Microfinance Consensus Guidelines

DEVELOPING DEPOSIT SERVICES FOR THE POOR

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DEVELOPING DEPOSIT SERVICES FOR THE POOR

INTRODUCTION

Deposit services provide value to clients, financial institutions, and local economies. This paper distinguishes deposits from savings: whereas savings are a broad set of activities related to holding assets stored by others, deposits are that portion of people's savings that are held in financial institutions.

Access to deposit services can enable the poor to better manage emergencies; smooth consumption; meet expected demands for large sums of cash, such as school fees; and take advantage of investment opportunities. In some cases, credit can also serve these purposes. In other situations, particularly because the irregular income stream of poor clients often prohibits them from assuming loans with fixed regular payments, deposit services can play a critical role.

Despite the benefits, the poor rarely have access to voluntary deposit services offered by either formal or semi-formal institutions.[1] Until recently, the chief providers of voluntary deposit services outside of the informal sector have been government-controlled postal savings banks, financial cooperatives, and—in South Asia—self-help groups. But market penetration of these organizations has been limited.

Lacking alternatives, the poor are forced to save—and often lose their savings—in the informal sector. They invest in livestock, hide cash at home, and participate in rotating savings and credit associations. These types of savings in many cases are illiquid, high risk, indivisible, or impose uniform terms on savers. Their wide use by the poor attests to the magnitude of demand for savings services and the tremendous lack of options that are secure and flexible.

[1] Robinson, "Savings and the New Microfinance"; Wright, "Beyond Basic Credit and Savings," and "The Case for Voluntary, Open Access Savings Facilities"; Mohammed, "Savings as an Instrument for Poverty Reduction."

For microfinance institutions (MFIs), deposit taking can be the key to financial sustainability. For the purposes of this paper, MFIs encompass all formal and semi-formal financial institutions that serve poor clients with specialized financial services. By providing a stable means to finance a growing loan portfolio, deposit mobilization can release MFIs from their dependence on unreliable donor funds, government subsidies, and external credit. Deposits may also fuel local development by increasing the resources available for productive investment.

However, mobilizing deposits on a large scale and viable basis is difficult for both MFIs and the donors that support them. It requires strong accountable governance, sound asset management, and an enabling legal and regulatory environment. Many MFIs find it quite challenging to fulfill these requirements.

Given that demand for deposit services far exceeds the supply, how can this demand best be met? What are the most appropriate services and institutions that could meet this need? Should donors promote deposit services and, if so, how? This paper aims to answer these questions by

- assessing the options and identifying the requirements for delivering secure deposit services;
- highlighting key issues that should be considered in developing these services; and
- providing donors with guidance on whether and how they should promote deposit mobilization.

I. STATE OF THE PRACTICE

This document takes as its basis the principles delineated in *Small and Microenterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries,*[2] an excerpt from which can be found in appendix A.

Vision

The objective of mobilizing deposits is twofold: (1) to provide relatively secure deposit services that meet the demand of large numbers of poor people on an ongoing basis; and (2) to improve the sustainability of institutions that provide credit services to the poor by developing a relatively stable means to finance their portfolios.

For some practitioners and donors, the primary motivation for promoting savings is to develop communities and empower the poor, particularly women, through the development of self-managed economic groups.

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[2] *Small and Microenterprise Finance: Guiding Principles for Selecting & Supporting Intermediaries.* Donor Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development (Washington, DC: World Bank, 1995).

Thus, security, outreach, sustainability, and for some donors, community development or empowerment are the paramount objectives that guide the development of deposit services. Security implies sound management (i.e., sound asset management, financial performance, and internal controls) backed by effective supervision that protects clients' deposits from losses. Outreach refers to "expanding access to increasing numbers of low-income," or otherwise disadvantaged, clients. Sustainability—financial and institutional—"provides the means to expand and maintain outreach."[3]

It is appropriate that a range of institutions provide deposit services. Different types of institutions use specialized methods to serve particular market niches. Each type has different comparative advantages vis-à-vis the objectives of sustainability, outreach, security, and community development. In some cases, linkages between different types of institutions may be the key to optimizing deposit services for the poor.

Savings Preferences of the Poor

The poor need savings services that allow them to (1) deposit small, variable amounts frequently and (2) access larger sums in the short, medium, or long term.[3] Like everyone else, they demand a portfolio of savings products that offer differing terms of access and generate differing returns.

Although the precise services most desired depend on the context, the poor tend to prefer individual voluntary products. For some purposes, such as to cope with unexpected emergencies, poor people prefer liquid services that can be accessed on demand. For other purposes, such as expected school fees, they prefer illiquid services that protect their deposits from daily demands. Even in the event of an emergency, a loan may be preferred to liquidating savings. Finally, many poor people receive regular flows of remittances from relatives living in urban areas or abroad and require appropriate deposit services to keep these remittances secure.

Small depositors usually value convenient and relatively secure delivery systems above all else: proximity is critical. Receiving positive real returns on deposits is a less important consideration than transaction costs. In some environments, delivery systems that are useful to women must fit their restricted mobility and time availability. Depositors also value privacy, preferring systems that do not reveal to other clients how much they deposit and withdraw.

Types of Deposit Services

Voluntary Deposit Products

Different types of voluntary products serve different functions for clients and have different management and viability implications for MFIs. **Voluntary products** allow savers to deter-

[3] *Small and Microenterprise Finance,* 3.
[3] Rutherford, *The Poor and Their Money.*

mine the amount and timing of deposits and withdrawals. These terms may be left open or they may be set in advance.

- With **demand deposits,** the amount and timing of deposits and withdrawals are not set in advance. A demand-deposit product can enable clients to smooth consumption, cope with emergencies, take advantage of unexpected investment opportunities, or securely store excess cash. Of all deposit services, demand deposits tend to require the most sophisticated and costly management because the volume and unpredictability of transactions require more complex internal controls, liquidity management, and management information systems.

  Demand deposits are, by far, the most challenging savings service to offer on a viable basis. Current accounts are demand-deposit accounts that allow transfer payments (e.g., checking services). Because they enable the poor to receive remittances, current accounts may be a highly valued service in some environments.

- With a **contractual product,** clients agree to regularly deposit a set amount for a set period of time, after which they can withdraw the entire amount plus interest. Contractual products provide clients with the valued opportunity to build lump sums out of small, frequent, and uniform payments that are not vulnerable to day-to-day demands. Contractual savings accounts can be used for expected needs or can allow the client to collect returns while storing savings in a safe place. Because contractual products involve predictable cash flows, they are less administratively demanding and pay a higher rate of interest than demand deposits. They are easier to offer on a viable basis in spite of their higher financial costs.

- **Time deposits** allow the client to deposit a set amount once for a specified term. Time deposits meet the demand of clients to deposit and withdraw large sums for expected needs. They also can provide a secure, relatively profitable place to store savings. Except for small farmers at harvest time, the poor less frequently have large amounts to deposit and therefore typically have a lower demand for time deposits than for other types of savings products. The cost and management requirements of time deposits are somewhat lower than contractual products and their interest rates are typically somewhat higher.

- With an **equity** product (found in self-help groups, in credit unions in the form of shares, and in financial service associations), members invest savings in a member-owned and -managed institution, receive periodic dividends, and in many cases can access larger sums through loans. Unless they can sell their investments—which can be difficult—clients cannot access their savings in these institutions.

  Equity matches the ability of many poor people to save and suits their illiquidity preference only if they can make

small, frequent, and irregular payments and if they can access loans as needed. Any requirement to invest a large lump sum is likely to exclude many of the poor. Among voluntary deposit services, equity is the easiest to manage and certainly the most viable.

Mandatory Deposit Services

Also known as "compulsory," "tied," "forced," or "locked-in" savings, mandatory savings are deposits that are a required condition for receiving a loan. In group-based credit methodologies, mandatory savings are often used to back the group guarantee with tangible collateral.

With most mandatory savings products, borrowers must deposit a portion of their loan amount as savings along with each loan repayment. In some cases, deposits may be withdrawn at the end of the loan cycle; in others, only when a client terminates membership. Often, borrowers may "access" deposits in the form of a loan. In self-help groups and some village banks, savers jointly control the institution's investments and own its proceeds.

For an MFI, mandatory savings resemble contractual savings with respect to their management demands and potential viability. Relative to voluntary deposits, mandatory savings provide MFIs with a more stable and, in some cases, legal means to fund the loan portfolio. They also provide joint collateral for loans and a mechanism to reduce net exposure. With this type of savings product, however, stability for the MFI comes at the expense of the client's ability to access his or her savings.

Because the depositor does not control the amount of deposits or the timing of withdrawals, clients often do not perceive mandatory savings as a deposit service, but as an additional cost that must be born in order to access credit. Small, regular mandatory deposits that can be liquidated at the end of a short loan cycle are likely to be valued by some clients, although not as highly as voluntary contractual services. Mandatory savings services are particularly burdensome to clients if access to their deposits is severely limited or if a large deposit is required when the loan is disbursed.

Mandatory savings can have many other limitations. Because group-based credit methodologies may use them as collateral, mandatory savings can be risky for clients. In some mandatory schemes, the loan size is set equal to the size of the previous loan plus accumulated deposits. As a result, the effective interest rate increases with loan size, which may lead clients to voluntarily limit the size of their loans or drop out of the institution altogether. Moreover, the outreach of savings services tied to loans is limited to those who are well enough off to assume the risk of regular loan and savings payments.

When an institution lends out mandatory deposits to microcredit clients, these loans represent a very inexpensive source of funding. The loans, however, put clients' deposits at

risk. Yet if an MFI banks the forced savings from its clients in a commercial bank, they benefit neither the MFI nor the client.

Designing Deposit Services

The range and design of an institution's deposit services should be determined by the demand of the target market, management capacity of the institution, potential for financial viability of the services, and regulatory environment. Market research, particularly into the terms, usage, and client assessment of existing informal and semi-formal services, is essential to design an appropriate delivery system and products.

Although clients prefer an array of services with a range of liquidity and interest-rate options, even large formal institutions can usually only manage a small number of products. Semi-formal groups and small financial cooperatives may not have the capacity to deliver liquid services on their own. As discussed in more detail below, linkages with formal and second-tier institutions may have the potential to expand the capacity of these small and semi-formal institutions to deliver more flexible deposit services. Low-cost technologies may also make it possible to deliver flexible services more securely at little additional cost.

In order to offer deposit services on a viable basis, larger formal institutions will need to design services to attract large as well as small depositors. A large and diverse client base can also reduce liquidity risk, defined as the risk that a significant number of clients will withdraw a large proportion of an institution's deposits at the same time. Clients from different socio-economic segments will be less likely to react in the same way, for instance, to a natural disaster.

Types of Institutions and Their Potential for Deposit Mobilization

Different types of institutions have different comparative advantages in deposit services relative to the objectives of outreach, sustainability, security, and empowerment.

Commercial and Government-Controlled Banks

Regulated banks provide the greatest potential for security, scale of outreach, and breadth of services, but often face significant hurdles in reaching a large portion of very small and remote depositors. Driven by the bottom line, non-specialized commercial banks tend to have efficient, effective operations. In some countries, a range of factors makes it unlikely that they will orient their services towards remote, poor, and illiterate depositors. In other countries, commercial banks are already serving poor clients. Although their clients are likely to be the better-off of the poor, they may be able to expand their outreach to poorer clientele by focusing on their demand.

The geographic spread and client diversity of regulated banks minimize covariant risk,[4] but to reach large numbers of small, remote depositors on a viable basis, they must establish an appropriate spread between their interest rates for lending and deposits. They may also need to implement cost-effective innovations, such as the employment of deposit collectors, group-based service delivery, or, in some cases, automation.

- In some countries, **commercial banks** adopt a competitive strategy that makes attracting corporate or clients with high net worth a priority. This strategy results in a relatively high cost structure and an organizational culture that make it difficult for these banks to reorient themselves towards poor clients. Commercial banks are also be unlikely to establish branches in poor or sparsely populated areas.
- **Government-controlled banks** tend to have the mission, branch network, and trust to serve large numbers of small and remote depositors, but typically require fundamental changes in governance and management before they can do so. In some cases, government-mandated lending programs and unprofitable branch networks undermine the profitability of these banks. Although government-owned banks provide an implicit state guarantee on deposits, such banks may neither be solvent nor have sound management systems. Their implicit guarantee, however, gives such banks a competitive advantage among customers who value security.

  To reach large numbers of small depositors on a viable basis, government-controlled banks would have to secure operational autonomy, institute market-oriented governance, decentralize their operations, and gain effective supervision. They would also likely need to considerably strengthen their asset management policies; lending practices (if they engage in lending); and recruitment, incentive, and management systems.

  This type of reform should only be attempted if senior leadership in the government and the bank are committed to these reforms, if the institution has the legal ability to charge and pay interest rates that cover its costs, and if the bank has a significant branch infrastructure.

Non-governmental Organizations

Most non-governmental organizations (NGOs) lack the governance, legal status, and institutional capacity to intermediate voluntary deposits from the public. NGOs can provide clients with voluntary deposit services without intermediating savings by depositing mobilized deposits in a regulated institution, organizing self-help groups, or facilitating linkages

[4] Covariant risk refers to the risk that a large number of clients will behave the same way because they are engaged in the same activity or share a similar risk perspective. A typical example is farmers of a particular crop who all default on their loans at the same time when the crop fails in a given season.

between clients and formal financial institutions. For microcredit institutions, developing viable deposit services entails breaking into new markets, assuming a client-responsive culture, and more rigorous and complex financial management.

Specialized Microfinance Banks and Non-bank Financial Institutions

By transforming into specialized microfinance banks or non-bank financial institutions, NGOs may develop the governance, institutional capacity, and license to offer voluntary deposit products. Formalization may be a key to deeper outreach, enabling the scale and breadth of outreach that would allow MFIs to accept very small deposits on a viable basis.[5] However, transformation into a regulated entity can also increase the cost structure and change the culture of an MFI, making it prohibitive or unattractive to serve rural or very small depositors.

Specialized microfinance banks typically do not have existing large-scale infrastructure and must usually grow branch by branch to reach large numbers of clients. Non-bank financial institutions can be established and grow more quickly than microfinance banks because they face fewer regulatory hurdles, but their range of services tends to be more restricted by regulations.

Financial Cooperatives

Financial cooperatives (also known as credit unions, or savings and credit cooperatives) are significant and often sustainable providers of deposit services to rural and relatively poor people. Cooperatives generally have higher levels of cost recovery and fund a greater proportion of their loan portfolios with mobilized deposits than NGOs with similar clienteles. Having been deposit-service providers for a long time, cooperatives also tend to provide a wider range of more flexible financial services than NGOs, particularly if membership in a federation provides them with access to a liquidity pool.

Even small financial cooperatives typically have the legal and institutional capacity to provide services with a range of liquidity options. A cooperative's potential for scale, however, depends on the nature of its common bond (e.g., whether it is employer-based or village-based). Capacity-building initiatives with cooperatives can be ineffective, however, if an institution's governance structure and social focus undermine financial performance and limit its outreach. Cooperative management committees, moreover, can be captured by better-off members who seek to direct loans to themselves and their relatives. Uninterested in the cooperative's deposit services, these insiders may contribute to high rates of default that, in extreme cases, lead to the institution's failure.

Focusing on individual cooperatives with the will and ability to take on fundamental change has typically proven more effective than working with an entire cooperative system.

Keys to strengthening the security and outreach of the deposit services of cooperatives are

- improved by-laws, board composition, and staff incentives to promote business-like operations, sound credit technologies, deposit mobilization, and growth; and
- promoting information transparency, ratings, and regulations that establish basic standards through barriers to entry.

It is important to note that the share requirements and membership fees typical of cooperatives may be prohibitive for the very poor. A promising strategy for deepening the outreach of such financial cooperatives would be partnership with an NGO that could develop their capacity to build self-managed member groups.

Self-Managed, Semi-Formal Groups

Self-managed, self-help groups and autonomous village banks may be able to better serve smaller and more remote depositors than other institutions due to their low cost structure. Members of these groups know one another and directly control operations. These groups typically offer a few simple services that can be managed by members or by part-time, minimally paid staff. Member control and the small number of standardized transactions preclude the need for complex management systems, reducing client costs and increasing the interest rates paid on client deposits. Such community-managed institutions can also have a social value beyond their utility as a delivery system for deposit services.

Without external support or linkages, however, semi-formal groups have limited potential for growth in outreach, sustainability, long-term security, and service quality:

- Significant growth in outreach can only be accomplished through the development of new groups.
- Typically unsupervised, these groups often suffer from the misuse of funds or dissolve over time.
- The limited management capacity of these groups and their small clientele severely restricts the range and flexibility of the services they can offer. Typically, such groups can manage only one or two standardized services.

  If self-help groups offer both credit and deposit services, their limited capacity to manage liquidity requires that access to one or the other product be quite limited. For example, self-help groups typically require regular, uniform deposits from all members and may provide access to these deposits only through loans that are rationed.
- Loans from deposits are vulnerable to high covariant risk.

Each of these limits can be mitigated through linkages to the formal financial system and/or the support of NGOs or second-tier financial institutions. Scale can be achieved through replication rather than growth: a bank, NGO, or sec-

ond-tier institution can promote new groups. Linkages to a federation or a bank can also increase the capacity to offer more flexible services by providing access to loans for on-lending, a liquidity pool, or the services of a bookkeeper. However, such a growth strategy may require ongoing subsidies to establish new groups.

Informal Mechanisms

Informal financial mechanisms range from rotating savings and credit associations to deposit collectors. In most environments, such mechanisms are located near the poor and are already in the business of collecting payments from them. They exist without the benefit of external capital injections or technical support. Such informal mechanisms tend to provide accessible, convenient services that enable them to serve the very poor to an extent rarely achieved by other types of organizations.

Like semi-formal groups, informal financial mechanisms are characterized by highly limited standardized services, a lack of supervision, high covariant risk, and growth potential through replication, not expansion. Experimental strategies to strengthen informal financial mechanisms offer the potential for rapid expansion and deep outreach, but risk undermining valuable existing institutions.

Donors may wish to explore options to enhance the quality, security, and scale of outreach of services offered by self-managed, semi-formal and informal financial mechanisms. Experimental strategies include:

- strengthening their skills and operations,
- providing them with access to financial management services,
- linking them with commercial banks,
- establishing networks and enlisting them as members,
- transforming them into financial intermediaries through the use of a loan fund, and
- upgrading them into regulated financial institutions.

Incentives, from training to accreditation to access to liquidity, can motivate informal financial groups to upgrade and mainstream their operations. However, donors should be cognizant of their power to undermine valuable existing institutions.

Financial and Institutional Capacity

Strong governance and management, in particular strong asset management, is essential to the security of deposits. Intermediating liquid deposits means MFIs must have the capacity and governance to manage a higher volume of less predictable transactions. This requires more rigorous and complex information systems, internal controls, and financial

systems. Before developing or expanding deposit services, institutions should have the following capacities.

Profitability and Capital Adequacy

To be allowed to mobilize deposits from the public, an institution must be profitable. An institution that incurs losses puts the safety of client deposits at risk. Projected profitability is based on a cost of capital that includes the administrative, financial, and reserve costs of savings—not just the financial costs. The institution requires sufficient reserves, capital, and operating funds to cover initial operating losses and losses due to catastrophic events without using client deposits.

Credit Management

If deposits are to finance the loan portfolio, credit management must be stringent, portfolio quality high, and the lending technology based on the capacity to repay. Poor portfolio quality resulting from high levels of loan delinquency can put deposits at risk.

Liquidity Management

In order to mobilize deposits, the institution must have sufficient skills in asset and liability management. Client deposits should be invested in assets that match their term and pricing structure. For instance, if deposits are to finance the loan portfolio, highly liquid, short-term passbook savings accounts should not fund long-term housing loans. The institution must also be able to anticipate and manage the likely consequences of external shocks.

Information Systems

Systems must be accurate, timely, and transparent, whether manual or computerized.

Internal Controls

Strong internal controls must ensure the security of transactions and the reliability of information.

Incentive systems that promote accountability, profitability, and outreach are the key to strong management. Clients will save with an institution only if they trust it, that is, if they perceive the institution to have strong, honest governance and management.

Supervision, Regulation, and Public Disclosure

Effective supervision of some sort is essential to ensure the security of deposits. Yet mainstream banking authorities typically lack the capacity to effectively supervise microfinance institutions—even those that they regulate. Small institutions, moreover, may not be able to bear the cost and information requirements of meeting regulations. A combination of strategies may need to be employed to promote effective supervision.

Governments should establish accountability structures that are appropriate to the size and ownership of different types of savings institutions. Three types of retail organizations should be exempted from regulation, even though they mobilize deposits:

- Membership-based organizations that mobilize deposits only from members, who have direct personal control of the organization and knowledge of its operations
- Organizations that mobilize only mandatory deposits to secure loan repayment
- Organizations that are not engaged in deposit mobilization other than pilot testing innovative technologies where deposits are completely covered by a guarantee

For some types of institutions, non-governmental or alternative forms of supervision should be explored. For example, possible supervisory bodies might be a deposit insurance fund, a bank that serves as a liquidity pool, or an MFI rating agency. These supervisory bodies should not be controlled by the MFIs they supervise, as this would represent a conflict of interest.

Where alternative supervisory options are not available, governments might require frequent public disclosure of an institution's unregulated status, together with some form of external scrutiny such as an audit.

Supervision is a complex topic covered more authoritatively and comprehensively elsewhere. In summary, donors should not support the development of deposit services unless they are satisfied that supervision of the institutions offering these services will be reasonably effective.

II. IMPORTANT CONSIDERATIONS

Operating Environments: Instability, Inflation, and Financial-Sector Policy

Although economic and political instability threaten the security of deposits, people in unstable environments may willingly shoulder such risks in a formal institution rather than save in the informal sector or save in kind. Nevertheless, donors should be careful about promoting the investment of poor people's money in formal financial institutions or in national currency when inflation is high.

For clients who use passbook savings accounts simply to secure excess cash over the short term, high inflation may be of little concern. To preserve the real value of deposits, institutions in inflationary environments should attempt to use indexing or hard currency to maintain the value of client deposits. For the institution, total asset growth is a crucial strategy for preserving asset value in the wake of monetary devaluations and high inflation.

Financial-sector policy can threaten the sustainability of institutions providing microfinance, including those that offer deposit services to the poor. In particular, policies that place ceilings on lending interest rates or floors on deposit interest rates can force institutions to provide microfinance services at a loss or to avoid offering them altogether. In addition, these policies often produce the opposite effect than was intended. Instead of increasing the affordability of financial services to the poor, they engender a rationing of subsidies that leaves the poor with virtually no access to favorably priced products.

Costs and Pricing

Deposit mobilization is costly, but exactly how much it costs is unknown. Methods of costing deposit services are not well understood among microfinance practitioners. The viability of deposit services, however, depends on understanding the administrative as well as financial costs of mobilizing deposits, and then weighing these costs against alternative sources of funding for onlending.

Graduated pricing is the key to offering deposit services on a sustainable basis: interest rates can be higher for larger deposits, while deposits under a certain threshold may not receive interest. Such a pricing structure reflects the higher administrative costs associated with small deposits and the market reality that large depositors tend to be sensitive to interest rates. Poor clients willingly pay for doorstep deposit collection, which represents a collection as well as a savings service.

Market Orientation

For a formal savings institution to be viable, its organizational culture must ensure that large numbers of clients trust it with their savings. This requires a market orientation, rather than an exclusively social orientation. Staff recruitment, training, and incentive systems should emphasize salesmanship and stewardship. Pilot testing and client feedback should inform product design. Most institutions will need to employ strong promotional strategies that convey institutional safety and motivate clients to save with the institution.

Depth of Outreach

MFIs whose objectives include serving small and remote depositors should explicitly recognize this objective in their incentive systems and technologies. Because of the high cost of reaching these groups, MFIs are unlikely to develop deposit services that reach these target populations unless this goal is made part of their mission.

There is considerable room for the development of viable savings technologies that better meet the needs of the poor while remaining manageable and relatively secure. The key challenge is to find ways to deliver highly convenient services

while covering costs. To date, few institutions have been able to provide voluntary deposit services to remote and very poor clients; even fewer have provided them with demand-deposit services.

Serving small and remote depositors is more costly than serving large, institutional urban depositors, even if the former are a more stable source of funds. The poor tend to require services that are located close to their homes or workplaces. Serving remote depositors on a viable basis seems to require non-office-based strategies, such as group-based services, mobile collection, and charging fees and/or paying no interest for doorstep services. Even with these delivery and pricing options, serving less profitable depositors on a viable basis requires ruthless efficiency. Tactics that have been found to work in some settings include:

- serving a broad range of clients including institutional, large, and small depositors;
- increasing the size and decreasing the frequency of deposits by using lockboxes and lotteries;
- locating deposit collection sites near places of employment, such as markets;
- employing technologies, such as smart cards;
- establishing deposit facilities like postal savings banks that are adjuncts to other widely used services; and
- using the same delivery system for deposits and other financial services (e.g., having staff collect deposits and loan payments at the same time that they disburse loans).

III. RECOMMENDATIONS FOR DONORS

Should Donors Promote Deposit Mobilization?

Supporting institutions to mobilize deposits is a high-risk and serious business: donors that support deposit mobilization assume the weighty responsibility of assuring the safety of the poor's savings. Even in stable environments, the weak asset management typical of many microfinance institutions may severely compromise the security of deposits. Where deposits are backed by an explicit or implicit deposit guarantee, institutional failures can still cause long-term damage to the financial sector. Sudden high inflation or currency devaluation can sharply erode the real value of deposits. External shocks, such as crop failures in environments with high covariant risk—where most donors work—can catalyze liquidity crises that quickly lead to institutional insolvency.

These risks exist with or without donor support. However, donor funding confers a message of security to potential clients. Donors thus have an obligation to ensure that the organizations they support will merit the trust that their backing implies to customers.

The risks of supporting deposit mobilization can be justified by the even higher risks borne by poor people who save in the informal sector, to which they turn in the absence of formal or semi-formal alternatives. At-home and in-kind savings are vulnerable to theft, destruction by rodents, loss from the death of livestock, and demands from relatives or neighbors. In this context, the poor in a number of countries pay for the convenient opportunity to save with an informal deposit collector. Similarly, even weak semi-formal financial groups attract large amounts of deposits. Often, they are the most secure savings option available.

Few donors are equipped to support deposit initiatives. Compared to credit, deposit mobilization involves much smaller amounts of donor funding. Yet this funding carries more risk because it involves using the savings of the poor (rather than donor funds) for onlending and requires more sophisticated financial management. Donors should support deposit mobilization only if they have the mission, and adequate structure, and financial capacity:

- **They must be able to attract and retain the in-house expertise needed to responsibly promote deposits.** In-house donor capacity is necessary to identify appropriate technical assistance providers and partner institutions, as well as to monitor their progress. To work with larger institutions, donors need the regional technical expertise to assure timely monitoring, as deposit initiatives can deteriorate rapidly.
- **They should be prepared to undertake long-term commitments that involve significant risk and, in the absence of institutional failures, little funding.** Unlike supporting credit services, which requires the initial funding of a loan portfolio, supporting deposit services requires relatively small grants, but a long-term commitment to technical assistance.

Selecting Partner Institutions

Donor Priorities

As discussed previously, different types of institutions have different comparative advantages in terms of achieving the objectives of large-scale outreach, deep outreach, security, and community development. Donors should select a retail institution partner based on their own priorities, the institutional and financial landscape of the market in question, their time frame, and the availability of capable technical assistance providers.

Institutional and Financial Landscape

The decision whether or not to support a particular institution should focus, first and foremost, on the strength of its managers and their commitment to capacity-building objectives. The second consideration should be the institution's

capacity for safe and sound deposit operations (i.e., management of credit, liquidity, and interest-rate risk; internal controls; management information systems; and the financial capacity to withstand shocks and generate profits).

The decision on a partner institution should also focus on the existence of effective supervision and the legal and regulatory environment for different types of financial institutions. What precise criteria a partner should meet will depend on the market, country, and type of institution being considered. Institutional capacity varies considerably among the same three categories. Because most microfinance institutions that mobilize deposits do not meet the standards set out in appendix A, donors should seek to support the strongest institutions possible.

Technical Capacity

Donors should only support formal institutions if they can engage technical assistance providers that have the appropriate capacity. It is important to note that the technical capacity needed to support formal institutions is quite different from that required to support informal and semi-formal ones.

Supporting large, formal institutions requires expertise and a sophisticated understanding of the distinct governance and management challenges of larger institutions, commercial banking culture, and the unique features of microfinance operations. To work with banks, technical assistance providers should have a track record, technical skills, and a business culture that give them credibility with bankers.

To support semi-formal and informal financial institutions requires knowledge of simple systems to track and control transactions, the means to develop second-tier institutions or linkages with banks, and basic financial management. Whatever the institutional type, technical assistance providers should have the demonstrated ability to improve the performance of a similar type of institution over the long term.

Time Frame

Donors should be cognizant of the time frame necessary for different institutional strategies: the reform of government-owned banks, the strengthening of financial cooperatives, and the transformation of microcredit institutions can take many years. For financial cooperatives and microcredit institutions, donors may need to address how effective supervision will be provided over the long term. Supporting the promotion and training of community-based institutions or linkages between NGOs and regulated financial institutions are likely to be shorter-term endeavors.

Donor Strategies

Coordination of Advocacy

It is appropriate for donors to coordinate discussions with governments and central banks about policies, laws, and reg-

ulations needed to facilitate the mobilization of small deposits and to protect small savers. Such policies and regulations might include deregulation of interest rates, the prevention and control of damage to the financial system from fraudulent pyramid schemes, and appropriate regulation and supervision of deposit providers.

Appropriate Uses of Donor Grants

Donors need to recognize that strategies are context-specific and to be careful not to distort the priorities of local institutions. They should not, for example, undermine sound management by dictating how deposits should or should not be invested, requiring uniform or positive real interest rates, or restricting potential clients by gender or income level. Appropriate uses of grants include funding for:

- **Capacity building of regulatory and supervisory bodies.** Target institutions might include non-governmental bodies as well as government institutions.
- **Research and development.** This includes research on products, delivery innovations, management tools and/or systems; market research; case studies of good practice in deposit provision; regulatory alternatives; systems to protect deposits against inflation (e.g., indexing); and linkages between different types of financial institutions.
- **Information dissemination. Information about the profitability of financing portfolios through deposit mobilization** from the poor can be disseminated to commercial banks and other regulated retail distributors with large branch networks. Information on good practice in deposit mobilization can be disseminated to donors as well as to training organizations and banking institutes.
- **Initial physical infrastructure and initial operating losses for retail institutions.** Strong institutions that have little experience in mobilizing deposits from the poor may require temporary institution-building grants to cover costs such as secure safes, infrastructure, and operational losses. This support should be for a limited time and disbursed against the attainment of clear performance targets on the part of the institution.
- **Institutional development of new actors in deposit services.** This includes retail institutions, financial intermediaries that serve as liquidity pools, alternative supervisory bodies, second-tier institutions that provide technical support, and training institutions.
- **Recapitalization of existing institutions.** Capital grants to existing financial providers should be used very selectively and tied to the achievement of specific reforms within a realistic time frame.

Appropriate Uses of Donor Loans

Donors should recognize the following principles when considering the provision of loan capital to institutions that identify deposit mobilization as an objective:

- **Loans that fund loan portfolios should be priced at least as high as the total cost of mobilizing deposits.** Pricing external credit lower than the rate on deposits will undermine the incentive for an institution to finance its loan portfolios with deposits. The price of a loan should include the financial and administrative costs of mobilizing deposits, plus the cost of protecting savers (including a reasonable level of reserves).
- **For savings-financed institutions like credit unions, funds for on-lending should be approached with great caution.** Access to external credit has often severely weakened the governance and undermined the deposit mobilization of financial cooperatives. Boards and senior managers of institutions that receive donor funds for on-lending tend to orient themselves toward attracting donor funds rather than marketing services to clients.

  External loans can also attract better-off members to leadership positions in order to capture large loans. In many cases, these large borrowers default, running off with the deposits of less privileged members and, at times, putting the institution at risk.

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APPENDIX A

Small and Microenterprise Finance: Guiding Principles for Selecting and Supporting Intermediaries, Donor Guidelines for Microfinance International Best Practices is a product of the Donors' Working Group on Financial Sector Development and the Committee of Donor Agencies for Small Enterprise Development. The document is largely consistent with recommended standards set out by a U.N. expert group convened by Women's World Banking in 1994. The donor committees adopted the principles in their current form in June 1995, following consultations with donor agencies involved in small enterprise and micro-finance.

The following text is an excerpt from the document.

I. INSTITUTIONAL PERFORMANCE STANDARDS AND PLANS

Intermediaries seeking support should be able to demonstrate the following characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions.

A. Institutional Strengths

1. ***Institutional culture, structures, capacities, and operating systems*** that can support sustained service delivery to a significant and growing number of low-income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership, and accountability.

2. ***Accurate management information systems*** that are actively used to make decisions, motivate performance, and provide accountability for funds. Such systems are essential for effective and efficient management.
3. ***Operations that manage small transactions efficiently*** with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).
4. ***Meaningful, transparent financial reporting*** that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data listed in the Annex [of these Guiding Principles] should be reported, and institutions should regularly monitor [their] financial condition using appropriate financial ratios derived from such data.

B. Quality of Services and Outreach

1. ***Focus on the poor:*** evidence of service to low-income clients, women and men, especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.
2. ***Client-appropriate lending:*** for example, quick, simple, and convenient access to small loans, often short-term, that are renewed or increased based on excellent repayments. Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cash flow and project appraisal for larger and longer-term loans.
3. ***Savings services:*** savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds—either independently or with another institution.
4. ***Growth of outreach:*** significant progress in expanding client reach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

C. Financial Performance

1. ***Appropriate pricing policies:*** offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit

should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses, and a minimum return on equity.*

2. ***Portfolio quality:*** maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days below 10 percent of loans outstanding and annual loan losses under 4 percent of loans outstanding satisfy this condition.
3. ***Self-sufficiency:*** steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency (defined as covering all administrative costs and loan losses with client revenues) within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and financial self-sufficiency (defined as covering all administrative costs, loan losses, and financing costs at non-subsidized rates from client revenues) within five to ten years.
4. ***Movement toward financial independence:*** building a solid and growing funding base with clear business plans, backed by operational capacities, that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programs also provide non-financial services, such as business advisory services, health, or education, they should account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this document.

II. STRATEGIES FOR DONOR SUPPORT

Funding based on large, ongoing subsidies with a charity rationale has failed. Such programs have drained resources without becoming sustainable and have contributed to the mistaken notion that the poor are unbankable. Funders should provide financial and other support in such a way to ensure the quality of services provided and the widest outreach, as well as to foster the movement to scale, financial self-sufficiency, and independence from donor support, taking into account the particular characteristics of different types of institutions. Donors should ensure that institutions, in their effort to become sustainable, maintain a focus on offering appropriate services to the poor.

A. Appropriate Uses for Grants

1. ***Institutional development.*** Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective, as institutions become able to meet more of their organizational development needs from within. It should also become more specialized, as institutions tackle more difficult problems.
2. ***Capitalization.*** Grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale. Externally financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.
3. ***Operating losses.*** Donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business, every program will take some time to reach a break even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.
4. ***Fixed assets.*** Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

B. Appropriate Uses of Loans

Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings-based institutions, such as savings and credit associations, by making loans available to them below the cost of mobilizing funds locally.

C. Commercial Sourcing of Funds

The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as:

1. ***Investor equity,*** from both official and private sources. Donor support can help leverage private investment.
2. ***Second-tier operations,*** which raise funds from commercial sources and on-lend to microenterprise finance institutions.
3. ***Partial guarantees*** of loans made by commercial banks to NGOs.

D. Coherence of Donor Policies

Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to small and microenterprise institutions, donors should ensure that they coordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied. Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

APPENDIX B

Resources On Deposit Mobilization

MicroSave-Africa: www.microsave-africa.com

Papers of CGAP Working Group on Savings Mobilization:
www.cgap.org/html/p_cg_working_group_papers.html

Microfinance Gateway:
www.microfinancegateway.org/search.htm

GTZ Publications:
www.gtz.de/publikationen/english/publications/index.asp

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KfW group
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