether an MFI is minimalist or integrated.
MFIs using the minimalist approach normally offer only financial intermediation, but they may occasionally offer limited social intermediation services. Minimalists base their approach on the premise that there is a single "missing piece" for enterprise growth, usually considered to be the lack of affordable, accessible short term credit (Ledgerwood, 1999:65).

The integrated approach takes a more holistic view of the client. It provides a combination or range of financial and social intermediation, enterprise development, and social services. While it may not provide all four, the MFI takes advantage of its proximity to clients and, based on its objectives, provides those services that it feels are most needed or that it has a comparative advantage in providing. (Ledgerwood, 1999:66)

2.2.5.3. Who will be the clients of microfinance?

The clients of microfinance—female heads of households, pensioners, displaced persons, retrenched workers, small farmers, and micro-entrepreneurs—fall into four poverty levels: destitute, extreme poor, moderate poor, and vulnerable non-poor (CGAP, s.a.).

There is much debate in the field of microfinance as to whether access to financial services should be extended to include the poorest of the poor in a way that benefits them. Hume and Mosley (1996) in their book ‘Finance against Poverty’ state that using data from MFIs in seven countries, indicate to have found out that clients below the poverty line were worse off after borrowing than before.

On the other hand, a comprehensive literature review of microfinance and poverty reduction by Morduch and Haley (2001: 2) concludes that there is strong evidence that microfinance can be effective for a broad group of clients, including the very poor.
or poorest. It also concludes that financial performance of poverty-targeted MFIs can be comparable to those that do not reach the poorest.

Conventional wisdom – as expressed by the formal banking sector and many in the donor community – told us that poor people (let alone the poorest) could not use credit, and even if they could, the costs of providing credit to them would be prohibitively high. Therefore, it would be foolhardy to try, as poor people were bound to fail to use the credit well and would be bad risks. Such skeptics have been proven wrong. Millions of poor people now have access to credit and other financial services, and there is no doubt that these services can be delivered to the poor in a financially sustainable way, and that they are effectively used (Simanowitz and Walter, 2002:10).

Now the former conventional wisdom is being repeated in terms of the poorest. There is lack of progress in reaching the poorest, which is leading many to conclude that microfinance is not an appropriate intervention for most very poor people. Like the conventional wisdom of the bankers, this message is based on perception rather than evidence. There is no evidence to say that in general the poorest are unbankable. The “failures” of MFIs to reach very poor clients result not from failure of the very poor to benefit from microfinance, but from failures to design programmes to meet their needs. (Simanowitz and Walter, 2002:10)

Based on this, Hulme and Mosley (1996) suggest that recognizing the heterogeneity of the poor should lead to more innovation and experimentation, which deepens the downward reach of financial services. The depth (level of outreach) of outreach achieved by an MFI will depend to a great extent on its objectives and its ability to design products and services suitable to the level of poverty it is targeting.

**A market–based approach vs targeted approach.**

According to Simanowitz and Walter (2002:17), many people in the microfinance
industry adopt the financial systems approach – they see the primary goal of MFI as developing strong institutions that can sustainably meet the needs of the market they choose to serve. They argue that the main test of success should be client demand for the service. Steps to limit access – through eligibility criteria or targeting – raise the cost of operations and distort the market. Instead, microfinance can offer appropriate market-based approaches to deliver the right services to the right people. They argue that the increased costs incurred by poverty-focused MFIs undermine their financial performance, and result in services that are inappropriate to the market needs. The very poor should be recipients of government or donor-funded development services, not microcredit.

Simanowitz and Walter (2002:17) admit that these arguments have some logic, but they argue that they are wrong when viewed through a social lens. For a poverty alleviation objective, we need to look at how best to provide financial services to both poor and very poor clients in a sustainable way. Market-led approaches tend to serve the most profitable markets first. Thus, the more easily accessible urban and peri-urban areas will be selected before rural and marginalized areas, clients with previous business experience will be selected before those without experience; less-poor clients who can take relatively large loans will be selected before very poor clients who need very small loans. (Simanowitz and Walter, 2002:17).

It is not good enough to wait for the market to serve the poor and very poor. There is a strong case to try to understand the needs of the very poor and design services specifically for them. This is not to say that all microfinance should be implemented in this way, since there is clearly a strong case for achieving poverty reduction through working with the moderately poor and vulnerable non-poor. (Simanowitz and Walter, 2002:18)

According to Simanowitz and Walter (2002:18), from a developmental perspective,
many people view microfinance as inadequate on its own to combat poverty. Particularly they believe that credit is mostly not an appropriate service for the poorest. Much of the work looking at risk and vulnerability, points to the important role of savings and other financial services for the livelihoods of the very poor. Unfortunately, this is often cited to support arguments that credit is inappropriate for the very poor, or that the needs of the very poor are separate from mainstream microcredit.

Robinson (2001:21), for example, argues that savings are better able to reach poorer people than credit, and that the extreme poor, whom she defines as the majority of those below the poverty line, need subsidized poverty alleviation programmes, not financial services.

Simanowitz and Walter (2002:19) argue against this perspective, and demonstrate that millions of people living below the poverty line and indeed below half the poverty line can, and do effectively use credit, savings and other financial services. They take the position that the full range of financial services may or may not be appropriate for different people at different times. Poverty level is not a determinant of this, but does create a challenge for MFIs to deliver appropriate services. The challenge is to look systematically at what is appropriate in what contexts, rather than to accept what is becoming a status quo created by accepted wisdom.

2.3 Sustainability concept and microfinance factors affecting it

2.3.1 The meaning of sustainability

Because the people who belong to the target group need a reliable supply of financial services – that is, access to credit facilities – and an institution to which they can entrust their deposits, it is of paramount importance that the MFI be stable or
sustainable or at least be clearly on the way to becoming so.

While there is no universally accepted definition for sustainability, in general a microfinance institution is said to be sustainable when it manages to establish a mature organization with a programme that achieves impact at a reasonable scale of operation and has satisfactorily addressed the issues of financial and technical viability. This implies generating a regular flow of benefits to clients on terms increasingly favorable to them and the institution (Edgcomb & Cawley, 1994:86).

This also indicates that sustainability has institutional as well as financial dimensions. Institutional sustainability is the institutional aspect that can be assessed in terms of durability of the organizations set up and/or contribution to wider capacity building of staff and clients. Financial sustainability is that which can be calculated in economic terms, balancing monetary costs against income. These can be taken as their respective criteria (Mayoux, 2002:261).

In line with this, Sorensen describes the two concepts as follows:

"A financially sustainable credit scheme is one, which can generate a net profit or break even, when all costs have been met, and thus would not need subsidies anymore for its operational costs. An organizationally sustainable credit scheme would be able to manage and develop itself as an organization without external support. It would be independent with its own management and decision-making structures." (Sorensen, 1999:35)

If an MFI is self-sustainable, its existence and function is not threatened by a lack of funds for making necessary payments and it is solvent at any given moment. A sustainable institution must be able to maintain or expand its scale of operations. This is important for two reasons. A growing institution can meet the demand. Growth is also an efficient way to reduce costs.

An MFI need be subsidy independent. This means that the revenues from its operations be sufficient to cover all of its costs, including loan losses, the opportunity
cost of equity, and the full, inflation-adjusted cost of debt. It involves the ability to obtain and cover the cost of loan funds provided at unsubsidized interest rates. In most practical cases, most of them are not. To what extent their costs exceed their revenues, and whether and how fast their dependence on external support decreases over time, is the real question.

In line with this Edgcomb & Cawley (1994:89) indicate that sustainability does not mean 100 percent self-sufficiency in all programme aspects. They can and must meet 100 percent auto financing for their credit operations and establish a diversified funding base for other operational expenses not directly linked to credit. The base should include local funding as well as external support. In other words, training, business services, and other activities may continue to require a subsidy. In these areas, sustainability is determined by the ability to generate resources on favorable terms from a diversified, reliable set of sources. This includes local fund-raising from private and government sources, fund raising from external donors, and internal income generation from interest, other client fees, and savings (when legally possible) (Edgcomb & Cawley, 1994:89).

According to Yaron (1992:vii), in practice many microfinance institutions have long been sustained by various types of implicit or explicit subsidies to ensure continued operations. To eliminate subsidy dependence, a MFI needs to have positive on-lending interest rates that cover costs, adequate deposit interest rates, a high rate of loan collections, and reasonably low administrative costs.

According to Rhyne and Otero (1994:17), institutional performance intended towards self-sufficiency can be analyzed in terms of four distinct levels. In other words, financial self-sufficiency is achieved in four stages:

- In the lowest level, level one, programmes are highly subsidized. Grants or soft loans cover operating expenses and establish a revolving loan fund. It is
likely for loan funds of such programmes to erode quickly through delinquency and inflation and for revenues to fall short of operating expenses, resulting in a continuing need for grants.

- At level two, programmes raise funds by borrowing on terms near, but still below market rates. Interest income covers the cost of funds and a portion of operating expenses, but grants are still required to finance some aspects of operations.

- At level three, most subsidies are eliminated, but programmes find it difficult to eradicate a persistent dependence on some element of subsidy. It is probably necessary to reach at least this point in order to achieve large-scale operations.

- The final stage, level four, is reached when the programme is fully financed from the savings of its clients and funds raised at commercial rates from formal financial institutions. Fees and interest income cover the real cost of funds, loan loss reserves, operations, and inflation.

To eliminate subsidy dependence, Yaron (1992:5) says that a MFI should meet the following conditions:

- Have positive on-lending interest rates that are high enough to cover non-subsidized financial costs as well as administrative costs, to maintain the value of equity in real terms.

- Have adequate deposit interest rates so as to ensure that voluntary savings become an increasingly significant factor in financing the loan portfolio.

- Achieve a very high rate of loan collections, which eventually results in very low loan losses.

- Keep administrative costs low through efficient techniques and procedures in assessing investment plans, screening borrowers and processing loans,
collecting repayments, and mobilizing and servicing savings to ensure that lending rates do not become prohibitive.

What has been said so far implies that sustainability of an MFI can be taken as financial sustainability. However, sustainability used to get different interpretations in different microfinance paradigms.

2.3.1.1 Different Interpretation of microfinance

According to Mayoux (2002:246), there are three different paradigms underlying the different interpretations of the sustainability concept. These are i) the financial self-sustainability paradigm; ii) the poverty alleviation paradigm; iii) the feminist empowerment paradigm. Sustainability is interpreted differently as follows:

i) Financial self-sustainability paradigm:

Here sustainability is interpreted as programme financial self-sustainability. The main policy focus is to set up financially self-sustainable microfinance programmes that increase access to microfinance services for large numbers of poor people.

ii) Poverty alleviation paradigm:

Here sustainability is interpreted as the establishment of local-level participatory institutions to ensure long-term community self-reliance and self-determination for the poor. The main policy focus is to take microfinance as part of an integrated programme to alleviate poverty and vulnerability and increase well being for the poorest households.

iii) Feminist empowerment paradigm:

Here sustainability is interpreted as development of self-sustaining participatory women’s organizations linked to a wider women’s movement for transformation of gender relations.
2.3.2 Financial service products and their delivery mechanisms and procedures.

The primary role of MFIs is to provide financial intermediation. The products commonly provided include credit and savings though MFIs are beginning to experiment with other financial products such as insurance, credit cards and payment services.

2.3.2.1 Credit

Credit is borrowed funds with specified terms for repayment. When there are insufficient accumulated savings to finance a business and when the return on borrowed funds is expected to exceed the cost of the loan, it makes sense to borrow rather than to freeze the business until further savings (Waterfield & Dual, 1996). Sorensen (1999:48) describes credit as follows: “Credit is delayed payment for goods and services. It is future income spent before it is earned. Credit is thus ‘somebody else’s money’. To borrow money has a price.” Loans are generally invested to generate income. Some MFIs, however, also make loans available for consumption, housing, or special occasions. Credit when invested, functions as capital to generate an income. This income must be bigger than expenditure and the loan repayments must also be drawn from it. In a cycle form, credit relates to savings, investments and income as shown in the diagram.
Figure 2.1: Credit, investment, income and savings cycle

![Credit, Investment, Income, Repayment of loan and Interest, Savings cycle diagram]

Source: Sorensen (1999:48)

Most MFIs strive to reach sustainability. To achieve this they try to ensure that the services offered meet the demands of clients, operations are as efficient as possible, costs are minimized, interest rates and fees are sufficient to cover costs, and clients are motivated to repay loans. MFIs can be sustainable provided they have enough funds to continue operating in the long term.

i) Delivery mechanism

Two common problems in developing delivery mechanisms are how to ensure efficient and relatively low-cost operations and how to guarantee the sound selection of loan applicants and ensure adequate loan collection so that the MFI can be sustainable. Methods of credit delivery generally designed to attain these objectives can be divided into two broad categories of individual and group lending approaches. Individual loans are delivered to individuals based on their ability to provide the MFI with assurances of repayment and some level of security. Group-based approaches make loans to groups, that is, either to individuals who are members of a group and guarantee each other’s loans or to groups that then sub loan to their members.

a) Individual lending model
According to Waterfield and Duval (1996:84), characteristics of individual lending models include:

- The guarantee of loans by some form of collateral or co-signer
- The screening of potential clients by credit checks and character references.
- The tailoring of the loan size and term to business needs
- The frequent increase over time of the loan size and term
- Efforts by the staff to develop close relationships with clients so that each client represents a significant investment of staff time and energy

Individual lending requires frequent and close contact with individual clients. Loans to individuals are usually larger than loans to members in a group. Individual lending models may be less costly and less labour-intensive to establish than group based models (Ledgerwood, 1999:68).

b) Group based lending model

Group-based lending, commonly referred to as solidarity group or peer group lending, involves the formation of groups of people who have common wishes to access financial services. It is one successful model for financial service delivery widely introduced over the last decade by poverty-oriented financial institutions (Berenbach & Guzman, 1994). It frequently builds on or imitates existing informal lending and saving groups. Group-Lending approaches have adapted the model of rotating savings and credit associations (ROSCA) to provide additional flexibility in loan sizes and terms and generally to allow borrowers to access funds when needed rather than having to wait for their turn. More well-known group-lending models include the Grameen Bank in Bangladesh and ACCION International's solidarity group lending, both of which facilitate the formation of relatively small groups (of 5 to
10) people and make individual loans to group members. Other models, such as the Foundation for International Community Assistance (FINCA) village banking model, utilize larger groups of between 30 and 100 members and lend to the group itself rather than to individuals. (Ledgerwood, 1999:70)

According to Ledgerwood (1999:70), some of the advantages of this type of lending cited frequently in microfinance literature are the following:

1. Peer pressure is used as a substitute for collateral which cannot easily be provided by the very poor. Here group guarantees are established as collateral substitutes. Though strict joint liability of group members is assumed, members are seldom held responsible. Instead, the default of one member generally means that further lending to other members of the group is stopped until the loan is repaid. In other cases, the group may recognize a legitimate reason for the arrears of a certain member and offer to help until the problem is resolved. In still other cases, the mandatory savings of group members may be used to pay off the loan of defaulter.

2. It may reduce certain institutional transaction costs by shifting screening and monitoring costs to the group. People are very careful about whom they admit into their group, given the threat of losing their own access to credit (or having their own savings used to repay another’s loan). Hence group formation is a critical component of successful group lending.

3. The institution can be useful to save more by hierarchical structure where loan officers do not deal with individual group members but rather collect repayment from a group or village leader.

Several disadvantages such as pointed out below exist as well:

1. Group lending institutions have better repayment rates than individual lending
programmes in good years but worse repayment rates in years when there is some type of crisis.

2. If some members of a group encounter repayment difficulties the entire group often collapses.

3. Group training costs tend to be so high that some critics question the assumption that transaction costs are indeed lower with group lending (Huppi & Fedder, cited in Ledgerwood, 1999:71).

4. Many people prefer to have individual loans rather than being financially punished for the irresponsible repayment of other group members. Given the presence of opposing advantages and disadvantages associated with group lending, it is not surprising to see group lending work well in some contexts and collapse in others.

2.3.2.2. Savings
According to Rhyne and Otero (1994:16), savings are crucial in establishing sustainable financial institutions. There are clear indications that when savings are approached using the following principles customers respond enthusiastically. First, the savings instruments should offer safety, convenience, ready access to money, and a positive real return. Second, the opportunity to save should not be limited to those who borrow. Lastly, lending to borrowers can be financed to a significant extent by savings from the same communities, provided savings services are designed with customer needs in mind.

Though savings mobilization has long been a controversial issue in microfinance, new developments in recent years have shown that low-income clients can and do save. The World Bank's Worldwide Inventory of Microfinance Institutions found that
many of the largest, most sustainable institutions in microfinance rely heavily on savings mobilization. MFIs apply two models of savings which are compulsory savings and voluntary savings.

a) Compulsory savings model

Compulsory savings represent funds that must be contributed by borrowers as a condition for receiving a loan, sometimes as a percentage of the loan, sometimes as a normal amount. For the most part, compulsory savings can be considered part of a loan product rather than an actual savings product, since they are so closely tied to receiving and repaying loans (Ledgerwood, 1999:72).

According to Ledgerwood (1999:72), compulsory savings are useful to:

- Demonstrate the value of saving practices to borrowers
- Serve as an additional guarantee mechanism to ensure the repayment of loans
- Demonstrate the ability of clients to manage cash flow and make periodic contributions
- Help to build up the asset base of clients

However compulsory savings are often perceived by clients as a fee they must pay to participate and gain access to credit. Generally, compulsory savings cannot be withdrawn by members while they have a loan outstanding. They act as collateral. Clients cannot use their savings until their loan is repaid. In other cases such savings cannot be withdrawn until the borrower actually withdraws his or her membership from the MFI.

b) Voluntary savings model

Voluntary savings are not an obligatory part of accessing credit services. They are
provided to both borrowers and nonborrowers. Interest rates paid range from relatively low to slightly higher than those offered by formal financial institutions. The provision of savings services offers advantages such as serving as an insurance mechanism, allowing consumption to be spread evenly across time and as a stable source of funds for the MFI (Ledgerwood, 1999:73).

The requirement of compulsory savings and the mobilization of voluntary savings reflect two very different stands (CGAP, 1997). The former assumes that the poor has not developed a habit of savings and that there is a need of nurturing such a culture among the poor. The latter assumes that the working poor already save and that what is required are institutions and services appropriate to their needs. MFIs should always clearly separate compulsory and voluntary savings services. Microfinance clients may not feel comfortable putting voluntary savings in compulsory savings accounts or even in other accounts with the same MFI.

According to CGAP (1997), there are three conditions that must exist for an MFI to consider mobilizing voluntary savings:

- An enabling environment, including appropriate legal and regulatory frameworks
- Adequate and effective supervisory capabilities to protect depositors
- Consistently good management of the MFI’s funds. The MFI should be financially solvent with a high rate of loan recovery.

Requirements for effective voluntary savings mobilization include (Yaron, Benjamin & Piprek, 1997)

- High client confidence in the institution
- A positive real interest rate
• Flexibility and diversity of savings instruments

• Security

• Easy access to deposits for clients

• Easy access to the MFI

• MFI staff incentives linked to saving mobilizations

According to Yaron, Benyamin and Piprek (1997), the provision of savings services contributes to improved financial intermediation by:

• Providing clients with a secure place to keep their savings, enabling consumption during low-income periods, hedge against risk, and accumulation of assets

• Enhancing clients' perception of ownership of an MFI and thus potentially their commitment to repaying loans to the MFI

• Encouraging the MFI to intensify efforts to collect loans due to market pressures from depositors

• Providing a source of funds for the MFI, which can contribute to improved loan outreach, increased autonomy from governments and donors, and reduced dependence on subsidies.

Saving mobilization is not always feasible or desirable for MFIs. This is because the administrative complexities and costs associated with mobilizing savings – especially small amounts – may be prohibitive. Institutions may also find it difficult to comply with prudential regulations that apply to deposit-taking institutions. (Ledgerwood, 1999:74).
2.3.2.3 Financial policy
i) Financial policies and legal enforcement at sector level

Financial policies include: interest rate policies, government-mandated credit allocations, and legal enforcement of contractual obligations and the ability to seize pledged assets. They are very important whether to create, or not, a conducive environment towards establishing a sustainable microfinance institution.

*Interest rate policies*: Interest rate restrictions usually undermine an institution's ability to operate efficiently and competitively (Rock & Otero, 1997:23). It makes sustainable micro lending impossible. MFIs need to charge interest rates that are considerably higher than normal bank rates because the administrative costs of making small loans are high in relation to the amount lent.

Restrictions do not achieve their public policy purpose of protecting the most vulnerable sectors of the population. Instead, they drive informal lenders underground, so that poor borrowers fail to benefit from the intended low-cost financial services. MFIs need to price their loan products to allow for full cost recovery.

*Government mandates for sectoral credit allocations*: Governments mandate that formal financial sector institutions provide a certain percentage of their portfolio or a certain volume of their assets to informal or poorer segments of society or to certain economic sectors. Mostly sectoral allocations do not work well because there are no incentives for commercial banks to participate, rather they almost always distort the market. Operational sustainability of MFIs making use of these funds may be negatively affected because of imposed conditions - such as below-market interest
rates – attached to them. Therefore rather than mandating credit allocations, governments should be encouraged to focus their policies on increasing outreach to the poor by creating enabling regulatory environments and building institutional capacity.

**Legal enforcement of financial contracts:** In some developing countries, the legal framework is unclear or does not allow for effective enforcement of financial contracts. The fact that well defined property rights and good contract law help to minimize transaction costs cannot be denied.

ii) **Financial policy within an MFI**

The financial policy of an MFI can vary from institution to institution with time and paradigm shifts that occur. The financial policies in the financial self-sustainability paradigm as described by Mayoux (2002:258) are as follows:

**Reducing programme costs:**

- Programme growth to benefit from economies of scale
- Keeping staff costs low through decreasing staff numbers or keeping salary levels down through decentralization
- Increasing voluntary contributions of clients and groups
- Decreasing transaction costs of services through simplification of procedures and decentralization to locate services near clients
- Reducing services

**Increasing repayment levels for both group and programme sustainability:**

- Introduction of efficient management information systems to track clients and monitor financial performance
- Application of 'The stick': negative coercion, programme penalties for repayment, group peer pressure

- Application of 'The carrot': positive incentives to repay, such as larger repeat loans for good repayment record.

**Increasing programme income:**

- Increasing interest rates and service charges

- Mobilizing savings, leaving significant interest margin between interest on loans and savings

- Profitable investment of programme assets

- Selling shares to clients and/or private sector

However, evidence indicates emerging contradictions within the financial sustainability paradigm itself, because of insufficient attention to the interests of clients and because the financial sustainability is itself costly in both the short and the long term. Mayoux, (2002:259) summarizes these 'inherent tensions" within the paradigm as follows:

- Keeping programme costs low vs
  - Need for professional financial staff in competition with private banking sector
  - Staff costs for programme growth
  - Providing clients/members with the skills to make a useful contribution to the running of the programme

- Willingness/ability of poor clients to join the programme and repay (and hence successful targeting and programme growth) vs
o High interest rates

o Requirements for voluntary contribution

o Reduction in services

Successful MFIs such as Badan Kredit Kekamatan, the Bank Rakyat Indonesia Unit Desa in Indonesia, the Bank for Agriculture and Agricultural Cooperatives in Thailand, and Grameen Bank in Bangladesh as reviewed by Yaron (1992: viii) have a policy which in general looks as follows:

They charge positive real interest rate, yet below the rate of informal credit markets. Some of them would have had to increase the rates or reduce their lending volume if their access to cheap sources of funds was eliminated. Some have provided savings services, though with varying degrees of success. They have used various financial incentives such as obligatory savings, interest rebates for timely repayment, and a gradual increase in borrowing eligibility upon timely loan repayment to introduce financial discipline among inexperienced first-time small-scale borrowers, and to reduce the financial risk to the MFIs. The use of the strict collateral requirements is frequently not compatible with the goal of extending small-scale loans to the poor or to low-to-middle-income clients, so most of the MFIs studied have used various alternative methods such as character references and joint liability. (Yaron, 1992: viii).

2.3.2.4 Regulation and supervision

According to Ledgerwood (1999:21), financial regulation refers to the body of principles, rules, standards, and compliance procedures that apply to financial institutions. Financial supervision involves the examination and monitoring of
organizations for compliance with financial regulation.

Financial institutions are regulated and supervised to protect depositors and prevent risks to the financial system. To create a conducive environment to financial intermediation, care should be taken by governments and policy makers so that financial regulation does not result in financial repression. Examples of financial repression are imposed interest rate ceilings, subsidized credit, and tax structures that discourage investment in microfinance (Chavez & Gonzalez-Vega, 1994:56).

MFIs which do not take deposits and are too small to pose much risk for the financial system are often not subject to regulation. MFIs should be regulated:

- If and when they mobilize deposits from the public.
- When standards of good practice are clearly needed, whether because there are no practising organizations or institutions or because existing practitioners are not operating effectively.
- When they reach the size at which their failure would have consequences that reach far beyond owners and creditors (Ledgerwood, 1999:21).

Regulatory approaches can be self-regulation, in which the industry develops its own supervisory and governance bodies or full regulation either under existing laws or through the establishment of specialized laws specific to MFIs. Another alternative is for MFIs to be regulated by the regulatory authorities, while contracting a third party to perform the supervisory functions (Ledgerwood, 1999:22).

2.4 Outreach

Financial results are only one part of the sustainability equation. There are two other parts: achieving regular and significant results for the institution’s clients and
reaching enough of them to have an impact in the operational context (Edgcomb & Cawley, 1994:89). In other words, a sustainable institution must be able to maintain or expand its scale of operations. This is important for two reasons. A growing institution can meet the demand. Growth is also an efficient way to reduce costs. This is to say that sustainability can serve as a means for wider outreach; on the other hand, large outreach can also help to attain sustainability because of economies of scale. They are two interrelated things.

Outreach can be measured by (i) the value and number of loans extended, (ii) the value and number of savings accounts, (iii) the types of financial services offered by the MFI, (iv) the number of branches and village post/units, (v) the percentage of total rural population served, (vi) the real annual growth of MIF assets over recent years, and (vii) women’s participation. The growth rate of an MFI’s assets might, under given conditions, also serve as a crude proxy to new clients’ access to the financial services (Yaron, 1992: vii).

2.5 The implication of sustainability for poverty alleviation

Reaching the poor and sustainability are in large measure complementary, and particularly sustainability serves outreach. Only by achieving a high degree of sustainability, have microfinance programmes gained access to the funding they need over time to serve significant numbers of their poor clients. To get sustainability of an MFI there is in fact only one objective – outreach that, in other words, is maximizing benefit to poor people. Sustainability is but the means to achieve it. Sustainability is in no way an end in itself; it is only valued for what it brings to the clients of microfinance (Rhyne, 1998 cited in Robinson, 2001:25).

However, the relation between sustainability and poverty alleviation is not that
simple. There is an ongoing debate about their compatibility (Morduch, 2000; Rhyne, 1998). The measures and models considered to be best practice are too costly for the very poor. In the solidarity group formation, the group members naturally select individuals of similar economic and social position and the very poor are regarded as higher risks and are likely to be excluded (Hume and Mosley, 1996). MFIs seeking institutional and financial sustainability are required to charge interest rates, which cover the costs of the capital and operational expenses, impose compulsory or mandatory savings and apply a rigid repayment system. Unfortunately, all these act as barriers for the poor. (Ruit, 2002:6)

Furthermore, evidence indicates emerging contradictions within the financial sustainability paradigm itself, due to insufficient attention to the interest of clients. When an MFI charges costs high enough to lead to sustainability, the underlying assumption is that the development costs can be passed on to groups and clients and it is assumed they will be able and willing to contribute the time, skills and resources to access the services on offer. Yet, there is increasing evidence that the poor may not be willing (even if they are able) to pay the high interest rates required if they can find alternatives. Moreover, they may not remain passive once they get alternatives. (Mayoux, 2002:257)

Therefore, it has been believed widely and for a long time that MFIs have to make a choice between institutional sustainability and poverty outreach. At the time of the 1997 Microcredit Summit, conventional wisdom argued that you could either build financially self-sufficient institutions or you could reach the poorest; but you could not do both (Littlefield, s.a.). Yet in spite of the evidence, which shows the trade-off between these two objectives, both MFIs and donors used to sustain the rhetoric of micro-credit being a strategy, which promotes poverty alleviation and allows for the financial sustainability of service providers (Ruit, 2002:7).
MFIs seeking the sustainability route extend credit to the non-poor or the moderately poor whose enterprises have the potential for economic growth and employment creation. In contrast, institutions with poverty alleviation focus have found that specific targeting strategies and support measures are required which prolong their dependence on donor support. In fact, they are premised upon long-term donor support. (Ruit, 2002:7)

However, financial sustainability has become the dominant paradigm (Mayoux, 2002:246). At the time of Micro-Credit Summit in 1997, the microfinance field was speeding toward a vision that placed financial performance above all else. Many in the field contended that the poorest families in a community were too costly to identify and motivate and their inclusion would keep a programme from becoming financially self-sufficient (Daley-Harris, 2002: xiii).

Microfinance has tended to exclude those that cannot use the one-size-fits-all services provided. The services that have been developed tend to meet the needs of a particular segment of the client market, and have led to the exclusion of those that cannot use or pay for these services. (Simanowitz and Walter, 2002:5)

Over the last years, however, says Daley-Harris (2002: xiii) these arguments have been answered by the Micro-Credit Summit Campaign and others who see that the microfinance industry has the ability to work with the very poor and offer them the services they need to move themselves and their families out of poverty. Littlefield (s.a) has also said: "...thankfully we have encouraging evidence on the ground that Microfinance Institutions (MFI) can do both [reach the poorest and be financially self-sufficient...]

Similarly, a comprehensive literature review of microfinance and poverty reduction by Morduch and Haley (cited in Simanowitz & Walter, 2002: 2 2001: 2) concludes that there is strong evidence that microfinance can be effective for a broad group of
clients, including the very poor or poorest. It also concludes that financial performance of poverty-targeted MFIs can be comparable to those that do not reach the poorest.

According to Churchill (as cited in Simanowitz & Walter, 2002:32) an analysis of 114 MFIs in the Micro Banking Bulletin concluded that there is no evidence that sustainable MFIs cannot work with very poor clients – "the data suggest that it is possible to provide very small loans and be financially self sufficient".

That said, Littlefield (s.a.) remarks:

"... trade-offs clearly exist between reaching, say, extremely remote, scarcely populated areas in rural Africa or post-conflict situations with limited economic opportunities, and reaching financial sustainability. ...But, in the end, the challenge facing the industry is to be more creative in pushing the "sustainability-poverty" frontier through improving service delivery mechanisms, developing new, more client-responsive products and focusing on making services more efficient. For most MFIs there is plenty of room for improvement on both frontiers before they might ever come into conflict (Littlefield: s.a.)"

In conclusion, all that is said as evidence of the compatibility of sustainability and poverty alleviation cannot convincingly refute the trade-off between the two. However there is enough to show that something is being done about the issue, and what has been achieved so far is promising. There is reason to hope that the effort of developing new policies, methods and procedures will enable an MFI to be fit for the double ended mission.

2.6 Summary

The preceding discussion has focused on the meaning of sustainability and the
various aspects of microfinance that influence the establishment of sustainable microfinance. The discussion has been limited, mostly, to identification of the most practiced delivery mechanisms, policies and models. However, these should not be taken as exhaustive. Nevertheless, they are considered to be the most widely common and important ones practiced by most contributor institutions in the field of microfinance.

The intention of these factors was to promote and ensure the sustainability and outreach of MFIs and an attempt was made to relate the factors to sustainability and outreach. Similarly, in the following chapter, by looking at the policies and mechanisms applied, activities conducted and the results achieved, the sustainability of the programme in the Eritrean case will be analysed.
CHAPTER THREE: ASSESSING THE SUSTAINABILITY OF SAVING AND MICRO-CREDIT PROGRAMME (SMCP) ERITREA

3.1 Overview of Eritrea

Eritrea is located in the Horn of Africa and lies north of the equator between latitudes 12°22'N and 18°02'N, and longitudes 36°26'21"E and 43°13'E. It has an area of 124,320 sq.km. As can be seen on the map on the next page, the country is bordered by the Red Sea in the east, Djibouti in the southeast, Ethiopia in the South and the Sudan in the north and west.

Estimates of Eritrea's current total population range from 3.2 to 3.9 million. Some 80% of the population lives in rural areas, practicing a range of agricultural and pastoral activities depending on the ecological zone in question. Population densities vary considerably from high densities in the central highlands (up to 200 persons/km²), where about half of Eritrea's population lives, to very low densities (some times fewer than 10 persons/km²) in the coastal plains and western lowlands. Administratively, the country, as shown in the map, is divided into six regions (zobas): Debubawi Keh Bahri, Semienawi Keh Bahri, Debub, Anseba, Gash Barka and Maekel. Again, these are subdivided into 56 sub-regions, in which there are 2564 villages clustered into 654 legally registered administrative villages/areas.

Eritrea was established in 1889 by the Italians at the height of the European colonialists' scramble for Africa. Until its liberation in May 1991 from the Ethiopian occupation, Eritrea has been under successive colonial rule for almost 100 years: under the Italians, the British and finally the Ethiopians. Eritrea has gone through almost half a century of political struggle for freedom accompanied by an escalated almost thirty years of bitter war of liberation against the Ethiopian colonizers. The
Note: This is not the official and political map of Eritrea.
decades of struggle and especially the thirty years of war, has had a devastating
effect on the country and its people. It has resulted in untold human sufferings and
material loss.

Economic rehabilitation and reconstruction was firstly aimed at setting the country on
a sound footing again and ready for departure to development. This programme
scored considerable success to the extent that it put the Eritrean economy on a good
footing. The physical infrastructure has greatly improved especially in rural and
remote areas. Supply of transport and communication, power and water services
have been restored and even extended. Social infrastructure was being rehabilitated
and maintained and has thereby been made accessible to a much larger proportion
of the population. GDP growth has reached about 7%, among the highest in Africa,
Office, 2002:2). Inflation progressively declined from about 11 percent in 1995 to

In its efforts to place the economy on good footing to sustainable development, the
government targeted the period 1998-2000 to complete the transitional phase of
rehabilitation and reconstruction. However, in May 1998, under the pretext of a
border dispute, Ethiopia declared war against Eritrea and occupied some part of the
Regions of Gash Barka and Debub. An armistice between the two countries was
brokered by the OAU in June 2000.

The war has resulted not only in much human suffering, but also in widespread
destruction of property, housing and socio-economic infrastructure which had been
painfully built in the previous years. Though the damage incurred was indescribable,
over one million Eritreans were displaced by the conflict; and whilst many have since
been able to return to their villages and towns, just over half a million was forced to
remain either in makeshift displacement camps or in host communities (World Bank,
Damage to property in Gash Barka and Debub regions has been valued at US $570 million (Medani, Sholton & Winter, 2001:2). More than 75,000 ethnic Eritreans have been forcibly expelled from Ethiopia leaving behind their possessions (Manalo, 2002:48). Finally, the need to put the economy on a war footing and to mobilize thousands of citizens has had a clearly detrimental impact on economic growth (which slowed to nil in 2000). This has been aggravated by drought, which is estimated to have affected about 783,000 people (World Bank, 2002).

Because of the thirty years of war, neglect and deprivation of the Derg regime, the recent border conflict as well as the recurrent drought, Eritrea remains one of the poorest countries in the world. A range of indicators points to the incidence and intensity of poverty in the country. For example, according to the 1999 Human Development Index, Eritrea is ranked 167th out of 174 countries; GNP per capita in 1998 was estimated at only US $200 and is unlikely to have increased much since then. Most of its population (80%) live in rural areas and are largely dependent on subsistence farming and animal husbandry. In urban and peri-urban areas, most poor people engage in unskilled or low-skilled activities in the informal sector.

In general, in spite of all the impressive levels of investment and improvements made to services and all that has been done to address social and economic problems of individuals and groups, there is still widespread poverty. The level and spread of social services is still comparatively low. For a large group of the Eritrean poor, gainful employment that can generate basic or supplementary income is very difficult to secure.

The literature of microfinance indicates that savings and micro credit institutions help in alleviating poverty. This can also be true in countries such as Eritrea, where the formal financial services sector in general is still to develop and provision of such a service to those unserved and underserved by these formal institutions is vital.
3.2 Saving and Micro Credit Programme Eritrea

3.2.1 Background of SMCP

Microfinance has been functioning for many decades in local, traditional Eritrean forms of rotating savings and credit clubs known as the Ekubs and Mahbers. Moneylenders have also been a common source of funds for rural people but at high and unaffordable rates (Manalo, 2002:48). Semi-formal and formal microfinance programmes developed only recently. At present, eight microfinance programmes exist including the government sponsored Savings and Micro Credit Programme (SMCP).

SMCP is the largest savings and micro credit programme of its kind in Eritrea. According to SMCP management (cited in ICC, 2003:15) the scale of outreach of all the other players in the market combined is less than half of SMCP’s current client base. It began in 1996 as a pilot programme within the Eritrean Community Development Fund (ECDF) as one component of its projects.

ECDF was initiated in 1993 as part of the social sector in the Recovery and Rehabilitation Programme of Eritrea (RRPE). Its objective is to support the rehabilitation and reconstruction of basic social and economic infrastructure with the ultimate goal of alleviating the widespread poverty in the country. ECDF was housed as semi-autonomous unit within the Ministry of Local Government. The source of funds of ECDF/SMCP is the government of Eritrea, the International Development Association (World Bank), loans and grants from other bi-lateral donors such as the Belgium, the Dutch and Italian governments and savings contributed by members. However, the loans and grants are the main source of the funds (Menghesteab, 1999:20).
ECDF had a mandate to pilot a micro credit and savings programme. Thus, SMCP was started within ECDF and continued to be a component of ECDF projects until 2001. In January 2001, the government of Eritrea agreed to take SMCP out of ECDF and establish it as an autonomous programme of the Ministry of Local Government (MOLG) with a National Steering Committee (NSC). The NSC constitutes representatives from MOLG (chairperson), the Ministry of Finance (secretary), and members from the Ministry of Agriculture, Ministry of Trade and Commerce, and the Commercial Bank of Eritrea.

The main aim of SMCP is to provide credit services to the vulnerable group in the rural and urban areas who are unserved and underserved by the formal financial institutions and who are in great need of capital to conduct income-generating activities. In fact, SMCP emerged within ECDF in response to Eritrea’s economically and socially war torn condition. Enterprises were not active; the war, deprivation and neglect of the colonizers severely damaged the agricultural sector and the basic social service. The disruption of family life due to war, displacement and drought has left thousands of citizens destitute. Until May 2000, there were about 270,000 internally displaced persons (IDPs) who had escaped from the border territories (Manalo, 2002:47). There was a spontaneous influx of returnees from neighboring countries. The government has committed itself to demobilize a big portion of its fighters and already some 50,000 combatants have left the service and returned to civilian life (Menghestaeb, 1999:20).

SMCP had to cope with the crisis of wartime and the aftermath of the war to facilitate the resumption and reconstruction of local business activities and enable the most disadvantaged sector to play an important role in jump-starting the economy. Indeed, SMCP has showed its commitment to operate not only under normal development contexts but also under precarious conditions of conflict and crisis.
SMCP have had to modify its operational procedures and strategies to be flexible to provide relevant services in a relevant manner in such a period. Of course, it is not difficult to imagine that such a hard time will give rise to operational challenges and delays in the ability of SMCP to attain scale and financial sustainability.

3.2.2 Objectives and Strategies of SMCP

The goal of SMCP is to support the investment activities of enterprises at the village level; create new income and employment opportunities in poor communities; contribute to the improvement of living standards and increased overall prosperity of these communities; and demonstrate that institutional-building is an effective and right approach to attaining these aims (Menghesteab, 1999:20; Manalo, 2002).

The programme has four operational strategies to achieve its objectives. These are:

- To provide credit and savings services for income generating activities, to target beneficiaries who are outside the reach of the formal banking service of credit and savings. These include grassroots enterprises, women and poor entrepreneurs.

- To strengthen community representative structures from village to higher levels, particularly in the economic domain.

- To build institutional capacity and capability at the local level.

- To establish a legal base so that the SMCP could become an autonomous, people-controlled and people-oriented financial institution, which is organizationally and financially sustainable. (Ibid)

Here, one can easily see that the objective is clear, sustainability as an objective is clearly spelt out, and the programme is committed to involve active participation of clients. All these in turn indicate the program's intention to move along the sustainability road.
3.2.3 Organizational Structure

Figure 3.1: SMCP's organization chart

Source: Adapted from Menghesta (1999:67); ICC (2003:25)
As shown in the SMCP organization chart, the National Steering Committee (NSC) comprising representatives from five concerned government bodies, is at the top of the management structure. It is supposed to supervise the whole programme. The programme has three main departments: Finance, Research and Training, and MIS. The Operation Department follows up programme activities at regional level. The Operations Officer who is also Deputy Programme Manager heads this department. The Business Development Service Unit is a newly established one. It aims at providing business development services to clients but is still in its formation stage. SMCP’s operations are decentralized and organized by administrative regions. It has regional and sub-regional, as well as village level operations. SMCP Regional Offices are housed at the MOLG regional offices. The MOLG Regional Administrator is a signatory to SMCP’s regional bank accounts and as per the directive actually heads SMCP operations at regional level but in reality, the contact is one of coordination, as well as advisory and consultative. SMCP has a Regional Manager who reports to Head Office on regional matters. (ICC, 2003:25)

The Regional Manager used to work with credit officers and promoters. The credit officers that have to deal with Tier I and Tier II are different. As such, a Regional Manager should have a minimum of two credit officers: one for Tier I clients and the other for Tier II clients. However, recently this was reviewed and it was decided to replace the specialized credit officers with all-round credit officers that monitor both Tier I and Tier II clients. The intention is to distribute the caseload evenly and improve the credit officers’ productivity. (Ibid)

Promoters are SMCP’s front line employees at sub-regional level. They work with Village Bank Committees (VBCs) to ensure that village bank operations are administered smoothly and in conformity with SMCP’s operational guidelines.
Promoters only play an advisory role to village bank committees and do not make decisions on village bank administrative issues. Such decisions are the sole responsibility of village bank committees. Each promoter has a caseload of 5 to 8 village banks (400 clients on average) depending on population densities in their sub-regions.

3.2.4 SMCP's legal base, political and economic environment

The legal framework governing the microfinance sector such as licensing, supervision and monitoring of MFIs, and savings mobilization access to local resources requirements is yet to be developed. Although the government strongly supports well-focused, best practice based provision of micro-credit services, it remains in control of, or heavily involved in the key microfinance activities and programmes.

The Civil Code limits commercial lending rates to below 12 percent irrespective of the cost of funds or the administrative cost of financial services. There is no doubt that this hinders microfinance institutions from attaining financial sustainability and competitiveness. In spite of the limit set in this code, the SMCP was allowed to pilot microfinance and charge 16 percent on a declining basis for all its credit facilities. Still this limits SMCP’s ability to raise revenue levels sufficiently to cover all its actual costs and to introduce measures that would enable it to reward its staff and village administrations.

Modification to Civil Code regulating the interest rate structure, the introduction of regulations governing deposit mobilization and access to local resources by MFIs, and defining SMCP’s legal status are areas that need be addressed if SMCP is to be sustainable. It would also be helpful to that aim to introduce measures that would enable inter-linkages and cooperation between microfinance institutions and
commercial banks. This is in order to increase the scale of operations of the microfinance sector. Large-scale outreach depends on access to commercial sources of funds. In other words, such inter-linkages and cooperation with the commercial banking industry can help liberate MFIs from donor dependency. More important than this, establishing such links and cooperation is seen as a way to build upon each other’s comparative advantages and mitigate the effects of each other’s comparative disadvantages (Gerimidis 1990; Ghatel92; Zeller et al. 1997 cited in Howard et al. 2002:272).

All Eritreans below the age of forty are required to participate in the country’s National Service. This affects SMCP both at staff and at client level. To mitigate the negative impact of losing experienced employees leaving the programme to do National Service, SMCP has decided to recruit employees that are exempt from the National Service either because they are above forty years of age or for other reasons. Besides this, the government has allowed SMCP to have some youngsters work with it as part of their National Service obligation. This measure enabled a number of young people to get on the job training and develop skill. It also served as a good source of trained labour for SMCP.

In the economic aspect, the inflation rate is estimated at 15 percent and is projected to rise steadily during the near future. The national currency is depreciating and the same trend is expected for the next few years. At present, lending rates are 12 percent per annum and they are on the rise. Such trends put pressure on SMCP to offer larger loan amounts, while at the same time having to adjust its product price upwards to meet its quest of sustainability (ICC, 2003:14).
3.3 SMCP’s working policies and procedures and their implication to sustainability

3.3.1 Loan products, and their use

Currently SMCP utilizes the village-banking model and has three loan products. These are Tier Ia, Tier Ib (a derivative of Tier Ia) and Tier II. The different features characterizing these loans are outlined in Table 3.1.

Tier Ia: This is a group-guaranteed loan to individual members of solidarity groups organized in Village Banks. So far, it has been an entry-level product to the majority of SMCP clients. The different features of the product are as pointed out in Table 3.1 and 3.2.

The loans provided in this tier are provided for various income generating activities. They are used for bulk purchases, for agricultural inputs, tea stalls, food preparation and catering, selling traditional brew, vegetable vending, and to establish retail kiosks and small grocery shops. They are also provided for the use of small and short cycle livestock such as poultry, sheep and goats to complement crop production and supplement incomes, etc. Though the activities carried out by the people making these loans are many, all are income-generating activities. This shows that there is room for diversifying the loan product to include other uses like consumption, school fees, housing etc.

The eligibility criteria to obtain a loan under this Tier are:

- Membership of a solidarity group of 3-7 members who provide character references and joint liability;
- A mandatory deposit guarantee equal to 10% of loan amount;
- A business plan approved by the solidarity group members and the village bank committee.
Table 3.1: SMCP loan products

<table>
<thead>
<tr>
<th></th>
<th>Tier Ia: Groups</th>
<th>Tier Ib: Individuals</th>
<th>Tier II: Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan cycles</strong></td>
<td>Nakfa</td>
<td>Nakfa</td>
<td>Nakfa 10,000 - 100,000</td>
</tr>
<tr>
<td>Cycle 1</td>
<td>1,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 2</td>
<td>2,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 3</td>
<td>3,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 4</td>
<td>5,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 5</td>
<td>7,000</td>
<td>7,000</td>
<td></td>
</tr>
<tr>
<td>Cycle 6</td>
<td>8,500</td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td>Cycle 7</td>
<td>10,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td><strong>Interest rate</strong></td>
<td>16%</td>
<td>16%</td>
<td>16% -2% discount for on time payment</td>
</tr>
<tr>
<td><strong>Registration fee</strong></td>
<td>Nakfa 2</td>
<td>Nakfa 2</td>
<td></td>
</tr>
<tr>
<td><strong>Loan fee</strong></td>
<td>Nakfa 5</td>
<td>Nakfa 5</td>
<td></td>
</tr>
<tr>
<td><strong>Lending technology</strong></td>
<td>Groups 3-7</td>
<td>Individual loans</td>
<td>Individual loans</td>
</tr>
</tbody>
</table>

**Savings:**

<table>
<thead>
<tr>
<th></th>
<th>10% of loan amount</th>
<th>15% of loan amount</th>
<th>No savings required</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Compulsory savings</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Voluntary savings</strong></td>
<td>Any amount</td>
<td>Any amount</td>
<td>No savings required</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Mutual guarantee</th>
<th>15% of loan amount plus co-signer else 20% of loan amount</th>
<th>Co-signer required</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Security</strong></td>
<td>3-12 months for cycles 1-4 and 3-24 months for cycles 5-7</td>
<td>3-24 months</td>
<td>3-60 months</td>
</tr>
</tbody>
</table>

**Instalments**

<table>
<thead>
<tr>
<th></th>
<th>Monthly for cycles 1-4 and either monthly or quarterly for cycles 5-7</th>
<th>Monthly or quarterly for cycles 5-7</th>
<th>Monthly or quarterly</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trade</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Service</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Manufacturing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Agriculture</strong></td>
<td>Monthly, quarterly or biannually</td>
<td>Monthly, quarterly or biannually</td>
<td>Monthly, quarterly or biannually</td>
</tr>
</tbody>
</table>

Source: ICC (2003:5)
Table 3.2: Tier 1a product

<table>
<thead>
<tr>
<th>Product features</th>
<th>Old Tier 1a product</th>
<th>New Tier 1a product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group size</td>
<td>3-7 people</td>
<td>3-7 people</td>
</tr>
<tr>
<td>Village Bank size</td>
<td>Minimum 35 people</td>
<td>Minimum 35 people</td>
</tr>
<tr>
<td>Loan amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 1</td>
<td>1,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Cycle 2</td>
<td>2,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Cycle 3</td>
<td>3,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Cycle 4</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Cycle 5</td>
<td>7,000</td>
<td>13,000</td>
</tr>
<tr>
<td>Cycle 6</td>
<td>8,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Cycle 7</td>
<td>10,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Cycle 8</td>
<td></td>
<td>25,000</td>
</tr>
<tr>
<td>Cycle 9</td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>Cycle 10</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>16%</td>
<td>16%</td>
</tr>
<tr>
<td>Loan fee</td>
<td>Nakfa 5</td>
<td>0.5%</td>
</tr>
<tr>
<td>Registration fee</td>
<td>Nakfa 2</td>
<td></td>
</tr>
<tr>
<td>Compulsory savings</td>
<td>10% of loan amount</td>
<td>10% of loan amount</td>
</tr>
<tr>
<td></td>
<td>before disbursement</td>
<td>before disbursement</td>
</tr>
<tr>
<td></td>
<td>6% of loan amount</td>
<td>plus ongoing savings</td>
</tr>
<tr>
<td></td>
<td>spread over number</td>
<td>of instalments</td>
</tr>
<tr>
<td>Loan security</td>
<td>Group guarantee</td>
<td>Group guarantee</td>
</tr>
<tr>
<td>Voluntary savings</td>
<td>Any amount</td>
<td>Any amount</td>
</tr>
</tbody>
</table>

Source: ICC (2003:7)

Various changes were being made from time to time to this product in response to demands from clients. A change was made on the loan amount and the number of loan cycles. At first, loans were extended under seven lending cycles with loan amount ranging from Nakfa 1,000 to Nakfa 10,000. Recently this changed to ten lending cycles with a loan amount ranging from Nakfa 3,000 to Nakfa 40,000 (Table 3.2). This was because the prior amount was not adequate for clients to engage in meaningful business, given the rising inflation rate.

Besides demanding a change in the loan amount, linked to the current economic hardship in the country, clients have been asking for reduction of interest rate on the loan. However, if at all SMCP is to strive for sustainability, it needs instead to review its interest rate and fees upward.
Tier 1b: This is a modified Tier 1 loan. It is allowed to individual members of solidarity groups that wish to stand alone after having demonstrated perfect repayment performance in four prior loan cycles. The loan amount and fee structure changed to address clients’ dissatisfaction and the shortage of operational incomes (See Table 3.3).

Table 3.3: Tier 1b product

<table>
<thead>
<tr>
<th>Product features</th>
<th>Old tier 1b product</th>
<th>New Tier 1b product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 5</td>
<td>7,000</td>
<td>13,000</td>
</tr>
<tr>
<td>Cycle 6</td>
<td>8,500</td>
<td>15,000</td>
</tr>
<tr>
<td>Cycle 7</td>
<td>10,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Cycle 8</td>
<td>10,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Cycle 9</td>
<td>10,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Cycle 10</td>
<td>10,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>16%</td>
<td>16%</td>
</tr>
<tr>
<td>Loan fee</td>
<td>Nakfa 5</td>
<td>0.5% of loan amount</td>
</tr>
<tr>
<td>Registration fee</td>
<td>Nakfa 2</td>
<td></td>
</tr>
<tr>
<td>Compulsory savings</td>
<td>Either 15% or 20% of loan amount paid upfront depending on ability to find a co-signer</td>
<td>Either 15% or 20% of loan amount paid upfront depending on ability to find a co-signer plus ongoing savings of 6% of loan amount spread over number of instalments</td>
</tr>
<tr>
<td>Loan security</td>
<td>Co-signer required</td>
<td>Co-signer required</td>
</tr>
<tr>
<td>Voluntary savings</td>
<td>Any amount</td>
<td>Any amount</td>
</tr>
</tbody>
</table>

Source: ICC (2003:8)

The requirements to get loans under this Tier are:

- Approval of the solidarity group members (who still provide character reference but not joint liability) and the village bank committees;
- A co-signatory;
- A guarantee deposit equal to 15% of the loan amount. In the absence of a co-signatory, a higher guarantee deposit equal to 20% of the loan amount is required.
• Ongoing savings of 6% of loan amount spread over number of instalments.

Tier II: This is a loan to individual borrowers or associations, whose capital demand is beyond Tier 1 product. It started in the second half of 1997. In its old form, its loan amount ranged from Nakfa10,000 to Nakfa100,000 and did not have loan cycles. Clients tended to request the maximum, most of the time resulting in the product taking up over 50% of SMCP’s outstanding loan portfolio, while reaching only 50% of SMCP’s client’s base. Recently, as a corrective measure the loan was designed in cycles to ensure that enough resources are available to Tier I, which is the important product of the programme. The programme further intends to limit the value of loans disbursed to this tier to 40% of loans outstanding. A loan fee was also introduced. These as well as other features of the product are as shown in Table 3.4.

To access a loan under this Tier, the requirements are:

• Produce a feasibility study;
• Have a co-signatory for the loan;
• Clients are required to contribute up to 20% of loan amount to their business either in cash or kind prior to loan disbursement;
• Obtain approval of the project at sub-regional, regional, and SMCP headquarters levels.
• If loans are for groups, their by-laws or articles of association are required.

(ICC, 2003:9; Manalo, 2002:50)

These loans are used for developing micro enterprises. These include activities such as digging a well, installing a water pump for irrigation farming, agricultural inputs, establishing wood and metalwork shops, house construction, grocery shops, restaurants, dairy farming or the fattening of stock, etc.
All the adjustments made show that SMCP has been making an effort to develop a product mix that is tailored to meet the needs of the target market by refining its product offering in line with clients’ preferences. It also indicates that the programme has been struggling to ensure that the delivery system remains responsive to clients’ preferences. From the sustainability perspective, these are plausible measures.

### Table 3.4: Tier II product

<table>
<thead>
<tr>
<th>Product features</th>
<th>Old tier II product</th>
<th>New Tier II product</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cycle 1</td>
<td>10,000-100,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Cycle 2</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td>Cycle 2</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Cycle 2</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Cycle 2</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td>Cycle 2</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Interest rate</td>
<td>16%..2% discount for on time payment</td>
<td>16%..2% discount for on time payment</td>
</tr>
<tr>
<td>Loan fee</td>
<td>0.5% of loan amount</td>
<td></td>
</tr>
<tr>
<td>Registration fee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan requirements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compulsory savings</td>
<td>No savings requirement</td>
<td>5% of loan amount before loan disbursement plus ongoing savings of 6% of loan amount spread over number of instalments</td>
</tr>
<tr>
<td>Loan security</td>
<td>Co-signer required</td>
<td>Co-signer required</td>
</tr>
<tr>
<td>Voluntary savings</td>
<td>No savings required</td>
<td>Any amount</td>
</tr>
</tbody>
</table>

Source: ICC (2003:9)

Further more the change made on Tier II has an implication. It indicates SMCP’s commitment to maintain a balance between the social and sustainability objectives. Though lending bigger amounts would have been less costly and thus profitable, SMCP decided to trade off this in order not to crowd out the poor whose lending
capacity is mostly within the remaining other products. The graduation system from one loan cycle to the next would enable a client to expand his scope of investment gradually. This is certainly much better than the high initial ceiling. In this system, repeat loans are only granted if the previous loans are successfully repaid. This in itself is an incentive for timely repayment in-built in the system, which of course will contribute to sustainability.

**Figure 3.2 Loan use in percentage**

Source: Adapted from ICC (2003:21)

The use of the loans is not restricted to a particular sector of the economy. Provided a loan is for productive purpose and is feasible, a client is free to use it for any purpose that can generate income, and which will enable the borrower to repay his loans. It appears in Figure 3.2 that 52.42% of SMCP clients used the loan for trading activities, 42.37% for agricultural activities, 3.67% for service activities and 1.54% for manufacturing activities. As mentioned earlier, typical trading activities include groceries, vegetable vending, grain kiosks, etc. Typical agricultural activities include inputs for irrigation and crop farming, digging wells, livestock raising, poultry, bee
raising, etc. Typical service activities include restaurants, tea stalls, grinding mill service provision, etc. Typical manufacturing activities include wood and metalwork shops, house construction, weaving, etc. Eritrea being a country prone to drought, the loans engaged on agricultural activities, especially crop farming, could be risky so this share appears too high and SMCP should be cautious in financing rain crop agricultural activities (ICC, 2003:20).

3.3.2 The programme model

SMCP applies the Village Bank model when providing financial service to its target clients. The Village Banks are autonomously functioning units typically each serving 35-80 members each. The programme of solidarity group at the village level is conducted by these banks. A Village Bank Committee, which is comprised of the village administrator, as a chairperson, and two persons from the clients as a secretary and a treasurer, administers the Village Bank. At least one of the members is a woman, in order to ensure that women are well represented in the committee. These are democratically elected by the village community in a general village meeting conducted by the SMCP regional agents to explain the objectives, requirements and methodology of SMCP. Once the committees are formed, it is then up to the elected members to form solidarity groups and to establish village banks.

The Village Bank Committees are responsible for group formation, loan processing, management, follow-up, and record keeping. According to interviews conducted with SMCP management by the author (Menghesteab July 25, 2003, Efrem July 20, 2003), the Village Bank committees have, though not to the desired level, started to pay important roles in managing credit and savings activities. They make key decisions regarding membership and access to SMCP credit facilities. This indicates that there is community participation in Village Bank activities. It also indicates that
the work is decentralized and brings the service to a doorstep level, rendering it efficient and cost effective. These are important matters in regard of organizational and financial sustainability. However, it is important that Village committees be trained to upgrade their skill as well as to update them on the program’s policy and procedures so that they can perform better.

3.3.3 Security, loan term and repayment method

SMCP loan products are not collateralized. The type of security required varies with the type of loan product. As appears in Table 3.1, mutual guarantee applies to Tier Ia, co-signer plus 15% of loan amount else 20% for Tier Ib and co-signer plus 20% for Tier II. In a number of interviews conducted by the author with clients of Tier Ia in various places (July 2003), clients express their dislike for the mutual guarantee for having to pay for group members’ default. They prefer to borrow on individual basis with their spouses as co-signers. The matter should be given due consideration. Otherwise, high desertion rates can take place in the solidarity group arrangement. Fortunately, however, the village banks have not suffered, so far, from significant dropout rates in their membership base, a familiar adverse development with the village banking methodology (Manalo, 2002:51).

Repayment is made by instalments at fixed time intervals. It appears in Table 3.1 that the maturity and repayment methods vary with the type of the product and the use of the loan. The term for Tier Ia is the shortest and that for Tier II is the longest. The time interval for instalments is longer in Tier II than in the remaining two segments. It also appears in the table that instalments for agricultural activities are allowed the longest of all maturities.

All these indicate that SMCP avoids the one-size-fits-all approach of delivering its services, but it tries to offer its service in a way tailored to each particular context.
There is no doubt that this helps to improve SMCP's competitiveness and performance and ultimately its sustainability.

### 3.3.4 Group formation

Beneficiaries are eligible for a Tier I product if they are members of a solidarity group, which consists of 3-7 members. The formation should be voluntary and more than one member of a family should not join the same group. The purpose of forming a group is sound enough. It creates a possibility of mutual guarantee for repayment, a chance for group members to share experience and market information, to cooperate in loan repayment, and to collaborate in product distribution, etc.

There is active involvement of solidarity groups in credit and savings operations. Group members hold bi-weekly or monthly solidarity meetings. However, almost all the clients contacted in the fieldwork tell that their meetings mostly deal with loan repayments and deposit savings. These and other things indicate that the majority of the groups consider repayment as their sole responsibility and there is little evidence of their commitment to dynamic cooperation as envisaged. Therefore, it is important to strengthen solidarity groups to function effectively.

### 3.3.5 Loan processing and approval procedure

With the solidarity group loans, which are the flagship product of SMCP, clients submit their loan application, together with their business plan, to their respective solidarity group, most of the time orally. Here the group applies initial screening and approval, and hands it over to the village bank in writing or orally for final approval and decision. Waiver of the requirement of submitting written documents by the group member and the group is made to avoid access barriers to the illiterate poor. The Village Bank has the mandate to reject what the solidarity group approved.
However, in all cases it formally informs the solidarity group of the base for its decision. Finally, after confirming that the loan processing procedures are in order, the regional SMCP credit officer quickly disburses the money to the Village Bank for the applicant to take. (Menghesteab, 1999: 25)

According to Menghesteab (1999:25), processing and procedure was lengthy in the early days of the programme. However, after getting feedback and demand for improvements from the clients, SMCP made the following adjustments:

- On the spot lending and decentralization: The time needed to receive the first loan must not exceed five days, but for repeat loans within the same visit in which it is requested. Promoters then take the documentation to the regional offices for updating of depositors’ loan accounts.

- Allowing a client to select among loan maturities instead of requiring all to comply with fixed loan terms as in the past.

- Decreasing the rate of increase in the maximum loan amounts between consecutive loans. To some extent, this decreases the magnitude of the defaults.

Based on its marketing strategy which according to Menghesteab (2003) is “On the spot loans to gold customers”, the delivery mechanism of Tier II is also efficient. The client submits his simple loan form together with his business plan to the regional credit officer for screening and approval. The Regional Office hands over the approved application to the Head Office for fund release. Having a business already and good credit history are important criteria here.

The importance of such efficient loan processing to increase the quality of the service, thus, the competitiveness and sustainability of the programme is clear. Besides this, only saving accounts earn interest (4.5%) in Eritrea; other investment opportunities do not exist. To disburse loans “on-the-spot” particularly to its repeat
clients that require funding rather than to deposit it in the bank account is more profitable to SMCP. It gets better returns for its money, and is able to turn around loan requests quickly. (ICC, 2003:23)

3.4 Organizational and financial sustainability of SMCP

According to Sorensen (1999:35), an organizationally sustainable programme is one that is independent, with its own management and decision-making structures for which it would likely require a legal base and registration. A financially sustainable programme is one which can generate income to cover all its costs. These two aspects are interdependent and therefore it is wise for an MFI to strive for both. Both organizational and financial sustainability are not things that can be built over night. Rather they are complex issues that need time and hard effort to develop or establish. It is clear that assessing the ongoing effort of achieving these issues is of paramount importance to input measures that may be required.

3.4.1 Organizational structure and governance

The National Steering Committee (NSC), which is the top governing body in SMCP and is supposed to have supervising powers, is not active. It lacks commitment to the programme. SMCP is thus starved of quality input and direction that it would have received from an effective board with functional board sub-committees that handle specific programme governance issues.

The main problem behind such problem in governance and related areas is that the legal status of SMCP is not yet defined. This is crucial if SMCP is to have an effective governance structure. There is a suggestion for registration of SMCP as a Trust and the appointment of Trustees comprised of a team of Eritrean professionals from various disciplines. If this is approved and materializes, the team, together with
the program's management could work on developing an appropriate regulatory environment. (Menghestaeb, 25/09/03)

SMCP's decentralized structure is ideal for its type of business and target market. It ensures regular contact with operations at grassroots level and quick decision-making. The major challenge, however, is the sparsely populated nature of some regions, especially the Southern Red Sea and Northern Red Sea Regions where the village banks are too far apart from one another, causing increase of administrative and operational costs. Communication with some of the remote regions is also a challenge. More cost effective ways of reaching these communities will need to be explored to ensure that they do not negatively affect programme viability, e.g. increasing the minimum number of clients per village bank in sparsely populated areas as a necessary condition before SMCP can launch operations in such areas.

The involvement of MOLG officials at the regional level was not meant to be large enough to violate SMCP's latitude to deal with its tasks. The involvement was rather a sort of partnership and it did help SMCP in advocacy work, on-time repayment, etc. and to some extent it contributed to the good performance of the programme particularly at its initial stages. At present, SMCP is in a stage where it can manage its tasks independently. Therefore, it is preferable if the involvement of the MOLG regional officials be phased out so SMCP can run its operations as a stand-alone programme that assumes all its operational overheads.

3.4.2 Savings

Mostly SMCP has been applying obligatory savings characterized by locked-in or group accounts. As pointed out earlier, the savings requirement for Tier Ia is to deposit 10% of the loan amount, and 15% or 20% without a co-signer for Tier Ib. For Tier II clients the requirement is to deposit 5% of the loan amount as up-front savings
and ongoing savings of a minimum of 0.5% of their loan amount with each instalment they make.

Such mobilized savings are deposited in the Commercial Bank of Eritrea in the name of the Village Banks. Although SMCP is not allowed to mobilize savings deposits beyond those serving as guarantee fund, it continued to encourage its clients to save voluntarily and to hold their individual group accounts. However, despite its importance to the clients as well as to the programme, SMCP experienced very slow growth of voluntary savings. It appears in Table 3.5 that in 2001, the number of voluntary savers increased to 126 savers, a jump of about 43 percent from the 1999 and 2000 levels. However, the average savings balance essentially remained unchanged at about $200.

Most respondents reveal that they don’t save voluntarily. The reason they give for this is that they don’t have a surplus. But one can also assume that the fact that the saving account is not open-access, the low interest (4.5%) paid on saving accounts in the Commercial Bank and the increasing inflation rate against the backdrop of the depreciating national currency are additional reasons. Exploring the problem further and initiating solutions to make saving more attractive is important. However, introducing a law that would allow microfinance institutions to mobilize savings could have helped a lot to expand the viability and sustainability of microfinance institutions’ operations.

3.4.3 Interest rate

The Civil Code limits interest rate on loans to be not more than 12%. SMCP is mandated to serve remote and marginalized areas as well. It is clear that such areas involve a higher operational cost than areas in the vicinity of towns. Taking this into
consideration, the government allowed SMCP to charge 16% on a declining balance for all its loan products. This is relatively higher than some other micro-lending institutions in Eritrea. For instance, the ACORD sponsored Southern Zone Saving and Credit Scheme charges 14%. At earlier stages, SMCP had to face organized challenges, from a number of communities asking for more subsidized loans. However, by giving much consideration to advocacy work among the concerned parties, SMCP managed to convince the beneficiaries and remained steadfast in its decision concerning the interest rate.

The 16% rate seems to be enough for attaining a full cost recovery. But it is not. To price its products on a full cost recovery basis while maintaining competitive product prices is still a challenge to SMCP. Particularly at present with the increasing inflation rate the effective real interest rate is barely 1%. This clearly shows that SMCP has been limited in its ability to raise revenue levels sufficiently to cover all its actual costs and to introduce measures that would adequately reward its staff and village administrations. Thus if at all SMCP is to be sustainable and a vital player in Eritrea’s economic development, modification to the law that regulates interest rate is important.

3.4.4 Repayment

It appears in Table 3.8 as well as in Figure 3.3 that repayment was good till 1998. Loan loss rate was only 0.6% and delinquency rate (portfolio at risk on the basis of more than 30 days late) was 0%). Much of this success, according to Menghesteab (1999:28) was due to close monitoring, innovative and flexible loan terms and conditions, decentralized decision making, efficient loan processing and procedures, strong social pressure and the still not eroded norm of being trustworthy concerning one’s debts and the incentive to on-time repayments.
Various methods are in use to motivate clients to repay on time. They are assured access to repeat loans in increasing sizes. Upon demonstration of a perfect repayment record some are allowed graduation from joint liability loan to individual liability loan and some others are allowed to benefit from a partial interest refund. Penalties and financial disincentives such as taking away the compulsory savings that serve as guarantee funds, refusing all the group members new loans, or calling upon mutual guarantee group members to provide group peer pressure, etc. are used to discourage late repayments (Menghesteab, 2003).

Figure 3.3: Loan loss and delinquency rate

![Loan loss and delinquency rates graph]

Source: Adapted from Manalo (2002:34)

It also appears in Table 3.8 and Figure 3.3 that loan loss rate and delinquency rate started to rise in 1999 and went up in 2000 to the level of 30.8% and 28.3% respectively. This was as a result of the border conflict which was at its height at this time. As a result of this war some of SMCP staff and clients were either displaced or called to the war front to support the war. As of June 30, 2000 there were 894 clients
in the national service and 897 internally displaced persons (IDP) in the first tier loan area alone. In the second tier loan programme, there were six clients in the national service and another four displaced. All in all, 1801 of SMCP clients had joined the army or became IDPs. The government, recognizing that clients under these circumstances would not be able to meet their obligations decreed that loans belonging to them be frozen. The total frozen loans in both loan tiers amounted to 3,544,286.81 Nakfa. These frozen loans are included in the 28.3% delinquency rate mentioned earlier. (SMCP, 2003:6)

Despite the government decree that such loans be frozen, SMCP has continued its efforts to collect these loans whenever there is any possibility. It tries to collect the loans when the national service or IDPs return home and resume their normal life or from family members who might have taken over the business and can afford to pay. As a result of this a remarkable reduction down to 10.3% level was achieved by the end of 2001. This portfolio at risk ratio includes the frozen loans and compares unfavourably with that of seven African MFIs of more or less the same age at 1.9%. If the frozen portfolio is not included SMCP portfolio at risk (>30 days) rates would have read 2% and its portfolio at risk (>90 days) rate 1.5%.

The effort to collect these frozen loans has been an ongoing process and as of December 31, 2002 of those 1801 national service and rendered IDPs only 930 clients who owe SMCP 1,867,667.97 Nakfa remain. That means SMCP managed to regain 1,676, 618 Nakfa (SMCP, 2002:6). Besides these outstanding frozen portfolios there are loans that SMCP used to handle in one of three ways: allow client to pay previous loan in full and take out new loans, reschedule/refinance when appropriate, or write off loans for clients who because of any justifiable reason could not pay.
**Rescheduling:** Rescheduling a loan refers to extending the loan term or changing the payment schedule or both, and refinancing a loan refers to providing an amount of loan funds in addition to the original loan amount (Ledgerwood, 1999:246). SMCP used to reschedule late payments for reasons such as drought and some other crisis which is beyond the clients' control. As of the end of December 2002, a total number of 552 loans for a total sum of 3,088,435 Nakfa were rescheduled mostly because of drought condition. This was intended to reduce the arrears in a portfolio by converting a delinquent loan into one that appears to be a healthy loan.

**Write Offs:** Once it appears unlikely that a particular loan will be repaid, a write-off occurs. Write-offs are simply an accounting entry; they do not mean that loan recovery should not continue to be pursued or that the organization has relinquished its legal claim to recover the loan. MFIs often fail to write off bad loans because of legal restrictions or the desire to show exaggerated profits or a high portfolio amount. On the other hand, as write-offs reduce the amount of portfolio at risk, MFIs that wish to report a healthy portfolio or minimal portfolio may choose to write off loans more frequently than they should. (Ledgerwood, 1999:191)

Because it was worried about the bad impact it could have on its clients and staff, SMCP was not in the habit of writing—off bad loans. It strove to have any unpaid loan fully paid up. However, it is sound policy that loans of borrowers who have died or left the area or if there are other justifiable reasons, should be written-off. Accordingly, for the first time in its life, SMCP decided to write-off 36 loans for a total sum of 68,802.33 Nakfa as of December 31st, 2002. Thirty five of these loans belong to Tier I. These clients have their 10% savings in the bank. These as well as the savings of their solidarity group members when they withdraw from the programme can be used to pay for the written-off loans. At the end of the day, only a small
fraction of the written-off loans and the interest that should have accrued will be lost (SMCP, 2002:6).

There is no doubt that SMCP's decision to write-off bad loans is good. However, the decision on when to write off a loan should be based on a sound policy established and agreed to by the board members. Due consideration should be given to establish such a policy. Moreover an institution's ability to track the status of its portfolio in a timely and accurate manner is essential to enhance its financial performance. This greatly depends on having a reliable management information system (MIS).

3.4.5 MIS

The management information system of an institution includes all the systems used for generating the information that guides management information in its decisions and actions. It monitors the operations of the institution and provides reports that reflect the information and trends that management considers the most significant to track and interpret properly.

An institution's ability to track the status of its portfolio in a timely and accurate manner is often the most pressing need. The reliability of the systems tracking this information is in many cases the difference between success and failure of the lending and savings operations and, therefore, of the institution. (Ledgerwood, 1999:169)

According to Ledgerwood (1999:169), MFI management information systems generally fall into three main areas:

- An accounting system, with the general ledger at its core
- A credit and savings monitoring system, which captures information and
provides reports about the performance of each loan disbursed, often with a savings system that monitors all transactions related to client savings

- a system designed to gather data of client impact

Not all institutions have a management information system that covers all of these areas. However, the first two (general ledger and loan tracking) usually exist in some form.

So far, SMCP has been using a locally developed programme, which was not adequate to answer SMCP's needs. With such a system, one can imagine how difficult it is to track performance adequately and regularly and come up with timely information that can help identify and interpret trends properly. As well it is not easy to come up with reliable key financial indicators to monitor the status of the operations and take the necessary measures. SMCP has identified this as a problem and has been working seriously to solve it. In consultation with the World Bank and programme owners and developers, it is in the process of choosing a suitable programme and it will do so soon.

3.4.6 Outreach

Outreach is one of the criteria for the success of an MFI. Growing outreach can help a microfinance institution to attain financial sustainability. According to Yaron (1992:vii), the value and number of loans extended can be used to measure outreach.

It appears in Table 3.5 that both the value and number of loans grew by 192% and 53% respectively in 1997, and by 150% and 128% respectively in 1998. It also appears that this loan value and number declined tremendously to the level of 4% and 9% in 1999, followed again by a small rise in 2000 and big rise in 2001.
Table 3.5: SMCP outreach performance

<table>
<thead>
<tr>
<th></th>
<th>Dec-96</th>
<th>Dec-97</th>
<th>Dec-98</th>
<th>Dec-99</th>
<th>Dec-00</th>
<th>Dec-01</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of Village Banks</td>
<td>25</td>
<td>38</td>
<td>76</td>
<td>85</td>
<td>88</td>
<td>146</td>
</tr>
<tr>
<td>No. of active loans</td>
<td>1526</td>
<td>2329</td>
<td>5318</td>
<td>5785</td>
<td>6187</td>
<td>11229</td>
</tr>
<tr>
<td>Total outstanding loan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>balance (Nakfa)</td>
<td>1316100</td>
<td>3845474</td>
<td>9418148</td>
<td>9766917</td>
<td>11942838</td>
<td>32032022</td>
</tr>
<tr>
<td>Average loan balance</td>
<td>862</td>
<td>1651</td>
<td>1771</td>
<td>1688</td>
<td>1930</td>
<td>2853</td>
</tr>
<tr>
<td>Number of voluntary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>savings clients</td>
<td>16</td>
<td>57</td>
<td>81</td>
<td>88</td>
<td>126</td>
<td></td>
</tr>
<tr>
<td>Total balance of</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>voluntary savings</td>
<td>21103</td>
<td>67869</td>
<td>135744</td>
<td>207427</td>
<td>3503338</td>
<td></td>
</tr>
<tr>
<td>(Nakfa)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Staff members</td>
<td>12</td>
<td>18</td>
<td>18</td>
<td>14</td>
<td>36</td>
<td>60</td>
</tr>
<tr>
<td>Year end market</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>exchange rate</td>
<td>6.74</td>
<td>7.2</td>
<td>7.38</td>
<td>8.15</td>
<td>9.6</td>
<td>10.9</td>
</tr>
</tbody>
</table>

Source: Adapted from Manalo (2002) and Menghestaeb (1999)

The reason for the decline in 1999 and 2000 was the war situation where, as mentioned earlier, a considerable number of SMCP clients and staff were displaced or called to do their National Service. As a result of this the SMCP human resource base suffered staff shortage. Beside the national service, higher paying NGOs pulling experienced SMCP staff members is also a problem that reduced SMCP's human resource base.

SMCP is accessible in all the regions even in those remote areas where communication and transportation is difficult, villages are hundreds of kilometres apart and the population density is low causing the operation there not to be cost effective. To counter such a challenge of low density realities and the long distances between village banks, and the loss of experienced staff members, SMCP had to recruit new staff members. It also obtained Government approval to strengthen its outreach and monitoring capabilities by supplementing its staff force with individuals who were trying to do their national service. It also introduced a new staffing level of resident programme promoters who were hired to serve in the localities of operation.
Figure 3.4 SMCP’s number of active loans

Overall, it is these staffing changes, adjustments and flexibility of SMCP that translated to increased outreach. This is reflected in increases in the number of active loans and outstanding loan portfolio. As of the end of 2002, the number of Village Banks had reached 162 and the number of clients in its two-tiered loan programme 13,891, living far and wide over the whole country but mostly in rural areas.
Figure 3.5: SMCP’s outstanding loan portfolio

Women’s participation: According to Mengisteab (1999:31), the percentage of women clients in the group loan was 31% in 1996, 26% in 1997, and 23% in 1999. Of the individual loans, it was 15% in 1997, and 6% both in 1998 and 1999. Manalo (2002:26) points out that women’s participation returned to about 30% in 2000 and over 35% in 2001. With more men joining the army to defend the country, women were promoted to fill the earlier male-dominated role. Comparing this with the 97% level that other medium-sized MFIs operating in Africa have achieved, this is very small. SMCP will have to develop other strategies to reach women (Manalo, 2002:27).

International aid donors, governments, scholars, and other development experts have paid much attention to microfinance as a strategy capable of reaching women and involving them in the development process. They believe that by providing
access to financing for income-generating activities, microfinance institutions can significantly reduce women’s vulnerability to poverty.

Large number of MFIs serve exclusively or predominantly women. For instance, MFIs such as BRAC, Grameen Bank, Foundation for International Community Assistance (FINCA) Mexico, Freedom from Hunger Foundation (FFH) Thailand, Ghana etc. exclusively serve women. The justification for giving priority to increasing women’s access to financial services is that women are relatively more disadvantaged than men. Women face considerable disadvantages relative to men because of more limited business networks and opportunities, less access to formal credit, greater domestic burden, weaker self-confidence, less education, and in many cases, a restrictive legal environment.

It is generally accepted that women are disproportionately represented among the world’s poorest people. In its 1995 Human Development Report, the UNDP reported that 70% of the 1.3 billion people living on less than $1 per day are women. According to the World Bank’s gender statistics database, women have a higher unemployment rate than men in virtually every country. (Cheston & Kuhn, 2002:171)

Further more, it is believed that women spend more of their income on their families, therefore when women are helped to increase their incomes; the welfare of the whole family is improved. On the grounds of sustainability, proponents of targeting women cite that women’s repayment records and cooperativeness are much better than that of men.

With regard to women’s condition the Eritrean context is not an exception. However SMCP’s financial service is not exclusively targeted to women. It is accessible to both male and female. This is because, regardless of gender, poverty is wide spread among the people. Moreover, provision of financial services is not the only required
niche for women’s active participation in income generating activities.

There may be a need of extra components such as training oriented around women’s household roles. Considerable attention to nonformal education activities designed to raise women’s awareness of the social and economic barriers they face as women or to strengthen women’s leadership ability may be needed. Incorporating such activities would to some extent affect the financial performance negatively. Despite this there is a microfinance run by the National Association of Eritrean Women which exclusively targets women. In such a situation for SMCP to target women exclusively will not be any more than duplication, and unnecessarily limit the outreach and thus sustainability of the organization.

Despite all this, SMCP pays special attention to women. Women’s needs and assets are taken into account in the design of products and programme planning both because women by default have less access to credit and because they face constraints unique to their gender. Data on group formation, savings and credit are disaggregated on gender. At least one of the three members of the Village Bank Committee is a woman, in order to ensure that women are well represented in the committee. However, the coverage of women pointed out earlier, clearly indicates that SMCP can still do much to develop products and services that attract women to make the best use of the financial services provision.

3.4.7 Staff productivity

Staff productivity is one of the areas that should be considered if an MFI is to achieve sustainability. With the nature of micro lending, the main responsibility for effective outreach and loan repayment rests with the credit officers. Average portfolio
Table 3.6: SMCP efficiency indicators

<table>
<thead>
<tr>
<th>Administrative efficiency (administrative costs excluding financial costs as % of avg. net portfolio)</th>
<th>Dec-96</th>
<th>Dec-97</th>
<th>Dec-98</th>
<th>Dec-99</th>
<th>Dec-00</th>
<th>Dec-01</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4.80%</td>
<td>11.50%</td>
<td>6.50%</td>
<td>4.30%</td>
<td>4.80%</td>
<td>14%</td>
</tr>
</tbody>
</table>

| Operational efficiency (total operational costs as % of avg. net portfolio) | 12.10% | 21.70% | 19.30% | 13.00% | 18.30% | 36.20% |

| Administrative cost per active loan (Nakfa) | n/a | 151 | 111 | 73 | 77 | 153 |

| Personell costs as % of total administrative costs | 75.90% | 84.70% | 89.30% | 89.40% | 83.90% | 69.80% |

| Number of active loans per staff member | 127 | 129 | 295 | 413 | 177 | 187 |

| Number of active loans per loan officer | 382 | 466 | 1,064 | 1,446 | 562 | 936 |

| Outstanding portfolio per staff member in Nakfa | 109,673 | 213,638 | 523,227 | 697,640 | 341,222 | 533,871 |

| Outstanding portfolio per loan officer in Nakfa | 329,027 | 769,097 | 1,883,627 | 2,441,732 | 1,085,712 | 2,669,334 |

Source: Adapted from Manalo (2002)

outstanding and the number of clients per credit officer are some of the ratios used to express productivity information. From this, one can see that productivity can be improved by larger portfolios achieved through larger loan sizes or by larger number of clients per credit officer. However loan sizes must be balanced against the demands of the target group and its ability to absorb and manage a greater amount. Similarly, increasing the number of clients per credit officer must be balanced with the credit officer’s ability to maintain the quality of the loan portfolio.
The optimal number of clients per credit officer depends on the credit methodology and the average loan term of an MFI. The number can be larger with group lending models with relatively long loan terms than with individual lending models with relatively shorter loan terms. This is because credit officers need to spend less time with clients if the loan terms are longer. Also group lending can transfer some of the administrative tasks to the group, thereby reducing overall costs. This shows that in the Village Bank model on which SMCP is designed, the optimal number of clients per credit officer would be relatively higher. In addition to this, the existence of a well-defined and well-planned incentive scheme is a thing that can affect staff productivity.

In the case of SMCP, it appears in Table 3.6 that at the end of 2001, the number of active loans and outstanding loan portfolio per staff member is 187 loans and about Nakfa 533,871, compared to 177 loans and about Nakfa 341,222 in 2000. This reflected a healthy reduction from their 1999 figures of over 1,466 loans and a balance of almost Nakfa 697, 640 per staff member. SMCP's loan officer's productivity ratio is very much higher, compared to the group of seven African MFIs' ratio of 277 active loans. Also, with 60 staff members, SMCP is below the staffing levels of its African peers who have 80 employees. (Manalo, 2002:36)

BKK (Badan Kredit Kecamalan) - Indonesia, BUD (Bank Rakyat Indonesia Unit Desa), BAAC (Bank for Agriculture and Agricultural Cooperatives) - Thailand, GB (Grameen Bank) – Bangladesh, are MFIs widely perceived as successful ones. The staff productivity of SMCP when compared to that of these MFIs is as shown in table 3.7.

SMCP salary scales are said to be above government salary scales but continue to remain below competing positions in the job market. SMCP is expanding and there
is an acute need of skilled manpower. However, unless it improves its remuneration package to be competitive, it will be at risk of losing those it has already, let alone attracting new staff.

Table 3.7: SMCP staff productivity compared to famous MFIs

<table>
<thead>
<tr>
<th></th>
<th>SMCP</th>
<th>BKK</th>
<th>BUD</th>
<th>BAAC</th>
<th>GB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of staff</td>
<td>60</td>
<td>1,875</td>
<td>13,666</td>
<td>6,900</td>
<td>6,000</td>
</tr>
<tr>
<td>Number of loans per staff member</td>
<td>187</td>
<td>272</td>
<td>120</td>
<td>203</td>
<td>127</td>
</tr>
<tr>
<td>Value of outstanding loans per staff member</td>
<td>$48,980</td>
<td>$6,900</td>
<td>$29,300</td>
<td>$131,800</td>
<td>$4,900</td>
</tr>
</tbody>
</table>

Source: Yaron (1992)

3.4.8 Financial performance

3.4.8.1 Financial sustainability: Financial sustainability/viability refers to the ability of an MFI to cover its costs with earned revenue. A financially viable MFI cannot rely on donor funding to subsidize its operations. To determine financial sustainability, self-sufficient indicators are calculated. There are usually two levels of self-sufficient indicators: operational self-sufficiency and financial self-sufficiency. (Ledgerwood, 1999:217)

The definition of operational self-sufficiency (OSS) varies. One, which can be referred as operational self-sufficiency index (OSSI₁), is generating enough operating revenue to cover operating expenses, and the provision for loan losses. The other, which can be referred as OSSI₂, is generating enough operating expenses to cover operating expenses, financing expenses and the provision for loan losses. The difference centres on the inclusion of financing costs. (Ibid)

92
Table 3.8: SMCP's financial performance ratios

<table>
<thead>
<tr>
<th></th>
<th>Dec-96</th>
<th>Dec-97</th>
<th>Dec-98</th>
<th>Dec-99</th>
<th>Dec-00</th>
<th>Dec-01</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan loss rate</strong></td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.60%</td>
<td>2.30%</td>
<td>30.80%</td>
<td>15%</td>
</tr>
<tr>
<td><strong>Delinquency rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(portfolio at risk basis &gt;30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>days late</td>
<td>0.00%</td>
<td>0.50%</td>
<td>0.00%</td>
<td>2.20%</td>
<td>28.30%</td>
<td>10.30%</td>
</tr>
<tr>
<td><strong>Operational self-sufficiency</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(excluding cost of funds)</td>
<td>4.30%</td>
<td>75.80%</td>
<td>118.20%</td>
<td>224.50%</td>
<td>184.20%</td>
<td>107.50%</td>
</tr>
<tr>
<td><strong>Operational self-sufficiency</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(including cost of funds)</td>
<td>3.90%</td>
<td>46.60%</td>
<td>63.70%</td>
<td>80.20%</td>
<td>62.00%</td>
<td>57.80%</td>
</tr>
<tr>
<td><strong>Financial self-sufficiency</strong></td>
<td>1.40%</td>
<td>26.80%</td>
<td>32.90%</td>
<td>35.90%</td>
<td>44.00%</td>
<td>58.60%</td>
</tr>
<tr>
<td><strong>Return on assets</strong></td>
<td>-10.30%</td>
<td>-9.10%</td>
<td>-5.10%</td>
<td>-1.70%</td>
<td>-4.30%</td>
<td>-9.40%</td>
</tr>
<tr>
<td><strong>Adjusted return on assets</strong></td>
<td>-28.60%</td>
<td>-21.30%</td>
<td>-17.90%</td>
<td>-12.20%</td>
<td>-8.80%</td>
<td>-9.00%</td>
</tr>
<tr>
<td><strong>Adjusted return on equity</strong></td>
<td>1497.20%</td>
<td>353.90%</td>
<td>225.20%</td>
<td>116.60%</td>
<td>-72.50%</td>
<td>-73.90%</td>
</tr>
</tbody>
</table>

Source: Adapted from Menalo (2002)

According to Ledgerwood (1999:217) regardless of which formula is used, if an MFI does not reach operational self-sufficiency, its equity (loan fund capital) will be eroded. This means that there will be a smaller amount of funds to loan to borrowers (which could lead to closing the MFI once the funds run out). To increase its self-sufficiency, the MFI must either increase its yield (return on assets) or decrease its expenses (financing costs, provision for loan losses, or operating costs).

Financial self-sufficiency index (FSSI) indicates whether enough revenue has been earned to cover both direct costs, including financing costs, provisions for loan losses, and operating expenses, and indirect costs, including the adjusted cost of capital.

In the case of SMCP, it has been pointed out that the National Service Programme, the displacement of clients as well as droughts have negatively affected the
performance of SMCP. Despite the losses it incurred from all these, it appears in Table 3.8 that OSSI\textsubscript{1} (excluding cost of funds) was above 100% for the years 1998 to 2001. This implies that SMCP has been covering its operational costs. The OSSI\textsubscript{2} (including cost of funds) also appears to have been increasing from year to year till it reached the level of 80% in 1999 followed by a decline in the years 2000 and 2001 which were about 60% and 58% respectively. This according to Manalo (2002:43), when compared to African MFIs, is below their level, which is 76%.

It is clear that SMCP strategies and operations had a positive effect on the financial sustainability. On the other hand, the decline of yield reflected on the “return on assets” ratios (Table 3.8) because of the clients' displacement, National Service and drought would clearly influenced it negatively. The rising administrative cost and operational cost, particularly in 2001, indicated by “administrative efficiency ratio” and “operational efficiency ratio” (Table 3.6) are assumed to have affected the performance negatively as well. The expansion of the programme to areas sparsely populated and with poor communication and transportation facilities, without adjusting the price of the service, could have been the cause of these falls in performance.

Table 3.8 and Figure 3.6 further indicate that financial self-sufficiency steadily grew in the years 1996-2001 to the level of about 60% in 2001. This is much higher than that of 1999 and that of 2000, which appear to be about 40% and 44% respectively. On the other hand, this, when compared to the older African MFIs, is below their level, which is 73% (Manalo, 2002:43). However, taking into consideration the hostile environment under which the SMCP was forced to work, this is a remarkable achievement. It indicates that the SMCP is making good progress towards sustainability.
If an organization is not financially self-sufficient, the *subsidy-dependence index* can be calculated to determine the rate at which the MFIs interest rate needs to be increased to cover the same level of costs with the same revenue base (loan portfolio). Nevertheless, as a problem of breaking down of costs, which was shared with ECDF, this ratio could not be dealt with.

### 3.4.8.2 Profitability

One of the indicators used to measure profitability is the *return on assets (ROA) ratio*. It measures the net income earned on the assets of an MFI. Factors that affect the return on assets ratio are varying loan terms, interest rates and fees, and changes in the level of delinquent payments. Analysis of this ratio will improve the ability of an MFI to determine the revenue impact of policy changes, improved
delinquency management, or the addition of new products. It can be expressed either in the form of a ratio of net income to average costs or in the form of adjusted return on assets which is the ratio of net adjusted (for inflation and subsidies) income to average total assets.

**Figure 3.7: Trend of SMCP profitability indicators**

![Graph showing trend of SMCP profitability indicators](image)

Source: Adapted from Manalo (2002)

It appears in Table 3.8 and Figure 3.7 that SMCP's adjusted return on assets was about 8-9 percent in the last years. This implies a declining profitability. This, as Manalo (2002:43) indicates, is about the same when compared to the older African MFIs. In general, what the indicators show is not bad, particularly when the situation under which the SMCP has been working is taken into consideration. However, there is room for improvement and many impediments to get rid of, if the SMCP is to achieve sustainability.
CHAPTER FOUR: SUMMARY OF MAIN FINDINGS, RECOMMENDATIONS AND CONCLUSION

Presented in this chapter is a summary of main findings of the study from interpretations and analysis of data in chapter three and field observations; recommendations and conclusion.

4.1 Main findings of the study

1. Legal status of the SMCP is not yet defined. The legal framework governing the microfinance sector such as licensing, supervision and monitoring of MFIs is yet to be established.

2. Although the government strongly supports well-focused, best practice based provision of microcredit services, it remains in control of, or heavily involved in the key microfinance activities and programmes. Some of its policies are not conducive to microfinance development.

3. Government limits interest rate. This limits the SMCP’s ability to raise revenue levels sufficient to cover all its actual costs and introduce measures that would enable it to reward its staff and village administrations.

4. SMCP has been making an effort to develop a product mix that is tailored to meet the needs of the target market by refining its product offering in line with clients’ preferences and apply a delivery system that remains responsive to clients’ preferences.
5. The use of the loans is left open. Provided the money is for an income generating activity, a client is free to use it for any application that he believes would be feasible. At present, 52.42% of SMCP clients used the loan for trading activities, 42.37% for agricultural activities, 3.67% for service activities and 1.54% for manufacturing activities. This shows that there is still a potential for diversifying the loan products to include loan uses such as consumption.

6. Eritrea, being a country prone to drought, the loans engaged on agricultural activities, especially crop farming, are too many, as this has proved to be risky.

7. Clients express their dislike for the mutual guarantee of having to pay for group members’ default. They prefer to borrow on individual basis with their spouses as co-signers.

8. SMCP’s work is decentralized and brings the service to a doorstep level, rendering it efficient and cost effective. Its decentralized structure is ideal for its type of business and the target market. It ensures regular contact with operations at grassroots level, and quick decision-making.

9. There are indications of the fact that the majority of the groups consider repayment as their sole responsibility and little evidence of their commitment to make the groups the dynamic creations they were envisaged to be.

10. SMCP applies “on-the-spot” disbursal of loans, particularly to its repeat
clients, that require funding, rather than to deposit the money in the bank account. This renders the service efficient and is more profitable to the SMCP. It gets better returns for its money, and is able to turn around loan requests quickly.

11. The National Steering Committee (NSC), which is the top governing body in the SMCP lacks commitment to the programme. The SMCP is thus starved of the quality input and direction that it would have received from an effective board with functional board sub-committees that handle specific programme governance issues.

12. The sparsely populated nature of some regions, especially the Southern Red Sea and Northern Red Sea Regions where the village banks are too far apart from one another, and the inefficient communication service to some remote areas of these regions are causing an increase of administrative and operational costs. The increase is indicated in the "administrative efficiency ratio" and "operational efficiency ratio".

13. The fact that a saving account is not open-access, the low interest (4.5%) paid to saving accounts in the Commercial Bank and the increasing inflation rate against the backdrop of the depreciating national currency are additional reasons for clients not to save voluntarily.

14. To price its products on a full cost recovery basis while maintaining competitive product prices is still a challenge to SMCP. Particularly at present with the increasing inflation rate the effective real interest rate is barely 1%.
This clearly shows that SMCP has been limited in its ability to raise revenue levels to sufficiently cover all its actual costs and to introduce measures that would adequately reward its staff and village administrations.

15. Loan loss rate and delinquency rate in 2000 went up to the level of 30.8% and 28.3% respectively. This was as a result of the border conflict during which some of the SMCP staff and clients were either displaced or joined the army.

16. The SMCP was not in the habit of writing-off bad loans. For the first time, it decided to write-off 36 loans for a total sum of 68,802.33 Nakfa as of December 31st, 2002.

17. The SMCP human resource base suffered staff shortage. In addition to the national service, higher paying NGOs pulling experienced SMCP staff members is also a problem that reduced SMCP’s human resource base.

18. Women’s participation was about 30% in 2000 and over 35% in 2001. Comparing this with the 97% level that other medium-sized MFIs operating in Africa have achieved, it is very small.

19. OSSI₁ (excluding cost of funds) was above 100% for the years 1998 to 2001. The OSSI₂ (including cost of funds) also appears to have been increasing from year to year till it reached the level of 80% in 1999 followed by a decline in the years 2000 and 2001 which was about 60% and 58% respectively. This, when compared to African MFIs is below their level, which is 76%. 

100
20. Financial self-sufficiency has been steadily growing in the years 1996-2001 to the level of about 60% in 2001. This when compared to the older African MFIs is below their level, which is 73%. However, taking into consideration the hostile environment under which SMCP was forced to work, this is a remarkable achievement.

4.2 Recommendations

The above twenty findings, among others, form the basis for the recommendations in this section.

4.2.1 Establishing legal base

The legal framework governing the microfinance sector such as registration, licensing, supervision and monitoring of MFIs, savings mobilization and access to local resources requirements should be developed. In other words, defining SMCP’s legal status, modification to the Civil Code regulating the interest rate structure, the introduction of regulations governing deposit mobilization and access to local resources by MFIs are areas that need be addressed if SMCP is to be sustainable. It is also helpful to introduce measures that would enable and encourage inter-linkages and co-operation between microfinance institutions and formal banks.

4.2.2 Introducing good and planned remuneration packages and incentive schemes

It is clear that the success of MFI greatly depends on the quality of its labour. SMCP is expanding and there is acute need of skilled manpower. The salary scales in SMCP are said to be above government salary scales but continue to remain below competing positions in the job market. There is no incentive scheme in use. As a
result of these, SMCP used to lose some of its skilled workers to well paying NGOs. So SMCP should improve its remuneration package to be competitive and introduce a well planned incentive scheme to avoid the risk of losing those it has and to attract new employees.

4.2.3 Pricing products on a full cost recovery basis

The 16% rate is not enough for attaining a full cost recovery. Particularly at present with the increasing inflation rate the effective real interest rate is barely 1%. This clearly shows that SMCP has been limited in its ability to raise revenue levels to sufficiently cover all its actual costs and to introduce measures that would adequately reward its staff and village administrations. So SMCP should price its products on a full cost recovery basis while maintaining competitive product prices if at all to be sustainable.

Extending its service to sparsely populated, remote and ill served areas is within the mandate of SMCP. However, more cost effective ways of reaching these communities will need to be explored to ensure that they do not negatively affect programme viability. Asking the communities to pay the full cost, introducing a small increase on the interest rate so that the service to those disadvantaged areas can be cross subsidized, increasing the minimum number of clients per village bank in sparsely populated areas as a necessary condition before SMCP can launch operations in such areas etc. can be options for further study.

4.2.4 Write-off of loans on policy and constant basis

SMCP took a step to write-off bad loans only once in its life. There is no doubt that this decision was good. However, the decision on which and when to write off a loan was not based on a sound policy established and agreed to by the board members.
Due consideration should be given to establish such a policy.

4.2.5 Upgrade the capacity of village committees

The SMCP Village Bank model is ideal for its type of business. The Village Bank Committees are responsible for group formation, loan processing, management, follow-up, and record keeping. These involve important decisions regarding membership and access to SMCP credit facilities. The aim is to make the work decentralized and to bring the service to a doorstep level, rendering it efficient and cost effective, which of course is an important thing for organizational and financial sustainability. However, it is important that the Village committee be trained to upgrade their skill as well as to update them on the program's policy and procedures so that they can perform better.

4.2.6 Settle the issue of frozen loans

The negative impact of frozen loans on the financial viability and financial indicators of the SMCP is self-evident. Therefore, the SMCP should run a dialogue with the government on how to deal with those loans, which it was unable to collect, in a way that will not damage the program's viability. Government's failure to settle these loans will not only harm the programme but those individuals who are liable for National Service. This is because the SMCP will be reluctant to grant loans to this age group.
4.3 Conclusion

In this study an attempt has been made to evaluate the sustainability of the Saving and Micro-Credit Programme in Eritrea. Like most microfinance institutions, SMCP faces some problems that impede sustainability.

This study has shown that the undefined legal status, imposed ceilings on interest rates, and the law that forbids microfinance to mobilize savings deposits were not conducive to proper functioning that enhances sustainability. It has also shown that the border conflict, drought, the National Service Programme, expansion of the service to remote and marginalized areas in ways which are not cost effective, lack of government support to introduce competitive remuneration packages and incentive mechanism are some of the problems that slow down the SMCP’s progress towards sustainability.

The study has also shown, however, that there has been strong government support for well-focused, best practice based provision of micro-credit services at an interest rate, which is positive, and a decentralized work system. It has also shown that the SMCP has been trying to develop a product mix that is tailored to meet the needs of the target market by refining its product offering in line with clients’ preferences and applying a delivery system that remains responsive to clients’ preferences. These activities enabled SMCP to be on the road to sustainability despite the hostile political and economic environment under which it has been working.

The objective of developing viable and sustainable institutions and the objective of poverty alleviation are not things which are easy to marry. It is important and interesting, therefore, to point out the SMCP’s effort to keep the appropriate balance between meeting the social objective of poverty alleviation and developing a viable
and sustainable institution. It has served the most disadvantaged risk prone, remote and sparsely populated areas where the poorest are likely to be found, not only in times of peace but also times of war. Despite their higher operational and administrative costs, it used to provide small loans in order not to crowd out the poor. In general it has been cautious to avoid deliberate and inadvertent mechanisms that can act to exclude the poor. All these activities indicate the SMCP’s commitment to social objectives trading off some sustainability gains. Taking this and the hostile environment under which SMCP has been functioning, into consideration, SMCP’s so far achieved success supports the assertion made about microfinance being sustainable and a poverty alleviation strategy. The repayment rates defy the common stereotype that poor people are not likely to use credit well and will be bad risks, rather it asserts that the poor repay.

The SMCP has not yet reached the stage of full sustainability though it continues to make good progress towards that. One can learn a number of lessons from the difficulties it underwent and the failures and successes it experienced. There is no doubt that these will help the SMCP to avoid a re-run of past mistakes and inadequacies, and not only the SMCP, but also other microfinance both within and outside Eritrea. Amongst others, the following lessons can be pointed out:

- The key measure to the so-far achieved success of the SMCP was identifying the appropriate institutional model. It has been cautious in its attempt to replicate and technically imitate the mode of operations of other model institutions. Sound practices identified were adapted to fit the Eritrean context.

- Credit is more or less not targeted because it is considered as a viable tool of poverty alleviation for all sections of the poor. It is offered to all the economically active, with special attention to the poor. It was a demand-driven
and efforts are being made to offer this and other products in a manner that meet client needs at prices that cover all costs of providing them.

- Decreasing transaction costs of services through simplification of procedures and decentralization to locate services near clients was applied as polices for reducing programme costs and lowering the average work load of the SMCP staff members.

- Obstacles which exclude the majority of the rural people, the less educated, and nearly all the poor such as slow and tedious application procedures, slow and bureaucratic processing, collateral etc. were avoided.

- From time to time SMCP tried to be more flexible on the products provided and their delivery to be appropriate for different groups of clients and to meet their preferences.

- It applied a flexible approach in responding to the war situation and drought that occurred in the country and the subsequent difficulties faced by its clients. It demonstrated the fact that conflicts need not be completely resolved prior to the introduction or continuation of microcredit services.

- The ancient moral values of duty and honesty are still a reality in the community, particularly in the rural community. This has no doubt contributed to the high collection performance. In addition to this, such performance is due, in large measure, to the financial incentives used to motivate timely repayments and financial disincentives or penalties to discourage defaults and arrears.

- Hostile policy and a regulatory environment such as restricting savings mobilization, legal ceilings on interest rate, delay in establishing legal base,
etc are some of the obstacles retarding SMCP's progress.

In general it is clear that the SMCP used a well-focused, best-practice based provision of micro credit services. Though it is not easy to provide empirical evidence and is beyond the scope of this paper, all the clients approached witness that SMCP helped in overcoming their vulnerability and helped them cope with shocks as they occur. However, the challenge is to build on this foundation and enhance the quantity and quality of the financial service for the poor. There is considerable scope for providing the poor with more and better choices.
ACKNOWLEDGMENTS

The research reported in this paper is part of a larger project on gender, health, and beliefs in the rural areas of the Philippines. The author would like to thank the researchers who have contributed to this project, particularly Screiv T. Osmena, of the University of the Philippines, and Dr. Grace Maria Ong, of the University of the Philippines, for their invaluable contributions. The author would also like to thank the donors who have supported this project, particularly the United Nations Development Programme (UNDP) and the World Bank. The author would also like to thank the reviewers who have provided valuable comments and suggestions for improving the manuscript.


Menghesteab, A. K. 1999. *Village Banks, Group Credit, Domestic Savings Mobilization and the Challenges of Sustainability: the Case of Eritrea*. MSc in


