Centenary Rural Development Bank, Uganda
A Flagship of Rural Bank Reform in Africa[1]

by

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Abstract

Centenary Rural Development Bank is a commercial bank in Uganda that provides deposit, credit and money transfer services indiscriminately to men and women of lower income. By insisting on loan recovery and cost coverage, it has reached more customers in rural areas than any other institution in Uganda. With minimum deposits of $5 and minimum loans of $58, access barriers are low. 73% of its deposits and 82% of its loans are in rural areas. Established by the Catholic Church of Uganda as a trust fund in 1983, it developed a strength in savings mobilization but performed poorly as a financial intermediary. In 1990, the political will to reform the fund evolved in the board, resulting in the fund's transformation into a commercial bank in 1993. With donor support, the Bank introduced a highly effective individual lending technology based on the analysis of total household activities; an incentives-driven repeat loan system; flexible but comprehensive loan security requirements; and stringent enforcement of timely repayment. This is backed by a system of computerized daily loan tracking, instant recovery action, and staff performance incentives with an emphasis on portfolio quality rather than productivity. This has made the bank the African flagship of rural and agricultural banking, combining sustainability with outreach to the rural poor and demonstrating the feasibility of agricultural lending. By Dec. 2002, total assets amounted to $61.3m, total deposits to $48.7m (316,650 depositors), and loans outstanding to $23.05m (31,500 borrowers). The Bank earned 4% on average assets and 27% on average equity. During 2002, the bank has started to overcome its quality-vs.-productivity dilemma: (i) shifting incentives from repayment towards disbursement; and (ii) adding mesofinance for small and medium entrepreneurs, while microentrepreneurs, without mission drift, continue to constitute 99% of its borrowers. This move has substantially contributed to both, the bank's sustainability and its outreach to the poor.

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0. The recent rise of rural microfinance in Uganda

Rapid start of microfinance in Uganda: Starting virtually from scratch only ten years ago, Uganda now has a small but rapidly expanding microfinance sector, with strong support from the central bank and numerous donors. Two formal institutions are involved, one a commercial bank with a rural mandate, Centenary Rural Development Bank, and one a finance company, Commercial Microfinance Ltd. (CMF). There is a large number of semi-formal NGOs/MFIs - among them 5 international NGOs, 17 large local NGOs and 50 financial cooperatives. In addition, there is an unknown number of indigenous informal microfinance institutions.

The policy framework in Uganda is conducive to the development and mainstreaming of MFIs – as one of several measures of liberalization and prudential regulation to improve domestic resource mobilization and financial deepening. A Microfinance Act is now (2001/02) before parliament, with stipulations for the transformation of MFIs into regulated deposit-taking institutions. There is effective coordination between BoU, government agencies, donors and MFIs.

The market for rural microfinance comprises 8 million adults in 4 million households engaged in agriculture, and some 800,000 microenterprises – in a total population of 23 million, of which 85% is rural (2001). As elsewhere in Africa, men and women in Uganda have separate income-generating activities (IGA) and therefore separate needs for deposit and credit services. Households tend to combine several agricultural and non-agricultural IGA, and, accordingly, have to finance a diversified enterprise portfolio. Total market size is thus 8.8 million people, among them 4.5 million women – approximately 55% of them poor -, with a multiple of IGA. They all require deposit services; fewer require credit.

Voluntary-saver outreach by authorized institutions in mid-2001 was around 300,000, dominated by Centenary with a market share of 84%. CMF and some 50 savings and credit cooperatives add another 9% and 3 %, respectively. UMU is the only NGO offering voluntary savings products. Major NGOs, CMF and government programs have another 160,000 customers with compulsory savings as liquid collateral. Together with smaller NGOs, this brings total saver outreach to around 500,000.

Total borrower outreach in mid-2001 was near 300,000. Centenary and CMF have a share of only 7% and 4%, respectively. The 22 biggest NGOs have a share of almost 50%, averaging 2% per NGO/MFI. Most have satisfactory repayment rates. There are three government programs with a market share of 31%, but at low rates of repayment.

1. The customer perspective

You can tell a bank, or MFI, by looking at its customers: Does the bank make its customers unbankable, eg, by providing oversized medium-term loans as many agricultural development banks do? Does it keep them in poverty through standardized group loans without opportunities for accumulating savings or graduating to larger individual loans as many MFIs do? Or does it contribute to poverty alleviation and development by offering small and large loans according to their customers' capacity? Here are two of the bigger customers of Centenary:

> ***The woman-entrepreneur who financed diverse micro-enterprise start-ups through profits from farming and their expansion through credit:*** *Nandina Zauma is 35, married and has four children, 13-20 years old. In 1983, she started with a small rice farm. To protect her savings from inflation, she put up a building for a mill in 1992, continued saving and installed a mill in 1996 – all self-financed from the proceeds of her farm. Since 1999, she received four loans from Centenary, each amounting to Ush 2 million ($1,150). She first purchased a second mill, then expanded her produce trading operations, and finally bought two minibuses. During this 2½-year period, the total value of her business operations grew from Ush 6 million to 14 million ($8,000). She has two full-time employees and several contract laborers.*
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> ***Hard work, savings and credit: Connie Watuwa's business empire:*** *Connie Watuwa is around 50, married and has six children. Born in a village, she moved to Mbale where business opportunities are less restricted. In 1971, she opened a small restaurant with her husband. From the income, she saved money in a bank and opened a hardware store of her own in 1975. In 1986 she got a first loan from the now defunct Cooperative Bank for a lock-up store and, in 1991, a loan from the Uganda Women's Finance Trust, a credit NGO, for produce trading: buying rice at Ush 400/bag and selling it after 3 months at Ush 1000/bag. When Centenary opened a branch in Mbale in 1998, she became one of its first depositors. "Centenary is a greener pasture, it gives you no headaches", she said. Within two years, she received three loans: Ush 2 million, Ush 4 million and Ush 10 million. As all her payments were on time, she recently graduated to a so-called automatic loan of Ush 15 million ($8,670) at a substantially reduced interest rate. She invested the loans in a second lock-up store, a mattress store, and an extension to the restaurant. The total net worth of her business empire is now Ush 230 million ($133,000). Her secret of success is hard work and credit: "I worked when I was pregnant up to my 9th month. I can work. All I need to expand is bigger loans."*

2. Centenary: a commercial bank for the poor

Centenary Rural Development Bank Ltd. variously referred to as Centenary, CERUDEB or CRDB, has several stories to tell:

(1) one about the feasibility and impact of **rural and agricultural bank reform** - addressed to the community of agricultural development banks in Africa and those who decide on their fate;
(2) another one about the **compatibility of institutional sustainability and outreach** in rural areas - addressed to the community of MFIs and their donors;
(3) a third one about the **feasibility of agricultural lending** - addressed to financial institutions afraid of risky agricultural lending.

Centenary is a commercial bank that offers economically disadvantaged people – the enterprising poor, not the poorest of the poor! - in Uganda a full range of financial services, comprising savings, credit and money transfer. Upon the initiative of the Uganda National Council of Lay Apostolate, it was registered in 1983 as the Centenary Rural Development Trust and started its financial operations in 1985.It converted to a full-service commercial bank in 1993. The Catholic Church holds a 61% majority through various church dioceses and the Uganda Catholic Secretariat. Other shareholders include the Development Finance Company of Uganda (19%), the Hivos-Triodos Funds from The Netherlands (10%), and SIDI from France (10%). Since its inception, Centenary has held on to its mission, “to provide appropriate financial services, especially microfinance, to all people in Uganda, particularly in rural areas”.

3. **From trust fund to commercial bank: The reform of Centenary**

Centenary is a reformed bank. Unlike Cooperative Bank, a government-owned agricultural development bank which was closed in May 1999, Centenary mobilizes its own resources, provides a full range of financial services to all segments of the population including rural women and the poor, has its loans repaid, makes a profit, and finances its rapid expansion from savings mobilized and its profits. This makes it a model case of microfinance and rural bank reform in Africa. The comparison with the Cooperative Bank is a telling one. Not only have they shared the same market. Upon its collapse, Centenary took over 10 of its branches. Where Cooperative Bank failed, Centenary now gains both, money and customers.

The political will to reform the Trust into a commercial bank, which is the most difficult part of rural and agricultural bank reform, was initiated in 1990 by one of the founding members of the Trust. He succeeded in convincing a board of nonprofessionals with a religious commitment to seek financial and technical assistance from the German Savings Banks Foundation, which brought in a German consulting firm, IPC, specialized on microbusiness banks. Starting in 1993, the Bank was reformed within a five-year period,of which only oral records were left when IPC pulled out in 1998.[2]

The first step of reform was the Trust’s **transformation into a commercial bank** in 1993, an institution under the banking law and under central bank supervision. Ownership was diversified, bringing in foreign and other domestic shareholders, while leaving 61% with the Uganda Catholic Secretariat and the dioceses; but there are as yet no private sector shareholders with predominantly commercial interests. While this has come under criticism on governance grounds, there is no evidence that the Bank, within the framework of its mission, could have performed much better under stronger private influence. The main emphasis of the reformers was on management restructuring and the lending technology. Changes in governance took place at all levels: a new chief executive came in; board members were retired; branch managers and loan officers were replaced; additional loan officers were hired; and all staff were systematically retrained. Whether a shift in majority ownership from Church to private investors would have entailed a *mission drift* is a matter of speculation.

The Trust had been quite successful with savings mobilization, facing little competition for deposits from commercial banks; and the new management continued to emphasize deposit mobilization, both as a source of loanable funds and as a service to customers. But the Trust had no system of lending: loan products were inadequate; the lending volume was low; and arrears were high. The management, together with IPC, then put into place a new **system of individual microlending** as the Bank’s sole lending technology. It is guided by five principles:

- *Business lending only:* The bank does not provide consumer loans. For a business to qualify for a loan, it must have been operating for at least six months, have opened a deposit account for six months, and the account must have shown some activities as proof of the business’s existence.
- *Analysis of the household:* Centenary lends to individuals. It examines first the household as an economic unit - its assets and liabilities, and its income and

[2] Much of the success of implementing the reforms is due to Dirk Van Hook, CEO of Centenary, who suffered a fatal accident while at work in March 2001.

expenditure together with its cashflow – and then the feasibility of the business, with more emphasis on repayment capacity than collateral.

- *Graduation principle:* Loans start small, at Uhs 1m ($58) or less, and short-term, 3-6 months. If repayment performance is 100% satisfactory, the customer may qualify for repeat loans of increasing size and loan periods up to one year. The customers learn that the Bank is rigid on timely repayment and loan security. As a result, they are cautious in their loan applications and conscientious in their obligations. After three successful loan cycles of an average of 6 months, they graduate to so-called automatic loans at substantially lower interest rates.
- *Loan security requirements:* The Bank is flexible concerning formal and nonformal collateral, combining fixed assets and guarantors according to the situation of their customers. Low-income customers may provide personal guarantors; land without a title; movable items like livestock, household items including nondurables, and business equipment. The guarantors, who are concerned about repayment, provide additional information on collateral or indebtedness.
- *Computerized monitoring & control,* with a software package originally supplied by IPC, is crucial for loan follow-up, staff performance analysis and incentives, and provisioning.

A major emphasis was placed on **incentives** at branch, staff and customer level:

- Converting branches into profit centers
- Introducing individual staff performance rating for lending staff and branch managers on position-specific scales, tied more to repayment (75% of the score) than disbursement, with incentive payments up to 45% of one's salary
- Rewarding customers who meet all their obligations, graded on a 1-5 scale, with repeat loans of increasing size and maturity and, after the third loan, a substantial reduction in the effective interest rate from 48% to 30%[3]; and dropping defaulters at the same time.

Arrears management and loan loss prevention are crucial factors in lending. They have an impact on cost-covering interest rates, outreach, and profit. High arrears rates reflect carelessness in loan examination or leniency in enforcement on the part of the lender; and negligence on the part of the borrower. Invariably, they lead to high loan losses and are detrimental to the bank and the customer. They make the bank reluctant to lend, lower its profit rate and slow down financial intermediation. As a result, customers have less access to loans, are more thoroughly scrutinized, have their loan sizes and loan periods cut down, and pay higher interest rates. At the same time, the costs of arrears management and the incentives for loan recovery must be kept within limits, lest disbursement and outreach are constrained.

Centenary measures arrears in terms of *portfolio-at-risk*: the outstanding balance of loans with late payments (overdue one day or more) over loans outstanding, one of the most stringent measures. By end-2000, the portfolio-at-risk ratio was 3.0%. It was brought down to 2.1% in 2001, but climbed back to 3.1% in 2002. How did Centenary accomplish such portfolio quality, a national bank with outreach predominantly in rural areas?

The single most important element in its financial technology is **a system of daily loan tracking backed by staff and customer incentives**. Functionally tied to the incentive system, it is one of the most impressive features of Centenary. This system of zero-tolerance of arrears is applied at four levels: the customer, the loan officer, the branch, and the Bank. It has the following operational elements:

[3] All loans are charged a flat 22% annual interest rate, an up-front acceptance commission fee of 2%, and a "monitoring fee" of 2% per month for the first three loans, which is thereafter reduced to 0.5% per month for good customers.

(a) *Daily tracking:* There are a minimum of five loan officers in every branch, one acting as a head loan officer. At the end of each day, every loan officer knows which customers have missed a payment.
(b) *MIS on-line:* At the end of the day that a payment fell due, the information is entered on-line into a data base.
(c) *Zero-tolerance action:* The very next day, action is taken: reminding the delinquent first orally, then in writing within a week, documenting the results of the investigation; after one month, the total amount falls due; and legal action is initiated. If there are reasons to suspect irregularities, the head loan officer may bypass the loan officer and approach the customer directly. Rescheduling has proven to be loophole for customers and loan officers and has been dropped, except in special cases.
(d) *Branch control:* The head loan officer receives the MIS data and submits them to the branch manager, who checks the performance of each loan officer.
(e) *Head office control:* The next morning, the General Manager of the Credit Division at head office receives the information and reports to the Chief Executive. A report from the branch manager may be requested; and a special analysis of branch problems, including fraud detection, and subsequent action may be initiated as seen fit.
(f) *Instant communication:* There is a direct telephone line of the Credit Division to the branches to discuss any problems at the loan officer or branch level and initiate action.
(g) *Staff incentives:* Staff members receive substantial individual performance incentives, provided loans in arrears for one day or more do not exceed 5%. The repayment performance of their customers has the biggest weight, accounting for 75% of the total score. The incentives of the head loan officer are tied to both his individual collection performance and that of the loan officers under his responsibility. The incentives of the branch manager are tied to branch performance including arrears. Each of these three loses up to 45% of his compensation package if arrears exceed 5%.
(h) *Customer incentives and penalties:* Customers who pay on time have access to bigger repeat loans and receive, after three successful loan cycles, a substantial lowering of the interest rate. Defaulters are dropped from the list of eligible borrowers; those who are late in repaying fall back on the rating scale.

The key elements of the system thus are: instant information, direct control at all bank levels, immediate action, staff incentives, and customer incentives. The MIS brings out problems at loan officer and branch levels and serves as an early warning mechanism for unsatisfactory performance and fraud.

The results of the reform process are impressive, providing strong evidence that rural bank reform is feasible in Africa (*Dec. 2002 data*):

- The bank mobilizes its own resources ($ 48.7m) from 316,650 depositors (up 13% over 2001);
- It lends to 31,500 borrowers (up 43%) with a volume of $ 23.05m loans outstanding (up 84%), 99% of them small and micro borrowers;
- It has its loans repaid, with a portfolio-in-arrears ratio between 2.1% and 3.1% during 2000-02;
- On a pilot basis, it lends to 4,900 smallholders and 323 commercial farmers , with lower-than-average arrears;
- Total assets are $61.3m (up 35%).
- It is highly profitable, with returns of 4% on average assets and 27**%** on average equity – despite a sluggish economy in 2002 and the depreciation on a newly acquired expensive computer system
- Since 1999, it fully finances its expansion from profits and deposits.

Total assets grew from Ush 63.5bn ($37m) in Dec. 2000 to Ush 86.2bn ($50m) in 2001 and Ush 116.5bn ($61.3m) in 2002; total equity grew 2000-01 from Ush 7.8 bn ($4.5m) to Ush

12.2bn ($6.4m) – increases of 35% and 56%, respectively, after a doubling of these figures between 1998 and 2000, and to 16.6bn ($ 8.7m) in 2002 (doubling from 2000 to 2002).

Table 1: Key balance sheet and performance data, 1998-2002[4]

	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002
Asset structure:					
Liquid assets	37%	56%	57%	61%	48%
Loans outstanding	46%	33%	29%	28%	38%
Other assets	17%	11%	14%	11%	14%
Total %	100%	100%	100%	100%	100%
Total assets in billion Ush	24.97	47.81	63.48	86.67	116.47
Total assets in million US$*	18.25	31.83	35.58	50.60	63.16
Growth of loan portfolio in %	17%	38%	14%	31%	84%
Lending ratio (loans/deposits)	57%	39%	35%	35%	47%
Capital & liability structure:					
Deposits	80%	85%	81%	78%	80%
Other liabilities	11%	7%	6%	8%	6%
Equity	8%	8%	12%	14%	14%
Total %	99%	100%	99%	100%	100%
Total liabilities in billion Ush	22.96	44.02	55.66	75.46	99.82
Total capital in million Ush	2.01	3.79	7.82	12.27	16.65
Growth of deposits	43%	102%	27%	33%	36%
Leverage (liabilities/equity)	12.4	12.6	7.1	6.2	6.0
Performance data:					
Operational sustainability	129%	122%	129%	139%	122%
Financial sustainability	110%	114%	124%	n.a.	n.a
Growth of income	34%	61%	45%	37%	13%
Growth of expenses	29%	55%	37%	28%	27%
ROA (return on av. assets)	4%	4%	5%	4%	4%
ROE (return on av. equity)	49%	49%	32%	28%	27%
Portfolio-in-arrears ratio:	6.2%	5.6%	2.97%	2.11%	3.08%

*Based on exchange rate averages for the period of December

4. Financial services and outreach

The **market** for rural microfinancial services in Uganda comprises an estimated 4 million households engaged in agriculture, which is 83% of the population, and an estimated 800,000 non-farm small and microenterprises. Their demand for financial services is largely unmet. While Centenary is a major provider of financial services, it meets but a fraction of that demand. For all practical purposes, its market is unlimited, constrained only by the Bank's ability to expand.

Vigorous deposit mobilization: By far the biggest demand, particularly by the poor, is for deposit services. They enable an individual or household to accumulate wealth, self-finance investments, safeguard against uneven income streams and protect against emergencies. Centenary has responded positively to that demand. Its strength in terms of outreach and self-financing capacity lies in deposit mobilization, with the following products:

- *Passbook savings* are the Bank's most popular product. They earn 2% interest p.a. with a minimum deposit of Ush 10,000 ($5) and up to 23 free withdrawals per month.

[4] The 2002 figures were not yet audited at the time of writing (February 2003).

- *Current accounts* or checking services require minimum deposits of Ush 100,000 for individuals, Ush 200,000 for associations and Ush 300,000 for businesses. No interest is paid
- *Fixed deposits* of 3 and 6 months offer yields up to 5% p.a.

Total deposits amounted to Ush 51.6bn by Dec. 2000, an increase of 27% over 1999; Ush 68.95bn ($39.9m) in 2001; and Ush 92.8bn ($48.8m) in 2002. Two-thirds of deposits are generated through passbook savings by small savers.

Table 2: Deposit balances and deposit growth rates, 2000-2001

Product	*Dec. 2000*	*Dec. 2001*	*Dec. 2002*
Passbook savings	32.81 64%	47.43 69%	62.05 67%
Current accounts	14.73 29%	16.76 25%	22.92 23%
Fixed deposits	2.99 6%	3.28 5%	4.34 5%
Foreign accounts	1.05 0%	1.01 1%	3.48 4%
Total (billion Ush)	*51.58*	*68.95*	*92.8*
*Total (million US$)**	*28.91*	*40.25*	*50.33*
Annual growth rate	*27%*	*34%*	*36%*

*Based on exchange rate averages for the period of December

Rapidly increasing lending: Loans outstanding amounted Ush 18.40bn by December 2000, an increase of 14% over 1999; Ush 23.8bn ($14.0m) in 2001, up 31%, and Ush 43.8bn ($23.05m), up 84%, in 2002. Thus, the deposits collected by Centenary are only partially intermediated and transformed into loans – at a lending ratio of 35% in 2001, and due to fresh efforts by new management, of 47% in 2002. A low lending ratio is detrimental to the entrepreneurial opportunities of the enterprising poor and non-poor, holding back rural development and the creation of employment for the poor. In terms of its mission and growth potential, this continues to be Centenary's single most important challenge, addressed through a new lending policy as of 2002 (see chapter 6).

Centenary's lending rate (loans/savings) dropped from 57% in 1998 to 39% in 1999 and 35% in 2000 and stayed there up to December 2001, then dropped further to 31% by June 2002 as banking activities went flat country-wide, but surged to 47% in response to new lending strategies.The initial drop was due to a general banking crisis in Uganda, which led to the closure of several banks and caused the remaining ones, including Centenary, to reduce their lending, while continuing to mobilize deposits. In a successful effort to fight inflation, the central bank took the excess liquidity off the market by offering Treasury Bills at rates up to 31%, with real returns up to 25% in 2001. This made it more lucrative for banks to invest in T-Bills than in risky loans. For several years, banks thus refrained from expanding their lending business. Centenary put all its emphasis on deposit mobilization and loan recovery, rather than borrower outreach. TB rates dropped to 3%-5% in early 2002, but continued to fluctuate widely; in late 2002, they were at 15%-16%: a warning to banks not to rely too heavily on easy but volatile earnings from T-Bills. Banks are unable to quickly respond to changes in the market and expand their lending. It took Centenary the entire first half of 2002 to come up with a new lending strategy (see below). Centenary has been offering the following **credit products,** to which SME loans were added in 2002 (presented in chapter 6):

- *Business loans*, with a maturity up to one year are the Bank's most popular credit product. First borrowers pay 22% interest p.a., a 2% acceptance commission up-front; a monitoring fee of 2% p.m., and a charge of Ush 5,000 for the loan application form. The effective interest rate for first borrowers averages 48% effective p.a. and declines to 30% p.a. after three satisfactory loan cycles (comparing favorably to commercial bank prime rates of 25-26% in 2000).
- *Investment loans*, with a maturity up to two years, newly introduced in 2000
- *Agricultural loans to smallholders* with less than 2 ha of land, provided by specially trained loan officers, were introduced on a pilot basis in 1998, with support by DFID.

- *Agricultural loans to commercial farmers*

Table 3: Loans outstanding and portfolio growth rates, 2000-2002

	Dec 2000		*June 2001*		*Dec 2001*		*Dec 2002*	
	Amount	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
Business loans:	16.17	85.5	17.93	88.5	20.8	86.2	40.2	93.2
Commerce			*15.40*	*76.0*	16.9	70.1	35.9	82.4
Service			*1.28*	*6.3*	2.5	10.3	2.8	6.5
Industry			*1.25*	*6.2*	1.4	5.8	1.4	3.3
Investment loans	0.05	2.7			0.08	0.3	0.2	0.4
Agricultural loans	2.18	11.8	2.32	11.5	3.25	13.5	2.86	6.4
Smallholders	*1.93*	*10.4*			1.99		2.01	
Commercial farmers	*0.25*	*1.4*			1.26		0.85	
Total percent		*100.0*		*100.0*		*100*		*100*
Total (billion Ush)	*18.40*		*20.25*		*24.13*		*43.26(*)*	
Annual growth rate	*14%*				*31%*		*79%(*)*	

(*) excluding staff loans

Outreach: Total **saver outreach** was 237,000 accounts as of end-2000, 280,000 as of 2001 and 316,650 as of 2002; 93% are passbook savers. The increase was 21% during 2000, 18% during 2001 and 13% during 2002.

Table 4: Number and growth rate of deposit accounts, 2000-2002

Product	*Dec. 2000*	*June 2001*	*Dec. 2001*	*Dec. 2002*
Passbook savings	214,289	229,307	256,598	293,991
Current accounts	22,105	22,784	23,257	21,886
Fixed deposits	350	446	525	667
Foreign accounts	68	74	78	106
Total	*236,812*	*252,611*	*280.458*	*316,650*
Annual growth rate	*21%*		*18%*	*13%*

Total **borrower outreach** was 18,411 in December 2000 and 24,120 in December 2001 – an increase of 31%. By December 2002, the number of borrowers had grown to 31,493, an increase of 30% over the previous year. The borrower-to-saver ratio was 1:12.9 both in 2000 and 2001 – pointing to a strong demand for savings deposit services, but also to inadequate borrower outreach; during 2002, it improved to 1:10.0.

Table 5: Number of borrowers and borrower growth rates, 2000-2002

Product	*Dec. 2000*	*Dec. 2001*	*Dec. 2002*
Business loans	14,102	18,191	26,200
Investment loans	18	56	75
Agricultural loans:			
Smallholders	2,734	3,215	4,896
Commercial farmers	61	353	329
Total number	*16,915*	*21,815*	*31,500*
Annual growth rate	*21%*	*29%*	*44%*

5. Sustainability and outreach in agricultural lending: experience at Mbale

In mid-1998, Centenary introduced agricultural lending in a pilot test in all its ten branches and subsequently extended it to the newly acquired branches. Its approach was prudent and gradual. In each branch, areas of operation were determined by a team of loan officers on the basis of the commercial potential of the crops grown, soil quality, rain fall, accessibility, and cultural factors of entrepreneurial and financial behavior.

The branch in Mbale, were half a dozen banks compete for depositors and borrowers, was established in July 1998 as the lead branch of agricultural lending. The ground had been prepared by the USAID-supported IDEA project, which provided technical assistance to farmers in the commercialization of their products. The loan officers divided the area into low lands (with rice, maize, cassava, millet, sorghum and, bananas as well as coffee and cotton as major cash crops) and high lands (with potatoes, bananas, vegetables, citrus fruit and coffee as major cash crops). They identified about 20 areas, each with some eight villages and 400 households on average. With the assistance of local leaders, the loan officers held customer education training sessions in the local language on all relevant aspects of banking, which were deepened in *loan sessions* at the time of disbursement. Particular emphasis was placed on the importance of timely repayment and the associated incentives. Through the interaction at local level, contact clients, motivated by the prospect of faster graduation to bigger loans, helped expanding.

Within three years, the number of agricultural loans outstanding in the Bank reached 3,000 and the portfolio outstanding Ush 2,9bn: 13% of all active borrowers and 14.5% of the portfolio outstanding as of June 2001. In a country with 83% of the population in agriculture, the potential for growth is virtually unlimited. However, at present it is Centenary's policy to limit its agricultural lending to 25% of its portfolio. The Mbale branch is the Bank's experimental station in agricultural lending. It accounts for 59% of all agricultural borrowers and 49% of the agricultural portfolio (June 2001).

The branch of Centenary in Mbale, a small town with five banks and several NGOs, differs from other branches in that its main business is agricultural lending: 65% of its customers, and 56% of the volume of loans outstanding, are in agriculture. The branch has a staff of 28, among them 13 loan officers. The branch experienced its most rapid growth during its first year of operation, with a saver outreach of 7,641 and a borrower outreach of 1,606 by end-1999. As of June 2001, it served 13,853 depositors and 2,646 borrowers, with Ush 1.67bn in deposits and Ush 2.01bn in loans outstanding. This makes the branch is a deficit unit, with loans outstanding exceeding deposits. Agricultural lending has thus enabled Centenary in Mbale to beat the competition. In terms of repayment, the Mbale branch is among the best performers. Its arrears ratio is a mere 1.51 % (June 2001), with an even lower figure for its agricultural portfolio (1.20%). Miraculously, the portfolio of the Mbale branch has been virtually unaffected by the bumper crop and the resulting precipitous drop in agricultural prices of early 2002. Its staff has earned maximum performance incentives throughout. Like all branches it is audited thrice a year by the internal auditors, twice by the branch operations supervisors, twice by the credit supervisors from head office and once annually by external auditors and central bank examiners.

The branch operates profitably, with an operational sustainability rate of *157 % (operational income over expenditure*). It reached its break-even point within 8 months, in February 1999. How did the branch accomplish sustainability and outreach in such a short period of time, and with its main business in agriculture? There are three major factors:

- Prudent staff selection and specialization on agricultural lending;
- holistic loan appraisal;
- rigorous enforcement of repayment through immediate recovery action, supported by a computerized system of instant arrears information, combined with powerful staff and customer incentives.

6. Overcoming the quality vs. productivity dilemma: from micro to meso finance

Financial intermediation faces two challenges: one is the mobilization of domestic resources, particularly through domestic savings; the other one is the transformation of these savings into loans that are repaid and allow the intermediary to make a profit. Centenary is one of an increasing number of banks and MFIs worldwide which successfully mobilize personal savings from a rapidly increasing number of small savers and which are now facing the problem of excess liquidity. Throughout history, governments, donors and bank managers have been surprised, time and again, that the poor are more eager to save than to borrow.[5] Centenary, which originated as a trust for the poor, responded to that demand from its onset, but found it difficult to lend. High levels of non-performing loans brought it to the verge of collapse. Reform during the early 1990s therefore focused on quality. The Trust was converted into a commercial bank; and every effort was made to ensure loan repayment. In that the banksucceeded: portfolio quality was assured. But this eventually resulted in a new problem: of productivity, ie, profiting from loans.[6] There is a related problem here which the bank shares with many MFIs including Grameen replicators: it is one thing to make a success of microloans to microinvestors; it is yet another thing to guide them into small loans for small investments and eventually meso loans.

Staff performance incentives were heavily biased toward loan recovery, which accounted for 75% of the incentive formula. Underperforming staff faced stiff penalties: in the form of total loss of their incentive package if arrears exceeded 5%. With regard to production, the formula has rewarded the officer who can book large numbers of loans, rather than the amount disbursed. In practical terms, this has resulted in a tendency for loan officers to stay with old customers and not to seek risky new business; and to offer short-term loans with maturities of three to six months that they can renew more frequently. When T-Bills fell around the turn of 2001-02, a bumper crop led to the collapse of agricultural prices, an all-time low lending ratio of 31%, and a new CEO came it, the bank was ready for a shift from quality only to quality-cum-productivity.

Centenary modified the incentive formula by giving more weight to production in terms of loan volume per loan officer and branch manger by including the growth rate of disbursements as a component. At the same time, three new loan products were introduced, exceeding by far the average loan size of Ush 1.1 million during 2000 and 2001 ($584): home improvement loans from Ush 100,000 to 10 million, averaging around three million; salary loans from Ush 100,000 to 25 million, averaging around four million; and small-and-medium-enterprise (SME) loans of a minimum size of Ush 15 million ($7,900).

Centenary's SME product raises the issue of micro vs. meso finance and related differences in interest rates and productivity. In microfinance, effective interest rates of 50% p.a. are nothing unusual, neither in Uganda nor elsewhere, and generally do not pose much of problem to the microborrower. In fact, high interest rates make sure that scarce financial resources flow into investments with the highest rates of return. As a result, much of microfinance has flowed into petty trading where profit margins can be very high. However, Centenary has noted that over the last 20 years many of its borrowers – the entrepreneurial poor! - have graduated beyond the micro benchmark and have turned into SMEs with a demand for larger loans, accompanied as stipulated by microeconomic theory by a decline in marginal productivity. Most were not able to afford effective interest rates of 48% or even 30%. The fortunate ones turned to regular commercial banks which charged interest rates in the 20s. The less fortunate ones were forced to grow slowly through self-financing from retained earnings, or stop growing. In either case, Centenary lost prime customers.

[5] Dirk Steinwand, The Alchemy of Microfinance. Berlin 2001: Verlag für Wissenschaft und Forschung.
[6] Mobilizing savings and not lending has been made attractive by monetary policy, offering up to 36% interest on T-bills. This has tempted many banks into a very volatile market, with T-bill rates recently oscillating down to around 5%.

Centenary therefore decided to break down its portfolio into two categories at the cut-off level of Ush 15 million ($7,900): below that are microenterprises which are charged microfinance interest rates of 48% or 30%, respectively; anything above are called *commercial loans* at *commercial interest rates* tied currently to a prime of 16% up to a maximum of 22%, with no monitoring fee, plus a 2% acceptance commission up-front which can be reduced to 1%.

The immediate result, within less than a year, is stunning and quite different from what those who fear mission drift would have expected: The commercial loan portfolio now includes a few hundred commercial SME loans. In a very difficult year where most banks in Uganda have suffered, this has helped the bank to keep its profitability level. Far from creating a sustainability-vs.-outreach dilemma, it has enabled the bank to continue growing during 2002: at an unprecedented rate of 44% of borrower outreach, from 21,815 to 31,500, and with 99% of these borrowers in the micro bracket. At the same time, the lending ratio, an indicator of development representing the conversion of savings mobilized into productive assets, has gone up from 31% to 45%. Yet, there is no mission drift: 99% of the customers continue to be in the micro bracket. Furthermore, it is expected that the higher profitability with meso credit will enable the bank to further expand its outreach to the poor.

7. Good donor intentions randomize behavior

Centenary's contribution to rural finance and development would be even greater were it not for the good intentions of some donors. It is donor policy to enhance domestic resource mobilization, self-reliance and sustainability in rural and microfinance. As a commercial bank with excess liquidity, Centenary took this claim seriously, approving commercial credit lines to several major credit NGOs. But donors continue to provide funding to these NGOs, thereby undermining the evolution of a self-sustained domestic system of banking relations.

8. **Recommendations**

The results of the reform of Centenary have been impressive. They are proof that rural and agricultural bank reform is feasible in Africa. Given its successful financial technology and the virtually unlimited size of the rural market, untapped in many areas, further expansion of outreach to rural and agricultural areas remains the Bank's biggest task. In that respect, the Bank has taken a new initiative, adding mesofinance for small and medium entrepreneurs to microfinance for microentrepreneurs. Far from creating a sustainability vs. outreach-to-the poor dilemma, this new venture allows the bank to mobilize more savings, which are of particular importance to low-income people, and to transform them into productive assets. Convenient deposit services for small savings are normally not available in the proximity of low-income people, but are of utmost importance to self-financed business growth and borrowing capacity. In this vein, major challenges and opportunities for Centenary include the following:

(1) Bringing microfinance to the poor: Expanding into remoter areas through sub-branches and linkage banking; improving its branch services by expanding its staff and premises; expanding its small saver outreach through nearby deposit and collection services; and expanding its small borrower outreach through sub-branches and linkage banking with MFIs and NGOs.

(2) Providing opportunities for graduation to mesofinance: Expanding into small and medium enterprise finance at substantially lower interest rates, using the same resulting economies of scale and scope to further improve its sustainability and outreach to the poor.

(3) Bringing the bank to intermediaries: Lending wholesale to NGOs, MFIs and associations of farmers and microentrepreneurs; and graduating clients of NGOs and SHGs to bigger loans and voluntary deposits – provided donors do not undermine finance with cheap credit to NGOs.

(4) Deepening financial services and impact: Offering tied savings-cum-credit products and cross-selling of financial products; strengthening microenterprises through business services by cooperating agencies

(5) Strengthening the delivery capacity of the bank: Expanding staff and staff training facilities; expanding and modernizing bank premises; providing more balanced staff incentives, with appropriate emphasis on disbursement, repayment and savings mobilization

(6) Disseminating sustainable rural finance, agricultural lending and agricultural bank reform: Providing exposure training to MFIs, commercial and development banks in Uganda and the wider region.

Many small banks and MFIs in Africa and elsewhere face a similar situation as Centenary. Rapid growth in deposits, outreach and sustainability is likely to bring many of them into a shortage of capital, which grows at a slower pace than deposits. Here is where donors can help: with investments in equity or quasi-equity, rather than end-user credit lines.