REACHING THE HARD TO REACH:

Comparative Study of Member-Owned Financial Institutions in Remote Rural Areas

LITERATURE REVIEW

Financial Services in Remote Rural Areas:
What We Know About Member-Owned Institutions

Madeline Hirschland
with Ahmad Jazayeri and Nanci Lee

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Comparative Study of Member-Owned Financial Institutions in Remote Rural Areas

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Hundreds of SACCOs and other member-owned financial organizations are the most important source of finance for thousands of rural and farm households (in Uganda). However, they are among the weakest and least sustainable of the financial institutions.

R. Meyer, R. Roberts & A. Mugume (2004)

Fifty eight percent of the total (Nepali) population lives in hills and most of them are poor…In some areas people have to walk a day or more to reach a bank or to get services from MFIs… SACCOs have proven to be effective means of providing financial services in a cost effective manner in the hill districts though their outreach and number are limited and they are not focused on poor.

Namrata Sharma (2002)

Credit unions in Bolivia, as in much of Latin America, provide financial services to many people who otherwise would lack access… unregulated credit unions are present in approximately 180 of Bolivia's 311 *municipios* (a territorial division somewhat akin to a U.S. county). Of these 180 *municipios*, 90 would be without the services of any financial institution if it were not for the presence of an unregulated credit union.

Glenn D. Westley (2001)

… there are topics related to organization, governance, legislation, regulation, and supervision of cooperative financial institutions over which there is no agreement but over which one is needed if we are to facilitate the growth of these institutions and realize their potential for serving the poor… Producing a set of principles…would be a giant step that would give the international (cooperative financial institution) movement a new jolt. The experiences and errors of the past aided by the sharp insights that modern economic and finance theory and research methods provide, should allow us to arrive at a consensus...

Carlos Cuevas & Klaus Fischer (2006)

Abbreviations

ASCA	Accumulating savings and credit association
ATM	Automated teller machine
CGAP	Consultative Group to Assist the Poor
CSO	Credit union service organization
CVECA	Caisses Villageoises d'Epargne et de Crédit Autogérées
DGRV	German Confederation of Cooperatives
FSA	Financial Service Association
LPD	Lembaga Perkreditan Desas
MACS	Mutually Aided Cooperative Societies
MACT S	Mutually Aided Cooperative Thrift Societies
MFI	Microfinance institution
MOI	Member-owned institution
NGO	Nongovernmental organization
ROSCA	Rotating savings and loan association
SACCO	Savings and credit cooperative
SDID	Societé de Développement International Desjardins
SFCL	Small Farmer Cooperative Limited
SHG	Self-help group
VSLA	Village savings and loan association
WOCCU	World Council of Credit Unions

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Executive Summary

Member-owned institutions (MOIs) can achieve impressive outreach. They often serve more rural markets than any other type of financial institution. They typically recover their costs. Through growth or replication, they can serve large numbers of clients. And though often limited in scope, their services may respond to client demand and cost clients less than their alternatives. Frequently, MOIs are plagued by fraud and mismanagement. Their scale and continued existence is limited by their governance.

This study examines what outreach can be expected of different types of MOIs and key controllable factors that affect it. We want to understand how MOIs might be supported to provide ongoing affordable financial services to meet the demand of large numbers of low-income remote-rural members. Therefore, we consider three drivers of outreach:

- Internal governance
- Participation in federations or networks and linkages to private suppliers, NGOs and government
- Regulation and supervision

Our analysis is based on a review of the literature on MOIs and focuses on MOIs that provide primarily credit and savings services in Africa, Asia and Latin America. We are particularly interested in MOIs that serve markets unserved by other financial institutions.

Outreach

MOIs run the gamut, from small informal ROSCAs to huge cooperative banks. To clarify our analysis, we define a simple typology of MOIs and then assess their potential using Schreiner's (1998) six aspects of outreach: Depth, breadth, length, scope, worth to clients, and cost to clients.

Depth: MOIs are often the only institutional provider of financial services in remote and rural areas. Because rural remote areas tend to be poorer, MOIs that serve them often serve poorer markets than other financial institutions. At the same time, within the geographic areas they reach, MOIs may not serve the poorest market segments. Depth of outreach varies by type of MOI. Smaller MOIs may serve more remote and poorer areas than larger ones and small cooperative-type MOIs may be the most cost-effective means to serve remote areas. However, even large MOIs tend to reach poorer market segments than commercial banks. MOIs may also be better-suited than other types of financial institutions to serve conflict and post-conflict areas.

Breadth: In many regions, MOIs serve large numbers both in absolute terms and relative to other types of financial service providers. The stimulus to grow often comes from donors or providers of technical support rather than from MOIs themselves. Breadth of outreach should be considered in relation to population density: MOIs can serve more sparsely-populated, poorer regions than other types of institutions precisely because they can be viable without achieving a large scale. The simplicity of group models enables them to be extended to large numbers of people quickly. Mergers can enable large-scale growth through economies of scale but may be more relevant in competitive markets than in remote-rural ones.

Length: Most MOIs of all types cover their operating costs from their inception. For most MOIs, the greatest threat to long-term outreach is weak governance and management capacity or inappropriately complex management systems. All but the simplest time-bound groups and the most sophisticated large MOIs seem to require ongoing support. The costs of this support should be figured into any assessment of MOI sustainability. Though not normally covered by operating revenues, the per-member cost of promoting groups might compare favorably to the per-client cost of developing sophisticated MFIs—a cost that also is not covered by operating revenues.

Net Worth: scope, worth and costs to members: In non-competitive markets, many large MOIs are not motivated to diversify their product offerings. However some now offer remittance and ATM services and a variety of loan, savings and insurance products. Linkages to commercial institutions and federations, incentives from donors, and technical assistance can help MOIs broaden their scope. Small MOIs are limited by their management capacity and lack of liquidity but their responsiveness to members can lead them to offer surprisingly well-adapted products. Non-financial services can strengthen their provision of financial services or can increase impact cost-effectively but also can increase costs, weaken governance, and limit the scope and innovation of their financial services. MOIs tend to impose lower transaction and financial costs on their members than other types of financial institutions but the risk of losses may be higher.

Governance

In large MOIs, the power to make decisions is diffused among so many members that individuals rarely feel that they have much influence and therefore do not actively oversee their MOIs. Because this leaves the boards and management of large MOIs relatively free to pursue their own interests, many large rural MOIs are plagued by mismanagement. Four other factors can also weaken their governance: Socio-cultural norms that inhibit members from holding their leaders accountable; a mismatch between member capacity and MOI management systems that leaves members unable to effectively monitor their leaders; the provision of non-financial services that can muddy the difficult job of overseeing financial services; and the absence of competition.

These challenges can be addressed by:

- Catalyzing member participation and strong oversight through participatory processes within the MOI, involving local leaders and governance structures in the MOI's governance, and economic incentives
- Enabling members to effectively monitor management by providing technical training and training in how to hold leaders accountable, outsourcing complex services, and implementing simple systems such as oral bookkeeping for groups
- Establishing by-laws or rules that legislate sound governance structures and practices and give members the means by which to hold their leaders accountable

Second-Tier Institutions and Linkages

MOIs require many types of on-going support from liquidity exchange to technical support. They can obtain this support from the market, from a second-tier institution, or from an NGO or the government. How this support is procured and paid for is important for two reasons. First, this support must be sustainable if the MOIs that rely on them are to be sustained. Second, how an MOI procures these inputs can profoundly affect its governance.

Federations can provide their member MOIs with some or all of the support they require. However, federations can also suffer from severe accountability and capacity issues such that they provide their members with little value, cost them a lot, and undermine their governance. A number of strategies can help keep federations accountable to their MOIs. For example, federations might fund themselves from members' service fees rather than from interest revenues. Another strategy is to decentralize: While centralization may be essential in competitive markets, in remote-rural areas some decentralization seems crucial to assure strong governance.

SHGs do not seem to be sustainable with bank linkages alone and alternatives such as linkages to microfinance institutions have not yet proven viable. Clusters of SHGs can strengthen and provide services to their members and typically are sustainable. They require skilled members and do not provide substantial economies of scale.

Market forces alone are unlikely to extend financial services to remote areas: Strategic subsidies are needed. Whether a moderate amount of external capital strengthens or weakens MOIs is fiercely debated. What is clear is that external credit that is subsidized hurts MOIs, their members' access to financial services, and the rural financial sector.

Regulation and Supervision
Developing effective regulation and supervision may be the single most important means of increasing MOI outreach. Consensus on principles for MOI regulation and supervision is urgently needed (Cuevas & Fischer, 2006). We explore the key questions that demand resolution: What types of MOIs should be regulated? Are tiered licensing standards appropriate? If so, how should they be defined and what should be required of each tier? What entity should supervise? Under what conditions, if any, might delegated supervision or self-regulation be acceptable? Under what conditions might it be appropriate for different authorities to supervise different classes of MOIs? How should the costs of supervision be covered?

The biggest impediment to effective supervision may be its cost. A key to cost recovery and to effective supervision is "fit"—simple regulatory requirements that are appropriate to an MOI's size and complexity (Jazayeri & Lee, 2006). Tiered regulations make this possible. For example, large open-bond MOIs might be subject to bank-like supervision, medium-sized and closed ones might simply be required to submit standard financial reports and external audits, and small MOIs that can effectively monitor themselves might not be supervised at all (Vogel, 2002).

MOI regulations should focus on governance, the greatest risk that MOIs face. We identify a set of regulations that can place a check on governance. Finally, we suggest some strategies for donors, governments and second-tier institutions and pose some questions for researchers that might help strengthen MOI outreach.

Introduction: Conceptual Framework[1]

In much of the global South, the poor are largely rural and the rural are largely poor. Thriving informal financial markets demonstrate that the rural poor demand financial services which can help them reduce their vulnerabilities and build up their assets. Because informal services can be limited in scope, insecure and unreliable, access to formal or semi-formal financial services in rural areas is critically important (Nagarajan & Meyer, 2005). Yet, the rural poor are largely unserved by institutional finance. Microfinance has reached mostly urban, peri-urban, near poor and upper poor populations while rural finance has primarily served larger commercial farmers and producers (Johnson, Malkamaki, & Wanjau, 2006; Sebstad & Cohen, 2001) (see Figure 1).

This limited outreach is not hard to explain. Serving rural areas on a sustainable basis is difficult and expensive. Where roads are poor, the costs of transport and travel time are high. Sparse population density and small transactions limit loan and savings volumes. Geographically limited markets and the lack of options for storing and accessing liquidity result in high liquidity and covariant risks. Cash may be less available than in urban settings while cash flow may be much more seasonal (Zeller, 2003). Furthermore, skilled staff and cost-reducing technologies often are not available or feasible. Finally, the rural poor may not be able to pay the high interest rates typically needed to recover the costs of even efficient microfinance operations (Harper, 2005). The challenges are daunting.

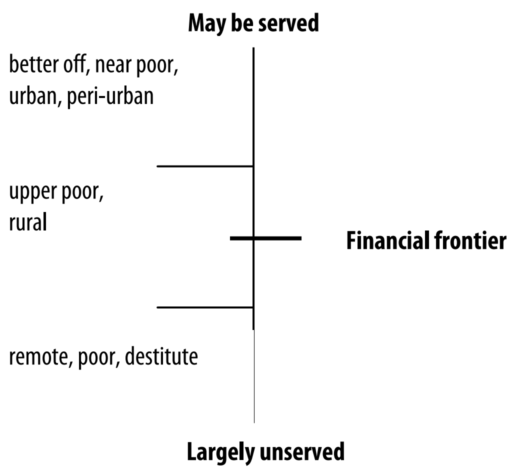
No type of financial institution meets these challenges better than member-owned ones. For this review, we define member-owned institutions (MOIs) as financial institutions that are owned and managed by many or all of their customers and that use member equity as a major source of funds with which to offer themselves financial services. MOIs include small self-managed groups as well as large professionally-managed SACCOs and cooperative banks.[2]

[1] The authors greatly appreciate the careful review and helpful comments of J.D. Von Pischke, Glenn Westley, Rich Rosenberg, Brian Branch, Malcolm Harper, and Renée Chao-Béroff.
[2] The review does not include publicly-owned institutions whose clients are not primarily members, such as some rural banks, or institutions for which policy decisions are made by the government or an MFI, such as FINCA-style village banks. "Member-owned" is distinct from "community-based": Many MOIs such as national credit unions are not managed by communities while many community-based services, such as moneylenders, are not member-owned.

Small MOIs can serve more rural areas than other types of financial institutions because their staff and transport costs are lower (Grant & Coetzee, 2005; Nagarajan & Meyer, 2005; Johnson, Malkamaki, & Wanjau, 2006; Hirschland, 2005). Typically, they rely in part or wholly on volunteer labour or part-time local staff who are not highly educated. Less educated staff may be able to manage only simpler products that require fewer reserves. MOIs that are fairly autonomous avoid the overhead and travel costs associated with a distant head office. Finally, in smaller MOIs member involvement lowers the costs of information related to credit management.

The characteristics of small MOIs that make reaching more rural and poorer markets feasible are less pronounced in larger MOIs. Nevertheless, even larger MOIs tend to have lower staff costs and, in many cases, serve more rural areas than other types of microfinance institutions (Richardson, 2003). Not surprisingly, then, MOIs are of great interest to those who seek to extend financial services to poorer unserved markets.

Figure 1: Financial Frontier without Member-owned and Informal Institutions



Those who seek to deepen outreach—policymakers, donors, and practitioners—are the audience for this study. Its aim is to help them by shedding light on what outreach can be expected of MOIs, what controllable factors most affect this outreach, and how outreach might be expanded. The analysis that follows is based on a review of the literature on modern-day MOIs and focuses on MOIs in Africa, Asia and Latin America that provide primarily credit and savings services. It builds on the Ford Foundation study *Rural Finance: Recent Advances and Emerging Lessons, Debates and Opportunities* that identified MOIs as promising means to provide financial services in remote-rural areas (Nagarajan & Meyer, 2005).

We begin by establishing a typology of MOIs. We then explore what we know about their outreach: How poor and rural are the people that can they reach? What scale and sustainability can and do they achieve? What types of services do they offer and at what cost and value to their members? Finally, we identify some strategies MOIs use to expand this outreach.

In the second half of our study, we explore key controllable factors that enhance or limit this outreach. MOIs' outreach is greatly affected by three sets of factors:

- Internal governance including structures, bylaws and local oversight
- Participation in federations or networks[3] and linkages to external agents such as donors, suppliers, and NGOs

[3] For purposes of this study, the terms federating and *networking* (and *federations* and *networks*) can be used interchangeably. For the sake of consistency, we shall use the terms federate and federation except in regards to specific named institutions that are commonly called a network, for example, the MC2s network.

- Regulation and supervision

We examine each of these in turn and then finally, we suggest some strategies for donors and pose some questions for researchers that might help us strengthen MOI outreach.

Types of MOIs

MOIs run the gamut from neighbourhood ROSCAs and self-help groups (SHGs) to village cooperatives to cooperative banks with anywhere from a handful to over a million members (see Appendix A). To proceed, we need to be able to talk about types of MOIs characterized by similar governance and outreach.

MOIs' outreach and internal governance arise from a number of characteristics, some of which are internal. Chief among these is size, whether or not an MOI is small enough for its members to assess each other's capacity to manage credit, follow-up on delinquency, and monitor operations. We classify as small, MOIs in which this sort of "peer monitoring" can be effective and as large, MOIs where it cannot. Within these two broad categories, two other defining distinctions may be made. Among small MOIs, whether they accumulate funds on an ongoing basis or disburse them periodically will determine if their operations are simple and transparent enough to make external support and oversight unnecessary. Within the category of large MOIs, some are large enough to afford internal controls and attract government supervision that can compensate for the lack of peer monitoring, while others occupy a more challenging middle ground. These characteristics lead us to the following typology:

Groups that are time-bound: In these small MOIs, all members participate in all decision-making and periodically disburse all their funds. These groups tend to have a handful to a few hundred members. Peer monitoring is effective.

Small MOIs that accumulate funds: In small groups, all members participate in all decision-making. In other small MOIs, members elect representatives to govern, and these volunteers or paid staff manage day-to-day decision-making. These MOIs are small enough for peer monitoring to be effective. This maximum size will vary by context but would not exceed a few hundred members.

Medium-sized MOIs: With several hundred to several thousand members, these MOIs are governed by elected representatives and rely largely on paid staff. MOIs of this size face a particular challenge. Though too big for peer monitoring to work, they are too small to afford or attract some of the controls that replace it; for example, professional auditors, more skilled staff, and government supervision (Wanjau, 2007). At the same time, their roots in a local community may provide them with some community oversight.

Large MOIs: Elected representatives also govern these MOIs that rely completely on professional management. The costs of skilled staff can be covered due to their economies of scale and they may attract direct or delegated supervision from the government. These MOIs do not benefit from peer monitoring or community oversight. In fact, they may look more like banks than like community-owned institutions. Their member numbers range from several thousand to, in the case of some cooperative banks, over one million.

With this typology in hand, we can now classify MOIs as follows in Figure 2:

Figure 2: Typology of Member-Owned Institutions

Small MOIs		Large MOIs	
Time-bound groups	**Accumulating-fund MOIs (groups and other)**	**Medium-sized MOIs**	**Large MOIs**
ROSCAS, traditional VSLAs, time-limited ASCAs	ASCAS, self-help groups, and some new VSLAs. Small FSAs, SACCOs & village-based MOIs (e.g. CVECAs).	Large FSAs and village-based MOIs. Some SACCOs & LPDs.	Large SACCOs & LPDs. Cooperative banks

Defining Remote Rural

Our interest in MOIs stems from their potential to serve remote-rural areas. We draw a distinction between *remote* and *remote-rural*. Remote, by itself, has elements of economics, livelihood, locale, and social status. Remote areas are characterized by limited economic potential, low cash circulation, and fragile agro-ecosystems—such as mountainous, coastal or desert regions. Their economic activity tends to be agricultural. Residents' livelihoods are particularly vulnerable to co-variant risks such as drought, flooding, decline of the natural environment, and conflict. Remote areas usually are poor and sparsely populated, with limited infrastructure and tenuous links to urban financial systems (Grant & Coetzee, 2005). Often, their societies are more tightly-knit and have stronger social institutions than those in less remote areas. Their populations may also be socially excluded, as is often the case with indigenous groups.

But what of remote rural? We define it simply as markets that are not served by other types of financial institutions. This definition includes the remote markets just described, markets inhabited by, for example, tribal fishermen on the coast of India, pastoralists in Northern Ethiopia, and Quechua day labourers seeking work along the Bolivian border. At the same time, in the lush highlands of Western Kenya where cash-crop farmers can access non-MOI services, remote-rural includes other market segments—such as subsistence farmers—that cannot. By this definition, remote-rural is neither small nor marginal; in many countries the unserved are a large majority of the population.

What We Mean by Outreach

To discuss MOI outreach, we use Schreiner's (1998) six aspects of outreach, defined as follows:

Depth refers to the value we attach to the net gain of a given client. For example, we value more highly benefits to people who live in more rural areas.

Breadth is simply the number of people served.

Length refers to the time frame of supply. We consider financial sustainability – the ability to cover financial, operational and loan loss provision expenses with financial income after adjusting for inflation, the market cost of capital and subsidies. We also consider institutional sustainability, the capacity and will of the governing body, members and staff to continue to provide services. For example, weak governance that leads to insolvency shortens an MOI's length of outreach.

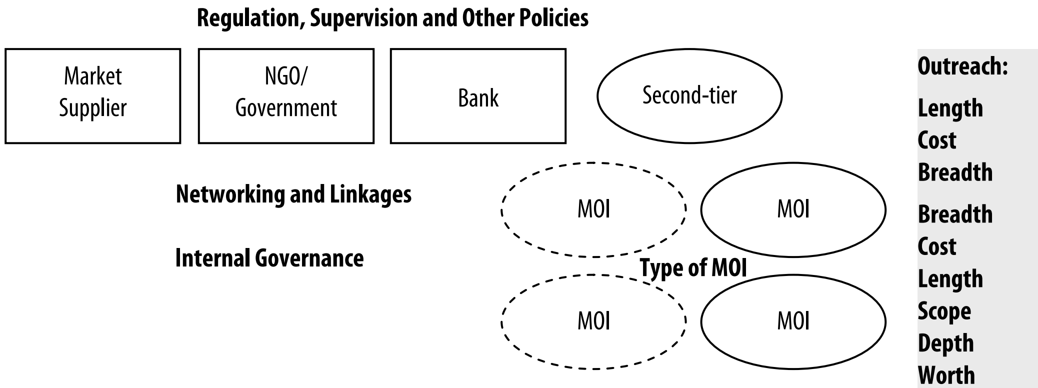
Scope refers to the range of financial and non-financial services available, the different types of financial contracts such as demand or fixed deposits on offer, and to the variations within products such as different terms for fixed deposits.

Worth to members is the value a member derives from participating in the MOI. In part, worth hinges on the fit between the terms of the financial service and members' tastes, constraints and opportunities. Members may also value simply participating in an MOI or its social support or non-financial services.

Cost to members refers to the sum of financial costs, transaction costs, and potential losses due to fraud, theft or mismanagement. Transaction costs include opportunity costs, for example the time it takes to apply for a loan or attend an SHG meeting, as well indirect costs such as the cost of transport.

We will consider scope, worth and cost together as the **net worth** of membership. With these definitions, we finish building the framework for our study (see Figure 3) (Fischer, Hirschland, Jazayeri, & Lee, 2006). We can now look at how MOIs fare with respect to each of the aspects of outreach.

Figure 3. Conceptual Framework: Controllable Drivers of Outreach



Part I: Outreach of MOIs

Depth of Outreach

To what extent do MOIs reach remote areas and to what extent do they serve the poor and women? Geographic, poverty and gender outreach vary by type of MOI. However, all types of MOIs often reach areas that are more remote than those typically reached by other types of financial institutions. And, because remote-rural areas tend to be poorer than other areas, MOIs that serve them tend to reach poorer markets. At the same time, MOIs may not reach the poorest segments within these markets.

Reaching Remote Rural

In many rural areas, the only institutions that provide financial services are MOIs (Cuevas & Fischer, 2006; Grant & Coetzee, 2005; Hirschland, 2005; Chao-Béroff, et al., 2000; Zeller, 2003; Westley, 2001; Sharma, 2002; Johnson, Malkamaki, & Wanjau, 2006; Sinha, 2007). Furthermore, small MOIs often reach areas that are more remote than large MOIs do (Grant & Coetzee, 2005; Johnson, Malkamaki, Mukwana, & Wanjau, 2002; Chao-Béroff, et al., 2000; Sharma, 2002; Hirschland, 2005).

Small MOIs can serve remote areas if they do not require regular transactions with another financial institution. In areas that are more costly to reach, promoting groups may be less cost-effective than promoting MOIs that are somewhat larger (Hirschland, 2005).

According to a few studies, institutional type determines rural outreach less than other factors, in particular, management (Young, 2003) and geographical placement (Hashemi in Helms, 2006). However, these studies do not consider small unregistered MOIs and one, a study of El Salvador, defines rural areas to include towns (Young, 2003).

Reaching the Poor

Because poverty tends to be more rural than urban, rural-remote MOIs often serve poorer markets simply by virtue of geography (MkNelly & Lippold, 1998). For example, in Bolivia where financial cooperatives alone serve many rural areas, over 80% of rural households are poor with nearly 60% in the poorest income category. In comparison, under half of urban households are poor with only 22% in the poorest category (Republic of Bolivia, 2001). In Mali, the Kafo Jiginew network's poor-friendly products offered in rural areas were found to reach a significantly poorer clientele than its standard products offered in towns. However, this was due solely to geographic targeting: the income levels of the rural clientele closely mirrored those of their rural communities *and* of the clientele of a government credit program serving the same community that was not targeted to the poor (MkNelly & Lippold, 1998).

In fact, while MOIs can reach poorer markets because of where they are located, within these areas they do not necessarily reach the poorest segments of the population or may not serve them as well as they serve better-off market segments (Anyango, et al., 2007). One reason for this is their governance. MOIs often are led by their better-off and better-educated members who may not understand or respond to the needs of poorer members. Furthermore, if credit must be rationed, these leaders often reserve it for themselves or for others who are close to them. This dynamic is known as "elite capture." Even when leaders do not dominate, MOI members themselves may exclude poorer community members.

Proximity and product terms may also prevent MOIs from serving poorer market segments. Particularly for small transactions, the poor may have neither the time nor the resources to travel to offices that are even several kilometers away (Hirschland, 2003). Product terms that may exclude the poor include obligatory credit, regular fixed payments, joint liability, and minimum balance requirements (Nteziyaremye & MkNelly, 2001). How well product terms meet the demands of the poor varies by type of MOI, as does poverty outreach overall.

Large MOIs

Evidence on poverty outreach of large MOIs is mixed. In at least some regions, large MOIs mostly do not serve the lowest or lower-income market segments (Rutherford, 1999a; Chao-Béroff, et al., 2000; Sharma, 2002). In East and West Africa, large MOIs serve primarily middle-income households: The poor may be excluded by significant share or savings requirements or credit products designed for large farmers (Chao-Béroff, et al., 2000). In Ecuador and Guatemala, credit unions serve low and lower-middle income populations (Almeyda & Branch, 1998).

How does the depth of outreach of large MOIs compare to that of other providers of financial services? In Latin America, credit unions typically serve a larger number of poor people than MFIs, even though the poor represent a smaller portion of the credit unions' total clientele (because credit unions tend to serve more people than MFIs.) Although imperfect proxies for the income-level of clients, the average savings balances and loan sizes of credit unions often are considerably smaller than those of banks and larger than those of member-owned groups. This may also indicate that the credit unions are serving poorer clients than banks and better-off ones than member-owned groups. A study of 2.4 million savers in credit unions in Latin America, Africa, Eastern Europe and Asia found that 94% had an average savings balance of US$33 (Richardson in Branch & Klaehn, 2002).

Small MOIs that are managed or governed by elected representatives

These MOIs often have more severe product limits than large ones. However, their leadership may be more motivated to serve the entire community by offering particular products for poorer community members or exempting them from onerous requirements. This may also be true of medium-sized community-based MOIs with several thousand members. For example, a number of community-based Nepali cooperatives waive share requirements for the poor and provide some with rickshaw loans.

Groups

The extent to which groups serve the poor, and poorer members share in their benefits, is not well-understood. In theory, groups could reach primarily poorer members of their community. However, several studies of promoted groups in India and Nepal indicate that they reach mostly better-off women or regions, or reach the poorest less than that group's incidence in the population (Ashe & Parrot, 2002; Thanka, 2002; Sa-Dhan, 2002; Reddy & Prakash, 2003, Harper & Nath, 2004). ROSCAs have been found to exclude people who are perceived as socially or economically unstable (Cope & Kurtz, 1980; Smets, 2000). Furthermore, leaders who are more educated than group members may accrue more than their share of benefits although time-bound groups may be more transparent and less vulnerable to this dynamic (Harper & Nath, 2004; Rutherford, 1999b; Rippey, n.d.).

The products offered by groups may be much more relevant to the poor than the products offered by other types of financial institutions. Groups can manage very small transactions because their costs are so low, and their small size can enable them to accommodate individual members' emergencies (Isern, et al., 2007). Although even the small fixed payments required in groups may exclude the very poor, overall MOI groups "may offer products that are better suited to serving the rural poor than any that MFIs and commercial institutions can afford to offer" (Rippey, n.d.).

In summary, although MOIs reach poor areas, they do not primarily serve the poorer segments in these areas. In some regions, large MOIs may barely serve this segment.

Reaching Women and Other Marginalized Populations

Gender outreach also varies by type of MOI:

- Large rural MOIs in Latin America (Almeyda, 1996) and East and West Africa tend to serve primarily male farmers. Women may be excluded by security and savings requirements, by the fact that men dominate agricultural activities, or by their more limited mobility (Harper, 2005; Chao-Béroff, 1999b).
- Smaller MOIs may serve more women, particularly where their mission is to serve an entire community. In fact, a handful of medium-sized MOIs are managed by and sometimes for women.
- Informal groups tend to serve women and men more equally. In many cases, women may outnumber men because women are more inclined to act collectively and to repay (Bortei-Dokhu & Aryeetey, 1995; Mayoux & Anand, 1995).
- The majority of promoted groups—groups that were initiated by outside agents—consist solely of women.

Although we do not know much about MOIs' ability to reach other marginalized populations, some studies note that MOIs' local base makes them less vulnerable than other types of financial institutions in conflict situations (Columbia Country Management Unit, 2003) and may make them more able to reconstitute quickly after a conflict (Christen & Pearce, 2005).

Strategies for Deepening Outreach

MOIs have employed a number of strategies to deepen their outreach:

- Some town-based MOIs that are managed or governed by elected representatives extend their services to rural areas by serving groups. These might be village banks or SHGs that they promote, SHGs that others promote, or existing informal groups. Consider the Kafo Jiginew cooperative network in Mali: within one year of starting to train and serve self-managed rural groups, the percentage of the cooperative's borrowers who started poor apparently tripled (Stack & Thys, 2000; Thys, 2000).
- Because groups may exclude the poor or the poor may exclude themselves, some promoters organize separate groups for the poor. The fixed amounts that these groups save may be smaller than in other groups (Bouman, 1989).
- Some MOIs extend their outreach to rural-remote areas by using low-cost, field-based delivery mechanisms such as lockboxes, mobile collectors, mobile units, and satellite offices with minimal staff. They often manage their costs by offering services only during a monthly or weekly collection time or in group meetings (Hirschland, 2002).
- Many SHGs focus on development activities as well as financial services. These groups may attract more of the poor (Wilson, 2002).
- Some cooperatives or cooperative networks establish branches or cooperatives in remote locations by cross-subsidizing them from surpluses generated by their urban branches or members (Frankel, Almeyda, Ashe, & Dettweiler, 1999). For example, in the Burkinabe credit union federation, RCBP, the 40% of member cooperatives that serve urban areas cross-subsidize the 60% that serve productive rural areas (Chao-Béroff, et al., 2000).
- Similarly, regulators have used mergers to maintain services to a particular community or population. For example, Banco Creditcoop, one of Argentina's leading banks, resulted from a merger of forty-four credit unions. Without the merger, some of these would have closed. Many of the bank's 194 branches serve

remote rural towns where no other bank operates (Frankel, Almeyda, Ashe, & Dettweiler, 1999).

- Some MOIs focus on providing product terms that are feasible and attractive for the poor such as liquid savings accounts with low minimum balance requirements, loans with small payment sizes that accept savings as partial collateral, loans with a choice of balloon or equal loan payments, lines of credit, seasonal emergency loans, loans that can be used non-productively, and remittance services (Frankel, Almeyda, Ashe, & Dettweiler, 1999).
- Others MOIs target the poor. Some use participatory wealth ranking or poverty indicators. Others target poorer geographic areas, sectors in which workers are mostly poor, or groups that include large portions of the poor—such as the landless.

Many of these strategies are donor-driven.

Breadth of Outreach

In parts of Africa, Asia and Latin America, MOIs achieve a significant breadth of outreach or penetration both in absolute numbers and relative to other types of financial service providers.

- In Niger, self-managed groups catalyzed by CARE have served nearly as many clients as the entire microfinance sector combined.
- In Latin America, large credit unions serve more low-income clients than the number served by MFIs (Westley & Branch, 2000).

- In Bali, Indonesia, more than five out of six households are somehow linked to the LPD system of village-controlled banks (Holloh, 1994).

However, MOIs are not inherently driven to grow, deepen their penetration or replicate and many stagnate (Stiglitz, 1990). Unlike other types of financial institutions, MOIs are not normally accountable to donors who seek large-scale impact or to boards who seek to maximize profits. Their member-owners typically do not prioritize or stand to gain significantly from growth or replication. In the cases where MOIs do pursue growth, the impetus often has come from donors and technical assistance providers. In the case of the Indian self-help group movement, government played a critical role. More typically, government involvement has stunted rather than stimulated the MOI sector (Turnell, 2005).

The size of individual MOIs in remote areas is limited by population density: the population which is in close enough proximity to use them is small. These MOIs can serve sparsely-populated, poorer regions precisely because they can be viable without achieving a large scale. Conversely, other types of institutions do not serve these regions because they are unable achieve a large enough scale there to recover their costs.

Breadth by Type of MOI

Different types of MOIs achieve breadth in different ways. Groups and remote MOIs are naturally limited in size. Unlike other types of MOIs that can grow to a large scale, groups and remote MOIs achieve breadth when an outside institution promotes the establishment of large numbers of groups, a process known as *replication* (Rutherford, 2000).

Groups

Taken together, the groups promoted by a single institution can represent significant numbers of members quite quickly. For example, the *Mata Masu Dubara* groups in Niger average 30 members per group but the program, in ten years, grew to serve an estimated 162,000 members. Rapid growth requires a simple, standardized model that is well-adapted to its environment (Ashe & Rhyne, n.d; Allen, 2005), Although reliable data is hard to come by, some practitioners report that self-replication—where members of existing groups train new ones—is common (Lee, 2006; Anyango, et al., 2007).

Remote MOIs
In remote areas, the pool of potential members for a single MOI might number in the hundreds. Although breadth arises from replication, MOIs that are managed or governed by elected representatives tend to be more complicated to promote and manage than groups. Furthermore, in sparsely-populated remote areas the aggregate scale of these MOIs, promoted by a single institution, may be significantly smaller than that of group programs in less remote areas.

Other MOIs
External technical support can help develop MOIs' impulse and capacity to grow. In Guatemala, Ecuador, Mexico and elsewhere, WOCCU's model credit union building strategy has stimulated and supported large-scale growth in credit unions.

Mergers of powerful second-tier institutions such as cooperative banks can result in large MOIs whose economies of scale better enable cost recovery and significant growth. In Canada, Germany, and the Netherlands, institutions of this type are huge, leading financial service providers. Because of their cost structures, these institutions' comparative advantage seems to be in competitive markets not in remote-rural ones. Westley and Branch (2000) argue that merging is difficult for credit unions, particularly because of the large number of owners to which their management is answerable. In some cases, mergers seem to create more problems than they solve.

Length of Outreach

Most MOIs cover their operating costs from their inception. The greatest threat to their long-term outreach is not the high operating costs that prevent other institutions from serving remote-rural areas; it is weak governance and management capacity. Strong governance of MOIs often does not ensure sound management or protect against fraud. Large MOIs in particular, often lack the capacity to adequately protect savings and may collapse because of high delinquency, inadequate reserves, or poor liquidity management (Berkhoff, 2003; Harper, 2005). Governments exacerbate these weaknesses when they interfere with operations or use MOIs to channel subsidized credit (Harper, 2005).

These vulnerabilities can be countered through carefully-designed support from a federation or other linkages and through effective supervision. Because most MOIs are sustainable only with some or all of these supports, Isern, et al. (2007) assert that any assessment of an MOI's sustainability should include the costs of promotion, supervision and other necessary support from federations or external agents: "Unless core external support functions are provided in a sustainable manner, and are paid by revenue generated within the system itself, the community-level units will degrade over time and eventually unravel."

Governance, linkages, and regulation and supervision are the subjects of the second half of this literature review where we take up questions about costs. In this section, we consider the financial and institutional sustainability of MOIs, and the costs of promotion.

Cost Recovery of MOIs
The dynamics of cost recovery vary by type of MOI.

Small MOIs typically cover their costs by relying on the volunteer work of members, by hiring low-cost staff and in some cases, by charging high rates of interest. For example, the part-time manager of a small MOI might have just six years of education and might be supported by a volunteer board with even less schooling. In MOIs managed by representatives of the members, purely volunteer management may lose their motivation unless they receive some remuneration. Achieving a minimum size, though small, is important. In uncompetitive markets, MOIs can charge relatively high interest rates, an option taken mostly by groups and some FSAs.

Large MOIs recover costs using strategies that are standard microfinance fare: Scale, efficiency and low-cost funds.

- The larger the volume of assets, in particular, mobilized deposits, the easier it is to recover costs. (Richardson in Branch & Klaehn, 2002). A study of 15 Latin American credit unions found that credit unions with over US$1 million in savings enjoyed clear economies of scale and could compete with commercial institutions (Richardson in Branch & Klaehn, 2002). Providing a positive real rate of interest can motivate high levels of savings. However, when the savings portfolio is bigger than the loan portfolio, investing the excess at a high enough rate of return to recover costs can be difficult.
- Data from the *MicroBanking Bulletin* indicates that credit unions tend to be more efficient than other institutional providers of microfinance in large measure because of their lower personnel expenses (Richardson, 2003).
- Credit unions typically keep their cost of funds low by mobilizing deposits from large as well as small depositors. A review of 85 credit unions found that the 6% of accounts with balances of over US$300 contributed 74% of the mobilized savings. As noted earlier, the other 94% of the accounts had an average balance of US$33 (Richardson, 2003).

Providing non-financial services can weaken cost recovery by increasing costs and muddying financial monitoring. Tracking non-financial services as a separate product line can keep the cost recovery of the different services transparent (Staschen, 2001).

Institutional Sustainability of MOIs
All types of MOIs are vulnerable to credit and fraud risk and most contend with governance and capacity issues. However, their institutional sustainability differs.

Small MOIs
For small MOIs of all types, developing clear, transparent and accurate bookkeeping systems is a major challenge.

Time-bound groups may be less vulnerable to mismanagement, embezzlement and defaults than groups that accumulate funds. Their periodic self-liquidation creates a sort of "action audit" (Rutherford, 1999) and not pushing members to continually borrow or to continually borrow larger amounts can help with repayment (Rippey, n.d.). Ashe and Rhyne (n.d.), Allen (2005) and Rippey (n.d.) each advise against providing these groups with ongoing support. A recent study of new time-bound VSLAs found 100% survival rate over two years (Anyango, et al., 2007).

Groups that accumulate funds may survive at a much lower rate than is apparent because the surviving groups are the solid ones and there are no written records to examine (Johnson & Sharma, 2004). Fraud is a major source of failure that groups combat by using cash boxes with several keys, group training videos (Zapata, 2002), oral record-keeping (Allen, 2005), and by instituting clear roles, responsibilities, and controls (Matthews, 2004).

Evidence from India suggests that a large portion of SHGs are sustainable only with ongoing management support. SHGs seem to fail or disband at a high rate: 15% to 20% according to one study (Seibel & Dave, 2002; Isern, et al., 2007; Thanka, 2002). While SHGs promoted by the government seem to be weaker, even those that have received three to five years of NGO support often seem unable to engage directly with banks or other entities. SHGs often suffer high rates of delinquency in that they do not track, do not provide for loan losses, and hold excessive amounts of idle funds. According to one study, group fatigue typically sets in after two years (Thanka, 2002). A founder of the SHG bank linkage model concludes that SHGs "need a self-supporting institutional framework and effective supervision" (Seibel, 2005).

Other small MOIs that accumulate funds. Although we have little data on their survival rates, small MOIs that are governed or managed by elected representatives also seem to require ongoing support. Despite fifteen years of operation and careful planning for their autonomy, the remote-rural CVECAs continue to require technical support (CERISE, 2002). In Nepal, the Small Farmer Savings and Credit Cooperatives Limited (SFCLs) also require ongoing technical support (Wehnert, 2004).

Large MOIs
To survive and thrive, large MOIs benefit from technical assistance for ongoing procurement, liquidity and product development services, and regulation and supervision. Fraud, mismanagement, and above all, delinquency are key vulnerabilities (Jazayeri, 2005b; Westley & Branch, 2000). A study of 58 Latin American credit unions found that key causes of delinquency included low real interest rates on deposits, a low return on assets, low wage levels for personnel, and lax default sanctions and attitudes towards delinquency (Westley & Branch, 2000).

The literature suggests that with the exception of time-bound groups and some large sophisticated MOIs in competitive markets, every type of MOI seems to require ongoing support to be sustainable (Seibel, 2005; Churchill, Hirschland, & Painter, 2002; Wehnert & Shakya, 2001; Branch & Klaehn, 2002; Fischer, 2002).

Cost Recovery of Promotion
Although some SHGs are profitable enough to cover the cost of promotion and still maintain a positive return on assets (Isern, et al., 2007), the cost of promoting small MOIs is typically borne by the promoting institution. Wilson and others justify this by comparing promotion to other investments in the financial sector. They find that the cost per member to develop a group is a fraction of the institutional development cost per client for an MFI (Wilson, 2002). A recent CGAP study finds that the subsidy per client and financial sustainability of SHGs "compare favorably with many other microfinance approaches" (Isern, et al., 2007). Ashe and Rhyne (n.d.) counters that the per-member institutional development costs should be compared in the context of the quality and length of the financial services provided. For example, an assessment of the per-member institutional development costs should also consider the length of time for which the institution or group will provide services and what services it provides.

In any case, knowing the per-member costs of promoting different types of MOIs would be useful (Isern, et al., 2007). Data from four promoters of small MOIs suggests that the cost per member of promotion ranged from 2% to 48% of local per capita GNI, US$11 to US$140 (Hirschland, 2005). The cost of promotion decreases with a number of factors: Large scale, a focus solely on financial services, physical accessibility of the service area, and more educated and better-off clients. In addition, the cost of promotion drops dramatically when the promoting institution catalyzes self-replication, by training existing group leaders to promote new groups for a small fee which is paid by the new group (Ashe & Rhyne, n.d.). The length of time needed and therefore the cost of promotion, varies and may not be the one-time investment often envisioned (Sinha, et al., 2006).

Net Worth of Services: Scope, Worth and Costs

An MOI's net worth to its members is closely tied to its scope of services, how well these services fit members' demand, and their cost to members. Therefore, we look at scope, worth and cost together. First, we consider how member ownership affects MOIs' product mix. Then we look at the scope and responsiveness of products offered by different types of MOIs. We also review the findings of impact surveys even though these typically consider worth to society rather than to members alone. Finally, we consider the costs of being a member and using services.

Member Ownership and Product Offerings
Several factors related to member ownership affect MOIs' product range. First, the scope of small MOIs can be limited by capacity, costs and liquidity constraints. Second, because they are not driven to grow, MOIs in uncompetitive markets may have more latitude to diversify their product offerings.[4] Finally, small MOIs often offer non-financial services.

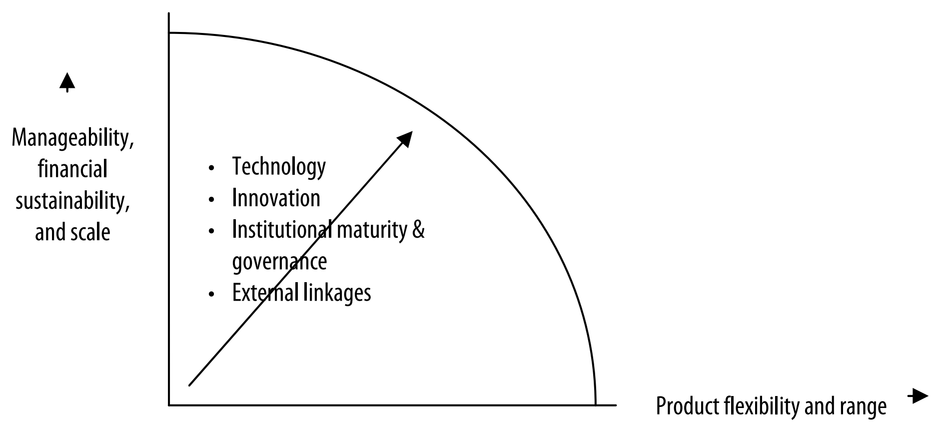
Management, Cost and Liquidity Constraints
When it comes to product mix, small MOIs face a number of constraints. Their volunteers and local staff

[4] Of course, the drive to grow can also motivate institutions to develop new products to attract new markets.

often lack the skills to handle the bookkeeping, liquidity management and internal controls necessary to manage flexible and multiple products – particularly liquid savings products. Groups, in particular, may rely on nearly innumerate volunteers to keep their books. Even if staff with these skills were available, small MOIs rarely could bear their higher costs. And, small MOIs typically lack access to instruments to cost-effectively manage excess or insufficient liquidity. Without these options, their loans must be small and short-term to match the size and terms of the savings they can mobilize (Hirschland, 2003). In rural-remote areas, where cash flows largely co-vary, the need to match savings and loan terms can make it hard to offer seasonal products.

Therefore, the scope of services that small MOIs can offer tends to be quite limited. Notably, these factors that limit MOIs' scope of services are the same factors that make it possible for MOIs to serve remote-rural areas in the first place: low staff costs possible because member-owners handle many management functions (Stiglitz, 1990; Hirschland, 2005). In any case, these limits might be softened through innovation, technology, or linkages to external management agents, financial institutions or federations. Furthermore, some unsophisticated institutions develop a surprisingly strong management capacity over time (see Figure 4).

Figure 4: Tradeoffs in Product Offerings



Space for Diversification Instead of Growth
At the same time, MOIs may be able to offer more responsive products than other types of financial institutions because MOIs are not inherently driven to grow or to maximize profits. Because managing a fuller range of more flexible products tends to diffuse management and staff focus, institutions that strive for scale may limit, simplify, and standardize their product offerings (Churchill, Hirschland, & Painter, 2002). Not surprisingly, MOIs that serve limited geographical areas often develop a fuller range of more responsive products than branches of more centralized institutions that strive to grow (Cruz, 2006). Similarly, promoters that seek to serve large numbers may promote more limited financial services than those offered by informal groups.

Non-Financial Services
Many promoted groups and some other MOIs provide non-financial as well as financial services. Many promoters see groups as a platform for social interventions, from HIV/AIDS and other health education to financial education, literacy training, and capacity building. For example, many SHGs seek to provide rural women with a forum to voice their opinions, share experiences, and initiate collective action (Sa-Dhan, 2003).

There are strong arguments for and against this. On one hand, mixing financial and non-financial services can increase costs to the MOI and its members, weaken management and governance, and limit the scope and innovation of financial services. Rutherford (1999) suggests that promoted groups offer significantly less innovative and responsive financial services than informal groups because promoters of the former prioritize development activities while the latter focus solely on financial services.

On the other hand, certain non-financial services may be necessary to provide financial services, may strengthen this provision, or may be a cost-effective means to increase development impact or worth to clients. Successful financial services may require investments in infrastructure at the community level, group and collective organizing, training, and business development services (Steel & Charitenko, 2003; Sharma, 2002). Furthermore, groups that engage in development activities may be stronger than those that do not (Wilson, 2002). Finally, if non-financial services are offered as a separate product line, delivering them through the same institution can be a cost-effective and valuable way to increase worth or development impact in areas where infrastructure is limited and travel costs are high (Staschen, 2001; Stack, 2004; Churchill, Hirschland, & Painter, 2002;).

Relationship Among Type of MOI, Product Scope and Fit

How member ownership affects product offerings also seems to vary by type of MOI. Informal groups and other small MOIs seem to innovate in response to members' demands. Even groups with very limited management skills sometimes devise ingenious product features to respond to their members' needs. With some exceptions, large MOIs operating in uncompetitive markets do not seem to share this drive although it may be implanted from outside.

Small MOIs

Groups typically provide just a few simple financial services, usually small short-term loans and illiquid savings with fixed regular payments. Promoted groups may be particularly limited. One study of SHGs found that only a third to a half of the members accessed external loans from their group (Harper & Nath, 2004). Rutherford (1999) also finds that the services of informal groups are neither as flexible nor as safe as sometimes assumed. In particular, the timing of payouts often does not correspond to times when members need funds.

Others find just the opposite. According to Bouman (1979) and Duursma (2004), informal groups often provide services that are very well-adapted to members' needs. For example, although they do not have the capacity to offer liquid savings services, ROSCAs have devised numerous ways to provide liquidity in the form of insurance. They forgive debt or create an emergency loan fund, auction the pot to the highest bidder, allow a member to exchange his/her future pot for an immediate loan, or give the organizer the first pot to lend to those in need (Cajomiris & Rajamaran, 1998; Klonner, 2003; Bouman, 1995; Seibel & Shrestha, 1988; Duursma, 2004). Furthermore, because groups are small, they can relax rules to respond to members' needs. Even when their product terms are more restrictive, member-owned groups may be more flexible than group-based microfinance programs that serve similar markets (Isern, et al., 2007). Furthermore, groups that accumulate funds often highly value their high rates of returns.

Small MOIs that are managed or governed by representatives of the members typically offer more services than self-managed groups and respond to local demand to the extent that their capacity and liquidity allows. They usually start by offering a small number of relatively inflexible products. A small cooperative managed by a part-time staff person with a secondary school education initially may offer only compulsory illiquid savings and loans; however, the same staff person can grow into offering a fuller product range over time (Hirschland, 2005).

Large MOIs

Large MOIs typically offer more products than other MOIs. How broad and responsive this product mix is seems to vary. A study from East and West Africa found that large MOIs often were not as strong as advanced MFIs in analyzing borrowers' demand for financial services. They offered mostly simple savings products with low rates of interest and consumption payable at harvest time (Chao-Béroff, et al., 2000). In contrast, a study of several Latin American credit unions and one African one concluded that they often offer a broader scope of products than other MFIs (Frankel, Almeyda, Ashe & Dettweiler, 1999). Similarly, borrowers in Nicaragua reported that credit unions provide quick convenient service and flexible terms as compared to group-lending MFIs (Branch & Evans, 1999).

Competition and technical assistance may explain these differences. Competition can push large MOIs to move beyond their standard credit, savings and loan insurance products (Chao-Béroff, et al., 2000). Technical support, sometimes coupled with financial support to develop infrastructure, can also motivate and enable large MOIs to diversify. Whatever the motivation, some large MOIs have begun to broaden their product mix as shown in the following examples:

- The Caja Popular Mexicana dedicates a third of its US$288 million portfolio to housing although it is not clear what proportion of this goes to low-income clients. Members can borrow up to 40% of their income for up to five years (Jazayeri & Lee, 2006).
- Ecuadorian credit unions provide small short-term loans with customized repayment schedules; supplier credit to higher-end entrepreneurs; a variety of contractual savings products; and field-based services in the rural highlands (Grell, Evans & Klaehn, 2005).
- A company created by the Guatemalan National Federation of Credit Unions insures the financial holdings of more than half a million Guatemalans. A separate policy covers funerals and accidents (Herrera & Miranda, 2004).
- Some large MOIs in Africa, Asia and Latin America serve existing or promoted groups that often are more rural and lower-income than the MOIs' other clientele.
- SEWA Bank offers income-generation, emergency and housing loans; a life insurance, work security insurance and maternity benefits scheme; comprehensive insurance that covers death, illness and asset loss; contractual savings products including a daily collection scheme; and financial counseling and education (Vyas, 2004, 2006).
- In Cameroon, the MC2 federation's "sons of the village" program attracts urban dwellers' savings. Urban immigrants—who often are the elite of their communities—can designate their savings to help develop their village of origin. These funds finance much of the creation and early operations of new MC2 cooperatives (Jazayeri & Lee, 2006).
- Some U.S. credit unions work with money transfer operators to provide Latino clients with low cost remittances services. Clients can send funds home to family members who have an account at a local cooperative (Robinson, 2004). The cooperatives mobilize large volumes of deposits while offsetting local cash flows (Klaehn, 2002).

Figure 5 provides examples of the product mix offered by different types of MOIs.

Figure 5: Examples of Product Mix of MOIs

	Credit	Savings	Insurance
Time-bound groups			
Informal ROSCA (5 to several hundred members)	One-time, small, fixed amount, timing may not match need	Regular, fixed amount, cycle can be seasonal	May have mechanism to provide for emergencies
Groups that accumulate funds			
Promoted SHG (x to y members)	Rationed, short-term, small, flexible amount & timing	Compulsory: regular, fixed, illiquid	
Other small MOIs that accumulate funds			
Bhumiraj Cooperative (185 members)	Rationed, flexible amount & timing	Compulsory: illiquid youth: long-term accumulating Passbook: for businesses	
Large MOIs			
Financiera credit unions in Nicaragua (Branch a& Klaehn, 2002)	Individual loans	Passbook savings; Youth Children's Contractual: many types Savings-Loan Fixed term; Money transfers	

Impact

Information on the impact of MOIs comes primarily from studies of groups. They suggest that participation is associated with significant social and economic impacts (Puhazhendi & Satyasai, 2000; Seibel, 2004). Whether or not promoted groups hinder formal financial institutions in rural areas is unclear (Nagarajan & Meyer, 2005).

- An eleven-state study of Indian SHGs found that member households experienced significant increases in assets, net income and consumption, and, on average, a tripling of annual savings compared to pre-SHG levels. Groups facilitated by NGOs experienced the greatest increases (Puhazhendi & Satyasai, 2000). The evaluation relied on recall data by self-selected members and did not use control groups (Meyer, 2003).
- Another SHG study that found similarly positive results attributed these benefits to savings services, especially contractual savings accounts; emergency services; and training and advice (Kaboski & Townsend, 2005).
- At the village level, the social benefits of SHGs reportedly include greater thrift, financial self-reliance and financial management skills; more self-confidence, awareness of options, and involvement of women in civic affairs; improved school enrolment and women's literacy; more family planning and better health; improved sanitation; and reduced drinking and smoking among men (Seibel & Dave, 2002).
- According to their members, informal groups contribute to greater savings discipline (Gugerty, 2003), consumption-smoothing, more social interaction (Bouman, 1994), a stronger safety net for members, family and the broader community (Verhoef, 2001), and greater circulation of cash (Sethi, 1995; Ardener, 1964).

How to design and integrate non-financial services into an MOI to maximize impact has received scant attention. Some suggest that the key is to integrate the pursuit of *strategic interests* (changes in power and policy) and *practical interests* (fulfilling day-to-day economic needs). For example, SEWA Bank consciously institutes a culture of dialogue and awareness-raising, helping women to question, weigh options, articulate their dreams, and realize their potential (Lee, 2004).

Costs to Members

Figure 6 summarizes the costs to members of different types of MOIs. The transaction costs and financial costs of MOI services tend to be lower than these costs for other institutions.

Figure 6: Summary of Costs to Members by Type of MOI

	Groups of all kinds	Other small	Large
Transaction costs • Transaction time • Management time • Travel time & costs	 • High • Regular meetings • Minimal	 • Varies • High for a few • Small	 • Varies • High for a few • Larger
Financial costs	High relative to other institutions; similar to informal market.	Low relative to other institutions and informal markets.	Low relative to other institution and informal markets.
Potential losses (theft, fraud, mismanagement)	May be high. Lower for time-bound groups.	May be higher.	May be highest.

Groups normally have the lowest travel-related transaction costs but this is partially offset by the time that members must spend in meetings, the value of which may fade over time (Ashe & Rhyne, n.d.). In MOIs that are governed by representatives of the members, the few members who participate in management must travel. However, participation may be perceived as a benefit in terms of the prestige, remuneration, access to credit, or other benefits it confers. Indeed, in large MOIs, a board or committee position often is lucrative or prestigious and coveted.

Although MOI interest rates tend to be lower than those of other alternatives, comparisons should factor in the opportunity cost of members' funds that are tied up in shares or mandatory illiquid savings. With the exception of FSAs, non-group MOIs typically charge less for loans than any other type of provider. In contrast, groups charge rates that are much higher than bank or MFI rates but are similar to the rates of local moneylenders. In general, the level of interest rates is related to whether they are being driven by members in response to the informal market or by promoters, donors or the government, in which case they tend to be set lower (Chao-Béroff, 2007). Whether these rates are appropriate generates much heat. Some argue that high interest rates restrict access to loans, particularly for small farmers whose enterprises do not generate a high rate of return (Harper, 2005). Others counter that subsidized rates distort the financial sector and leave MOIs without a cushion against default (Srinivasan, 2003).

Another cost to users is that of potential losses due to fraud, mismanagement or institutional failure. In the absence of effective supervision, large MOIs often are less secure than small ones in which peer monitoring is more effective (Stiglitz, 1990).

Summary of Outreach of Different Types of MOIs

Figure 7 summarizes the outreach of different types of MOIs.

Figure 7: Outreach by Type of MOI

	Small MOIs	Large MOIs
Depth	-Serve more remote & rural than other MOIs or financial institutions **Time-bound groups** Remote promotion not cost-effective Small payments fit poor; regular ones do not Women well-represented **Accumulating-fund MOIs** ***Groups*** -Remote promotion not cost-effective nor feasible if linkages are required -Transactions fit poor -Women well-represented ***Other (governed by elected representatives)*** -Most feasible & cost-effective for remote areas -May reach poorer with special products	-Serve poorer rural areas more than other types of financial institutions -Rarely remote **Medium-sized** -May include more of the poor & women than large MOIs **Larger** -Often miss poorer in their service areas and may serve mostly men
Length	-Recover costs **Time-bound groups** -Less vulnerable to fraud and failure -Naturally short-lived but often re-form **Accumulating groups and other small MOIs** -Require support -Groups: Risk of fraud. Often are short-lived -Others: Risk of failure	-Recover costs -Require support -Risk of failure **Medium-sized** -May not be able to afford internal controls or attract supervision
Breadth	-Achieved through replication -Group programs can achieve large scale quickly	-Achieved through growth -Not internally driven to large scale
Net value: scope, worth and cost	**Services: scope and fit** -Very limited but may fit demand well -Informal MOI services may be more responsive -Those of groups are most limited **Costs** -Risk of losses rise with size -Financial costs may reflect informal rates for group and may be much lower for other MOIs -Transaction costs: meeting times and travel.	**Services, scope and fit** -More able to diversify & respond to member demand but may not do so **Costs** -Financial costs: low -Transaction costs: more travel; fewer govern -Risk of losses: higher, increases with size

In general, the following can be said:

Depth: Smaller MOIs have the potential to serve poorer people and more remote areas than larger ones. Groups may have the greatest potential to reach women and the poor within the areas that they serve but small MOIs that are governed and in some cases, managed by elected representatives of the members may be the most cost-effective model for serving remote areas. Large MOIs have served remote areas the least.

Breadth: Large MOIs achieve scale through growth but are not inherently driven to broaden their outreach. Groups and remote MOIs achieve scale through replication. Because of the simplicity of group models, group programs can become quite big very quickly.

Length: All types of MOIs tend to recover their direct costs. At the same time, all but time-bound groups and the largest sophisticated MOIs seem to require ongoing support. The costs of this support should be built into their cost structures. Time-bound groups tend to be stronger and less prone to fraud or elite capture than accumulating ones.

Net Worth: scope, worth and costs: Large MOIs have the greatest potential to offer a broad scope of products but, in uncompetitive markets, their products may be the least responsive to member demand. The scope that groups can provide is quite limited although informal groups may be more innovative and responsive and may make exceptions to rules in order to meet the demands of their members. The scope of other small MOIs is somewhat less limited than that of groups. MOIs tend to impose lower transaction and financial costs on their members than other types of financial institutions. But the risk of losses may be higher. Large MOIs seem to be particularly vulnerable to fraud and mismanagement.

Part II: Drivers of MOI Outreach

…the important challenge for donors, governments, and others seeking to promote member-based organizations is to strike a tricky balance between providing the crucial support needed to reduce corruption, avoid mistakes caused by poor governance and incompetent management, and limit financial failure to acceptable levels, while not infringing on the ability of small information associations to operate viably.

- Christen & Pearce (2005)

MOIs can achieve impressive outreach. They often serve more remote-rural markets than any other type of institution. They typically recover their costs. Through growth or replication, they have the potential, sometimes realized, to serve large numbers of clients. Though sometimes limited in scope, their services may respond to client demand and cost clients less than the alternatives.

Frequently, MOIs' are plagued by fraud and mismanagement. Their breadth of outreach, in fact, their continued existence is limited by their governance. By governance, we refer to "the people and processes that keep an organization on track and through which major decisions are made" (Council of Microfinance Equity Funds, 2005). Governance comes from three sources: The MOI itself—its membership, governing body and management; oversight by a second-tier institution or external agent; and regulation and supervision. Not surprisingly, these three elements of governance also are key drivers of outreach.

In this section, we look at each of these drivers. Our aim is to understand what can enable MOIs to provide ongoing affordable services that meet the demand of large numbers of low-income members in remote-rural markets. We recognize governance as a key to achieving this goal. Therefore, we examine the sources of weak governance and strategies to strengthen it. We then consider how outreach and governance can be affected by federations and linkages to external agents. Finally, we focus on regulation and supervision. In regard to expanding remote-rural access to financial services, the key and key challenge, may be finding ways to provide effective regulation and supervision. We explore pressing questions about how the MOI sector ought to be handled.

Internal Governance

The same organizational design that gives the (MOI) its strength to undo market failure is at the root of its main weakness with significant impact on default risk.

- Cuevas & Fischer (2006)

Duursma (2004) suggests that strong MOI governance is characterized in part by participation of shareholders; transparent processes and decision-making, and accessible information; accountability; respect for rules; equal access to loans and other opportunities; strategy and leadership, clear duties and responsibilities and governance capacities.

Large MOIs do not naturally have strong governance. Their incentives for efficient management and watchful oversight are weak. In remote rural areas, the governance of MOIs of all types is weakened by several other factors. As a result, many MOIs are plagued by poor repayment and management, inequitable distribution of benefits, and loss of member confidence. We start this section by looking at the sources of weak MOI governance. We then consider strategies that can offset these weaknesses.

Inherent Governance Challenges

Conflicts of Interest
Weak governance is inherent in the structure of MOIs that are governed by representatives of the membership. As in other types of financial institutions, the priorities of MOI boards of directors and managers may differ from those of their owners (who, in MOIs, are their members). In cooperatives, unlike in other types of financial institutions, each owner has just one vote such that even relatively large groups of shareholders cannot influence management through their votes. As a result, members often are not motivated to carefully oversee the management of their cooperative. This leaves the board and managers relatively free to pursue their own interests instead of those of the institution and its members. This is known as the member-manager agency conflict (Stiglitz, 1990; Smith, Cargill, & Meyer, 1981; Poyo, 1986).

In fact, the member-manager agency conflict is alive and well in many large MOIs. Many are plagued by credit rationing primarily to board members, staff and their associates; large board allowances; board interference with management, particularly in issues of hiring and firing; a lack of board rotation; and inappropriate benefits for management. When, as is often the case, elected leaders and hired staff are more educated, powerful, and better-off than the general membership, this conflict is even more pronounced and is known as elite capture.

This conflict is aggravated by size. The larger the MOI, the more ownership is diffused, the less power individual members have to oversee management and the more managers and the board can act in their own rather than in members' interests (Cuevas & Fischer, 2006). As institutions grow and offer more complex services, they require more complex systems that members and the board may not understand and more skilled staff who may be intimidating to members. This can create a tension between active member participation and strong governance, on the one hand, and sound professional management, on the other (Westley, 2001).

Borrower Domination
The theory on MOIs governed by representatives of the members discusses a second inherent governance issue, borrower domination. While net savers favour high interest rates and sound financial management to keep deposits profitable and safe, net borrowers are likely to prioritize just the opposite (Stiglitz, 1990; Poyo, 2000). When borrowers dominate an MOI's decision-making, low interest rates and lax credit management can drive away depositors and shareholders creating a vicious circle. In practice, borrower domination seems to be less common than expected, prevailing primarily where MOIs are used as channels for subsidized credit (Cuevas & Fischer, 2006). On the other hand, where investors dominate, interest rates may be very high sometimes resulting in high rates of defaults (Chao-Béroff, 2007).

Aggravating Factors
These inherent governance challenges are reinforced by 4 factors that characterize remote-rural environments: Socio-cultural norms that discourage members from holding their leaders and each other accountable; a mismatch between member capacity and management systems; the absence of market competition; and the provision of certain types of non-financial services. In fact, these factors often weaken governance even in groups whose members and managers are one and the same.

Socio-Cultural Norms
While social cohesion can strengthen MOIs, certain other socio-cultural norms detract from good governance. In many cultures, challenging authority is not acceptable. In remote-rural areas where socio-cultural norms may be strong, members may not be willing to question managers or boards who govern inappropriately, particularly if they are perceived as more powerful by virtue of their education, class, age, gender or kinship (Matthews, 2004; Johnson & Sharma, 2004). Furthermore, members may not consider the possibility of fraud or

mismanagement by leaders that they know and trust. Finally, they may not expect people to repay a loan at a particular time. If debt is seen as open-ended, delinquency will not be treated as willful default. This norm can dissuade leaders and members from following up promptly on late loans—a key to managing delinquency and an important element of their responsibilities (Johnson & Sharma, 2004).

Prevailing norms can reinforce the power of governing bodies to appropriate more than their share of benefits and to govern irresponsibly. They explain how even groups may be plagued by elite capture with leaders taking more or larger loans than other members (Harper, in Harper & Nath, 2004; Matthews, 2004). Only groups that cash out largely escape this sort of leader domination (Rippey, n.d.). However, domination by more educated leaders and staff arises not only from socio-cultural norms. It also results from the members' inability to monitor records.

Member Capacity and Management Systems

If members cannot understand management systems, they will not be able to determine whether or not managers and board members are acting effectively and responsibly (Matthews, 2004). The same is true *vis a vis* board members and managers. Frequently, systems are lacking altogether, are inadequate or are far too complex for board and staff to comprehend (Reddy & Prakash, 2003; Matthews, 2004; Ashe & Rhyne, n.d.). In large MOIs, board members may also prefer not to pay MOI staff significantly more than they themselves earn. This may lead to the hiring of staff that lacks the skills or motivation to manage financial intermediation responsibly. In small MOIs, innumeracy can be a key constraint: Written systems that members cannot monitor lead them to rely on literate outsiders or leaders who can easily manipulate them (Kevane, 1996; Matthews, 2004, Ashe & Rhyne, n.d.).

Many MOIs cannot recruit board members and internal auditors with the expertise to oversee operations without significant amounts of training (Jazayeri, 2005a). Indeed, in large MOIs, board members without relevant experience often make sophisticated decisions and manage large amounts of funds (Chao-Béroff, et al., 2000). Where members cannot monitor operations, leaders can more-easily defraud the MOI (Chao-Béroff, et al., 2000; Matthews, 2004).

Non-Financial Services

MOIs whose mission is to affect poverty may be driven to provide non-financial as well as financial services. This is particularly true in remote areas where using one infrastructure to deliver both types of services can reduce costs for MOIs and for their members. As discussed below, some non-financial activities—training in governance, participatory processes and demand-driven non-financial services—strengthen members' participation and capacity to govern their MOI. However, non-financial services can also distract and diffuse the focus of governance and management.

Unless financial services are extremely simple, governing and managing them can be complex and challenging. Providing non-financial services can heighten this challenge. In some countries, multi-sectoral cooperatives are renowned for paying scant attention to their financial management. On the question of whether to undertake non-financial services, Westley and Branch (2000) reiterate the view of the World Council of Credit Unions, which argues strongly that cooperatives engaged in financial intermediation should never undertake other lines of business.

The Market

Finally, the absence of competition allows governance weaknesses to go unchecked. By driving down operating margins, competition forces efficiency and strong management, leaving less room for managers and boards to make a claim on MOI resources (Chao-Béroff, et al., 2000). It is in less competitive environments such as rural-remote markets, that the excesses that result from weak governance can thrive (Cuevas & Fischer, 2006).

Strategies to Strengthen Governance

Members themselves are the most important means to protect their own interests (Matthews, 2004). The member-manager conflict weakens governance by discouraging members from participating in governing their MOI. One key to countering this is to motivate members and community leaders to participate and oversee the

MOI. Another key is to give members the skills to do so. Finally, governance structures and policies can provide members with the guidance and means with which to take and maintain control. Chao-Béroff, et al. (2000) and Jazayeri (2005a) each note that all of this is necessary: Stimulating member participation and strong governance requires a combination of interlocking incentives and structures, including social incentives, economic incentives, training and appropriate systems and governance structures.

Catalyzing Strong Oversight

It is sometimes assumed that high levels of social cohesion and trust in a community—typically referred to as *social capital*—will naturally lead to greater member participation. Although some research supports this belief (Reddy & Prakash, 2003), Krishna (2002) suggests that social capital represents the potential for participation rather than participation itself. This potential can be catalyzed by a range of factors, discussed in depth below.

Focusing on Member Participation: For many promoters of MOIs, catalyzing strong member participation is seen as a key to increasing the power of the poor and enabling them to participate more actively in political and community life. For other promoters, participation is recognized as a means to strong governance. In both cases, strengthening member participation is pursued as a goal in itself. Not surprisingly, where participation is prioritized and institutionalized, it seems to be stronger (Agarwal, 2002, in Reddy & Prakash, 2003).

A study of SHGs in India found that governance was stronger where members decided policy, for example interest rates, repayment periods, and loan size (Reddy & Prakash, 2003). Similarly, Chao-Béroff (1999a) finds that a decentralized structure that keeps decision-making local contributes to member control and effective governance. Likewise, Reddy and Prakash (2003) note that participation is affected by proximity, how far the MOI is from where members live or work. And Agarwal (2002, in Reddy & Prakash, 2003) found that member control was higher when members were oriented towards democratic norms. However, terms that are determined locally may impede growth which typically requires some degree of standardization in product terms.

Participatory processes can strengthen members' sense of ownership and participation in governance, even when that is not their objective (Duursma, 2004). Examples include client financial and pictorial diaries that document individuals' financial management and the appreciative inquiry methodology used in groups. Therefore, Sa-Dhan (2003) recommends balancing the use of members' own qualitative and self-identified indicators with indicators that are demanded by donors.

Finally, some promoters of MOIs that are governed by representatives of the membership seek to strengthen member control and participation by adding a representative tier between the members and the governing body. For example, the Small Farmers Cooperatives Limited (SFCLs) in Nepal serves small groups of farmers. Each group elects a representative to participate in an "inter-group" that in turn elects a representative to the SFCL's management committee. These promoters find that the inter-groups, which meet near members' homes, strengthen members' participation and sense of ownership. Other promoters find just the opposite, that the added tier creates a sense of greater distance that weakens member participation. In this and other matters, we need to know more about the processes that increase participation.

Relying on Local Governance Structures: MOIs are stronger when they incorporate local leadership and governance structures into their own governance structures. The asset-based community development approach as developed by the Coady Institute emphasizes that community development efforts should start by recognizing existing community assets such as social relationships and norms, local leaders, and local governance structures (Mathie & Cunningham, 2005; Lee & Hamadrizipi, 2006). For smaller MOIs, building on local councils, village committees or existing groups and involving local leaders can be crucial to success (Duursma, 2004; Chao-Béroff, 1999a). Village management committees can play many roles: They might identify products, select borrowers, recover loans, approve plans, resolve disputes, oversee operations, and generally reinforce the MOI's authority.

For example, the LPDs in Indonesia are owned by the village and are controlled by the chief of the customary village council whose approval is required for all loans. The village council elects the LPD management committee, approves its annual work and budget plans, and can dismiss it if it does not comply with regulations or manage the LPD profitably. Peer pressure from the village council keeps repayment rates high: Delinquent borrowers can be expelled from the community and may no longer be allowed to pray in the village temples. Notably, the LPDs have exceptionally broad outreach but fare well only where customary law and social integration are strong.

The CVECAs in Mali also are owned by their villages. Each village assembly defines its CVECA's product policies, reviews its performance, resolves conflicts, and can modify its rules and regulations, which are rooted in local values. The CVECA management committee is accountable to the village as a whole. That the CVECAs have long escaped the opportunism typical of other MOIs may be due to this governance structure as well as to their financial incentive scheme. As with the LPDs, a weakening of the village assembly or social cohesion in the village could weaken these MOIs' governance (Chao-Béroff, 1999a).

Relying on local governance structures can be less effective where these structures are less powerful or where the connection is looser between them and the MOI. For example, the FSAs' reliance on pressure from the mayor or local militia to motivate repayment was only partly effective and reflected poorly on the institution. At the other extreme, incorporating local institutions into an MOI's governance structure can also lead to elite capture and can be particularly dangerous where the governance structure is linked to local politics and party interests (Harper, Berkhoff, Bajpai, & Kulkarni, 2004.). For example, small Cambodian MOIs that relied on village structures began to favour their more powerful members (Matthews, 2004).

Instituting Economic Incentives: Jazayeri (2005a) argues that while training, supervision and social incentives all play an important role in motivating strong governance, adequate economic incentives are paramount. MOIs must engage their members to participate by making it worth their while. As Jazayeri (2005a) writes, "The most important determinant of performance is the ability of the member-owned financial institution to offer economic incentives first to the majority of its own staff and then to its members for committing to the institution." If shareholdings are relatively small, ownership and profit sharing does not necessarily motivate an individual to join an MOI, remain a member, or repay loans.

For example, over 75% of FSA members were "free riders" who did not participate in its annual meetings, elections, or decision-making. FSA Board Member remuneration was a key determinant of the board's strength (Jazayeri, 2005a). Similarly, Sharma (2002) observes that very small MOIs managed by representatives of the membership will last only if their hard-working volunteer management committees receive more benefits than other members. Although not financial, certain demand-driven non-financial activities such as marketing assistance, may also be of sufficient worth to members to engage them to participate in the MOI (Jazayeri, 2005a; Staschen, 2001; Wilson, 2002).

At the same time, incentives need to be designed with great care. The CVECAs' strong governance was due in part to economic incentives tied to performance both for staff and for the governing body. Over time this incentive system encouraged some staff and management committees to grow the loan portfolio by soliciting interest-rate sensitive deposits from outside of the village. This destabilized and weakened these CVECAs (Chao-Béroff, 1999a; CERISE, 2002).

Enabling Strong Oversight

Even where members have the drive to oversee their MOI, socio-cultural norms and a mismatch between management systems and members' management capacity can make it difficult for them to do so. Training and simplified systems can help.

Training: Two distinct kinds of training can bolster governance. First, training can give the board the capacity to effectively oversee management, or members the capacity to effectively oversee management and the board. This training is technical and its content varies by type of MOI, for example, simple numeracy for groups and understanding financial management systems and controls for larger MOIs.

Second, training can be social, strengthening members' willingness to demand that their leaders repay loans, manage responsibly, and distribute loans and other benefits equitably (Ashe & Rhyne, n.d.). According to Johnson and Sharma (2004), MOIs must hold onto their mutual trust while "institutionalizing suspicion and rational accounting." The challenge is to "enable members to engage with their leaders and each other without challenging traditional authority in unacceptable ways." Matthews (2004) suggests that members must be willing to "assert their rights against powerful or wealthy local people".

How social training is designed may be important. Informal role plays enable members to practice applying unfamiliar and challenging principles and skills (Matthews, 2004). Johnson and Sharma (2004) note that tools for improving MOI management are based on Western assumptions and have not been effective. They recommend that training tools be used that build on an understanding of how socio-cultural norms support or contradict the MOI's formal rules. Training can be an imposition on members without providing significant value (Harper, 2007).

Systems: Rather than, or in addition to, expecting more skills of members, MOIs can simplify their systems. Appropriate, adequate user-friendly systems for accounting, credit management, reporting, and auditing are crucial for strong governance (Reddy & Prakash, 2003; Matthews, 2004; Ashe & Rhyne, n.d.; Sinha, et al., 2006), especially where members are not illiterate.

> Why must thousands of illiterate borrowers and depositors sign contracts whose terms are vital to their livelihoods, yet are written in opaque phonetic script…? Just as blind people can have unusually well attuned hearing, oral cultures can accomplish feats of recall that most of us would consider impossible without recourse to written text. (Matthews, 2004)

Both CARE- and Oxfam- promoted groups use oral systems. Their success depends on extreme consistency in implementation and short cycles. Every member saves the same amount; the loan period is fixed; and members always sit in the same place at meetings. Each member has a partner who helps remember that member's financial transactions (Ashe, 2005).

Alternatively, rather than expecting members to oversee systems that they cannot understand, some MOIs outsource more complex services such as insurance, serving only as the interface between the external service provider and the members. In India, PRADAN supports SHGs with a cost-effective computerized bookkeeping system (Sinha, et al., 2006).

Clarifying the Rules

Although clear by-laws and appropriate policies are not sufficient to overcome governance problems, they are a crucial starting point. By providing a reference point for what should be, these rules inform and empower members and boards to control their MOI (Branch & Baker, 2000).

By-laws or Rules: The breadth and formality of by-laws varies by type of MOI. In groups, they are less extensive and in simpler time-bound groups, may be unwritten. In other MOIs, by-laws are formal and written and should cover a range of topics.

In MOIs that are governed by elected members, by-laws should be used to tie the interests of management and governing committees to the interests of the members. For example, with the LPDs in Indonesia, the Supervisory Board is liable for losses in the LPD and may not benefit from their position. To help enforce good governance, the following should be included in a credit union's by-laws, size and literacy permitting:

- **The board or management committee:** The by-laws should mandate the board size, composition, qualifications, processes, compensation, terms, key decisions, and roles and responsibilities. They should clearly define the fiduciary responsibilities of the board, and its members' liability for the same. Roles and responsibilities of the board and management should be defined so as to avoid either management capture (where boards follow rather than supervise management) or micromanagement (whereby boards are overly involved in day-to-day decision-making). The by-laws should mandate staggered rotation for board members (Branch & Baker, 2000).

- **Supervisory committees:** The by-laws should define the crucial role of the supervisory committee, to supervise the MOI on behalf of the members, and should define the liability of supervision committee members.
- **Conflicts of interest:** The by-laws should spell out board and committee member conflicts of interest that are not permitted. In particular, insider lending should be controlled or prohibited. Where MOIs are too big for the credit committee to know all borrowers, its role should be circumscribed to assure that credit is apportioned according to set rules related to a technical assessment of risk by professional staff with suitable expertise.
- **Internal auditors:** The by-laws should call for an internal auditor who reports directly to the board and provides an ongoing on-site check on management. Particularly in small MOIs, assuring the independence and capacity of internal auditors and covering their costs is challenging (Jazayeri, 2005a).

In addition to by-laws, certain policies can help prevent borrower domination. These include limiting an MOI's reliance on external capital and offering attractive savings products and interest rates.

WOCCU, DGRV, and SDID have developed many useful tools to strengthen cooperative governance. WOCCU's comprehensive guidance is available on the web and includes the following: "safety and soundness principles" that identify what WOCCU considers to be the building blocks of strong credit union governance; model by-laws for credit unions that can be modified or adopted wholesale; short notes delineating the responsibilities of Boards, Supervisory Committees, Credit Committees, and Operational Management; and a prototype code of conduct that spells out guidelines to prevent officers and staff from acting for personal gain while fulfilling their responsibilities (WOCCU, 2007). Other types of MOIs may rely on having professionals from third parties as board members (Chao-Béroff, 2007).

Summary

In large MOIs, the tying of decision-making to member equity, in particular the one member–one vote system, can leave the board and management relatively free to pursue their own interests instead of those of the MOI and its members. As a result, many large MOIs are plagued by mismanagement. Four other factors can weaken the governance of remote-rural MOIs: Socio-cultural norms that inhibit members from holding their leaders accountable; a mismatch between member capacity and MOI management systems that leaves members unable to effectively monitor their leaders; the provision of non-financial services that can muddy the difficult job of overseeing financial services; and the absence of competition.

These challenges can be addressed by:

- Catalyzing member participation and strong oversight through participatory processes within the MOI, involving local leaders and governance structures in the MOI's governance, and economic incentives;
- Enabling members to effectively monitor MOI management through technical training of members, for example in numeracy or financial management, "social training" of members in how to hold leaders accountable, outsourcing services in order to keep management simple, and simplified systems such as oral bookkeeping for groups;
- Establishing by-laws or rules that legislate sound governance structures and practices. These inform members about the standards to which their leaders should conform and give members the means by which to hold their leaders accountable. Tools to help with this are available on the web.

Linkages: Federations and External Agents

The history of SACCOs, credit unions, cooperatives, financial service associations, community banks, and others have demonstrated that the reputation and ultimate success of the system depends on the strength of centrally provided support.
- Christen & Ivatury (2005)

Most MOIs require many types of support to survive and thrive. Some of this support—the initial promotion of small MOIs or intensive capacity-building of large ones—is a one-time investment in the financial system. Other types of support—from supervision to procurement and liquidity services —are required on an on-going basis. MOIs can obtain this support from the market, from a second-tier institution, a network or a federation that interacts with private suppliers on the MOIs' behalf, or from an NGO or the government.

How these inputs are procured and paid for is critical for two reasons. First, ongoing support functions must be sound and sustainable if the MOIs that rely on them are to be sustainable. Not building in essential ongoing support on a sustainable basis can curtail access to services. Second, how an MOI procures these inputs can profoundly affect its governance. Support structures can, and often do, sap member participation and oversight. And the failure of support structures may cost more than the failure of individual unsupported institutions (Von Pischke, 2007).

In many cases, support for remote-rural MOIs has been cobbled together without much thought to sustainability or impact on governance. While we have plenty of examples of what is not working, defining better practices for support structures is barely charted territory. Furthermore, what is charted is marked by some basic disagreements. These differences seem to stem from the fact that governance in remote-rural markets tends to be weaker than in competitive markets.

In this section, we look at the types of support that MOIs require and the models by which this support can be provided. We then focus on the dominant model, federations, and discuss some lessons that have been learned from federations and debates about this model. Finally, we identify some lessons that have been learned about providing financial support, in particular external capital.

Types of Support Required

MOIs may need the following types of support (Chao-Béroff, 2007; Isern, et al., 2007; Sharma, 2002; Pathak & Sriram, 2004; Fischer, Hirschland, Jazayeri, & Lee, 2006; Branch & Klaehn, 2002):

- **Supervision**: Supervision is crucial because it can help prevent or catch fraud and mismanagement. Because governments rarely have the resources to supervise small and medium-sized MOIs, this function must come from other sources. Models for and issues related to supervision are discussed in the section on Regulation and Supervision.

- **Procurement:** MOIs often are too small to procure or cost-effectively procure needed products and services. These can range from stationary, computers and management information systems to auditing, bookkeeping and financial services such as insurance for themselves or their members (Nair, 2005).

- **Liquidity management:** Especially small, stand-alone MOIs face high covariant and liquidity risks that, along with seasonality, limit their expansion and threaten their survival (Zeller, 2003). Pooling MOI funds and linking with institutions that provide refinancing and accept excess liquidity lowers these risks and makes it possible to offer a broader range of products. For example, the FECECAM federation's refinancing and liquidity management service allows deficit cooperatives, mainly in very remote areas, to survive through special credit lines and financial contributions (Basu, et al, 2004).

- **Capacity building:** Except for the simplest and the most sophisticated, MOIs typically require training, technical assistance, and help with management systems to manage their operations effectively. Typically, small MOIs need help with bookkeeping and credit management while large MOIs may require help with credit and financial management, accounting, all aspects of marketing, personnel management, and governance.

- **Management:** Small MOIs, particularly groups that choose to provide more complex services, may require an external party to keep their books and monitor their loans.

- **Marketing:** MOIs may not have the resources themselves to identify product opportunities and to elaborate norms and systems for managing them, to develop more technological delivery channels, or to promote themselves.

- **Representation, advocacy and networking**: Individual MOIs usually are too small to represent their interests to the government and other entities.

- **Promotion:** MOIs can emerge spontaneously or can be promoted spontaneously by other MOIs. Typically, however, achieving broad outreach requires promotion by an external agent. If these promoters understand better practices, they may able to promote more sustainable MOIs and may also be able to do this promotion on a more sustainable basis. At the same time, the sustainability of promoting institutions is less crucial than the sustainability of other support functions that are on-going.

Models for Providing Support

In general, MOIs procure this support from a federation to which they belong and/or from one or more external agents. These agents could be private suppliers including banks, a government agency or an NGO.

Federations: Federations can perform any or all of the functions described above. Although they may be promoted by outside agents, federations are owned and governed by their member MOIs. Normally, these members elect representatives to serve on the federation's board although in larger MOIs, they may elect delegates who in turn elect board members. Some federations have multiple tiers, each governed by representatives of the tier just below it.

Federations can be more or less centralized. Strategic decision-making may rest with the federation or with individual MOIs. The CVECA federations exemplify a decentralized model. The CVECAs are autonomous village-based MOIs that serve a sparsely-populated region of Mali. With an average of a few hundred members, the CVECAs can afford to pay a small stipend to management committee members and a portion of profits to two part-time staff. Their regional federations perform just a few functions. They monitor members, create new CVECAs, initiate and supervise peer auditing, and arrange for refinancing. Supported by fees from their members, the federations have no paid employees and pay only for building maintenance for their biannual meeting, biannual meeting expenses and support for troubled CVECAs. The banks and federations privately contract for other required services (Chao-Béroff, 1999a).

In contrast, Sharma (2002) proposes a more centralized model to support small MOIs in the remote hills of Nepal. There, MOIs are the sole institutional providers of financial services but they are not sustainable. With fewer than 100 members, they are too small to be able to remunerate volunteers or part-time paid staff, to justify the provision of needed technical support, or to effectively intermediate funds. The proposed federations overcome these obstacles by collecting fees from member MOIs and in turn, assuming many functions: Loan and policy decisions, planning, monitoring, bookkeeping, and networking. The MOIs become branches of the federation and pay for its staffing through interest revenues and are represented on its board. Though much larger, cooperative banks exemplify a similarly centralized model. In some cases, the individual MOIs merge into the bank, functioning as its subsidiaries or branches.

Fischer (2002) distinguishes between these two types of federations using the term "federated-network" to refer to second-tier organizations characterized by member MOIs that do not compete against each other and that share a common brand, and federations that represent, monitor, and generate products, services and other inputs for their members. He refers to other MOIs and their federations as "atomized-competitive."

WOCCU has recently promoted a hybrid model, networks of credit unions that are supported by a central service organization (CSO). For example, the members of the rural Financieros network in Nicaragua must adhere to strict standards of financial discipline. In exchange, they benefit from a shared brand name and marketing, and from other CSO services including liquidity pooling, insurance, technical assistance and the development of new products such as debit cards that they could not afford to develop on their own.

Support from an external agent: Less commonly, MOIs contract for support services privately. Technical support can be procured from individuals or for-profit organizations formed solely to provide it. In India, many SHGs pay individuals to keep their books. In Kenya, informal ASCAs purchase the services of for-profit ASCA management agencies established solely to help ASCAs manage their services. In rural Mali, the CVECAs complement their decentralized federations with the services of a private for-profit technical support organization providing auditing services, management training, and assistance in applying for refinancing. And in Cameroon, the MC2 cooperatives link with First Afriland Bank, which enables them to provide national and international money transfers. The bank also provides them with auditing, refinancing and liquidity management services.

As in the case of the MC2s, MOIs can use private suppliers to offer more complex services. The MOI serves as an interface between its members and the service provider. For example, some MOIs serve as insurance agents, making insurance available to members without handling its intricacies themselves. If members lack the skills to oversee sophisticated services, offering these services can weaken member control over managers. By outsourcing, the MOI can keep its operations simple enough for members to oversee while still offering more sophisticated products (Sriram, 1999).

MOIs that purchase support services privately can measure what they purchase, control its quality, and purchase only services they need rather than shouldering a portion of the recurring costs of an entire federation (Chao-Béroff, 1999a). At the same time, those providing support services typically are more educated than their MOI customers. This imbalance can enable the private provider to take advantage of the MOI or its members. The literature has not explored external agent successes or the elements of this success (Von Pischke, 2007).

Models for Groups

Like other types of MOIs, groups are supported by federations and by external agents. However, groups differ from MOIs whose members elect representatives to govern. Particularly in India, member-owned groups are supported in a profusion of ways that are difficult to distinguish from each other. To provide some clarity about these different models of support—what they are and how well they work—a few clarifying observations are in order:

Promotion only: Promoters of time-bound groups, normally an NGO or government agency, typically provide these groups with simple bookkeeping systems and training in how to use them, suggested product guidelines and rules, help in electing their leadership and defining their by-laws, and training in how to participate and to lead their groups. After this initial promotion, groups that cash out may best be left alone. According to Rippey (n.d.), most of these groups would not benefit from external funding and cannot pay for technical support services without changing their cost structures, a change which would transform them into a different type of institution. The need for support grows with the size of the funds groups are managing. In groups that cash out, this size is quite limited.

Bank linkages alone: The Indian SHG movement was founded on the idea of promoting and training ASCA-like groups with a development agenda, linking these groups to commercial funding sources and within a few years, letting them continue on their own. The linkages promised to marry the proximity, flexibility, peer monitoring, and small transaction sizes of informal groups with the strengths of the formal system—risk pooling, term transformation, broad outreach, and financial intermediation across regions and sectors (Zeller, 2003). Increasingly, researchers and practitioners have concluded that SHGs cannot be sustained with bank linkages alone (Thanka, 2002). Without other support, these groups seem to be short-lived (Thanka, 2002). This realization has led SHG promoters to explore a variety of options – from establishing different types of federations to linking groups to other sources of credit.

Linkages to non-bank sources of credit: Promoters of SHGs have recently established or linked a number of different types of institutions with SHGs as a means for groups to access credit for on-lending. These institutions include NGO microfinance institutions, non-bank financial corporations, cooperatives, not-for-profit companies, and wholesalers. Compared to funds from banks, this credit often is higher-cost but more reliable. Furthermore, the amounts available may relate to member needs rather than bank norms. These models tend to require substantial capacity-building and have not yet proven to be financially or institutionally viable. (Harper, Berkhoff, Bajpai, & Kulkarni, 2004). To a large extent, they are a response to an unsatisfactory regulatory environment. Cooperative structures might be more appropriate but may invite government interference or prohibit groups as members, and are not replicable or relevant elsewhere (Thanka, 2002).

Clusters: Some SHG promoters promote clusters of 10-40 SHGs located in neighbouring villages. Representatives of each member SHG meet regularly to discuss and deliberate on issues that affect them individually or collectively, such as linkages with government systems. Clusters can serve a range of functions: They might jointly purchase inputs, auditing or accounting services; they might manage an insurance scheme or serve as an agent for one; they might store grain and market outputs; or they might promote and train SHGs (Thanka, 2002). Some clusters simply strengthen and stabilize their member SHGs. Others facilitate inter-group lending that provides more and more reliable funds than banks (Thanka, 2002). Although clusters tend to be sustainable, they require strong skilled SHGs as members and their economies of scale are limited.

Mutually Aided Cooperative Societies (MACS) in India: A new regulatory framework in the state of Andhra Pradesh, India has spurred groups of SHGs to consolidate into cooperatives known as MACSs. Under the new regulations, SHG members but not the SHGs themselves are members of the cooperatives. The MACS have been heralded as a promising option for supporting SHGs but in fact, may disempower the SHGs while suffering from the same governance and fraud issues as other large MOIs. The SHGs no longer manage funds and in many cases, simply collect savings door-to-door rather than meeting. The MACS offer death insurance and a range of savings products, as well as loans. In most cases, they are led by staff of the institution that promoted them, have weak management systems, are not operationally sustainable, and suffer fairly high levels of delinquency (Thanka, 2002).

Issues with Federations

Federations can cost-effectively provide their member MOIs with some or all of the essential functions described above. In some regions and cases, federations have added value and strengthened their members' governance. In others, federations suffer from severe accountability and capacity issues such that they cost their member MOIs a lot but provide them with little value. These federations may even undermine the governance of their MOI members at the same time as they struggle to recover their own costs. Here we seek to understand the dynamics that produce these less promising results and to identify some strategies to offset them. We also consider what might explain these differences in performance.

Federation Governance and Accountability

In some cases, the conflicts of interest between members and managers that plague large MOIs are exacerbated in federations because of the socio-economic distance between their managers and their member MOIs. Federations must handle complex financial management, link with sophisticated financial institutions, and provide technical services. To do so, they must hire staff who, in most remote-rural areas, have more professional skills than those possessed by the leadership and staff of their member MOIs. Therefore, the MOIs often find it difficult to hold these staff accountable. This can be magnified in SHG federations where SHG leaders often have little education and organizational experience and federation staff often come from the promoting organization. The socio-economic distance between federation staff and their boards, and between federation boards and their MOI members, is heightened by physical distance: the further away the federation is, the harder it is for members to understand and actively oversee its management (Thanka, 2002; Reddy & Prakash, 2003).

Not surprisingly, West and East African federations often suffer from elite capture, lack of rotation of authority, power struggles between elected board members and salaried staff, and personal interests driving decisions. As a result, excessive spending and inappropriate hiring and firing are common (Chao-Béroff, et al., 2000). The advent of a federation reduces member MOIs' control over decisions (Sharma, 2002). Where members rather than promoters maintain control of SHG federations, performance seems to be better: Loan recovery seems to be higher, and the federations seem to be more stable, financially sustainable, and responsive (Reddy & Prakash, 2003; Sa-Dhan, 2002).

Fischer finds just the opposite, that federations increase cost-effectiveness and generate significant value. The marked difference in Fischer's conclusions seems to arise from his focus on federations operating in developed countries and in competitive, well-supervised environments.

WOCCU notes a fundamental reality, that federations are inherently political. Federations are set up to promote and to advocate for business but not to do business and their governance tends to be dominated by the majority of small credit unions that tend to be less business-oriented. Therefore, WOCCU focuses on building networks of business-oriented credit unions (Branch, 2007).

In any case, federation accountability and governance can be strengthened or weakened by several factors: How the federation is financed, whether the MOI system has more than two tiers, and whether it has non-financial as well as financial objectives.

The Impact of Federation Financing on Accountability

The accountability of federations may be affected by their income sources. If a federation earns most of its income from the interest rate spread between the external loans it receives and its loans to members, it may be less accountable to these members than if its primary source of income is members' fees for services (Chao-Béroff, et al., 2000). Moreover, if the federation charges its members for this on-lent capital and does not charge them for its services, the members may see it as a lending agency rather than as their own institution. Conversely, funding a federation with service charges from its member MOIs may increase accountability by demonstrating to members that the federation belongs to them and by forcing it to justify its expenses. An empirical comparison of how different MOIs fund themselves, and the apparent impact on governance, would be useful (Von Pischke, 2007).

Additional Tiers and Accountability

Some promoting institutions seek to achieve greater economies of scale and policy clout by adding tiers to MOI federations. Many West African cooperative networks have regional as well as national federations while SHG promoters sometimes federate clusters into a third-tier or introduce clusters as a tier between an existing federation and its SHGs (Thanka, 2002). Advocates of multiple tiers find that tiers encourage member participation. Others find that multiple layers of delegated power severely weaken accountability to members, increase the opportunities for mismanagement and fraud, cost more, and are less financially sustainable than two-tiered systems (Chao-Béroff, et al., 2000; Reddy & Prakash, 2003).

Writing of the national tiers in West Africa, Chao-Béroff, et al. (2000) observed that they are:

> Barely accountable either for their policy decisions or the management decisions they enforce… Widespread irregularities, fraud, and disregard for good management practice are observed at this level, and all the more so because it is usually here that donor grants and subsidies are concentrated. It is also at this level that the central financing facility is located, and where sound financial management is essential to handle the large sums of money involved and protect the interests of small depositors.

In India, clusters sometimes distance federations from their members, lessening members' control without adding value. In other cases, they bring federation leaders closer to their SHGs than they had previously been (Sa-Dhan, 2002).

Non-Financial Objectives and Governance

The governance of SHG federations can be affected by whether or not they engage in non-financial as well as financial activities. Federations that are driven by their members, rather than by promoters, may be more responsive, larger and stronger when they offer non-financial as well as financial services. This may also detract from their financial sustainability. In contrast, promoter-driven federations that support both types of services may be smaller and less well-managed than those that support solely financial services (Sa-Dhan, 2002). Thanka (2002) finds that most SHG federations have livelihood and other non-financial objectives that have been crucial to their development. At the same time, SHG federations that start with microfinance as a core business rather than an integrated development agenda may be stronger (Sa-Dhan, 2002). In this regard, the Indian rating agency M-CRIL suggests that the generally low levels of financial sustainability of Indian SHG federations are due to their social orientation (M-CRIL, 2004). Consistent with all these findings, SHG federations that offer both types of services seem to see their financial intermediation as a means of covering the costs of their primary focus, which are development activities (Sa-Dhan, 2002).

Strategies for Strengthening Accountability

Many of the strategies that can help keep federations accountable to their MOIs are similar to those that help keep MOIs accountable to their members. They include:

- **Using local leadership and institutions**. For example, establishing an advisory board of leaders of local institutions like banks or instituting performance audits by promoting institutions or other external agents.
- **Providing training and technical support** as well as opportunities for learning between federation boards.
- **Instituting economic incentives**. Ensuring that income comes from service fees rather than interest income and having one federation provide loan capital and another provide management support and oversight (Wehnert, 2004).
- **Stimulating member participation.** Numerous practitioners suggest decentralized decision-making is crucial for maintaining the strength and responsiveness of member MOIs and for strengthening the accountability and financial sustainability of the federation. Others contend just the opposite (Chao-Béroff, et al., 2000; Thanka, 2002; Wehnert, 2004; Sharma, 2002).
- **Establishing sound governance structures** through bylaws and credit and savings policies.
- **Enforcing prudential performance standards.** This is the strategy that WOCCU's CSO federation model applies by requiring members to meet prudential standards in order to join its new credit union networks.

Federation Capacity

The governance of federations and their value to members is also limited by their internal capacity. Federations often suffer from the same lack of experience, skills and user-friendly systems as their member MOIs. In India, SHG federations often are promoted by the same organizations that promote SHGs and these organizations often lack the skills to promote strong federations. As a result, federations in India and in West and East Africa often suffer from poor liquidity management and accounting; a lack of financial analysis, financial monitoring and portfolio management; weak internal auditing and staff supervision; unclear roles; and unsound governance practices. As with primary MOIs, training, technical assistance, and simple appropriate systems all can help improve the management of federations.

Covering the Costs of Federations

Regardless of the type of MOI that they support, federations can find it difficult to cover their costs with their operating revenues. Klaehn (2002) identifies cost recovery as one of the two major challenges that face CSOs. For Indian SHG federations, the timeframe for achieving financial sustainability is estimated at 5-10 years but to date very few SHG federations are sustainable (Gounot, 2001; Reddy & Prakash, 2003; Sa-Dhan, 2002). And, after fifteen years, the CVECAs, small MOIs governed by elected representatives, still require donor funds to cover some technical support.

Some MOIs and federations have found ways to recover their costs. Ensuring that operations are cost-effective, serving a larger number of MOIs and charging fees for all products and services can help. Member MOIs can cover these fees by raising their interest rates on loans to members (Isern, et al., 2007). Another key is to keep functions simple while having primary MOIs handle all the functions that they can (Thanka, 2002; Chao-Béroff, 1999b).

The Impact of Federations on MOI Governance: To Centralize or Not

Opinions diverge widely over the impact of federations on the governance of their members. Research from South Asia and West and East Africa suggests that participation in a federation weakens MOIs' governance and does not replace it with a strongly-governed higher level institution (Chao-Béroff, et al., 2000). Studies of federations primarily in North America and Europe conclude just the opposite (Fischer, 2002).

The Indian and African experience suggests that when an MOI relies on a federation's more professional staff and greater management capacity, its members participate less in its governance. Sharma (2002) finds that federations reduce transparency and trust, and weaken member control. Decentralization is found to result in greater local responsibility and involvement and weaker governance (Chao-Béroff, 1999b). With reference to small MOIs, several studies suggest that slowly developing federations from the grassroots up and with participation and decision-making from the members is crucial (Sharma, 2002).

In contrast, Fischer (2002) finds that federations help mitigate the member-manager conflict in their member MOIs and that centralized federations, or "federated-networks", perform better than decentralized, or "atomized-competitive" ones. This difference may be explained by Fischer's sample, primarily from Europe, North America and parts of Latin America, where more competitive markets and government's greater capacity to supervise federations may force stronger governance of MOIs and federations, on the one hand, and require larger institutions in order to compete, on the other. Indeed, Jazayeri (2005a) argues that mergers, central financing facilities, and a federated structure are crucial for credit unions to cope with their resource requirements and compete. Otherwise, they will not survive. The massive Desjardins credit unions in Canada and the Dutch Rabobank exemplify cooperatives that have survived and thrived in competitive environments by centralizing.

The debate over the desirability of cooperative banks illuminates these issues. Heller (2000) argues that cooperative banks offer many potential benefits over individual cooperatives: They achieve greater economies of scale, have the resources, capacity and regulatory approval to offer more services, are less vulnerable to covariant risk, provide more points of access for customers, and may lower the costs of supervision or, alternatively, qualify for supervision where cooperatives may not. On the other hand, Westley and Branch (2000) note that cooperative banks may be less efficient than individual cooperatives if the former are not managed efficiently, may be less responsive to local demand, may cost more if the cooperatives benefit from peer monitoring, and may be less able to focus on poorer and more rural markets.

The differing assessments of the relative efficiency and responsiveness of cooperative banks return us to the question of governance: Will the forces of the market, supervisory entities and member MOIs be sufficient to assure that cooperative banks act in an efficient and responsive manner? In competitive, well-supervised markets, the answer may be yes and centralizing may be essential to compete. Elsewhere the answer may be no and in those cases, centralizing may threaten the outreach, governance and survival of the member MOIs. Or, this tension between centralization and decentralization may drive us to new innovative models for federating that build accountability, responsibility and financial competence without sacrificing member control (Chao-Béroff, 2007).

Financial Support: Subsidies

Market forces alone are unlikely to extend financial services to remote areas: strategic subsidies are needed (Zeller, 2003). Because the innovations needed to deepen the financial system can easily be copied, the private sector may not invest in developing such innovations. According to CGAP's Donor Guidelines on Good Practice in Microfinance, "Longer-term subsidies may be required by institutions that target sparsely populated and otherwise difficult to reach populations since serving these client segments makes institutional viability harder to achieve" (CGAP, 2004). Furthermore, moderate levels of subsidies have been found to positively affect the provision of financial services in rural areas. If well-conceived and invested in well-managed organizations, they can be justified from a social point of view (Morduch, 2000, in de Aghion & Morduch, 2005; CGAP, 2003).

The support of the CVECA networks demonstrates how an external agent might support both innovation and sustainability by systematically phasing out subsidy as an MOI gains the capacity to recover the costs of the external supports it requires. In the initial phase, individual CVECAs cover their operating and financial costs while the costs of training, monitoring and auditing are borne by subsidies. This phase is used to create the conditions for future viability. In the second phase, the CVECAs also assume responsibility for the operating costs of their regional associations and might also pay some training and auditing costs. In a final phase, the CVECAs are also expected to pay for support services.

This section has outlined specific areas that merit donor support. However, one area calls for more detailed attention, the provision of external capital.

Financial Support: External Capital

Whether MOIs should accept external loans or not is fiercely debated. What is not debated is that subsidized external credit hurts MOIs, their members' access to financial services, and the rural financial sector. This lesson has been learned from hard experience, in particular, a rash of MOI failures in Latin America in the 1960s and 1970s and the resulting 20-year stagnation in rural finance.

Subsidized credit can distort and harm rural financial markets and it can erode credit discipline and discourage savings mobilization. Furthermore, by giving more power to the board and management and undermining incentives to mobilize deposits, these low-cost funds leave the board and management even more immune to member control (Cuevas & Fischer, 2006). This phenomenon has been well documented. Subsidized credit leads to a grant mentality among clients, credit rationing, high operating and transaction costs, poor repayment and corruption. It tends to benefit the rich and to lead to high levels of delinquency and default (Stiglitz, 1990; Adams, Graham, & Von Pischke, 1984; McCarty, 2001). McCarty (2001) found that subsidized government loans increased the availability of credit to rural and urban households but also undermined NGOs' ability to compete and thereby limited their penetration into remote rural areas.

Proponents of unsubsidized external credit note that funding the loan portfolio solely with mobilized savings can limit an MOI's size, slow its growth, and result in credit rationing which can discourage members. They claim that a moderate amount of external credit can "jumpstart" an MOI, quickly enabling it to lend and attract more clients without waiting to mobilize a high level of deposits (Shrestha, 2004; Koch, et al, 2004; Chao-Béroff, 1999a) They argue that over time, clients' savings will supplant external capital as a source of funds (Koch, et al., 2004). Furthermore, where savings are primarily short-term, external capital can enable an MOI to offer longer loan terms (Chao-Béroff, et al., 2000; Stiglitz, 1990). In their review of rural finance, Nagarajan and Meyer (2005) argue that external capital is essential for local MOIs that aim to serve remote rural areas where the demand for credit exceeds the volume of savings that can be mobilized.

Opponents of any significant level of external credit cite its numerous harmful effects. External loans decrease the incentive to mobilize deposits, skew incentives towards policies that favour net borrowers (unsustainably low interest rates and loose credit management) and are not managed as carefully as members' deposits (Branch, 2005; Klaehn, 2002; Stiglitz, 1990; Adams, Graham, & Von Pischke, 1984). Because depositors—who are concerned with the security of their savings—are MOIs' most effective check on management, external credit can weaken governance. A CGAP survey of sixty MOIs (Rosenberg & Murray, 2006) found that reliance solely on external capital always led to failure. The strongest institutions did not borrow externally, and the experience of those that accepted moderate amounts of external capital was mixed. Furthermore, channeling external credit through a federation—as is typical—can increase a federation's independence from its member MOIs. The result can be a more centralized rather than a grassroots cooperative system and often higher administrative costs.

The CVECAs seem to demonstrate both sides of this debate. After two years of successful operations, CVECAs began to borrow external funds reportedly without ill effect (Ouattara, Gonzalez-Vega & Graham, 1999). However, after 15 years of smooth operations, the CVECAs sharply increased their external borrowing, which led them to lend to non-residents and to attract volatile deposits to secure increased lending that weakened the local village councils and increased the rates of default (CERISE, 2002). Furthermore, the CVECAs have half the saver-to-borrower ratio of the *KF* network, a Malian MOI that does not accept external funds.

According to a number of studies, when the size and timing of external credit is well-considered, external finance can be a viable means of building on existing member deposits. For example, accessing bank capital is at the heart of the fast-growing SHG movement in India although some argue that members would benefit more from strong savings facilities (Harper, 2007). Experience in India, Africa and Mexico suggests that groups should save for six months to a year and develop loan management and bookkeeping capability before borrowing externally. Bank loans or lines of credit are thought to generate more discipline and to represent real financial costs to a greater extent than does donor credit. The experience of the CVECAS suggests that financing 50% of assets with savings balances the need to capitalize growth with the drive to mobilize deposits (Chao-Béroff, 2007). In contrast, WOCCU advocates that credit unions use external credit, including credit received from within the credit union system, to finance no more than 5% of total assets (www.woccu.org).

Summary

MOIs require many types of on-going support. They can obtain this support from a federation or a network—a second-tier institution to which they belong that interacts with private suppliers on the MOIs' behalf—or from an external agent such as a private supplier, an NGO or the government. How these inputs are procured and paid for is important for two reasons. First, ongoing support functions must be sustainable if the MOIs that rely on them are to be sustained. Second, how an MOI procures these inputs can profoundly affect its governance.

Federations can cost-effectively provide their member MOIs with some or all of the support they require. However, federations can also suffer from severe accountability and capacity issues such that they provide their members with little value, cost them a lot, and undermine their governance. A number of strategies can help keep federations accountable to their MOIs. One key is for federations to earn most of their income from service fees from their members rather than from interest revenues. In South Asia and West and East Africa, decentralization seems to be crucial to assure local responsibility, member participation, and stronger governance. While centralization may be essential in competitive, well-supervised markets, in other markets centralization may threaten the outreach, governance and survival of member MOIs.

Groups, particularly SHGs, seem not to be sustained with bank linkages alone and alternatives such as non-linkages to NGO microfinance institutions have yet to be proven to be financially or institutionally viable. Clusters of SHGs can strengthen and provide services to their members and typically are sustainable but they require strong, skilled members and do not provide substantial economies of scale.

Market forces alone are unlikely to extend financial services to remote areas. Strategic subsidies are needed.

Whether a moderate amount of external capital strengthens or weakens MOIs is fiercely debated. What is not debated is that subsidized external credit hurts MOIs, their members' access to financial services, and the rural financial sector.

Regulation and Supervision

(The standards formulated and advanced by the Basel Committee of Bank Supervision)…are de-facto guidelines for bank legislation in developing countries. The notion of a common standard is perfectly applicable to the CFI (community-based financial institution)… Designing an adequate legal and regulatory framework for CFIs is not an easy task… Thus, it makes sense to… (provide) well-documented principles for CFIs' legal and regulatory framework, which countries may then adapt to the particular context they face.

- Cuevas & Fischer (2006)

Regulation and supervision can protect small depositors, the financial sector, and MOIs themselves (Westley, 2001). When prudential supervision is effective, it provides an incentive for good governance, helping MOIs maintain the "financial discipline and prudent management" so often lacking in unregulated financial institutions. [5]

Unfortunately, the regulation and supervision of MOIs has not been largely effective. Many parts of the developing world still operate under outdated cooperative laws. Supervising entities often lack the technical expertise needed to supervise the financial performance of MOIs and in many cases do not do so either by regulation or because they do not have enough resources. Without effective supervision, most MOIs that are governed by elected representatives have limited outreach with mismanagement being common. In fact, developing effective regulation and supervision may be the single most important means of increasing MOI outreach.

Supervising MOIs would seem an obvious priority. MOIs are often the only service providers in rural areas, they represent substantial numbers of poor depositors and their frequently weak governance places the savings of the poor at risk. However, the MOI sector typically includes a large number of institutions that represent a small fraction of a country's financial assets. Because supervising the sector is relatively costly, resource-poor regulatory authorities often are unable or unwilling to do so. Indeed, MOIs are known as "the conundrum" of microfinance supervision (Lyman, 2006).

Cuevas & Fischer (2006) frame this challenge in an important way. Noting that disagreements over cooperative regulation are about core principles on which consensus is crucial if the sector is to move forward, they issue a call for a Basel Accords-like process to develop international guidelines for MOI regulation. With regard to such a process, the following fundamental questions beg for resolution:

- Which types of MOIs or MOI activities should be regulated?
- Are tiered licensing standards appropriate or should standards be uniform? If tiers are appropriate, how should they be defined and what should be required of each?
- Which entity should supervise? Is delegated supervision or self-regulation acceptable and under which conditions? Under which conditions might it be appropriate for different authorities to supervise different classes of MOIs?
- How should the costs of supervision be covered?

We now explore these questions. We then discuss two guiding principles for MOI regulation and note how MOI regulation and supervision should differ from that of banks. Finally, we identify other government policies that enable or limit MOI outreach.

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[5] "Prudential" regulation supports financial soundness through mandates such as capital-adequacy requirements or rules for loan loss provisioning loan losses. "Non-prudential" regulation screens out unsuitable owners or managers or requires transparent reporting and disclosure. Prudential regulation is more difficult, intrusive and expensive because it involves understanding and protecting the core health of an institution. Non-prudential regulation is "easier to administer because government authorities do not have to take responsibility for the financial soundness of the organization" (Rosenberg, 2003).

Core Principles

Which MOIs or MOI activities should be regulated and supervised?
Despite the potential benefits to depositors, MOIs and the financial sector, there are two compelling reasons for not regulating all MOIs. First, shutting down MOIs that do not meet licensing requirements can be hard to enforce and can cut the rural poor off from financial services. For example, credit unions had been the only institutional provider of financial services in nearly one third of Bolivia's *municipios* until new regulations exempted smaller credit unions from oversight by the bank superintendency but prohibited them from mobilizing deposits. In response, many of these credit unions were expected to shrink or close down altogether (Westley, 2001). Second, regulating more institutions can overburden the supervisory body and lower the quality of supervision (Christen & Rosenberg, 2000). Given these considerations, which MOIs should be regulated and supervised?

Possible Triggers
Decisions about which MOIs to regulate should be based on the risk they pose to the financial sector and to depositors in relation to the costs of supervising them (Fiebig, 2001). Proposed regulatory triggers include MOI size, services, maturity, and whether membership is open or closed.

Size: The most commonly-proposed trigger is size. Small MOIs pose less risk to depositors because members can more effectively monitor operations. At the same time, supervising small MOIs costs more per depositor or amount of financial assets. Size might be measured by the number of members, the amount of financial assets or capital (although this may be a proxy for poorer depositors who need the most protection) and/or the number of branches.

Most of the literature agrees that large bank-like MOIs should be prudentially regulated and supervised while small MOIs should not. Westley (2001) defines small MOIs as those with fewer than about 200 members. These MOIs might still be required to register or to be licensed and to fully disclose their unregulated status (Rippey, n.d.; McKee in Hirschland, 2005). Matthews (2004) and Seibel (1999) contend that even these MOIs need basic regulations such as minimum capital requirements and simple reporting requirements.

Although cost-effectively supervising large MOIs is challenging, the greatest challenge is posed by medium-sized organizations; MOIs that are too big to effectively monitor themselves but are small enough that subjecting them to bank-like supervision would be prohibitively costly relative to their size (Helms, 2006). One solution would be to require small and medium MOIs to be integrated into a federation that is regulated and supervised, as is required by the Central Africa Microfinance Regulation (Chao-Béroff, 2007). This would work only with "networked-federations," whose member MOIs are tightly integrated into the federation (Westley, 2007).

Services: Typically, mobilizing deposits from the public triggers regulation and supervision because regulation should protect depositors. Defining "the public" is trickier in MOIs. In any case, possible services that might trigger regulation and supervision are: Voluntary deposit-taking, on-lending of deposits, or offering current accounts.

Maturity: Writing in the context of the U.K., Mayo and Mullineux (2001) suggest that legal and regulatory status should match different stages of MOI development. New MOIs might be best served by assigning them a status that allows for experimentation, innovation and social funding without complex and costly reporting. More mature ones might require a status that imposes more internal control and permits access to public funding and tax-exempt status. Mature MOIs might require prudential supervision to protect depositors. Similarly, Basu, et al. (2004) and Seibel (1999) recommend that regulations enable MOIs to move from an informal to a semi-formal and formal status. As an MOI matures, it might choose to offer services that trigger regulation—or might attain a size that merits regulation—but these triggers again refer to size and services.

The nature of membership: It is sometimes assumed that closed-membership MOIs—in which members share a *common bond*, either coming from a discrete geographic area or being employed by a single company or employer—should not be regulated because their members know each other and monitor operations effectively on their own. However, even closed MOIs may be too large for their members to effectively supervise. Furthermore, the definition between closed and open membership may be porous: An open MOI might avoid regulation by redefining itself as closed while setting membership requirements that the general public can easily meet. In this way, using the open-closed distinction can backfire (Poyo, 2000).

Balancing Risk, Supervisory Capacity, and Access

These regulatory triggers might be set with reference to the country or MOI context. Hannig and Braun (2000) caution that governments should not regulate what they are unable to supervise. They argue that regulators should set reasonable entry standards and foster professionalism but should not restrict the development of the sector. CGAP (2003) concurs, noting that it is easy to underestimate what is required to supervise effectively and that unenforced regulation is worse than no regulation at all. CGAP emphasizes that discussions of regulation should look at supervisory capability and costs early on. At the same time, splitting supervision between two agencies does not save money. In fact, as in the case of Mexico, the duplication of functions greatly increases overall costs (Westley, 2007).

In line with this principle, Cuevas (2006) suggests that the regulatory trigger should depend on the percentage of MOI depositors that the government seeks to protect, the number of MOIs that this would represent, and the capacity of the supervisory entity. This approach seems to leave out asset size. Most regulators think system stability is a more important objective of supervision than depositor protection. Where the number of MOIs is manageably small, the government supervisory body might supervise just those MOIs directly. Where the number is too large, more MOIs might be supervised and an alternative supervising entity must be found. Rosenberg (2007) counters that system stability and therefore asset size is typically seen as more important than depositor protection.

Establishing a flexible capital regime is another way to avoid restricting access. For example, the capital requirements for Philippine rural banks vary from US$50,000 to US$500,000 depending on the size and urbanization of the town or district in which the banks are located. Westley (2001) argues a capital limit should not be imposed at all.

Several of these proposals lead us to consider a *tiered* approach to supervision.

What About a Tiered Approach?

A partial solution to MOI regulation and supervision may be tiering, whereby different types of MOIs are subject to different levels of regulation and might also be supervised by different entities. Tiered regulation for MOIs is used in many countries; for example, in Mexico where more regulated tiers are permitted to offer more complex services. Tiers might be based on a variety or a combination of characteristics: Size, source of funds, profile of savers and borrowers, reporting capacities, and ability to pay for external audits (Chao-Béroff, 2007). Tiering might also include incentives that enable MOIs to graduate from one tier to another, allowing them to, for example, offer more services or to access Central Bank refinancing in exchange for being subject to more regulations (Harper, 2007).

Drawing on the experience of Guatemala, Honduras, Peru, and the Philippines, Vogel (2002) proposes a simple and compelling three-tier system. The first tier includes large open-membership MOIs that should receive bank-like prudential supervision. The second includes closed-membership MOIs and medium-sized open MOIs. These must submit standard financial reports based on a standard system of accounts and an annual external audit. Disclosure is enforced but prudential norms are not applied. The final tier, small MOIs, is not subject to any regulation or supervision.

This simple system responds effectively to cost and capacity constraints as well as risks. For medium-sized MOIs, these three elements—standardized financial statements, accounting according to a standard chart of accounts, and an external audit—are a simple, appropriate and powerful means of establishing transparent, professional management and accountability.

Tiering recognizes that different types of MOIs pose different levels of risk and have different record-keeping and reporting capacities. However, tiered regulation and supervision also pose some risks. When MOI regulation becomes part of an overall tiered approached for microfinance, all types of MOIs may be relegated to a single bottom tier. This tier may be either "self-regulated"—in effect, leaving large MOIs unsupervised—or may be subject to regulation that is inappropriate for small MOIs. This can leave the sector weak, as it is in Uganda where SACCOs are relegated to a fourth self-regulated tier. Finally, tiering can create incentives for MOIs to change their legal status in order to take advantage of more lenient regulation and supervision.

Who Should Supervise?

Government entities responsible for supervising all cooperatives—financial and non-financial—normally lack the skills to supervise cooperatives whose business is financial. Supervision should be implemented by a specialized agency that has the skills, authority and resources to do the job well (Westley & Branch, 2000). There are several options for supervision: Direct, delegated, self-regulation, and private external oversight.

Direct Supervision by a government superintendency body such as a dedicated public office or the Central Bank can be ideal and feasible if the number of MOIs to be supervised is small and if the government can afford it. In Mexico, Bolivia and Argentina, for example, MOIs are supervised by this type of entity and tend to be stronger and have greater outreach (Grell, Evans & Klaehn, 2005).

Should the supervising entity be the same one that supervises the rest of the financial sector? This arrangement would have the advantage of supporting a consistent approach to supervision that would not distort the market and would avoid the cost and inefficiency of creating a separate supervisory agency with its own systems and personnel. However, supervision by another government entity might be more reliable. If the bank superintendency supervises both banks and financial cooperatives, when banks experience difficulties, inspectors and analysts may be reassigned from the MOI sector to the banking sector to the detriment of the former. This reshuffling, which happened in Peru in 1998 and 1999, is likely to occur because MOIs represent only a small portion of the financial system (Westley, 2001). In either case, authorities rarely have the resources to supervise the entire sector. Clearly, if a supervisory entity is assigned a large number of institutions to supervise, it should also be given the resources to make this task possible (Rosenberg, 2007).

Indirect Supervision—Delegated or Auxiliary: The bank superintendency can establish regulations for the sector and then delegate to another institution complete or partial responsibility for supervision. This institution might be responsible solely for collecting information and on-site inspection with the government body conducting analysis and off-site inspection, or it might be responsible for all aspects of supervision. Supervisory responsibility might be delegated to a private party or to a federation of MOIs. When, as is recommended, a third party conducts site visits and collects data but the central bank retains sanctioning power, this is called 'auxiliary supervision.' If sanctioning power is also delegated, then the system is referred to as 'delegated supervision.'

Whether a network or federation of MOIs can responsibly perform supervisory functions or not is hotly debated. Basing their work on observations made in developed countries, Cuevas and Fischer (2006) argue that indirect supervision by federations has proven effective in many countries for many years. In several developed countries, a single MOI has come to represent a significant portion of the financial sector, for example Rabobank in the Netherlands. Others counter that developed-country models are practically irrelevant in the developing world (Rosenberg, 2007).

Cuevas and Fischer (2006) note four conditions under which indirect supervision by federations might not be effective: Member MOIs are not tightly integrated into the federations, the federations are governed weakly, the federations are dominated by large and weak MOIs, or the federations promote and advocate for their MOI members as well as supervise them. In fact, these conditions describe many federations in uncompetitive environments.

Westley (2001) argues that at best, supervision by a federation works episodically. Delegated supervision suffers from a conflict-of-interest problem: federations promote and lobby for their members at the same time as they must supervise them and where performance is inadequate, shut them down. In many cases, the board of the federations is made up of representatives of the member MOIs. Supervision by federations failed in Costa Rica in the 1990s and in Brazil, where the Bank Superintendency delegated its supervision of credit unions to federations but reassumed this responsibility because of the poor results (Westley, 2001). Poyo (2000) supports auxiliary supervision by federations suggesting that federations might simply collect and process information and provide technical assistance to assist MOIs to comply with regulations.

Four features of the German model of delegating supervision to federations might contribute to greater success. First, supervision is delegated to regional federations that focus solely on supervision or to completely autonomous units of federations that do not promote or lobby for their members (Westley, 2001; Cuevas & Fischer, 2006). Second, at least two federations are established; a federation is not permitted to supervise an MOI that has a representative on that federation's board. That MOI is supervised by the other federation. Third, members of these boards are professionals (Westley, 2001). Finally, the federation's governance itself is strongly regulated and its supervisory unit must be certified by the government supervisory body (Cuevas & Fischer, 2006). Even with these features, whether or not the culture of discipline in the German federations can be replicated elsewhere is an open question (Westley, 2001).

A better option for indirect supervision may be to rely on a supervisory entity that is independent of the MOIs. The board might consist of at least five members, including a representative of the government supervisory body, the Minister of Finance, not more than one credit union representative, and prominent members of the banking industry and academia. Regardless of whether supervision is delegated to a second-tier institution or to an independent entity, "The bank superintendency should closely oversee the supervision process in order to ensure that it is being carried out competently and without bias. For the same reason, the bank superintendency should also retain the power to sanction the credit unions and the entity to which it has delegated supervision" (Westley in Westley & Branch, 2000); in other words, auxiliary rather than delegated supervision is recommended.

Self-Regulation: In some cases, an MOI or MOI federation defines its own regulations and oversees its own performance rather than being regulated by a public or external entity. Although self-regulation resembles delegated supervision to a second-tier institution, the lack of external accountability makes this model weaker. According to CGAP (2003), self regulation of financial intermediaries in developing countries has been tried many times and has virtually never been effective in protecting the soundness of the regulated organization. Numerous MOIs have run into difficulties because the organization that promoted them is also responsible for their oversight (Vogel, 2002).

At the same time, self-regulation may be the only alternative for small MOIs that do not receive external oversight. Sa-Dhan (2002) suggests that federations might effectively oversee SHGs in India if federation staff had adequate time and training.

Private External Oversight: MOIs seem to fare well when an external institution with a vested interest in the MOI's sound performance plays a supervisory role. For example, in Cameroon, the MC2 SACCOS are supervised and audited by First Bank, which also provides the SACCOs with remittance services. Where government supervision is not feasible, private external oversight may be a promising option. Private deposit insurers might be a promising source of supervision as they seem to have fewer failures than banking supervisors (Von Pischke, 2007). However, when a third party has an interest in the MOI – as is often the case - objectivity may be compromised.

How Should the Costs of Supervision be Covered?

Costs may be the biggest constraint to effective MOI supervision. Limited government resource is cited most often as the reason government does not supervise MOIs. Shifting the responsibility for supervision to another supervisory entity however, may not solve the issue of cost recovery (Westley, 2001).

For this reason, some suggest that MOIs should cover the costs of their own supervision. They argue that supervision is crucial, that governments cannot be expected to cover the costs of supervising many small institutions, and that these costs could be covered through a relatively small increase in interest rates. Christen and Rosenberg (2000) estimate that the cost of MFI supervision could be covered, on average, with a 4% increase in interest rates on loans. Furthermore, these costs might quickly be offset by the benefits of supervision; benefits which can include significant efficiency gains and increased deposits attracted by the increased security and regulated status (Christen, 2006; Isern et al., 2007; Westley, 2001).

While covering the costs of supervision might be feasible for large MOIs and for SHGs that can on-lend subsidized external capital, for other MOIs, the costs might be significantly less manageable. Based on experience with FSAs, Jazayeri (2005a) finds that it is not realistic to expect medium-sized MOIs to cover the costs of their supervision.

Others agree that the costs of supervision should eventually be covered by the supervised institutions but advocate that, for now governments should subsidize the costs of supervision. They note that subsidizing effective supervision would cost about the same as the subsidized credit that governments often channel through cooperatives, and that the former supports these markets much more effectively (Cuevas & Fischer, 2006).

Poyo (2000) suggests that one key to controlling costs might be to rely on external auditors. Rosenberg (2007) contends that auditors are as costly as examiners, regardless of who pays them. Another key proposed to controlling costs is to keep required reports very simple so that they fit the capacity of small and medium-sized MOIs. A central question is, "How simple and cheap can prudential supervision be and still be effective?" (Rosenberg, 2007).

Principles of MOI Regulation and Supervision

The regulation and supervision of MOIs should be guided by two key principles, appropriateness or "fit" and a focus on governance.

"Fit": Low-Cost Appropriate Standards

Regulatory standards should fit the size and complexity of the institution: they should be easy to understand and implementing them should be financially manageable for the MOI and the regulatory authority. Reporting that is manageable, comprehensible and valuable to both parties may be the most powerful solution to the conundrum of MOI supervision, even if it does not ensure the highest standards of security for deposits.

For example, with Vogel's tiering model described above, a large class of MOIs—those that are too small to merit bank-like supervision but too big to rely on peer monitoring—simply are required to use standard accounts and submit standard financial statements that have been certified by an external auditor without being subject to prudential supervision. Because many large MOIs do not use a standard chart of accounts and do not undergo standard external audits, implementing these low-cost measures alone could significantly improve their management.

In the microfinance sector, establishing performance standards has driven improved performance and professionalism. For MOIs as well, simple, appropriate standards may be the key to improved outreach and governance. The challenge is to arrive at a few appropriate indicators that MOIs can understand and track. While not ensuring institutional safety, this could be a low-cost way to improve the security of funds.

For large MOIs, the best-known reporting system is the PEARLS monitoring system used by the WOCCU network and some governments. Generated from standardized financial statements and a portfolio report, this set of forty-four indicators measures key areas of financial operations: protection and quality of assets, financial structure, returns and costs, liquidity management, and growth (www.woccu.org). Boards and managers are to analyze the significance of each individual indicator in the context of the others. WOCCU considers thirteen of these indicators to be the most crucial and has found that using the indicators contributes substantially to improving some credit unions' portfolio quality, provisioning and institutional capital (Evans & Branch, 2002; Richardson, 2002). Understanding the system however, may not be realistic for less sophisticated MOIs some of which may be quite large.

Compared to the indicators used in the PEARLS system, the indicators emerging from the Indian self-help group movement are broader. They are likely to be about ten that assess most of the following areas: A group's constitution, organizational structures, organizational discipline, financial management, financial performance, credit policies, linkages, activities, and capabilities and achievements (Sa-Dhan, 2003). These indicators are unlikely to move less-sophisticated organizations towards greater accountability and financial discipline. Furthermore, the indicators related to governance are mechanical or first-level indicators such as attendance at meetings (Harper, 2007).

To implement simple reporting requirements, Vogel (2002) suggests the following sequence of interventions: instituting standardized accounts followed by establishing performance indicators; choosing a regulating entity, which may require changes in banking and cooperative laws; and, finally, providing this entity with technical assistance. Standardized reporting can be encouraged through incentives. A private agency that both supervises the MOI and provides it with services such as liquidity may have the leverage to enforce compliance (Vogel, 2002). Along these lines, Indian MFIs that voluntarily submit financial reports can receive support based on the grade they receive.

Governance

One of the greatest risks to MOIs is the weak control that members exert over their boards and managers. For example, a study of the Colombian credit union crisis found that the main reason for credit union failure was managers' abuse or mismanagement of members' deposits and capital (Desrochers & Fisher, 1998). Therefore, MOI regulation should focus on governance (Cuevas & Fischer, 2006). With this in mind, Branch and Baker (2000) suggest that MOI regulations include or require the following elements:

- **Member representation:** Members' right to elect new directors and to annual membership meetings
- **The Board (Management Committee):** Minimum qualifications for directors; limits on terms and compensation; and clarity about the board's functions, limits, and responsibilities including fiduciary responsibilities, penalties for not meeting them, and the distinction between board and management's responsibilities
- **Supervisory Committee functions:** Clarity about the functions of the supervisory committee. The committee should serve as internal controller of the credit union overseeing all operations including those of the board and management.
- **Credit analysis:** Credit decisions should be based on risk analysis once an MOI or loan amounts become too large to be approved with reference to personal knowledge of applicants.
- **Conflicts of interest:** Prohibition of conflicts of interest including: no insider lending; no familial connections among directors and employees; and no contractual working relationships between directors and the credit union. Furthermore, directors should not be allowed to be delinquent with loan payments.
- **External audits:** Annual external audits should be conducted with a standard scope of work.
- **Internal controls:** Systems should be put in place to prevent fraud and a professional internal auditor should be hired who is free to carry out his or her work and who reports to a supervision committee that has the competence to understand his or her reports.
- **Prohibition of deposit-taking from non-members:** Poyo (2000) and Westley and Branch (2000) argue that all depositors should be required to be members of the MOI. They reason that members who are depositors are MOIs most important force for prudent management.

Bolivia has implemented precisely this type of regulation. Its regulations define: the functions of the board as distinct from those of management; the numbers, liability, qualification and disqualification criteria for board members; and the functions and authority of the supervision committee, and liability of its members. The regulations also legislate the hiring of a professional internal auditor to be supervised by the supervisory committee, prohibit insider lending, and limit compensation to directors.

How Else Should MOI Regulation and Supervision Differ From That of Banks?

In most other respects, large MOIs require prudential regulations that are similar to those regulating commercial banks. However, MOIs also face certain distinct risks that call for somewhat different regulations and supervision. In addition to regulations related to governance, other recommended MOI regulations that differ from banking regulations include:

Capital adequacy ratios: Large MOIs must be expected to maintain higher capital adequacy ratios than banks. Unlike the boards of profit-driven institutions, the boards of large MOIs may not scrutinize financial performance and stave off bankruptcy by replacing lost capital. Credit unions also require more capital reserves to manage their typically lower access to external sources of liquidity and to manage their greater covariant risk. WOCCU finds this to be crucial (Branch, 2007).

To offset high covariant risk, Poyo (2000) recommends that capital adequacy requirement vary depending on the geographic concentration of an MOI's portfolio. Whether shares should be counted as capital is debated: some argue that they should not because they are withdrawable while others suggest ways to make them less liquid so that they can be counted (Westley, 2001; Westley & Branch, 2000; Poyo, 2000; Vogel, 2002).

- **Liquidity ratios:** Similarly, MOIs should be subject to higher liquidity ratios because they have no or more limited access to liquidity facilities than banks.
- **Loan documentation and provisioning:** Banking regulation usually requires significant loan documentation and high levels of provisioning for uncollaterized loans. This is not appropriate and would be too costly for MOI loans that often are assessed on the basis of character and current cash flow and are supported by other types of guarantees (Westley, 2001).
- **Limits on external credit:** Because external credit can harm MOIs, some but not all of the literature recommends restricting credit union borrowing to a small percentage of total assets (Richardson, 2002; Evans & Branch, 2002; Westley, 2001).
- **Minimum capital requirements:** Typical minimum capital requirements cut remote-rural areas off from access to financial services. These requirements must be lower than they are for commercial banks (Westley & Branch, 2000).
- **Operational restrictions:** Regulations that require branches to be open a certain number of days and hours may prevent outreach to less densely-populated areas where long hours of operation are neither warranted nor cost-effective.
- **Portfolio Diversification**: To offset MOIs' high covariant risk, regulations should address the concentration of loans by sector and geographic area (Trigo, 2000).
- **Fixed assets:** Fixed assets should be limited as a proportion of total assets to prevent managers and directors from spending large amounts on unproductive but showy assets. These limits might be relaxed for small or start-up MOIs (Westley & Branch, 2000).
- **Nonfinancial businesses:** Poyo (2000) and Westley and Branch (2000) recommend prohibiting cooperatives that engage in financial intermediation from engaging in unrelated non-financial business because such activity puts members' savings at risk. Expecting a board that can barely oversee financial services to also oversee non-financial services is not sound. However, Wehnert (2004) and others suggest that such businesses – for example, marketing – may make sense.

Beyond enforcing regulations, supervisors of credit unions should pay particular attention to the following issues that can affect credit union governance (Westley, 2001):

- **Portfolio management:** in particular, credit quality, provisioning for loan losses, appropriateness of loan analysis, and rigor of loan recovery.
- **Interest rates:** whether or not market rates are paid on savings and charged on loans.
- **Fixed assets expenditures:** whether spending on fixed assets is too high or low.
- **Salaries:** whether salaries are too low. Supervisors should educate directors, managers, and members on how low salaries can weaken performance, portfolio quality, productivity and profits (Westley & Shaffer, 1999).

Enabling Strong Governance and Outreach

Some central bank and government policies support strong MOI governance and outreach while others do just the opposite. Governments can enable strong MOI governance and outreach by:

- Propagating simple performance indicators for unsupervised institutions (Barry, 2002; Vogel, 2002; Llanto, 2000)
- Deregulating interest rates so that MOIs can set their rates to cover their costs, including the costs of serving marginal areas or of providing doorstep services.
- Improving the legal framework for secured transactions, titling land, and permitting titles to be used as the basis for collateral (Westley, 2001).
- Permitting MOIs to serve groups (Vyas, 2004).
- Permitting and supporting alliances between MOIs to allow them to exploit economies of scale (Fischer, 2002).

Furthermore, governments should avoid policies that:

- Shield MOIs from competition such as preferential tax treatment. Competition strengthens MOIs and discourages board and manager opportunism (Cuevas & Fischer, 2006).
- Provide MOIs with excessive external credit or any subsidized credit.
- Force credit union mergers, which can create more problems than they solve (Westley & Branch, 2000).
- Interfere in MOI operations - interference may stunt the growth and health of the sector.

Two other policies deserve particular note. A properly-structured stabilization fund and deposit insurance can strengthen the governance and outreach of MOIs that are governed by representatives of the membership. But, both must be instituted with great care (Westley, 2001). Deposit insurance reimburses depositors for losses in the event that their MOI fails while a stabilization fund provides technical and financial assistance to MOIs that are in trouble. Stabilization funds are funded solely by MOIs with contributions matched to size. Therefore, they motivate the largest members to monitor others' performance and create an incentive for objective self-regulation (Westley, 2001). In Burkina Faso, the RCBP network of credit unions established a security fund under a management contract that requires rural credit unions to be self-financing within three years - those failing to do so are subjected to oversight (Chao-Béroff, 1999b).

Care is required in implementation because stabilization funds and deposit insurance can also create adverse incentives: they may motivate managers and the board to take risks for which they will not have to pay. To avoid this, management and governance of the stabilization fund and deposit insurance must be separate from the MOIs' second-tier institution. Above all, their services should be made available only after stringent supervisory control has been functioning for some time to assure that the supervisory entity will "detect and control excessive risk-taking by credit unions before it grants them access to the safety net" (Westley & Branch, 2000). Finally, deposit insurance should cover only a portion of deposits and should not include the deposits of managers and board members. It is imperative that these guidelines be followed to assure that the MOI sector is strengthened and not weakened. The same extreme caution should be applied to access to lender-of-last-resort liquidity facilities and to access to other government bail-outs.

Summary

Developing effective regulation and supervision may be the single most important means of strengthening MOI outreach. It can provide the drive MOIs need to shift from a social to a business model and to focus on institutional strengthening and pricing. Consensus on principles for MOI regulation and supervision is urgently needed.

The biggest impediment to effective supervision may be cost. One key to cost recovery and effective supervision is "fit": regulatory requirements should suit the size and complexity of the MOI. Supervision must be realistic in terms of the available budget and human resources—sometimes only simple disclosure will be used. Reports should be simple and appropriate so that MOIs and supervisory entities can easily manage and understand them. Tiered regulations make this simplified approach possible. For example, while large MOIs might be subject to bank-like supervision, medium-sized ones might simply be required to submit standard financial reports based on a standard system of accounts and an annual external audit. Small MOIs, with an upper limit of 200 or fewer members, can effectively monitor themselves or might not be supervised at all.

Direct supervision by a Central Bank or government superintendency body can be ideal. Where this is not feasible, supervision might be delegated by the government to a third party that is independent of the supervised MOIs. Unless MOIs are tightly federated with strong governance at the federation level, delegation to a federation can be vulnerable to conflicts of interest. Self-regulation has a miserable track record. However, supervision by a third party that has an interest in the MOI's strong performance is more promising.

MOI regulations should focus on governance, which is the greatest risk that MOIs face. In many respects, large MOIs require prudential regulations that are similar to those governing commercial banks. MOIs face certain distinct risks however, that call for somewhat different regulations and supervision. In particular, the risk posed by inattentive or inexperienced governance as well as high covariant risk suggests that MOIs may require greater protection in terms of capital adequacy, liquidity, external borrowing, and portfolio diversification.

Part III: Conclusions Supporting MOI Outreach and Governance

Donor Strategies

MOI outreach and governance can be strengthened by supporting:

- The promotion of small MOIs, and the appropriate infrastructure to provide them with ongoing support in remote-rural markets. In other markets, donors should assess whether or not this strategy complements or substitutes for more flexible institution-based services or if it provides other benefits (Seibel, 1999).
- Training to strengthen NGOs as promoters of good practice (Seibel, 1999).
- The costs of supervisory entities, particularly for medium-sized MOIs (CGAP, 2003).
- Market research, product development and pilot testing for small, medium-sized and remote-rural MOIs (Ranson & Bennet in Dror & Preker, 2003).
- The development of appropriate regulatory frameworks and effective supervision within a government or Central Bank supervisory entity (Klaehn, 2002).
- Training, technical assistance and exchange visits to build the capacity of large MOIs. These programs should be tied to targets related to good governance.
- Training, technical assistance, and exchange visits to strengthen federations that support small MOIs.
- Research to identify best practices in developing sustainable federations that are soundly-governed and that support sound governance at the MOI level (Klaehn, 2002).
- Research to identify best practices for developing the management capacity and strong governance of different types of MOIs.

Donors should be cognizant of the following guidelines:

- Donors can be a powerful force for strong governance if technical support is tied to specific expectations about improved governance.
- External intervention can adversely affect transparency, community ownership and local innovation.
- It is essential that mechanisms for attaining full cost recovery and which lead to institutional sustainability of support structures should be instituted from the beginning.
- Finding mechanisms to shield MOIs from interference by local officials is also of great importance.
- Providing financial services alone can only go so far in promoting rural development and reducing poverty. Addressing other constraints such as the lack of access to knowledge, infrastructure and markets may be equally or more important (Zeller, 2003).

Research Questions:

Many interesting questions about member-owned institutions remain unanswered. Answering the following questions will be particularly important for improving MOI governance and outreach.

Outreach

- Are there types of non-financial services that better enable MOIs to serve rural-remote areas? If so, what services and why?
- What strategies enable MOIs established in rural-remote areas to serve poorer households within those areas? What impedes them from doing so and how might these obstacles be overcome?
- What factors and strategies enable different types of MOIs to achieve broad outreach while maintaining sound governance? How do these factors vary across contexts?
- What have been the most innovative responses to covariant risks, limited property, and limited property rights? To what extent can small, decentralized MOIs provide these innovative products and product features?
- What incentives and tools enable and motivate different types of MOIs to develop market-driven products?

Internal Governance

- For each type of MOI, what practices, incentives and structures effectively increase member participation and strengthen member oversight? What motivates and enables members to hold MOI leaders accountable? To what extent do capacity-building, member education, capital stakes, rules, group organizing and social capital contribute to effective governance?
- What are the tradeoffs between simplifying management systems versus training members to manage more complex systems? For example, what are the tradeoffs between using oral systems versus training members in numeracy?

Linkages

- Can linkages extend product innovations from rural to more remote areas?
- What are the relative strengths and weaknesses of different models for second-tiers. In particular, what are the strengths and weaknesses of decentralized clusters versus centralized cooperative federations?
- How can necessary support functions be provided to MOIs without weakening their governance? Or, how can MOIs and their federations be promoted and supported to handle these functions themselves?
- Under what conditions does external finance and mobilization of non-member deposits make sense for MOIs? What are the effects, benefits and challenges of external sources of funds as compared to members' own contributions? How might external capital and non-member deposits be used to broaden outreach without weakening governance?

Regulation and Supervision

- In what contexts and for which types of MOIs are the various models of supervision more effective and cost-effective? In particular, what models of regulation and supervision might best strengthen MOIs that are too small to justify costly bank-like supervision but too big for peer monitoring to be effective? How do different regulatory models affect rural financial systems? Cross-country analyses that relate MOI performance with industry structure and systems of regulation and supervision would help to define guidelines that are consistent with the scale, diversity, and state of development of the MOI sector.
- For medium-sized MOIs in particular, how might the costs of supervision be minimized and covered?
- How should MOI regulation and supervision fit within the authority that regulates and supervises banks?
- What types of regulations, government policies, and supervision are necessary to support financial services in rural remote areas?
- How might supervisory capacity and MOI capacity to comply be improved?
- What are appropriate indicators and requirements for supervising different types of MOIs?

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Appendix A:
Different Kinds of MOIs

Informal MOIs: ROSCAs and ASCAs

Found across the globe, informal MOIs are the most prevalent savings and loans "institutions" in the world. They have anywhere from five to a few hundred members. Many members of informal MOIs also make use of institutional financial services; they value the informal services in their own right. Informal MOIs come in two basic types: Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings and Credit Associations (ASCAs).

In a **ROSCA**, all members contribute a multiple of the same fixed amount at fixed intervals, the sum of which is distributed to each member in turn (Geertz, 1962). Each member receives the sum once unless he or she contributes more than one multiple. Usually, contributions are made at weekly or monthly meetings. The recipient of the sum can be decided by consensus according to member need, by the group's prior agreement, by the organizer, by drawing lots, or through a bidding process. When each member has received a sum, the group may disband or start a new cycle with the same or new members. Typically, members neither pay nor receive interest. In some cases, ROSCAs accumulate the first few rounds to establish a fund from which loans are then made to members.

Because ROSCAs require regular equal contributions and pay out once per member, members typically must have a regular income flow, although groups may disband in anticipation of cash-strapped seasons. ROSCAs tend to be homogenous and small. The length of a cycle seldom exceeds one year and the costs are negligible. Ardener and Burman (1995) found ROSCAs to be widespread in Africa, Asia, Latin America and the Caribbean. In fact, in parts of West Africa, Bouman (1994) and Gugerty (2003) found between 50% and 95% participation.

ASCAs differ from ROSCAs in several ways. Above all, ASCAs are formed to accumulate and to lend member contributions rather than to distribute contributions on the spot. The group decides when to distribute funds, if ever. Furthermore, members may contribute different and irregular amounts, and loans are allocated by following a decision-making process rather than automatically. A member may take more than one loan or may simply save and borrowers pay interest that is allocated to members according to the size of their contributions. In some ASCAs, savings may be withdrawn. For these reasons, ASCAs may be larger and more heterogeneous than ROSCAs and their loans may be larger and longer-term. The timing and amount of loans can vary according to the member's cash flow. Because ASCA operations are complex—savings, loans, and interest earned vary by member and funds accumulate—rules may be documented and they may require a facility for safekeeping of funds. While costs and the risk of fraud or mismanagement are higher, ASCAs can pay handsome interest rates on savings.

Village Savings and Loan Associations (VSLAs)

Also known as MMD-type groups (mata masu dubara), VSLAs are groups of fifteen to thirty members who save weekly, bi-weekly, or monthly with all members saving multiples of the same amount. Savings are pooled and often stored in a locked box with keys that are held by different members. The groups meet regularly to collect and to lend savings to members. Loan terms are typically one to three months, and interest rates are set by the groups (typically 10% a month). The groups accumulate savings and interest on loans. Periodically, savings are returned to members along with their share of the interest, which usually is distributed in proportion to the amount saved. This distribution or cashing out is sometimes called the *action audit*. At this time, all loans must be repaid, members' disputes are resolved, members can leave the group, and new members can join. After the action audit is complete, the group can then start afresh. The action audit zeroes out all accounts and allows the group to move on with renewed confidence. VSLAs have been promoted in fourteen countries in Africa, in Haiti and in India. Although VSLAs are increasingly being encouraged not to disband, in this study, we refer to the original model that includes a periodic action audit (Rippey, n.d.).

Self-Help Groups (SHGs)

Like ASCAs, SHGs have ten to thirty members from similar socio-economic backgrounds who regularly contribute fixed amounts that the SHG then lends to individuals. Members save regularly, earn interest from loans, and may receive a loan. Rather than cashing out, the groups accumulate their funds. Unlike indigenous ASCAs, SHGs:

- are promoted and trained by an individual or an institution,
- often save in an institution in order to receive loans for on-lending to members,
- have a membership that is mostly comprised of women,
- change their leaders annually rather than relying on their original organizers,
- typically charge rates of interest that are lower than in the informal market,
- have social aims beyond providing financial services, such as reducing poverty, building awareness or literacy, or catalyzing political participation or family planning.

In India, NGOs, banks, government entities, and individuals have promoted over 1.6 million SHGs with over 30 million members. SHGs are also found in other parts of Asia and in Mexico. Promoters of linkages between SHGs and financial institutions see these linkages as a way of providing SHGs with a deposit facility and SHG members with access to larger and longer-term loans. By bundling the transactions of smaller clients, SHGs enable financial institutions to serve clients who wish to make smaller transactions.

Financial Service Associations (FSAs)

FSAs are MOIs whose members must buy shares. Designed to serve remote-rural areas, FSAs resemble financial cooperatives except voting rights are proportional to the number of shares owned, with a maximum of ten votes given to any member to avoid concentrating power in the hands of a few members. This method of voting enables the elected body to defend the interests of those whose capital is at stake. The high interest rates charged on loans indicate that FSA boards seem to be dominated by large shareholders rather than borrowers. The price of shares fluctuates with the FSA's financial performance. In 2000, 160 FSAs served over 50,000 members in South, West and East Africa. FSAs tend to be independent but some supplement share capital with short-term external funding in order to augment their loan portfolio.

Caisses Villageoises d'Epargne et de Credit Autogérées (CVECAs)

CVECAs are village-based MOIs found in West Africa with, on average, 400 members. Unlike cooperatives, CVECAs do not require compulsory savings and loan size is not linked to savings. Members pay a fee to join rather than buying shares. Rather than providing dividends to members, annual surplus is invested in the CVECA or the village. A CVECA's management committee is composed of representatives of each neighbourhood in a village. As in small cooperatives, the management committee handles many management functions, with other functions being handled by a few part-time staff. In contrast with a typical cooperative, however, the CVECA management committee reports to a General Assembly of all villagers rather than to only those who have chosen to be members.

Financial Cooperatives (SACCOs, Credit Unions, Savings and Credit Organizations)

Also known as credit unions, savings and credit cooperatives, or savings and credit organizations (when they are small), financial cooperatives are MOIs in which each member purchases one or more shares and has one vote. Financial cooperatives are governed by a management committee that is elected by the members or members' elected representatives. Typically, their work is supported by an elected credit committee and an elected supervisory committee whose role is to assure that operations are sound. In small cooperatives, these member committees play a major role in managing operations. However, all but the smallest cooperatives hire at least one part-time manager. Financial cooperatives typically return some earnings to members in the form of dividends, interest on savings, or a low interest rate on loans, and retain the rest.

According to the World Council of Credit Unions (2005), 30,168 credit unions serve over 34 million members in Asia, Africa, Latin America, the Caribbean, Eastern Europe and the Newly Independent States. A global study of financial services to markets not served by commercial institutions suggests that cooperatives hold over 20% of these savings and credit accounts globally and over 30% in Latin America. Financial cooperatives run the gamut from small remote cooperatives that have fifty to a few hundred members and a single part-time manager to national cooperatives with hundreds of thousands of members.

Rural banks are a key financial service provider in some areas: a small percentage of rural banks are cooperatives, including all of the LPDs in Indonesia but none of the rural banks in Ghana. Of 800 rural banks in the Philippines, 51 are member-owned (Meagher, 2002).

Cooperative banks are second-tier institutions that support cooperatives while, in many cases, also serving individuals. They can also be banks that have a cooperative structure because they have grown out of a cooperative. In comparison with an individual MOI, cooperative banks may be able to achieve greater economies of scale, have the resources, capacity and regulatory approval to offer more services, are less vulnerable to covariant risk, provide more points of access for customers, and may lower the costs of supervision or, alternatively, qualify for supervision where smaller MOIs do not. On the other hand, cooperative banks may be less efficient than individual cooperatives if the former are not managed efficiently. Individual cooperatives may be more responsive to local demand, may cost less if they are small enough to benefit from peer monitoring, and may be better able to focus on poorer and more rural markets (Heller in Westley & Branch, 2000).

Multi-purpose cooperatives function like financial cooperatives offering financial services as well as marketing and other non-financial services.

Appendix B:
Comprehensive Bibliography of Additional Sources Consulted

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