

Bridging the gap between rural microenterprise and the formal banking system



In many countries, some formally established banks have outreach programs aimed at the poor. Government-owned development banks may even have an impressive network of branch offices in rural areas. In Guatemala, such is the case with BANRURAL. However, poor *campesinos* (peasants) will not easily decide to appeal to the bank, for a series of cultural, social and even economic reasons.

Problems

Cultural barrier

In some areas, people speak a native language. However, even those who went to school may have difficulty understanding financial terminology in Spanish. Many rural women never attended school and cannot communicate with people from outside the region. In addition, banks are strongly associated with the ruling class, very far from the indigenous culture.

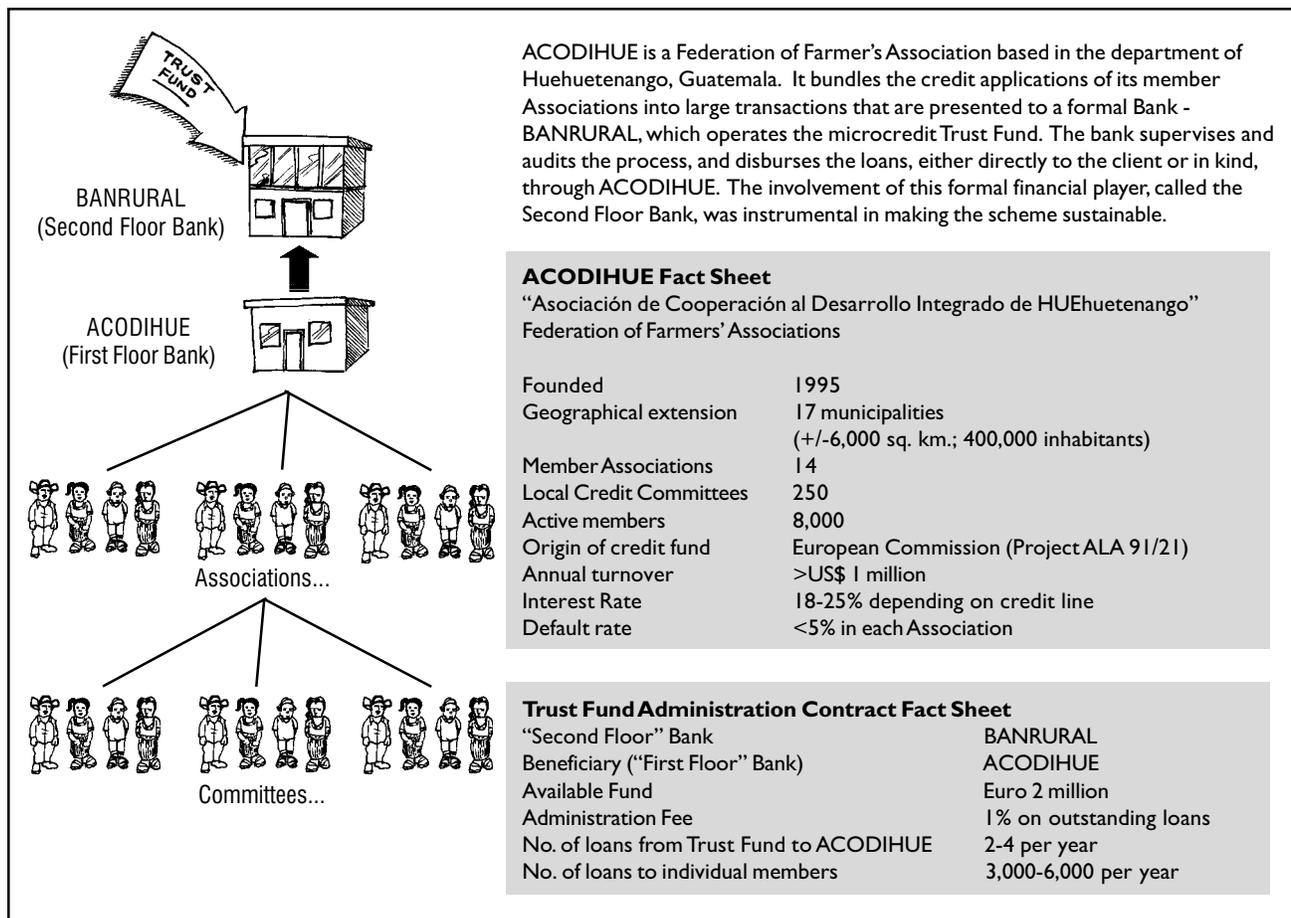
Amount of paperwork required in banks' established procedures

A BANRURAL loan application file typically consists of 26 forms, none of which can be easily understood, let alone filled out by an average *campesino*. Moreover, the file is to be completed with photocopies of ID-card and land tenure documents, among others. However, many people lost their ID documents during the civil war, others never registered, and nearly everyone lacked any kind of land title. But even for someone who has all the necessary documents, the total cost of going to the city from a remote rural area for a loan application would nearly equal the amount to be borrowed.

Small loans

Banks cannot afford to actively go for the people, unless relatively important transactions can be expected. This is never the case with microcredits for very poor people, especially at the initial stage. In our example, the average first loan was about US\$ 100, while the minimum loan accepted by a formal bank would be 10 times that figure. For smaller transactions, relatively higher overhead costs can offset all possible profit.

The ability to handle larger loans is gained only after having gathered a minimum starting capital. Therefore, poor people, often on the limit of subsistence, cannot profitably use large amounts of money. Consequently, BANRURAL did not reach more than a very tiny part of its declared target population.



Solutions

Faced with such problems, banks are invariably interested in collaborating with intermediaries to bridge the gap between themselves and the target population. Such intermediaries (NGO's, cooperatives, Farmer's Associations or other local organizations) serve as "First Floor Banks". Nevertheless, these organizations do not necessarily qualify as real banks under the national legislation, nor do they have to handle money directly. They group individual loan applications into bigger units and submit these to a formal ("Second Floor") Bank, in their own name. To do this, it is sufficient to be legally registered. There is no need to qualify under banking laws, which would carry requirements regarding assets and accountancy well beyond the capacity of most local organizations.

	Definition	Roles
First Floor Bank	Local organization active in microfinance	<ul style="list-style-type: none"> ● Direct link to the clients ● Select borrowers ● Analyze and approve loans
Second Floor Bank	Formal bank that accepts the 1 st Floor Bank as a client	<ul style="list-style-type: none"> ● Administer Trust Fund ● Audit 1st Floor operations

On the other hand, intermediaries can accept guarantee mechanisms that are inaccessible to formal banks. As local organizations, they know the prospective clients personally, and therefore, do not have to depend solely on official documentation.



	Benefits
Individual Client	<ul style="list-style-type: none"> ● is attended by a local organization ● safety of savings deposits ● opportunity to build a credit history
First Floor Bank	<ul style="list-style-type: none"> ● gains access to the formal financial system ● obtains guaranteed interest rates on savings deposits
Second Floor Bank	<ul style="list-style-type: none"> ● gains access to new, otherwise unreachable clients

The administrative costs incurred by ACODIHUE and its member Associations are covered from the interest paid by the client (18-25%):

- A. Maintenance of the Credit Fund's buying power
 - 1. Inflation 8-12 %
 - 2. Financial costs (Second Floor Bank's operations) 1-3 %

- B. Operational costs of intermediaries
 - 1. Member Associations 2 %
 - 2. Federation (ACODIHUE) 5-8 %

Recommendations

Avoid cash handling

If a formal bank has branch offices in the area, the actual cash handling can be done at the bank's counters. The intervention of the intermediary can be limited to handling documents and follow-up of transactions and individual accounts. In Huehuetenango, many farmers who would never go to the bank otherwise did so without problems after having received clear instructions from the intermediary - their local Farmer's Association and ACODIHUE.

Alternatively, the intermediary would have to set up an independent cash handling system, complete with security. This can be extremely expensive, especially in remote areas. In Huehuetenango, such a venture (i.e. guarded office and secure transports) was estimated to be feasible only when the expected annual turnover exceeded Q 7 million (about US\$1.2 million). This is well above what a starting rural organization could possibly make.

Initially, attempts were made with cash handling directly by the intermediaries (local Farmer's Associations). This proved to be a continuous source of problems and the practice was abandoned after an amount of money "disappeared" from a local office. From then on, any cash handling by officials or employees of the intermediaries was avoided. This turned out to be very beneficial for the public's confidence in the system. This strategy is to be recommended especially where young and inexperienced organizations are involved for even though it may not be true, mere suspicions of embezzlement against its elected officers and employees can destroy a young organization.

The "Credit School" concept

After a few transactions, through intermediaries, the "ice" between the *campesino* and the formal bank is broken. The client has built up a credit history and perhaps even a savings account. In the process, he may have capitalized a bit, enabling him to handle a more important financial volume. At a certain point, he can be accepted as a direct client of the bank.

The fact that neither ACODIHUE nor its member Associations handled cash themselves was helpful in reducing the gap between the clients and the bank. The microcredit scheme thus, served as a "Credit School", teaching how to find the way through the established financial system. All microcredit schemes should bear this objective in mind, since only the formal system will ultimately be able to attend the ever-growing financial needs of development. Moreover, releasing clients to the formal financial system frees up funds to attend other - poorer - clients.

Obtain the best possible guarantees for clients' deposits

In Guatemala, people are more often interested in saving than in borrowing. Consequently, savings and loan cooperatives are often unable to lend all deposits they receive to their own affiliates. A Second Floor Bank can, in such cases, provide both interest and safety guarantees for these excess deposits.

Credit schemes may also have compulsory savings deposits, both as part of their guarantee mechanism and for educational reasons, even if they draw credits from an external source such as a Trust Fund. The idea is to teach the link between savings and credit and to promote the capitalization of the clients.



However, collecting savings is subject to severe legislation. It can only be undertaken with specific government permission and is subject to strict control under the national banking laws. It would be illegal to collect savings from members without being a formally recognized bank. Therefore, people are required to deposit directly on specified savings accounts in the Second Floor Bank. These accounts have restricted access: savings cannot be withdrawn without a special authorization. On the other hand, when calculating interests, the combined savings of all the members are treated as if they are on one single account. Grouped deposits on such corporate savings accounts will always fetch a better interest rate than small individual savings, which greatly benefits the end users.

In Huehuetenango, an interest rate on savings deposits equal to the average rate on long-term deposits in the national banking system was negotiated in the Trust Fund Administration Contract. This is not the best possible rate, but even in the worst financial turmoil, it certainly does not fall below the inflation rate. If it does so, big institutional investors would flee from the national capital market. Therefore, at least the buying power of people's deposits is fully guaranteed. This is mostly not the case for ordinary savings accounts, which typically obtained interest rates *below* inflation.

Have the system audited at reasonable cost

Wherever loans are funded from an external source, the donor will want to know what his money is used for and how it is used. But he does not necessarily have the skill nor the time nor the personnel to go and look for himself. In such cases, the credit fund can be entrusted to a formal bank, subject to a Trust Fund Administration Contract. In that contract, the Second Floor Bank can be asked to audit the use of the funds by the intermediaries. This audit is independent of the "First Floor" players, and therefore the donor does not have to rely solely on the information provided by them.



Audit by the Second Floor Bank should not be expensive since their internal audit department can perform it as part of its normal activities. The annual cost of the Second Floor administration, including auditing, should probably not exceed 1% of the credit portfolio, depending on the portfolio's magnitude and on the Bank's experience with Trust Funds. Alternatively, an external auditing firm is to be contracted. Needless to say that this would imply a very high recurrent cost.

Finally, the Second Floor Bank is subject to supervision by the National Banking Agency ("*Superintendencia de Bancos*"). In Latin American countries, this is a very respected institution that controls the application of sound financial practices in the formal banking sector. This should be a sufficient guarantee for any foreign donor.

Prepared by:
Paul Cloesen

RESOURCE BOOK PRODUCED THROUGH A PARTICIPATORY WRITESHOP ORGANIZED BY THE **INTERNATIONAL INSTITUTE OF RURAL RECONSTRUCTION (IIRR)** WITH SUPPORT FROM THE **CITIGROUP FOUNDATION, SMALL ENTERPRISE EDUCATION AND PROMOTION (SEEP) NETWORK** AND **SWISSCONTACT**.