From recipients of reparation payments to shareholders of microfinance institutions: A study of the possible relations between reparations for victims of human rights abuses and microfinance

by

Hans Dieter Seibel

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Abstract

Allocating reparation benefits to victims of civil rights abuses with a lasting effect on their well-being and self-help capacity is a tremendous challenge. By converting benefit payments into shares and beneficiaries into shareholders of microfinance institutions (MFIs), the former victims turn into active partners of aid and owners of sustainable local MFIs. In many countries, self-help groups and indigenous informal savings and credit associations are the only civil society institutions which have survived the breakdown of society. They represent the social capital for the reconstruction of local financial institutions. In other countries, such institutions have to be newly built. In either case, experienced international NGOs may be instrumental in building, or reconstructing, MFIs owned or co-owned by recipients of reparation payments. Part of the funding in a reparation program has thus to be allocated directly to the victims-turned-shareholders, the other part to institution-building. Based on satisfactory performance of the MFI, the share capital may be augmented by donor grants and bank borrowings to increase the volume of loans to the user-owners for their income-generating activities. Experience has shown that networks of such institutions can be successfully built within 2-3 years; sustainability in terms of self-management, self-financing and legal framework not only of the MFIs but also of their network may take another five years. In terms of sustainable impact, there is no alternative to institution-building!

Contents

One of the biggest mistakes often made in a post-conflict environment is the focus on speed of loan disbursement. Getting money out the door quickly often entails a very limited institutional development focus, which is the core behind best practice microfinance principles. By not focusing on institution building, projects often pollute the environment for those who are attempting to abide by best practice microfinance.
(CGAP, Microfinance Policy Review Sierra Leone, June 2002, p. 24)

1. The challenge

According to the United Nations Universal Declaration on Human Rights, "Everyone has the right to an effective remedy by the competent national tribunals for acts violating the fundamental rights granted him by the constitution or by law" (Article 8). The Declaration further specifies that "the Court shall establish principles relating to reparations to, or in respect of, victims, including restitution, compensation and rehabilitation" (Article 75). Awards for reparations may be deposited in a Trust Fund (Rule 98). The emphasis in this paper is on material reparations which benefit the victims directly (de Greiff 2003:5-6):

On this legal basis, the International Center for Transitional Justice (ICTJ) assists countries pursuing accountability for mass atrocity or human rights abuse. Among the key elements on which the Center focuses are promoting reconciliation and providing reparations to victims of civil rights abuse: a relatively neglected field relative to the emphasis placed on prosecutions (de Greiff 2003). Given its commitment *to building local capacity and generally strengthening the emerging field of transitional justice*, ICTJ faces the challenge of how to build local capacity in such a way that reparation payments have a lasting impact on the well-being of the victims and their families. Experience in many countries has shown that, without an appropriate institutional framework, the benefits of one-off payments tend to be short-lived and unsustainable. There are two prerequisites of sustainable impact, which are mutually reinforcing: sustainable income-generating activities (IGA) and sustainable local financial institutions for the financing of such activities. However, in war-torn societies and other situations of total crisis, an institutional framework might have been destroyed or disrupted.

In this study, the main focus is on the second prerequisite, ie, microfinance institutions (MFIs)[1], which in many countries have now evolved from unsustainable projects to sustainable organizations (Robinson 2001; Seibel 1996, 2001). MFIs are defined here as formal, semiformal or informal institutions[2] providing financial

[1] *Microfinance* is a new term first introduced in 1990. Originally the term was meant to refer to small-scale financial intermediation comprising both microsavings and microcredit, moving away from a sole emphasis on credit. Meanwhile, the term has been used in many different ways, connotating, eg, microcredit or Grameen banking. An MFI is thus not a particular type of institution, eg, a credit NGO, but any type of institution offering small-scale financial services, usually to the poorer sections of society. To avoid this confusion, some, eg, CGAP, now prefer *microbanking* to connotate small-scale financial intermediation along commercial lines.
[2] Formal financial institutions, among them banks and finance companies, fall under a financial institutions law and are supervised by a financial authority such as the central bank or bank superintendency. Semiformal institutions, among them credit NGOs and most savings & credit cooperatives, are registered or otherwise officially recognized, but not financially regulated and supervised. Informal institutions of traditional or recent origin, among them self-help groups (such as rotating or accumulating savings and credit associations) and individual lenders or deposit collectors are neither officially regulated nor recognized, but may fall under customary law. Any such institution is referred to as a *financial intermediary* if it mobilizes deposits and transforms them into loans.

services (microsavings, microcredit, microinsurance) of a scale significantly below those of commercial banks[3] and to customers normally considered unbankable.

MFIs might be instrumental in providing an institutional framework for sustainable impact on recipients of reparation payments in three ways:

- by offering a secure place for the safe-keeping and accumulation of savings (partially derived from reparation payments), thereby strengthening the self-financing capacity of the recipients of reparation payments and other depositors;
- by offering credit for investments and working capital to successful small and microentrepreneurs, thereby providing opportunities for external finance of increasing size ;
- by offering recipients of reparations the opportunity of rehabilitating or constructing MFIs, thereby mobilizing the self-help capacity of the victims as shareholder-owners and users of these MFIs, particularly in situations where no functioning institutions exist.

2. From relief to institutional rehabilitation: a framework for reparation payments

Reparations are defined here as benefits provided directly to the victims of civil rights abuses (de Greiff 2003). How are reparation payments most effectively used, for relief or institution-building? In recent years large numbers of developing and transitional countries experienced situations of *crisis*, following political, economic or natural disasters, or *total crisis,* triggered by war or totalitarian oppression, in which the very structure of society has been put out of function. In a total crisis, the state virtually ceases to exist, national economies disintegrate, and social and political structures melt away. A significant number of people are exposed to a day-to-day struggle for survival, often separated from their homes and deprived of their usual sources of livelihood. In particular, total crisis means that, national governmental and civil society organizations have been destroyed; the production and market distribution of goods and services has been disrupted; institutional capacity for policy decisions and planning at national level has been eliminated or curtailed; communities and informal or traditional institutions have been detached from the broader society and markets; household economies have reverted to subsistence and survival strategies; large numbers of individuals have been physically and socially displaced and were subject to traumatizing experiences of violence. All this creates immense problems for rehabilitation and reconstruction.

When a crisis becomes acute, emergency aid aims at helping the population to survive periods of immediate danger of disease and starvation. When the immediate threat is over, the phase of reconstruction commences. Reconstruction and institutional rehabilitation mark the transition from an emergency to a development situation. The core task is the reconstruction of basic political, economic, and social

[3] With regard to loan size, there is usually a wide gap between MFIs and commercial banks, the former most likely averaging in the hundreds and sometimes thousands of USD and the latter in the tens or hundreds of thousands of USD. Agricultural and other development banks frequently offer medium or large-scale as well as microfinance services. There is no way of generally defining microfinance in terms of size, as there is wide variation between countries.

institutions which are essential to the functioning of a society. Specific rehabilitation programs of international donors offer a significant contribution to this process. *Emergency aid* is characterized by direct interaction between international aid organizations and beneficiaries as individuals or in groups. In contrast, *rehabilitation* aims at gradually restoring local institutions as a prerequisite for self-reliance and to enable them to function as intermediaries between international aid organizations and self-organized local participants. Whereas emergency aid is principally donor-driven, rehabilitation aims to establish a recipient-driven design of aid programs in line with local implementation capacity. Reparation payments must be designed in such a way that they survive the transition from emergency aid to rehabilitation and sustainable development. *Lessons learned* include the following:

- Rehabilitation from crisis is a *window of opportunity* for strategic policy changes; therefore, reparation and rehabilitation programs need to identify those strategic policy changes and support them.
- Rehabilitation from crisis entails institutional reform to bring government closer to the people; hence, strategic institutional reform and capacity-building should be funded as part of programs.
- There is room for reviving institutions of the civil society which were formerly repressed, restricted or ignored; research to unearth these institutions and to assess their potential for institutional upgrading should underpin planning.
- Self-help is the backbone of any war economy and might play a similar role during rehabilitation; research is needed to assess the potential of self-help for institutional rehabilitation and of linkages between self-help efforts, reparation payments and rehabilitation.
- Program ownership is critical for the impact of aid; support to community-based organizations is more appropriate than targeted reparation programs.
- Rehabilitation programs can play a crucial role in supporting local capacity for rehabilitation; needs assessment and focused capacity-building analysis should be part of reparation and rehabilitation programs.
- Practical solutions to the bottom-up vs. top-down dilemma are critical for sustainability; societies may differ widely in their cultural capacity for participatory vs. authoritative decision-making.

3. From unsustainable programs to sustainable institutions: the microfinance revolution

During the last two or three decades, there have been fundamental changes in development finance, captured by such terms as financial deregulation, development bank reform and the so-called microfinance revolution. These changes have led to a *paradigm shift* from subsidized targeted credit to financial systems development and institution-building, opening up a world of new options for agencies providing reparation payments to victims of civil rights abuses. In particular, a notion of *best practices*[4] has emerged, with a dual concern for institutional sustainability and outreach to the poor.

[4] The term *best practices* has been disseminated by CGAP and the World Bank. It refers to a set of principles and should not be understood as a model that can be blindly replicated around the world. This author considers the latter a real risk and prefers the term *good practices* or *sound practices*, indicating that institutional solutions, while adhering to fundamental principles of viability and

Inspired by the success of the Marshall Plan in reconstructing Europe and rehabilitating its institutions after World War II, *capital transfer* emerged as the principal strategy of growth and modernization during the 1950s and 60s. This has shaped the economic environment of many developing countries until today, especially the poorest among them. This strategy rested on three pillars:

- Given the dearth of suitable financial institutions, donors helped establish development banks, providing capital and loanable funds.
- Given the level of poverty, experts advised governments to subsidize interest rates.
- Given the level of illiteracy, experts also advised government administrations to guide investment decisions through directed credit.

Thus, governments ended up as policy makers, bankers and investors. Yet, they performed poorly in each of these tasks. Despite good intentions, government involvement in most countries resulted in totally inadequate financial infrastructures, the substitution of external debts for domestic resources, bank failures, and severe misallocation of scarce resources - all summed up in a single term: *financial repression* (McKinnon 1973). Vested interests and perverse incentives kept the repressive system alive, benefiting a select number of politicians, public servants, development bank staff and big borrowers.

Due to the dismal performance of development banks, many of the major donors, around 1980, pulled out their support, while governments found it increasingly difficult to provide budgets for loans that were not repaid. This led to the collapse of many development banks and technical bankruptcy of most of the remaining ones as well as their delivery channels, among them cooperative societies.

Instead, donor support, albeit on a reduced scale, shifted to non-governmental organizations (NGOs), particularly credit NGOs. They were supported by international NGOs and eventually also by bilateral and multilateral donors. This shift was initially not accompanied by a new paradigm: donors supplied the loanable funds; credit NGOs were not authorized to mobilize voluntary savings; interest rates were subsidized; repayment rates were low; viability was abysmally low and self-reliance non-existent. The new concern with poverty alleviation seemed to justify the need for capital transfer and low interest rates. How could we possibly expect the poor and the very poor to mobilize savings, build their own institutions, and invest their loans at profit rates that would enable them to pay market rates of interest and repay their loans on time? Not surprisingly, many credit NGOs met with a fate similar to that of development banks, combining donor dependency with a lack of both sustainability and outreach. As in Ireland and Germany during the 18th and 19th century (Steinwand 2001; Seibel 2003/6), it took some trials and errors to realize that, given the right incentives and institutional framework, the poor do save; they are responsible investors; they do repay their loans; and they may even own their financial institutions. It was also found that in many countries, women figure prominently among the prudent borrower-investors.

sustainability, invariably need to be developed, or adapted, within given cultural, social, economic and political conditions.

In an increasing number of countries, including some of former civil rights violations (eg, the Balkans, Rwanda, Cambodia), there have been notable changes to varying degrees from the old world of directed credit to a new world of sustainable institutions. In this new world, governments make determined efforts to create a **conducive policy environment:**

- with new legal forms for local financial institutions,
- deregulated interest rates, and
- prudential regulation and supervision of financial institutions,
- paralleled by a deregulation of foreign exchange and the trade regime.

Responding to the demands of their customers, institutions undergo reform and provide an array of savings and credit products for a wide range of income-generating activities, thereby generating the loanable funds and the profits needed for expansion. A number of agricultural and rural banks, cooperatives and other rural and urban MFIs have learned **to manage their risks by:**

- diversifying their portfolio,
- analysing the investment and repayment capacity of the entire household,
- providing a range of appropriate financial services,
- starting small and granting repeat loans of increasing size,
- providing incentives to both staff and borrowers to enforce timely repayment,
- changing from group to individual loans and offering opportunities for graduation to larger loans as need be, and
- expanding into remote areas through linkages with self-help groups.

The transition from the old to the new world of development finance, as described below, is a challenging framework to any institution and donor agency aiming at sustainable poverty alleviation and development.

Table 1: From the *old world* of directed credit to the *new world* of financial systems development and institution-building: Do's and Don'ts

	***Don't support* ::** *The old world of directed credit*	***Do support:*** *The new world of institution-building*
Policy environment	Financial repression	Prudential deregulation, fin. system dev
Legal framework	Lack of private local R/MFIs	New legal forms for local R/MFs
Develop't approach	Supply-driven	Demand-driven
Institutional focus	Monopoly institutions	Various competing financial institutions
Clients perceived as:	Beneficiaries	Customers
Selection of clients	Targeting by donors and governments	Self-selection
Outreach	Limited outreach to groups	Potentially all segments of the economy
Incentives	Perverse: leading to fund misallocation	Efficient allocation of funds
Non-formal FIs	Millions of informal MFIs ignored	Opportunities for mainstreaming
Semiformal FIs/NGO	No standards, no deposit mobilization	Conversion to deposit-taking formal FIs
Financial coops	Unsupervised, ruined by governments	Self-reliance; low costs, expansion
AgDBs	Lack of viability and outreach	Reforms towards autonomy, viability
Rural banks (RBs)	Lack of opportunities for private RBs	Legal framework for private RBs
Regulation and supervision (R&S)	Coops, MFIs, AgDBs unsupervised; donors keep distressed institutions alive	MF units in CBs; regulation of RBs/ MFIs; closing of distressed FIs
Commercial banks	Unable to lend to a variety of sectors	Some outreach to commodity producers and microentrepreneurs
Agricultural finance	Lack of self-financing; restricted credit	Self-financing from savings; external

	according to government directions	financing for profitable investments
Remote and marginal areas	Futile attempts of donors to drive ill-suited MFIs into remote areas	Self-managed savings-based SHGs and cooperatives operating at low cost
Individual and group technologies:	Rigid replications without growth of outreach and sustainability	Both can be profitable and reach microentrepreneurs and the poor
Non-financial services	Maximalist approach without cost coverage undermines FIs	Provided by SHGs, other agencies, FI subsidiaries; balance of objectives
Targeting	Undermines outreach and viability	Differentiated financial products
Linking banks and SHGs/MFIs	Lack of healthy banks with a mandate to be of service	Spectacular increase in outreach to the poor; profitable if interest rates are free
Interlinked schemes	Lack of institutional sustainability	Ltd.success under controlled conditions
Self-reliance	NGOs, AgDBs barred from deposit-taking; donor and gov. dependency	Self-financing through deposits and profits; institutional autonomy
Sustainability	Donors, gov. fail to insist on performance standards and sustainability	Increasing numbers of self-sustaining institutions of any type and ownership
Access to financial services	Very limited access of poor and non-poor to savings, credit, insurance	Sustainable access of the poor as users and owners of R/MF institutions

This transition to a new world of finance, as promising as it looks, has only just started. Neither does it cover all developing countries; not does it cover all institutions and spheres of the economy in those countries where it has commenced. In most countries, the situation is highly complex and frequently contradictory. Eg, failing and prospering institutions may exist side by side; governments pass laws on market-driven institutions, yet continue subsidizing the interest rates of others; agricultural development banks and commercial banks – facing high minimum reserve requirements and and high T-bill rates and plagued by weak lending technologies - may produce huge amounts of excess liquidity, yet the government borrows money from international donors and increases its external debts.

Under adverse conditions, as in post-crisis situations and in countries affected by the Asian Financial Crisis after 1997, governments and donors tend to ignore all lessons taught (and evidently not learned), reverting to the old world of development finance. Driven by pressures to show impact immediately, it is tempting for agencies administering reparations to do so in the old ways driven by donors and governments. Yet, ***it is only the slow way of involving the victims of civil rights abuses as partners and perhaps owners in building sustainable institutions*** that will lead to sustainable program impact: on both the victims in their capacity as microentrepreneurs and on their institutions.

Box 1: Requirements of sustainable microfinance
Sustainable financial institutions mobilize their own resources, provide financial services according to demand, cover their costs from their operational income, have their loans repaid, make a profit, and finance their expansion from deposits and retained earnings. *Resource mobilization* comprises equity, savings deposits, retained earnings and commercial borrowings, augmented by external resources such as soft loans and grants. Of these resources, three are fundamental to self-reliance and dynamic growth: savings deposits and equity including retained earnings. *Financial services* comprise credit for various purposes and savings deposit facilities; they may further include money transfer, check clearing and insurance. Insurance may serve the triple function of borrower protection, loan protection and resource mobilization. *Sustainable institutions* need an appropriate legal status which authorizes them to carry out all these functions; and they need to be properly regulated and effectively supervised. *Financial systems development* comprises processes of establishing a conducive regulatory environment (including a legal framework, prudential norms and effective supervision), an adequate infrastructure of viable small and large financial institutions, adequate demand-oriented financial products and good operational practices.

Experience around the developing world shows that virtually any type of financial institution, including commercial banks, can fail in the face of bad policy and bad management. On the other hand, experience also shows that any type of financial institution, once reformed and well-managed, can provide finance in a profitable and sustainable way for a wide variety of income-generating activities, emergencies and consumer purposes. Among the *flagships of rural and microfinance* are:

- AgDBs like BRI in Indonesia, BAAC in Thailand, BNDA in Mali, CNCA in Burkina Faso, BNA in Tunisia, BK in Iran
- Specialized banks for the poor like Grameen Bank in Bangladesh
- Rural and community banks in Nigeria, Ghana, Tanzania, the Philippines, Indonesia
- Commercial mesobanks like Centenary RDB in Uganda, CMF in Uganda, EBS in Kenya, Banco Caja Social in Colombia, Bank Dagang Bali in Indonesia, Micro Enterprise Bank (MEB) in Bosnia
- Member-owned financial cooperatives like SACCOs in Kenya and Tanzania, credit unions in Madagascar, People's Credit Funds in Vietnam, Small Farmers Cooperatives Ltd. in Nepal, savings and credit cooperatives in the Philippines
- NGOs like CHF/JACP in Jordan, UMU in Uganda, EKI in Bosnia, ASA in Bangladesh
- Credit-NGOs establishing banks like SEWA in India, ACLEDA Bank in Cambodia, CARD and others in the Philippines, Bina Swadaya and Purba Danarta in Indonesia, K-Rep in Kenya, BancoSol in Colombia, Compartamos in Mexico
- Member-owned village funds like sanadiq (sg.: sanduq) in Syria, caisses villageoises/village banks in numerous countries
- Member-owned SHGs as autonomous financial intermediaries linked to banks in India, Indonesia, the Philippines, Nepal, Nigeria, Burkina Faso, Mali.

For these institutions and their customers, rural and microfinance have turned into a commercial proposition. Their experience has demonstrated that the social and economic objectives of agricultural, rural and urban small & microenterprise development are best achieved not by charity, but by financial relations between institutions and their customers based on **commercial principles**:

- mobilizing financial resources locally;
- having their loans repaid;
- covering their costs;
- and financing the expansion of outreach from deposits and retained earnings.

It should be noted that these principles are not new in rural and microfinance. In the absence of external support, they have always been fundamental to indigenous informal financial institutions around the world.

4. Microfinance strategies: NGOs as financial agencies in post-conflict situations

4.1 Prerequisites of sustainable impact

There appear to be four major ways of carrying out reparation payments:

(1) Direct payment through specialized agencies
(2) Payment through commercial banks
(3) Payment through NGOs
(4) Investment in local financial institutions (co-) owned by recipients of reparation payments.

The likelihood of sustainable impact of reparations on the life and well-being of recipients depends on how payments are transacted, increasing from (1) to (4) on the scale above. For a sustainable impact, the following conditions have to be met:

- profitable investment of payments in income-generating activities[5];
- access to deposit facilities for the safekeeping and accumulation of savings (derived from reparation payments and profits) as a source of self-financing;
- access to credit (at commercial rates) as a source of external financing;
- the repayment of loans on time as a prerequisite for repeat loans of increasing size.

Direct payments through specialized agencies may have some positive impact in individual cases (likely to be reported as success stories), but are unlikely to substantially and durably benefit a larger number of recipients. Chances of sustainable impact may improve somewhat if payments are administered through commercial banks, which are usually among the first institutions re-established after a crisis. If the beneficiaries are required to open a bank account first and payment is made through this account, there is a modest chance that this might lead to a lasting bank relationship. In this case, some other agency would have to provide training and consultancy services to guide the beneficiaries in their banking relations as well as in their investments. However, exceptions notwithstanding[6], few commercial banks have shown an inclination of dealing with small customers; to the contrary, many erect formal and informal barriers to keep them away, eg, through sizeable minimum deposits and unfriendly treatment.

4.2 Strengths and weaknesses of credit NGOs

In most post-crisis situations, NGOs are the major agencies of providing financial services. They are capitalized by donor agencies: international NGOs, bilateral or multilateral agencies. They provide microcredit and rudimentary savings services, usually in the form of compulsory savings as part of the credit package. They have a number of strengths, which are of particular importance in countries destroyed or distressed by crisis:

[5] Payments may also be invested in housing, either as a source of rental income or, given the fungibility of money, freeing other income for profitable investments,
[6] The Commercial Bank of Sierra Leone might turn out to be such an exception, as it is reportedly making preparations for a new window for small loans (ARC 2002: 2).

- they are easily and quickly established and do not require a complex legal framework;
- given their orientation to poor target groups, they are able to communicate with the poor and distressed;
- and they are flexible in providing a range of services, including, in addition to finance, microenterprise training & consultancy as well as education, health care, counselling and others directly related to demand and felt needs.

While this broad orientation may be appropriate in the immediate post-crisis situation, as the situation consolidates, many NGOs find out the hard way that, if they want to handle finance well, they better specialize on that, leaving microenterprise development, education and health care to other agencies. An example of the spectacular proliferation of credit NGOs is Uganda, where after the elimination of the country's human and social capital through murder and repression by the regimes of Idi Amin and Milton Obote (1972-1986), some 400-500 credit NGOs emerged during the late 1980s and 1990s, more or less within a decade.

Yet, some of the strengths of the NGOs are also their weaknesses. *Their first weakness* is that, while easily established in a legal void, they lack the legal status of a financial institution and tend to feel quite comfortable with donor support and the absence of regulation and supervision. As credit NGOs, they are not authorized to mobilize savings, at least not beyond a certain level, and may not feel the need to do so if they have a generous and understanding donor. Donor dependency and lack of self-reliance in terms of operational and loanable funds have two repercussions: lack of viability (with operational self-sufficiency rates frequently far below 100%); and lack of growth of outreach, which would require rapidly increasing internal resources derived from savings and retained earnings. The following box , taken partly from a CGAP report on microfinance and partly from an NGO project design may serve as an illustration of the struggle for sustainability in Sierra Leone.

Box 2: Sierra Leone - the emergence of microfinance in a war-torn country…

Despite an 8-year civil war that left Sierra Leone one of the poorest countries in the world…, much has been achieved since the peace agreement in 1999. The government has made impressive gains in obtaining countrywide security, reaching positive GDP growth, stabilizing inflation and maintaining a stable currency.… Despite these gains, the country continues to struggle with ways to achieve employment for the large numbers of demobilized soldiers and the newly returning IDPs and refugees, who at the height of the conflict represented one quarter of the entire population. It is this rationale that has inspired the government's Recovery Strategy… Microfinance is a key policy tool to address the large informal economy, considered one of the sectors to have the potential to efficiently and quickly absorb the large number of the economically active population. To date, microfinance has been a relatively small sector in the country, with widespread experimentation by various providers utilizing various models…:

- There are some microfinance institutions (MFIs) in the country that have the potential to become sustainable MFIs. Many, however, are quite weak.
- None of the existing experience with microfinance in Sierra Leone would be considered exemplary in comparison to experiences elsewhere. …
- Quick cash disbursement through an informal structure is often mislabeled as microfinance. Such programs are best categorized as grant programs as they do not focus on institution building, a core principle behind best practice microfinance**….**
- There is momentum, both at the government level and at the practitioner level, to increase financing significantly. Caution is advised here, as capacity must first be addressed before substantial resources are invested in unsound institutional structures and models. (CGAP (2002/6)

… and the drive for institutional sustainability
Sierra Leone is in the process of reconstruction. With its 10-year-old civil war concluded, refugees and internally displaced persons are returning to their homes and starting anew. There they have found peace, but few resources to rebuild their lives. Sierra Leone's infrastructure, both economic and social, was largely destroyed during the civil war and is only now being restored. This destruction was especially deep in the finance sector, where the system of rural and postal banks collapsed. As a result, returnees arriving with few assets of their own or host populations who are already impoverished, lack the capital necessary to restart agricultural or business activities. In this situation, providing financial services has become essential to provide income for Sierra Leoneans and to jump-start the economic recovery process.

Recognizing this need, American Refugee Committee International (ARC) began a microfinance program in 2001. Working through three local implementing partners, the program provided loans and savings services to returning and host populations to restart their businesses and lives. Clients used the loans to purchase basic equipment or supplies to begin small scale trading, production, and service businesses, such as carpentry, market gardens, or tabletop retail enterprises, while forced savings helped clients to accumulate liquid assets that could be used to sustain businesses or respond to emergencies. Over the first year and one-half of implementation, the microfinance program served over 3,000 clients in 5 Districts and the Western Area of Sierra Leone. Despite some initial difficulties with repayment, the program has recorded 100% repayment in its newest branches and improving portfolio quality in its old ones….

With field operations running smoothly, ARC has turned towards making its program sustainable…. and reach 15,000 clients with demand-driven financial services with an outstanding portfolio valuing over $1.8 million USD. Though remaining under ARC International management initially, *Finance Salone* will be "spun-off" within three years and register as a local microfinance institution, managed by national staff. With professional local staff and national outreach, *Finance Salone* will be operationally self-sufficient by 2007 and financially self-sufficient by 2009. (ARC 10/2002)

4.3 Upgrading NGOs to formal financial institutions

Over time, many credit NGOs benefit from the microfinance revolution and strive for adequate repayment rates, coverage of operational costs and even profits as an engine of growth. However, without legal status and effective regulation & supervision, this has invariably taken an inordinately long time and eventually hit a barrier of growth which only well-managed and properly supervised financial institutions have overcome. In the interest of breadth of outreach and the deepening of financial services to ever-larger numbers of the poor, this barrier can be overcome, as the case study below of CARD in the Philippines will show: an NGO first turned into a Grameen replicator and then into a rural bank. Grameen banking may be a useful technology for organizing recipients of reparation payments; CARD has some lessons to teach about the social capital involved (Box 3).

Box 3: The Philippines: CARD - transforming an NGO into a sustainable rural bank

The Grameen Bank in Bangladesh is known worldwide for its success in providing credit to the poor. However, subsequent replications of its methodology in other parts of the world have been less successful. After a checkered history, the Center for Agriculture and Rural Development (CARD), has recently set itself firmly onto the path to sustainability by becoming a formal sector rural bank – the first credit NGO and Grameen replicator in the country to do so. CARD started as an NGO in 1988, with 150 borrowers and a repayment rate of 68%. Adopting the Grameen group-lending technology, repayment soared to 100%; but outreach dropped to 89, as all male participants rejected the rigid weekly repayment discipline. Subsequently, CARD's all-female outreach increased gradually to 6,844 borrowers as of 1996. By turning into a rural bank, accepting voluntary savings and accessing refinance from ADB and IFAD, its outreach subsequently soared to 69,223 active borrowers and 100,288 savers by December 2002; the repayment rate was 99.2%, portfolio-at-risk 0.3%, operational self-sufficiency rate 150%, financial self-sufficiency 123%, and adjusted return on assets 6.4%. Serving as training institute for the Grameen replication project supported by ADB and IFAD, CARD has contributed to the dissemination of the approach to a total of 162 active replicators: rural banks, rural cooperative banks, NGOs and cooperative societies. The principal lesson to be learned is that Grameen-type MFIs can be sustainable and can substantially increase their outreach. CARD's social capital comprises: (a) a core of good Grameen practices, such as high moral commitment on the part of the leaders, based on values instilled through training; peer control – to preclude adverse selection and moral hazard; and a strict credit discipline; (b) innovative adaptations to the Philippine context, such as the adoption of rural bank status under central bank supervision; mobilization of voluntary savings; provision of differentiated, profit-making loan and insurance products; and a broadening of the clientele to include poor and non-poor depositors, while adhering to its mission of lending to poor women only. (Seibel & Torres 1999)

Similarly among the credit NGOs in Uganda, there are some 40 or 50 large ones, which may now take advantage of the recently prepared microfinance law and convert into regulated deposit-taking institutions; or directly into a commercial bank, like Centenary RDB (Box 4).

Box 4: Uganda: transforming a trust fund into a commercial bank

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 the bank's sustainability and its outreach to the poor.

In Ethiopia, a microfinance law was passed in 1996; though quite restrictive in operational respects, it led to the emergence of some twenty regulated, but poorly supervised, MFIs, a couple of them with savers and borrowers in the hundreds of thousands. Their total borrower outreach in mid-2002 was around 500,000. It is important to include a transition to a regulated financial institution in the planning, preferably from the very beginning. This would then permit a dialogue with policymakers to start working at an appropriate legal and supervisory framework for local financial institutions, avoiding perhaps some of the errors of financial repression by wellmeaning central bankers, as in Ethiopia. Other examples of banks of NGO origin are BancoSol in Bolivia, Bank Purba Danarta and numerous other NGO banks in Indonesia.

4.4 Ownership and governance

The second weakness of NGOs pertains to ownership and governance. NGOs, like development banks, have no real owners with vested interests in autonomy and self-reliance. As a result, there is little orientation towards profit-making and growth and no accountability for losses. In the case of development banks, privatisation has been a common solution in Latin America, but rejected in most African and Arab countries, with the result of actual or technical bankruptcies. However, there are notable exceptions, including BRI in Indonesia, BAAC in Thailand, Bank Keshavarzi in Iran, BNA in Tunisia and BNDA in Mali. Effective regulation and supervision together with incentives for individual performance may offset some of the disadvantages of public ownership. This applies similarly to NGOs; but there the problem of ownership is more difficult to solve, particularly when donors inject equity and NGOs evolve into banks, which is now becoming more common. Constructs of fake individual ownership (backed by contracts between the NGO and board members acting as individual owners) are legally questionable and do not foster accountability. One solution would be cooperative ownership by the clients; this however has rarely been accepted by the board and management of NGOs. Converting credit NGOs into member-owned institutions may be a desirable option, but does not seem to meet with much sympathy among their stakeholders.

5. Using reparation payments for sustainable institutional rehabilitation and capacity-building: investing in local financial institutions (co-) owned by recipients of reparation payments

5.1 Types of local financial institutions

A different approach, with ownership clearly established from the onset, would be support to locally owned financial institutions, which may be (co-) owned by recipients of reparation payments. These are mostly small local institutions, which are flexible and adaptive. Because of their institutional size, their sole business is microfinance. They may be formal, semiformal or informal, or combine two levels, as in the case of a village bank with a surrounding network of informal savings and credit associations as retailers. They may have great evolutionary potential: from informal to semiformal, from semiformal to formal, and from unit banking to branching-out. There are three major types of locally owned institutions:

- member-owned (*cooperative*) institutions;
- community-owned institutions; and
- privately owned institutions.

Member-owned institutions based on *social solidarity* (de Greiff 2003:22) are typically self-financed and self-managed. They can be formed by any type and number of people within or across neighboring communities, comprising microentrepreneurs, small farmers, women and the poor. Membership is normally contingent upon an equity capital contribution but may also include other criteria (e.g. gender as in the case of a women's bank, occupation as in the case of a market or traders' bank) and is a prerequisite for access to the institution's services. In some cases such institutions are also open to non-members but at different terms. Member-owned institutions rely fully or largely on their own resources, i.e. on savings and equity including retained earnings. Equity contributions (*shares*) may be equal (as in formal cooperatives) or unequal (as in most indigenous savings and credit associations and in the ASF presented below); similarly, votes may be equal or tied to voting shares. Among the financially self-reliant institutions owned by their members are vast numbers of group-based informal financial institutions. Among them are the ubiquitous rotating and non-rotating savings and credit associations. Whether nonformal institutions can evolve into banks depends on the legal framework, which is of course subject to change.

Community-owned financial institutions may be people- or local government-based. They are *people-based* if the members of the community are either directly (through individual or household membership) or corporately owners of the institution. There must be a provision in the rules and regulations or bye-laws that the community members or its recognized representatives have a say in the running of their affairs. This should also be reflected in the perceptions of the people, who should consider the institutions as *theirs.* In some developing countries community banks are *government-based*, be they government-owned or government-imposed and perceived as government institutions. In fact the dividing line between institutions owned by local government or by the people of the community is not always sharply drawn and may be as much a legal as a social issue. A useful quantitative indicator may be the extent to which community banks depend on government resources vs. savings and retained earnings as a source of funds.

Privately owned financial institutions are owned by one or several wealthier individuals. Examples are the rural banks in the Philippines and Indonesia. Sometimes they are owned by large numbers of not-so-wealth individuals, with shares similar in size to those in cooperatives. The difference lies in governance: cooperatives are governed by the principle “one man, one vote”; in privately owned institutions, registered perhaps as stock companies, voting power is by number of shares. Financial Service Associations in Benin, Guinea and Uganda permit unlimited ownership of shares, but restrict the number of voting shares.

Community Banks in Nigeria, based on a law enacted in1990, are an example of a crossbreed between all three types, combining a variable mix of ownership by informal self-help groups, registered Community Development Associations and private individuals. Tossed around between deregulation and re-regulation, their number has fluctuated around 1000; between one and two thirds of them have been viable.

5.2 Strategies of promoting locally owned financial institutions: upgrading, innovating, linking[7]

There are three major strategies of promoting local financial institutions, which may be (co-) owned by recipients of reparation payments:

- Upgrading informal financial institutions
- Innovating, ie, establishing new financial institutions
- Linking formal and informal finance, or banks and self-help groups.

[7] Downgrading or downscaling banks is a fourth microfinance development strategy. This is not discussed here, because it would be illusionary to request co-ownership by local people. (Seibel 1997)

5.2.1 Upgrading informal finance

Informal financial institutions (IFIs) of indigenous origin are widespread in many developing countries, particularly in Africa and Asia. Organized self-help is part of the social capital of almost every ethnic group, comprising a range of institutions referred to by terms in the local language. In a stable environment, , they typically mobilize their own resources, cover their costs, have their loans repaid, and finance their growth from their profits. They are generally renowned for the effective-ness of social control. There are two types: individual intermediaries, such as money-lenders and deposit collect-ors; and group-based intermediaries, such as the rotating and non-rotating (*accumulating*) savings and credit associations. The emphasis here is on the latter, ie, self-help organizations owned and managed by groups of local people, poor and non-poor. (Box 6)

Box 5: Bye-laws of a ROSCA among the Mano in Liberia

All members should agree upon one sum of money to be paid every Sunday. And one late to pay that Sunday five cents interest will be added to the sum he suppose to pay. Members should always put in the income; No matter how hard money business might be; you will have to put in the income. The five officers should agree before the money should be loaned to someone. Any money missing from the bank the Treasurer is responsible to pay for what is missing. Time for the income: Every Sunday. (Seibel & Massing 1974)

Box 6: Liberia and other countries: Informal finance
Inspired by the studies of Herskovits and Westermann in West Africa at the beginning of the 20th century, I surveyed organized economic cooperation in the late 1960s in all 17 ethnic groups in Liberia. All over the country, I found people forming self-help groups in which each person regularly contributed equal amounts of something valuable: labor, rice, money or other items. One participant at a time received the accumulated total which he could use for his own individual benefit: to fell trees with the help of a rotating work group, to feed a wedding party with the rice accumulated by a rice savings group, or as microenterprise working capital provided by a rotating savings group. A cycle was considered to be complete when each member had received the total once over. A new cycle could then start with the same or a different membership.

Accumulating and reallocating labor, rice or money are three seemingly different forms of economic cooperation. Yet in the eyes of a peasant whom I met in Côte d'Ivoire in 1985, they are all about financial intermediation: "Le travail, c'est notre argent!" In Ghana, in 1979, I saw groups of women jointly producing palm-oil which they sold on the market, allocating the proceeds to one member of the group at a time. Most of these groups also provided social insurance by allocating scarce resources, out of turn, to members in emergency situations. In the early days this consisted mainly of food items whereas nowadays it is usually money.

The institution of rotating savings is ancient, dating back at least to the 16th century, when Yoruba slaves carried it to the Caribbean, as part of their institutional luggage – or social capital. Both the term *esusu* and the practice have persisted to this day, as *esu* in the Bahamas, *susu* in Tobago or *sou* in Trinidad. Among the Yoruba in Nigeria today, there is hardly a single adult who is not a member in one or even several esusu, numbering anything between two and several dozen or even hundreds of members. The institution exists all over West Africa as well as in many other parts of the world, where it is an integral part of the local microeconomy and referred to with its own vernacular term, eg, *arisan* in Indonesia, *paluwagan* in the Philippines, *gameya* in Egypt, *ekub* in Ethiopia, and *cuchubal* in Guatemala.

Substantial changes have occurred in recent decades. Although with no predetermined pattern, these changes have tended to be in the following directions: from labour, kind or premonetary currency, to cash; from non-financial to financial groups; from rotating to nonrotating patterns; from short-lived to permanent groups; from savings only to savings-driven credit. With the expansion of the money economy, they have multiplied, both in number and diversity. Banks, with their inappropriate products and practices, have not prevented them from spreading. Many bank staff have been found to participate; and some banks have even adopted some of their financial technologies. (Seibel 2001/4:84-85)

When the state with its institutions collapses, institutions that are part of the traditional fabric usually remain. In fact, in the absence of other options, indigenous institutions may gain in outreach and vigor. In many parts of **Ethiopia** for example, *edir*, the ubiquitous funeral society, has evolved during the crisis years into a village-based financial institution with a range of innovative financial services to its members. Some NGOs, like the Norwegian Redd Barna, have built on that basis.

In post-conflict situations, informal finance as a *cooperative coping mechanism* has been found to develop much more quickly than semi-formal or formal microfinance, to do so at low cost, and to be more appropriate in terms of products and services. With increasing stability in the post-conflict environment, the following shifts have been observed: from loans in kind to loans in cash; from short-term to longer-term loans; from trust to trust-cum-collateral. Both consumption and production loans for low investments and quick returns are heavily in demand, in that order. (Williams et al. 2001; Wilson 2002).

Reparation payments may be used for groups of recipients, together with people who bring in resources of their own, to first establish such IFIs according to local traditions, and then upgrade them. This may entail:

- enhancing management skills and operational practices;
- transforming rotating and nonrotating savings and credit associations, funeral societies and similar IFIs into permanent financial intermediaries;
- upgrading to semiformal financial institutions;
- mainstreaming and integrating into the formal financial sector.

This process of upgrading may be driven by incentives rather than pressure or project design. A particular strategy to be supported by donors, in partnership with an NGO, might be upgrading & mainstreaming through networking among informal financial institutions as an incentives-driven option. IFIs may be offered assistance to establish networks and enlist as members. The network may be registered under a suitable legal form: as an association, a foundation, a cooperative, a company and eventually perhaps, at a higher evolutionary stage, a formal financial apex institution. In a stepwise order, the network may offer services as an incentive to join: training, consultancy, book-keeping tools, legal assistance, exchange of experience, interest representation, dialogues with local and national authorities, auditing & supervision services, liquidity exchange, and commercial bank linkages. As members of the network, IFIs are free to choose whether they remain informal network members or, with network assistance, seek a semiformal or formal status for themselves.

Box 7: An incentives-driven approach to stepwise mainstreaming of informal financial institutions

Mainstreaming	*Incentive*
1. Registration	Accounting training
2. Reporting	Financial management training
3. Legal status	Consultancy services in good practices
4. Prudential norms	Liquidity exchange and refinancing
5. Supervision	Accreditation with a seal of quality

5.2.2 Establishing new financial institutions

New financial institutions may be established if no other institutions exist; or if the upgrading or reforming of existing institutions is not feasible. In post-conflict situations, such institutions are normally established with foreign capital as credit NGOs, usually owned by an international NGO. In contrast, we are suggesting the establishment of financial institutions owned by their members, using reparation payments of beneficiaries as well as savings of other people, no matter how small. At inception, such institutions will be semiformal, ie, recognized but not registered with a financial authority. They should be planned in such a way that they may eventually be upgraded to a regulated institution. This will pave the way for a policy dialog with the central bank and other financial authorities, aiming at a suitable legal framework. Two examples are given below.

Financial Service Associations (FSAs) are an IFAD innovation built on the principles of indigenous nonrotating savings and credit associations: proximity, local financial intermediation, ownership and self-management by the poor, self-reliance, and sustainability. The model is very close to that of upgrading IFIs, the main difference being terminological. If local terms are used, like susu, sanduq, arisan or paluwagan, they are likely to be perceived as indigenous institutions; if referred to as FSAs (or cooperative societies), they are considered as implants.

With a view to promoting cost-effective delivery of financial services at the village level in areas devoid of banking facilities, IFAD first introduced this model in the

Republic of South Africa in 1994, followed by the Republic of Congo in 1996, and in the Republic of Guinea and in the Republic of Benin in 1997. Widest coverage has been achieved in Benin, where, as of mid-2003, 144 ASF cover some 820 villages, ie, one-third of the country. The FSA model avoids use of external funds by mobilizing local savings in the form of equity and transforming them into small loans to shareholders for quick turn-around activities. Once reparation payments are made available, they can be used like local savings and paid into FSAs as equity shares. The salient features of the FSA model are as follows (*details refer to Benin*):

(a) *Proximity.* An FSA is a joint stock company with a variable capital that is owned and operated by shareholders, who are local residents.
(b) *Savings.* Local resources are mobilized through equity shares rather than withdrawable deposits. Local resource accumulation and security of funds are major incentives for buying shares.
(c) *Accounting.* Record-keeping, including the annual closing of accounts, is done locally by FSA staffwith the assistance of specialized NGOs .
(d) *Governance.* All decisions including creditworthiness examinations are taken and carried out by board members elected by the shareholders . There is no ceiling on the number of shares held by a member; but no shareholder can have more than 10 votes in the General Assembly where all major management decisions are taken.
(e) *Controls.* The mechanisms for internal and external controls constitute a coherent whole that facilitates the rapid attainment of autonomy and self-regulation.
(f) *Profitability.* The shareholders define the FSA's strategy for profit generation, determining interest rates and the allocation of profits; concern for profitability is an integral part of all decision-making.[8]
(g) *Lending Operations*. FSA mobilizes financial resources in the form of equity from within its area of operations for investment back into the area. The main financial product of the FSA are small short-term loans to members and, if so decided, to non-members.
(h) *Sustainability.* The members define strategies for risk management and bad debt provisioning, they decide on allocations for operational costs, retained earnings and dividends
(i) *Networking.* An apex organization is expected to be operational by the end of 2005. (Tounessi 2000; Seibel 2003)

Thus, the FSA concept is a flexible model of microfinancial intermediation in rural areas, resting on member-owned financial structures that are initiated, owned, and operated by the villagers themselves. In a restrictive policy environment of francophone West-Africa which limits interest rates on loans to twice the central bank discount rate, FSAs have preferred to remain informal rather than register as savings and credit cooperatives which are regulated by the *Loi PARMEC*. Operating outside any formal regulation and supervision certainly is a risk to their growth and long-term sustainability; but during the start-up phase, this would be an advantage in post-conflict situations where a formal institutional framework has yet to evolve. For post-conflict reconstruction and a sustainable impact of reparation payments, the FSA model could easily be adapted to countries like Liberia and Sierra Leone , with a similar cultural background in terms of indigenous local finance.

[8] By December 2002, interest rates in most ASF in Benin had declined from 10% to 2-6% per month (compared to 10%/day for one-day loans 30%/month for one-month loans by moneylenders); the annual dividend stood at 20%.

Sanadiq (pl.; sg.: ***sanduq***), based on ancient Arab traditions, are member-owned local financial institutions in **Syria**, a command economy where all banks have been state-owned. With a mixture of member-equity and external equity contributions, the sanadiq have been shaped in their structure and functioning by the local people in Jabal al-Hoss through an intense participatory process and not by any authorities. Support has come from the Ministry of Agriculture and Agrarian Reform and UNDP. Through self-help as the basic principle, cost-coverage and profitability have been attained by the sanadiq within their first year of operation – perhaps not surprising to rural and microbanks when they establish branch offices, but certainly beyond the expectations of NGOs! In a situation of incipient liberalization, the unusual degree of self-determination, self-reliance and local initiative, together with an excellent performance record, have earned the Sanadiq national visibility in government and donor circles. (Box 8)

Box 8: Sanduq, a financial innovation in a marginal area of Syria
Jabal al-Hoss is one of the poorest areas in Syria where UNDP has supported the establishment of self-reliant local financial institutions, *sanduq* (*sg*.) lit. *savings box*: a revolutionary concept in a command economy. The sanadiq (*pl.)* are self-managed and autonomous in their decision-making, which has included the adoption of Islamic banking. The start-up is self-financed through member share capital, from which small loans for up to three months are given. Whenever initial financial intermediation is satisfactory, UNDP provides an additional capital injection, thereby increasing outreach, loan sizes and loan periods. Between September 2000 and December 2002, 22 sanadiq were established, comprising 4,691 members, with shareholder equity of US$ 130,000. UNDP contributed $370,000 in equity; but as repayment stood at 100%, it is difficult to be critical of the donor dependency ratio. Return on equity was 17%, almost half of which (46%) was paid to shareholders, the rest retained as capital. Anecdotal evidence shows that loans permit farmers to bypass trader-moneylenders and sell their produce at a higher price; laborers turn into farmers; and microentrepreneurs use quick-turnover repeat loans for rapid business growth and marketing innovations. Women, who constitute 41% of the membership, opted for integrated sanadiq, in which female members manage their own affairs through separate women’s committees. They find access to loans easy, as sanadiq do not require physical collateral. Loans are used by younger and older women to do business of their own, eg, renting land to plant their own crops and opening small shops. The additional income is used for business growth and family support. It is not rare that women – among them a mother of ten - are the better entrepreneurs, perhaps ushering in a small social revolution. In 2002 a network and a central fund (Sanduq markazi) were created, to provide central services and initiate the preparation of a legal framework. Upon the successful conclusion of the pilot phase, expansion of sanadiq throughout Jabal al-Hoss is now under way. There are also plans of extending networks of sanadiq throughout Syria as a strategy to alleviate unemployment and poverty in both urban and rural areas. (*For further details and a pictorial view see www.undp-hoss.com*.)

Sanadiq in Iraq? Given the experience in Syria, the time may have come to examine the feasibility of establishing sanadiq in countries with a similar cultural background. Foremost among them may be Iraq where the institutional void is deepest and the need greatest. Reparation payments, if any, might be instrumental in pump-priming sanadiq as member-owned village banks. In the present political situation, institutions which are entirely member-driven and adjusted to perceived local traditions including Islamic banking may turn out to be vital in building a sustainable financial infrastructure accessible to all, including women and the poor. Two United Nations organizations, FAO and UNDP, might be instrumental in the process. The possible role of the Agricultural Cooperative Bank of Iraq would have to be explored.

5.2.3 Linking formal and informal finance

Reparation payments can be instrumental in establishing self-help groups as informal financial institutions or in the upgrading of such groups to semi-formal and perhaps formal levels. Yet, without integration into national financial markets and access to capital markets at a later stage, there are limits to their growth, which in turn imposes limits on the growth of the micro and small enterprises of the members of such institutions. Linkage banking has opened the way for virtually unlimited growth.

At their own initiative, and sometimes aided by consultancy proposals, informal financial institutions have entered into numerous linkages, mostly depositing savings in cooperatives and banks. But being informal, these institutions had great difficulty in accessing credit from those banks or cooperatives. This is where APRACA, a Bangkok-based association of central and rural-agricultural banks in Asia and the Pacific, intervened. An increasing number of member institutions, such as Bank Indonesia, Landbank in the Philippines, NABARD in India and BAAC in Thailand, have encouraged banks to cooperate on commercial terms with financial self-help groups with joint liability. This has reduced the transaction costs of lenders and borrowers and simultaneously of deposit-takers and depositors. NGOs and other non-financial organizations have contributed social mobilization, training and consultancy services; some have also acted as financial intermediaries in the inception stage when banks lacked confidence in informal groups. This has worked well in Asian countries where policy frameworks have favored financial innovations, cost-covering interest rates and institutional viability (Ghate 1992; Kropp et al. 1989; Seibel & Parhusip 1992; Seibel 1996). In Africa, where policy environments have been unfavorable or less stable, as in Nigeria, APRACA's sister organization AFRACA found it more difficult to promote linkage banking. However, some of its member institutions, such as CNCA in Burkina Faso, AFC in Zimbabwe, and the Central Bank of Nigeria, have taken promising initiatives. In Ghana, the World Bank, IFAD and the African Development Bank have been involved in a new initiative of linking indigenous savings and credit associations, the so-called susu clubs, and daily deposit collectors to banks.

Linkage banking, or SHG banking, as a strategy for linking banks with informal financial intermediaries and self-help groups (SHGs), is a three-pronged approach:

- mobilizing local resources through member-owned local financial intermediaries and providing access to credit from commercial sources;
- integrating these SHGs/IFIs into national financial markets;
- enabling banks to reach out to smallholders and microentrepreneurs as a new market segment.

Indonesia is the country where linkage banking, under the auspices of the central bank and GTZ, was first implemented on a national scale, starting in 1988. Inspired by that experience, Nabard, the National Bank for Agriculture and Rural Development in India, pilot-tested linkage banking during 1992-96 and achieved spectacular results within the last five years, aiming at 100 million rural poor by 2006 (Box 9). With some modifications, the approach could also be jumpstarted by, or otherwise incorporate, reparation payments.

Box 9: SHG banking in India – the largest non-directed microfinance program in the world
Nabard's SHG Banking programme aims at providing sustainable access to financial services for the rural poor. The emphasis is on the unbankable who had been too poor to organize self-help groups (SHGs) at their own initiative. Through NGOs, government agencies and banks, large numbers of SHGs have been established in recent years: as self-reliant autonomous local financial intermediaries. 85% of the members are women; in India, they have proven to be the better savers, borrowers and investors. Most of them are from the lowest castes and other disadvantaged groups. The SHGs mobilize their own savings, transform them into loans to members and plow their earnings from interest income back into equity. By using the existing rural financial infrastructure, comprising 150,000 banking and cooperative retail outlets under Nabard's supervision, and linking them to SHGs, there are economies of scale and scope, resulting in substantially lower transaction costs. In the absence of interest rate restrictions and with repayment rates of 98%, SHG banking has been highly beneficial to SHGs, members and banks - a message that has convinced stakeholders in increasing numbers.

National implementation started in 1996, after four years of pilot-testing. By March 2002, the program encompassed 461,000 self-help groups with 8m members, covering 40m household members; 17,000 bank branches were involved, mainly government-owned Regional Rural Banks and Cooperative Banks. Average loan sizes were around $500 per SHG and $30. When the results of a profitability study were presented at a national conference in Delhi in October 2003, showing that its profitability (at very low interest rates to SHGs around 13%, but repayment rates of 98%) was higher than that of any other financial product, commercial banks joined the program in increasing numbers. As of March 2003, outreach had surged to 702,000 SHGs, with a total membership of 12 million, covering 60 million household members. The program has turned into a social movement, fuelled by competence and enthusiasm at all stakeholder levels. With its balanced emphasis on both savings and credit, it is the largest non-directed microsavings and microcredit programme in the developing world. Nabard has now lowered the date of reaching 100 million, i.e. one-third, of the rural poor in India, from 2008 to 2006.

Self-reliance of SHGs based on internal savings and retained earnings, a salient feature of the program, was found to be rapidly growing, exceeding in older groups the volume of bank refinance by an increasing margin. SHGs also deposited substantial amounts of savings voluntarily in banks as reserves. In addition to direct effects on bank profits, SHG Banking has *indirect commercial effects* on banks in terms of improved overall vibrancy in banking activities. *Indirect benefits* at village level include the spreading of thrift and financial self-reliance and of a credit culture among villagers, microentrepreneurial experience, growth of assets and incomes, the spreading of financial management skills, and the decline of private moneylending. *Intangible social benefits* are reportedly many: self-confidence and empowerment of women in civic affairs and local politics, improved school enrolment and women's literacy, better family planning and health, improved sanitation, reduction of drinking and smoking among men, and a decline in adherence to local extremism.

5.2.4 Some principles of promoting locally owned financial institutions

Promoting local financial institutions combines the advantages of (a) individual grants[9] with those of (b) development and social investments, while avoiding their disadvantages, such as delayed impact and uncertain success of broad-based (*integrated*) development programs. Guiding principles in the choice of strategy should be social solidarity, integrity and coherence (de Greiff 2003:28-29), and immediate real and perceived benefits:

> *Self-financed and self-managed local financial institutions – promoted through reparation inputs to individuals or through programs – provide such immediate real and perceived benefits: access to credit and deposit services for the safe-*

[9] (a) Respect personal autonomy; satisfy perceived needs; improve the quality of life for the beneficiaries, ease of administration; (b) Recognition given to entire communities and other social entities; reaching goals of justice as well as development; politically attractive.

keeping and accumulation of savings, together with opportunities for communication among peers on income-generating activities and other coping strategies.

Ownership is essential to governance in microfinance. To create a solid base of individual ownership and accountability, preference should be given in the disbursement of reparations to payments directly to individuals, or into the microfinance accounts of individuals.

5.3 NGOs revisited: promoters of good practices

NGOs can have a special role to play in the establishment and promotion of sound microfinancial institutions, bringing together recipients of reparation payments and other local people among the poorer sections of the population, acting as social mobilizers. They can disseminate information and organize exposure training programs. Through training, they can assist small institutions to improve their viability and upgrade their legal status. They can also initiate financial operations which, in many countries, precludes deposit collection. If they are themselves seriously interested in financial operations, they should register as a rural or commercial bank, finance company or savings and credit cooperative.

NGOs may propagate good microfinance practices (not necessarily *best* practices, which evoke notions of universally valid optimal solutions), particularly in member-owned local financial institutions. Good practices are crucial to the sustainability of microfinance services. They may comprise:

- The social mobilization of recipients of reparation payments and other poor people into founders and owners of local financial institutions based on self-help;
- the mobilization of internal resources for institutional self-reliance through savings collection including reparation payments, higher interest rates on loans, share capital, profits and insurance premiums;
- the promotion of microsavings as a source of microenterprise or farm household self-financing through financial products such as voluntary withdrawable savings, time deposits, mandatory regular savings, lottery savings, and daily savings collection on doorsteps;
- appropriate microcredit products with small loan sizes growing according to repayment performance and absorptive capacity, mostly short maturities and installments according to customer capacity, insistence on timely repayment, and market rates of interest covering the costs of each product;
- an appropriate mix of group and individual technologies, including graduation from small group loans to larger individual loans.
- microinsurance products contributing to loan security, such as life, health and cattle insurance;
- product reciprocity, tying credit to savings (including reparation payments) and insurance to enhance financial discipline and bankability;
- collection reciprocity as a means of arrears prevention, combining savings and loan installment collection or financial and commodity transactions;
- customer-oriented microfinance procedures and services set by financial institutions rather than government, including sound financial management, convenient collection and deposit facilities, appropriate loan processing,

adequate risk management, timely repayment collection, monitoring and effective information gathering;
- terms and conditions which benefit from the experience of formal and nonformal institutions and serve the interests of both the institution and its customers;
- access to bank refinance, externalizing bank costs by organizing joint liability, loan negotiations and coordinated collection of payments.

In sum, NGOs may be instrumental in using reparation payments, together with other sources of finance, to promote

- the establishment, growth and development of sustainable local financial institutions (co-) owned by recipients of reparation payments; and
- the establishment, growth and development of sustainable farm and micro-enterprises owned by recipients of reparation payments.

These two objectives are interrelated and mutually reinforcing. In post-conflict situations, they may provide the basis for a process of *development from below*, combining self-help and self-reliance with external financial and technical support.

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