

The Other Microfinance

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Jean Claude Rodríguez
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I. Introduction

Those of us who wrote this book are social entrepreneurs who have devoted much of our lives to carrying out development projects. As such, we have designed and implemented our own models constantly keeping in mind their ability to be used in many other cases and not just in a particular one. The essence of social entrepreneurship is precisely that: *creating replicable programs*.

In this book we present our reflections on how society has attempted to provide financial services to millions of people who do not have access to them, yet need them. We also present part of our experience in the field: what we tell here are the experiences and analysis of what has actually come about. This is not a thorough academic research piece on microfinance, but rather our findings in working and sharing with thousands of individuals belonging to low-income communities in Africa, Latin America, and Europe. We just tried to tell our experience under a thoughtful approach and perhaps to venture to draw the attention of people and institutions doing scientific analysis to devote time to review, validate or deny our hypotheses and conclusions.

Our first major claim is that the most massive financial system is not formal. Most people, especially in low-income communities, resort instead to a series of instruments and informal mechanisms, individual and collective. The term *informal* is understood here as *not regulated by the state*, i.e. it covers all financial practices that are beyond supervision and control by the State. *Informal* then is not synonymous with *illegal*; it just means not controlled or supervised by regulations. It is important to emphasize the difference, because not everything that is not regulated in the financial system is illegal. There are many mechanisms and practices not regulated by the state because they are unknown and are not within the scope of any specific laws. Some are deeply rooted their culture and foster values such as solidarity, trust and integration, and cannot be ignored simply because they are not supervised by the state. By ignoring these community financial practices, regulatory

authorities have endeavored to make them "illegal" or quasi-legal, whereas in fact they are models of long cultural tradition, which in most cases offer poor financial services, but are more suited to the needs of low-income populations than those provided by mainstream financial institutions.

With the emergence of microfinance, attempts were made to develop formal customer service (banking) mechanisms for the large number of individuals with no access to mainstream financial services. Almost forty years have passed since the emergence of this movement and, although it has come a long way, the goal of reaching the majority of the world's population is far from complete. There is no denying that today microfinance does exist and has reached a certain number of achievements, but it must be added that these are still very limited. Four decades later, there is a significant stagnation and some of the leading spokesmen of the movement have severely criticized the turn taken by this current. Among them is professor Muhammad Yunus himself, considered to be the founder of microfinance and Nobel Peace Prize winner in 2006. Perhaps it is time to seek new sources of inspiration.

But the history of microfinance could have been a very different one if instead of turning to banking, scholars had bother to study the many possibilities provided by unregulated financial mechanisms that people use. Professor Yunus focused on loan sharks and speculators who certainly made the most of misery and thought he had found the solution in providing access to banking systems to attract the money going to those hands. But he lacked further exploring and understanding of the local mechanisms that millions of people use, which - with minor changes to make them safer, fair and fit - may suitably combine savings and credit while reducing the costs that users pay for having access to financial services. Had it started with unregulated mechanisms, microfinance would have been very different, much simpler and adapted to the reality of its users. Furthermore, using and improving traditional savings and loans practices would have contributed to better effectiveness of current mainstream financial system, which already experiences difficulties in

providing quality banking services to higher-income communities, and additionally has been constrained to enter markets where profitability requires that the costs be borne by those who have less. The microfinance path described here resembles that of Socrates, who, before taking the hemlock, after his lengthy explanations on freedom, realizes that this good is not out of his own soul but it is part of it. Hence, microfinance has gone through informality towards banking, to finally have to recognize that the same local unregulated practices could involve more efficiency, responsiveness, and even more profitability. In recent years, the academic world began to study this phenomenon with some methodological rigor. In *Portfolios of the Poor*¹, a group of professors from Princeton and Oxford universities has been systematically analyzing how over two hundred fifty people in three countries (India, Bangladesh and South Africa) use a variety of informal mechanisms. Their conclusions will surely surprise many within the world of traditional mainstream microfinance, but for us it is a study – well-documented and with outright academic support and an outstanding educational value - which mostly confirms our findings as social entrepreneurs within the groups we have been serving in our daily endeavors for several years.

The book is a first attempt to spread our ideas and experiences amid an audience interested in the subject, with the plan of broadening the discussion. The content has been organized as follows: The first chapter explains the importance of financial services in improving people's quality of life. In the second one, the different unregulated savings and loans mechanisms that people use and have traditionally used are reviewed. The next two chapters show the most noticeable strengths and weaknesses of these mechanisms. In the fifth chapter, the microfinance banking strategy as the path chosen to bring financial services to the poorest is reviewed and, in the next one, the *Other microfinance* is presented as a different and complementary strategy to open up access to these services for all. Chapters seven and eight

¹ 1 Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, *Portfolios of the Poor. How the world's poor live on 2\$ a day*, Princeton University Press, Nueva Jersey, 2009. Ebook, PC Kindle.

explain the microfinance model developed by FUNDEFIR in Venezuela and then developed in Spain by CAF² Association (an appendix is attached explaining CAF experience in Spain). The book concludes with a call to join efforts to promote a worldwide movement to make the need to implement the *Other microfinance* visible and remarkable, in order to complement and extend the efforts undertaken by traditional microfinance in its nearly four decades of existence.

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²Visit: <http://www.comunidadesCAF.org/web/index.html>

II. Importance of Financial Services

*“Before, for buying the blocks and
the cement we had to wait for a long
time. And then, when we finally got
the money, prices of
things had gone up and we
could never manage ...
Now I apply for a loan and
all at once buy what I need.
In this community there are almost no more
hovels thanks to the community bank.”
Member of a Bankomunal
Margarita, Venezuela*

People used to mainstream financial systems usually are not aware of their importance since these are part of their everyday life. Services provided by these institutions, however, are vital not only for developing the world economy and companies, but also for the exercise of *full economic citizenship* by the person in the street.

Some years ago, while giving a lecture to students in a Spanish university, we talked about the lack of access to financial services. We asked them what would happen if henceforth banks closed their current accounts or savings accounts or those of their parents and blocked their credit or debit cards. They were all bewildered. In imagining the situation, they were suddenly alarmed with this scenario, and they understood the limitations of living without such services. But in fact this is the reality of the vast majority of people in the world, even years after the emergence of microfinance. They cannot access these services.

Just imagine that, you, reader, live in a rural community in any Latin American, African or Asian country. This year you had a great harvest that yielded economic surplus, and although temporary, you want to place it somewhere safe, protected from inflation. But it turns out that the nearest financial institution is 30 km away and the cost of transport to that location means spending five percent of the amount you want to save. However, you are persistent, and that payment or distance does not discourage you, so you take your transport and get to the bank. When entering you learn that opening the account

requires an amount higher than what you have, and unfortunately you cannot save your money in that bank.

Now, do not be pessimistic, and let's assume that the amount you intend to put does reach the minimum required to open a savings account. Other problems immediately arise: the complexity of filling in application forms or having all documents required to submit in order to open an account. It seems then that the system is made so that it is really hard to keep your money in that bank. It is as if the bank had a sign placed outside it that reads: "This service is not for poor people."

Continuing with the example, let's say that, fortunately, in this town there is a microfinance institution (MFI) that made this process simple and you can finally open a savings account in that town. You go back to your community very happy with your great savings account (paying return transportation). But the next day one of your children has a minor accident and requires medical care. Hence you are constrained to use part of the savings you just deposited. Again, you have to take transportation to go to the bank agency to withdraw your money, paying the transportation costs. But as we speak of a rural community, let's assume that the poor road conditions prevent you from getting on time to the agency and it, unfortunately, is already closed when you finally get there. Therefore, you will have to wait until the next day.

The above account is not a far-fetched invention, but a situation that millions of poor people experience in their daily life, especially those living in rural areas, far from the banks and, therefore, with difficult access to mainstream financial services. This reality shows that the system *is not designed to serve their needs* and that, despite the efforts microfinance institutions have made for over three decades, the vast majority of poor households do not use and perhaps will never use these services.

As for credit, the situation is worse, because what is at stake is the money of savers. Take, for example, that in the previous case the person needs to apply for a relatively small amount to pay the cost of his child's medical emergency. Evidently, he would not even try to go to a commercial bank, knowing that he will not find such a service there. If there were a microfinance institution in the area where he lives, he might consider applying for a loan. But when he talks to the loan officer, his officer will tell him that funds are provided only for

productive activities or microenterprises, and, unfortunately, the applicant is not part of the ten or fifteen percent of the privileged residents of this community that belongs to such an area³. In these circumstances, he has no choice but to seek support from friends, family or, perhaps, to the known lenders: the *money lenders*. Now, depending, among other things, of the time he has been living in that community and personal relationships he has established there, perhaps not even in that way can he obtain the loan he needs.

The above examples show why it has been proposed that access to financial services be considered as a fundamental human right⁴, thus underlining its importance in people's lives. For in fact not having simple and reliable instruments to save money or to request a small amount of capital to enable them to solve an emergency is a terrible limitation for millions of people worldwide. Society should seek to eliminate this limitation, since it is a great unfairness that accentuates social inequalities.

Extending financial services to these sectors would also have other advantages that should be considered. Having them makes access easier to other services much needed by the population. In places where there are good savings and credit services, the number of children attending school increases because it is possible to build up or obtain money to buy books, uniforms, shoes. In rural areas, agricultural productivity increases, because of the possibility of having the necessary funds to purchase essential supplies in sowing season. It also improves the health of families, as there are resources allowing them to deal with medical emergencies. The capacity to create enterprises is developed because capital is available, which is one of the key inputs for business management. Access is provided to goods and services that contribute to improving the quality of life. It is

³ We criticize the banking model as the only microfinance choice, but we do not blame banks for this situation. These institutions are subject to a series of regulations and commitments with their savers, preventing them from granting under insecurity or break-even point conditions. In many countries, for instance, lending money to people who have no assets that can be secured would be unlawful.

⁴ See, for instance, the Merida Declaration by the International Association of Collateral and Social Loan Entities (*Declaración de Mérida de la Asociación Internacional de Entidades de Créditos Prendarios y Social*) of Mexico, September 2007, which requested the right of access to non-abusive credit as an "emerging human right."

further known that households who manage to save money develop a level of highly appreciated emotional security. In short, it could be said that there are better opportunities to fully exercise our economic rights.

Moreover, irregular income in these populations is a factor that contributes almost as much to maintaining the conditions of poverty as the lack of income. Many people stop sending children to schools, using the necessary agricultural inputs for the crops, visiting doctors or buying medicine for any treatment, not because of complete lack of income, but because these fluctuate considerably through the year. Thus, social groups with these characteristics need financial services that allow them to better manage their variable flow of income and expenditure. Not having income on a regular basis determines their possibilities to achieve higher standards of living.

All these reasons contribute to support the importance of financial services. That is why we have no hesitation in asserting that in populations where these services are diverse, permanent, accessible, and of quality, progress and development of their inhabitants is easier, while for people who have no access to these benefits, achieving full economic development is more difficult.

Nowadays credit is a fundamental tool for improving human and technological capital that enables economic progress of communities, regions, cities and countries. Moreover, channeling savings into productive activities contributes to steady production development and consequently the living conditions of people. Therefore, access to financial services by low-income communities is crucial if we want to break the vicious circle that keeps them in poverty. Hence the importance of studying thoroughly and without bias how they can reach these services, whether formal or informal.

III. Financial transactions of the poor

*“During the week I work serving
in a family house,
but on weekends I’m a banker”*

Member of a self-financed community
Barcelona, Spain

In this chapter we will provide a general explanation of some of the financial mechanisms traditionally used in communities and groups of different social and economic income levels across the world, but especially in poor areas with little or no access to banking or microfinance institutions. These are natural and spontaneous transaction mechanisms that people use in order to have savings and credit services. Their use is very old and originates from individual or group-based practices taking place even before the existence of money. We will also talk about methods designed and developed in communities by external institutions, especially by NGOs, which, although based on natural and traditional mechanisms, introduce additional components in order to enhance them. These methods are called “induced informal financial mechanisms” and we will explain them as part of what we call *the Other Microfinance*.

It is worth emphasizing that this kind of transaction is found not only in the least developed areas of the planet, from the banking point of view. In Europe and the United States, where the banking rate is very high, very similar practices are found among groups of immigrants, and also in middle class sectors.

There is a wide variety of informal financial instruments. In every country and every region new practices arise with particular names, forming a sort of maze that is hard to navigate. For the purposes of this discussion, their generic names will be used, but in some cases they will also be referred to by the specific names they have in different countries and/or continents, so that local readers can identify them.

Their classification and characterization is equally complex because of their adaptability to the groups’ needs and preferences, but we will attempt to set up a certain order to help understand how they operate without aiming to encompass all existing practices. For the purposes

of these reflections, an overall explanation and classification of some of their main variants shall be sufficient.

Informal financial mechanisms may be individual or group-based and refer to either of these two operations, savings and/or credit⁵. We will see, however, that in many cases both operations overlap and what appears to be a saving is actually a credit and vice versa. This depends on the characteristics of the mechanism and/or roles that users take in the transaction.

1. Individual Savings and Loan Mechanisms

Transactions among individuals that do not require involvement of any group, association or community are listed below. As said, they may be savings or credit operations or both at the same time, depending on the side from which one takes part in the mechanism.

Individual Savings Operations

Several individual savings mechanisms are widely used. A very common one is the so-called *hidden money pot*. (It is not always literally "a pot", but rather a widely used practice to squirrel money away to save or backup, in case of any contingency. A traditional way among poor people is hiding the saving box in a specific place. In fact, we could say that the vast majority of those interviewed assure to have at least a small amount saved in this way. It is just a natural behavior because the need for resources is often immediate and the *hidden money pot* is a convenient way to save money while having quick access to funds⁶. Another usual way of saving is, in the absence of another

⁵ Other informal mechanisms also exist, or special functions within practices described here, which are used to meet the needs for protection and/or insurance. In this book, however, we will focus on savings and loan operations.

⁶ This practice is not exclusively limited to low-income segments of population. In interviews with some Venezuelan middle class women, they said to have "cached cash", hidden to their husbands and relatives. They usually save this money in a bank account maintained only by themselves, or a friend or a family member. When asked why they do that, the common answer was that one should always have some money "cached", because men (fathers, brothers, husbands or friends) spend more money than necessary, and this way they prevent them from spending that money or they can use it in case of need. In other cases, the answer was: "one always wants something that husbands do not want".

denomination, the so-called *safe deposit box*⁷. It means putting money in the hands of someone of trust. This person is not going to use it (or at least should not), but will simply save it as in a safebox in an attempt to keep it away, knowing that by necessity, or lack of control, one tends to spend easily. Recognizing our inability to keep it, we accept to place it in someone else's hands to protect it from ourselves: the mother, aunt, a friend. Sometimes it is just about saving money for a specific purpose and not spending until having reached the amount needed.

In some very poor areas, a common practice similar to the *safe deposit box* is to hand in the money you want to save to the so-called *collectors*. These are individuals who go from door to door collecting people's savings. Normally, the collector has a very simple type of record of the proceeds and, at the end of the month or the scheduled time period, the collector hands in the amounts for each depositor as appropriate. The service provider usually charges a fee for the task. This is a very common practice in some countries in Asia⁸.

In some cases, these *safebox* type mechanisms are also used to keep the funds out of the reach of any cunning devil in the family who may find it and use it without the consent of the "money saver". People may also try to protect themselves from friends, neighbors, and relatives who could borrow money from them when in trouble, especially when there is no guarantee that it will be returned. The reasoning behind the mechanism is, of course, to protect the resources from ourselves and from others. And while certainly the procedure could be criticized from the traditional financial perspective, in this case the traditional financial reasoning of the poor does function, and differs greatly from that prevailing in segments of population having a higher income level. The latter seek profitability and security for their savings, but those having little or irregular income seek timely availability, or what we call *the proper distance*. That is, having the money at hand, but not quite.

⁷ We include this term just to make the discussion easier, but so far we have not found a specific term for this practice.

⁸ For further details, see, Stuart Rutherford, *The Poor and Their Money*. An essay about financial services for poor people. Institute for Development Policy and Management, University of Manchester. January, 1999.

These criteria for saving money are not typical only of the poor; they are also common among many people of the so-called middle class. In Europe, for instance, there are bank products which automatically put aside a certain amount from people's pay slip to allocate it for savings. That way people cannot make use of it directly, they must transfer it first from their savings account to their checking account whenever they want to. This way people find it harder to spend it. Here, the same criterion of having timely availability of reserves applies. The three mechanisms described above show that the poor need and want to save, but seek to do so by using savings instruments suitable for their life circumstances. Their funds should be far enough so as not to give in to pressure to spend them too soon, but as near as possible to use them in case of a true emergency. And that is the essential key to designing an appropriate savings model for the poor: *the proper distance*.

Rebecca M. Vonderlack and Mark Schreiner, in their interesting book: *Women, Microfinance, and Savings*, support our following conclusion:

[...] To maintain savings, poor women must resist demands from children who need clothes, husbands who want to drink or gamble, and relatives and neighbors who want loans or gifts. These short-term pressures are reduced if cash is out-of-sight and out-of-reach.⁹ But the funds should not be so far either, as the emergency may be of a more dramatic nature and require immediate action. Therefore, the funds must be relatively near.

Another criterion for choosing the savings mechanisms in these segments of population is the time it takes to save or recover the money; that is, how long it takes to mobilize the money. The middle class saves and manages to hold these funds "saved" for long periods, while for the poor the time periods tend to be shorter. When money is tight you have to make more financial transactions. Therefore, the process for having access to funds has to be easier. If a person, especially a woman who works and takes care of the house, has to complete complex procedures in a bank to deposit or withdraw funds, certainly she would not even attempt to do so since she cannot afford to waste time. That is why their usual financial instruments to perform these transactions are not formal banks but informal practices.

⁹ Rebecca M. Vonderlack and Mark Schreiner, *Women, Microfinance, and Savings: Lessons and Proposal.*, Center for Social Development, Washington University, St. Louis, December 2001, p. 6.

Therefore, acquisition of non-financial assets is another common form of individual savings. In urban areas, for example, there is a tendency to buy gold jewelry or other precious material, such as chains, bracelets, necklaces, and rings, among others, that preserve the value of money over time. In some places, purchasing home appliances is another way to save on assets, as these can become cash more or less quickly either by direct sale or because they can be used as guaranties for loans. In rural areas, assets are rather animals, machinery or agricultural products, which also maintain their value for long periods.

In our working with communities, it was difficult for us to understand that poor or middle class women buy jewelry not for foolish vanity, but because it is a widely used saving practice. Jewelry is an asset easily convertible into cash, as there is a permanent market of people willing to buy, and who in turn use it as a mechanism for having a temporary surplus to preserve and maintain its value over time. In this context, precious metals are permanently traded, and this makes their use easier as a savings mechanism since they are easily convertible (liquidity) and tend to preserve the value of money over time. However, it takes time to settle the sale, and this helps mitigate the temptation to use the savings. Again, the proper distance criterion works in this case.

Jewelry or jewels can also be pledged as collateral, that is, left in specialty shops (pawnshops) as security for cash loans. That makes them a very practical financial instrument. It is not surprising, then, that the word commonly used to describe these metal pieces is *pledge*, a synonymous of surety, guaranty and collateral. In many cases, the items left as collateral in pawnshops can be recovered by paying the debt within the agreed time periods plus accrued interest.

The “layaway” system is another common way of individual savings. As per this mechanism, when someone needs a product, but has not enough money to buy it, the storekeeper or seller receives partial payments for the product until the buyer completes the amount for the full value of the product.

One of the main reasons for this type of savings is the guarantee by the seller that the price will remain the same at the time the person makes the first down payment. Normally, a deadline to complete payments is set up so that the saver makes efforts to build the amount, and the seller ensures not keeping a fixed price for so long.

Another fairly common way to "save money" is the "loan" to relatives, friends or neighbors. Initially this looks like a credit facility and it certainly is, as we shall see, but for the person who lends under these conditions, credit can be a sure way to save.

This is because the most complex task in credit analysis is the personal knowledge (moral standing) and economic capacity (ability to pay) of the client. But when someone lends money to family members and friends, he/she normally has good knowledge of both aspects. It is not only a matter of trust, but of an objective knowledge of the real situation of the person to whom the money is being lent. Rather, the trust or distrust stems from this prior knowledge which results from the permanent relationship with that person. According to the traditional lessons of risk analysis, a loan of this type is unlikely to be lost, provided that the analysis is performed under objective criteria and not solely on emotions.

A brother, friend or neighbor, for instance, are well-known people. Usually you know if they have a specific economic activity providing income on a regular basis. Thus, it is very likely to have a general idea of the person's actual ability to pay and also of his/her attitude towards debts and commitments. You may also know the circumstances under which credit is being requested: perhaps the desire to buy something now, knowing that some time later he/she will receive income from a harvest or a special bonus at work. Lending money under such security conditions can mean a way to "save money". From the perspective of the person requesting the funds, the transaction is a loan, but for those who perform it, it is a savings operation. Again, with this procedure, the "saver" puts spare cash out of direct reach and keeps it relatively safe¹⁰ and at the proper distance, since he/she can always ask that person for help to solve a particular situation.

Individual credit operations

¹⁰ For a mathematical analysis involved in this kind of operations, see: Fafchamps, Marcel: Risk Sharing and Quasi-Credit. Stanford University Press, California, October 1998. (<http://www.economics.ox.ac.uk/members/marcel.fafchamps/homepage/irsa.pdf>).

These are financing transactions performed between one individual and another. The most common ones are exchanges among friends, relatives, neighbors, coworkers, employers, etc. These transactions may or may not set the payment of interest. When interests are not set forth - that is, when it is not for business purposes - there is however a moral reciprocity condition under which the individual receiving the loan is somehow committed not only to repay it, but also to return "the favor" when the lender will have a need for support in the future with money or any other transaction: "... loans bear an implicit obligation of reciprocity, as if to say: 'I am ready to help you today because I expect you to help me later the future'"¹¹. This commitment is established primarily in loans among relatives and friends.

This practice reflects the fact that in low-income communities not only is money tight, as described in many studies and as repeated several times in this book, but furthermore income is not regular. Hence, people who lend money to a relative or friend in a sense are both hoping that when they require funds in the event of any problem, the principle of reciprocity will work and they may then turn to those who they have helped before.

Therefore, retribution is the underlying reasoning in this type of transaction. From the traditional financial perspective this makes no sense, since not only is there a risk of giving capital to others without any guarantee, but in many cases the money is lent to be paid back on unknown time periods, and without interest. In fact, when people make such operations they are not acting irrationally, but instead are establishing a relationship that, considering the financial resources available, can ensure access to similar support when needed. That is, operations of this kind are not made only for their financial value. There are also emotional reasons behind them such as solidarity or fellowship that support and fully justify a more comprehensive rationale.

Another well-known form of individual financing is the credit granted by the so-called *money lenders*, i.e., individuals who provide money on a semi-professional or professional basis for a living. It should be noted that they rely not only on low-income communities, but often on people from middle classes.

¹¹ Idem., Page 2. [our translation].

Perhaps this type of loan is the most popular or best known financial transaction, but not necessarily the most used. Unfortunately, this type of loan is deeply rooted in people's views and this has led to take misconceived stands as to informal financing. There has been much confusion not only as to the alleged volume of transactions carried out with moneylenders, but also in identifying any informal financing with funding from lenders or loan sharks. The truth is that a relatively small percentage of loans in low-income segments of population is traded off with the so-called moneylenders. As noted in *Portfolios of the Poor*, which is based on reliable data, most of the time people in these sectors resort to credits with no interest, since they are granted by relatives, neighbors or friends and not by moneylenders.¹²

People almost always go to moneylenders whenever any community member has a more or less urgent need for money and cannot find a better option. This type of credit is usually granted for short periods of time and at interest rates that could be considered to be very high and even speculative. For many, moneylenders are really the last choice, only sought when no other options remain. Such transactions are common in newly formed urban centers, when a major geographical displacement of people has taken place and ties have not been able to develop strongly enough.

The transaction set up in these cases has been widely described and has generated much criticism, as we said, especially due to the high interest rates. But in working with communities, in many cases we have found that the figure of the moneylender is seen as a community member who provides a service required as would a grocer, a carpenter or a blacksmith, and in some way, this person is actually doing so. This person is not always a "monster exploiter" of the poorer. In fact, the moneylender is another community member having an often only temporarily better income level than others. Although there are indeed many cases of real usury, we cannot fail to mention, based on our experience, that some moneylenders just provide a much-needed service, meaning that they do not exploit others. At least no more so than in many other services available in low-income communities, since we must not forget that usually the poor are those who pay higher prices for food, supplies, medicines and services.

¹² Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, op. cit., position in PC Kindle: 582.

To better understand this, consider that whereas the nominal interest rate is very high in many of these transactions, including usury, in most cases there is no rate as such but rather a sort of dues (fees) or fine. Hence, the nominal rate (the monthly percentage) does not always reflect their reality. Many of the loans granted by moneylenders have a fixed interest rate, *i.e.* a specific amount (a fee) is fixed but it is not always related to deadlines. It is common to see, for example, that a credit is granted for 100 monetary units (mu) to be paid off in a one-month period, for which the customer must pay 20 mu. But when this period is extended to two or three months, the 20 mu that the customer paid for interest is set as a fixed flat fee. Hence, although the nominal rate appears to be 20 percent per month, actually its value is 20 mu divided by three, which is the actual installment in which the money was paid off. Thus, the interest being paid does not take exactly the form of what we normally know as an interest rate, but rather a fixed flat "fine" to be paid for the loan.

Although it is not always the case, this example shows a very common practice among the community groups we serve. Prejudice against the figure of the moneylender does not let us see that it is often someone from the community lending his/her money under high-risk conditions. Of course, there are countless real experiences of speculation and usury, but it is not uncommon to find that this alleged monster speculator is much appreciated by the people in the community. We have found cases of true usury rather when the moneylender is an outsider who lends money in an almost professional way¹³.

The case of a moneylender in a community in Margarita Island (Venezuela), who became part of a community-based savings bank (*Bankomunal*) in her area¹⁴, may serve as an example. We decided to interview her upon learning that, among many other things, she also engaged in money-lending, because her support for a mechanism that may be taking "customers" away from her did not seem logical to us. When asked if she saw the community-based bank (*Bankomunal*) as a threat to her business, she told us that for her it was rather a relief,

¹³ On many occasions, true usury is disguised, since outsiders use community members as intermediaries in order to lend money charging high interest rates.

¹⁴ Later on we will provide a detailed explanation of what is a community-based savings bank (*Bankomunal*) and how it operates. For now, we just say that it is a model of local informal financial institution.

since she had never felt very comfortable with lending money. And not because she felt she was a loan shark, but because she knew she was permanently at risk, a much distressing situation. She argued that in this money-lending business if lost profits were added, most of the time, "the balance would likely end in a draw."¹⁵ Clearly, only with a more in-depth study to review the true balance of moneylenders would it be known if this situation is common. But even without such an inquiry, simple observation shows that after years of providing such services, the standard of living of most moneylenders remains quite similar to that of the other community members.

Commercial loans, *i.e.* loans contracted with commercial entities such as grocery stores, hardware stores, and suppliers of agricultural and fishing inputs, are other common ways of accessing individual loans. In this case, people get into debt for the acquisition of certain goods necessary for carrying out economic activities and for the purchase of food or basic services. Whereas typically these loans have no fixed interest rate, usually the price paid for the purchase is greater than the one that could be obtained if paying with cash. A typical way to operate these kinds of loans is contracting them during the seasons when the borrower carries out his/her economic activity. Agricultural workers or farmers, for example, will set the term to pay according to crop harvesting, just as fishermen will do in catch time. Likewise, grocery store keepers, for instance, set the terms for payment according to clients' income and usually their collection strategy is related to the suspension of credit service at the end of this period.

These loans have been viewed as speculative, especially when they are subject to harvest or fishing delivery, for their sale by the money supplier. In Venezuela, for instance, the so-called "*caveros*" (refrigerated truck owners) provide funds to fishermen during bad times and get paid back their loan later on with the fish caught. Maybe purchase prices are set lower than in the market in order to make the deal, or sometimes simply to secure the products for sale. Something very similar occurs with agricultural and livestock farming products.

Individual credit also appears under the guise of hawkers or peddlers: people who go from house to house, and even from community to community, offering goods on credit. This is a very common practice

¹⁵This is a colloquial expression used in Venezuela meaning an operation yielding neither profit nor loss (to break even).

that is nearly worldwide, in urban and rural communities. Some of them are agents or sell products of large chains of companies, such as cosmetics, beauty products, household utensils, home appliances, furniture, clothes, etc. with the support or backed by marketing supply chains highly geared towards this type of credit sales. Others simply resell any kind of merchandise that is well suited to the needs of the population they serve. A key element in this type of sale is the distribution of payment in small installments, which enables the poorest customers to access the goods offered.

Shortly after the onset of Venezuelan oil production, a very special figure appeared and gave its name to the trade, when people from various countries in the Middle East (especially Lebanese and Syrians) engaged in door-to-door selling on installments. For reasons we do not know for sure, people started calling them the "Turkish"¹⁶, with no distinction, and the countries' population name became a synonym of *vendor*, in colloquial speech.

The acquisition of goods on credit in this way was and remains an important source of financing for the poor. Its influence among communities is so strong that we even refer to the whole set of skills that peddlers develop to give and collect credit in areas where no formal sources of financing usually exist as "the Turkish methodology"¹⁷. And while almost none of them are engaged in direct money-lending, most of them do by selling wares of any kind¹⁸.

We have never found a specific study to determine the amounts that peddlers grant as credits. However, when interviewing some of the peddlers working in Venezuela, they said they could have more than 100 regular customers, *i.e.* customers with loans at the same time.

¹⁶ They are also called: *marchantes* (merchants), *cuoter*os (small sale installment collectors) or *gotero*s (drip collectors). It seems that late in the 19th century and early 20th century, people migrating from some Middle East countries belonging to the Ottoman Empire arrived in Venezuela bearing passports or permits issued by the Turkish government. This stands for the name given to Lebanese who arrived in Venezuela during that period.

¹⁷ See: Salomón Raydán, *Guía para no meter la pata. Consejos empresariales para el nano emprendedor*, (A guide to avoid making a blunder. Business advices for micro-entrepreneurs) Fundefir /Sustainable Development Department. Total, Caracas, 2010. This text is also posted in website: www.fundefir.org.ve

¹⁸ Perhaps no cash lending is related to the Muslim tradition that prevents charging interest for granting loans.

There are many other forms of individual lending. Another very common form is the employer's credit. These are small sums of money that employers advance and are deducted in apportioned amounts from the employee's salary. This instrument is very common. We had the opportunity to interview many employers from small and medium-size businesses, who assure they have applications for this kind of credit on a permanent basis. But in most cases the demand is much higher than employers' resources and it is not always possible for them to meet it. Usually, the employer feels uncomfortable with this situation and tries to avoid it, or, on the contrary, seeks to profit by charging high interest rates. These operations are likely to bring conflicts, as the only guarantee for the employer is the employee's salary and legal benefits. But in many countries the laws protect the employee and securities are not enforceable.

It is also usual to obtain individual loans in the so-called "pawnshops" mentioned above. These are partially-regulated¹⁹ institutions engaged in money-lending secured on different types of objects that are normally left or deposited in those merchant houses. They lend money to applicants secured with applicants' assets as collateral. Usually people applying for credit have the opportunity to return after the scheduled term and take back the items, provided they pay the debt in full, including established interest. If the items are not withdrawn in due time, and the debt is not paid in full, pawnshops keep the items, for resale.

This is a very usual way to have access to credit across the world. The famous U.S. TV series *Pawn Stars* chronicles the daily activities of one of these shops in Las Vegas, Nevada.

In the TV show, the pawnshop keeper usually asks the customer if he/she wants to sell the item or just pawn it, since the two options are offered. But the most common practice is that these shops only "lend" money depending on the amount the guarantee represents, *i.e.* the object left as collateral to secure the loan. It is rarely a simple purchase of used items. It is worth noting that in this series, one of the owners of the pawnshop assures that 20 percent of U.S. citizens have no

¹⁹ Regulations of these merchant houses vary from one country to another. In some cases they abide by rules and regulations set forth by specific institutions of the financial system, and in other cases, by rules of business nature.

access to formal financial services and these stores may represent their only choice for obtaining cash.

Quick-credit entities advertised in nearly all European TV stations are other similar ways to obtain individual credit. Morning programs often show ads for these entities offering instant loans in amounts of up to 3,000 Euros. These institutions are normally regulated by official bodies, but many of them set interest rates much higher than those found in mainstream or formal banks or microfinance institutions. Generally they must be secured with customers' pay slips or guarantees providing evidence of steady and regular income. That is why they are mostly used by middle-class groups having those guarantees.

2. Group-based Savings and Loan Mechanisms

Group-based savings and loan mechanisms are usually more complex and inventive than individual ones. There is a huge variety of them, but we will try to make a simple and appropriate summary for this analysis. Group transactions, as well as individual transactions, will be divided into savings and loans. But in this case, such operations are not clearly distinguished, because they often overlap and thus what is saving for one group member is credit for another, and vice versa, as discussed below.

Group-based Savings Mechanisms

Basically, all of these mechanisms start with a group of people, of a highly varying number²⁰, who join efforts and "deposit" amounts of money (either fixed or not) to build up for future use. These are not formal regulated institutions, such as credit unions and savings and loan associations, but rather associative mechanisms widely used by low-income communities, without supervision by any authority.

²⁰The group size is varied. Can be small (6 to 10 people), or organizations with hundreds of partners. The massive use of these mechanisms is due largely to its great flexibility, allowing users to tailor many of their conditions (size, amount, duration) to the particular needs of each group.

The name usually given to this mechanism is *social savings club*²¹. The reasoning behind most clubs, regardless of their size, is that people feel unable to keep on a savings routine, and this practice helps create it and keep on, through peer pressure. This failure stems not only from a particularity in members' mentality, but also from the many small and great needs they face in their daily life, some of them of an urgent nature. Faced with this reality, again, people in low-income communities try to keep the money at the proper distance: so far as to not spend it easily, but close enough to use in case of an emergency, particularly if related to health.

It typically works with a group of people who decide to voluntarily establish a savings contribution for previously established time periods. These contributions are handed to an individual or several individuals, who have the responsibility to keep the money until the time-period determined by all members comes to an end. In some cases, they simply put money in a box and keep it closed until the period expires. Often this kind of club is created for a specific purpose, such as fundraising to celebrate religious festivities or to purchase supplies when children start the school year. It is essentially a savings scheme in which group members agree to "save" money in a fixed or variable amount, for a given period of time.

An example of the mechanism is as follows: In January, eight people decide to place an amount of 100 mu per month for a twelve-month period. Each month, the contributions of the eight people (800 mu) are handed to a "cashier" or safekeeper of the money. Under ideal conditions, after twelve months the balance will be of 9,600 mu (800×12), that is, each person will have saved 1,200 mu ($9,600/8$). In December, the final month of the scheduled period, that amount is handed in to each member. With this system, members saved enough money to purchase a particular item or to access an amount of money that otherwise would have been difficult for them to build.

The time period may also be of nine months, whereby each member would save 900 mu each. Summing up, there may be as many amounts, contributions and terms as the group may decide.

²¹ We prefer to use the term savings social club since in this case funds build up but are not lent. There are other names for this type of mechanisms such as Savings Associations (SAs) or Rotating Savings and Credit Associations (ROSCAs).

Of course there are different forms. One of them allows engaging people with a diversity of income levels and the agreed contribution is not equal for all, but is set according to what each one can afford. Thus, every person brings in the amount previously agreed. This mechanism is more flexible than the previous one and is used when trying to include more people. In another variation, the amount is not fixed in advance to anyone and each one puts in what he/she wants and can contribute each month. But in both cases, certain required administrative records make particular procedures more complex. Therefore, it is no coincidence that the most frequent practice is the former one: identical contributions and equal periods for all members.

Although the operating principle of the basic mechanism is similar in all clubs, irrespective of the time periods and the amount of contributions established, it is important to note that in each case the contributions are made with varying frequency. This is because the pace of deposit generally depends on how income is received. It can be on a daily basis, as in the case of carriers, taxi drivers, peddlers and street vendors, or weekly, bimonthly, monthly.

Once again, from a strict financial point of view, it seems nonsensical to put money in the hands of someone who may also have an emergency or needs, just to receive all amounts combined some months later, without any compensation for inflation, which unfortunately is usually very high in the poorest countries. But again, reasons of another nature explain this behavior. Saving money this way is not only due to the lack of access to commercial streamline banking. In fact, in some cases, such a possibility actually does exist. But it stems from the particular characteristics of individuals' psychological reasoning for savings taken into consideration from a broader rational approach.

This can be an individual way of saving. Thus, every person would save at his/her own pace and may even earn some interest. But many people prefer to save their money in a savings pool, since their commitment with the group obliges members to save. An example of this is that, though for the saver it does not matter if another member of the group does not contribute the whole amounts and/or in due time - since everyone receives exactly what he/she has actually saved - there is a permanent concern on what everyone has placed, since basically it is a matter of a *commitment* to save.

We have seen that, in most cases, the money is handed in at an event or meeting attended by group members. This shows that the purpose is essentially peer pressure to encourage savings. The *pledged word*, the *self-imposed obligation to the group*, is a moral commitment that binds every member to deposit, on time, the amounts to which they committed. And not doing so shows, in many cases, a lack of commitment to the group, or sometimes a personal or family hardship, which generally they do not want to show to others. These elements of peer pressure - commitment, shame - work when saving money in a group and forces, thus, the creation of a savings routine. Since these instruments are widely used and accepted in low-income communities, it is clear that many people are pleased to be pressured to save²².

Saving is essential for survival in low-income segments of population and the inability to set individual savings routines leads millions of people to form these groups. It is therefore important to analyze these mechanisms in depth - from the financial, social, and psychological point of view, in order to improve and better develop economic capacity building of individuals who use them. Practices such as those described above are used for psychological rather than financial reasons. And although from the standpoint of traditional finance these practices seem to lack soundness, individuals who use them have their own financial reasoning, highly adapted to their cash flows and their emotional needs.

What we have called here "social savings club", to simplify, takes many different names throughout the world and it is the basis for explaining other practices widely used not only for savings but also for loans.

Group-based loan and/or savings mechanisms

²² In a recent meeting with Hugh Allen, the creator of the Village Saving and Loan Associates (www.vsla.net), he told us that even though new models of financial services for mobile telephones (M-banking, SMS-Banking) are a powerful tool for making financial transactions – as shown by the number of people using them – people felt that they were not “forced to save”. For this reason, Allen thought that the VSLA would continue to operate even in places where this technology was present. According to Wilson, Harper, and Griffith (op. cit). Kim Wilson, Malcolm Harper, Mathew Griffith, in the introduction of *Financial Promise for the Poor*, also point out that in countries like Kenya, where massive programs for M-banking exist, people use group savings mechanisms to build a significant amount of money and then place it in savings accounts through their mobile phones.

Important variations of the social savings club are the ROSCAs (Rotating Savings and Credit Associations)²³ and the Accumulating Savings and Credit Associations (ASCAs)²⁴. In the case of ROSCAs, the money built with the amounts contributed in installments is delivered (lent) by turns to group members, unlike in the social savings clubs, where the money is just safe-kept. There are many more varieties in the ASCAs, but their peculiarity is that money is not delivered by turns, but it is lent to savers themselves or to others, under different criteria and in different amounts. A person can thus have access to an amount several times and not just because it is his/her turn²⁵.

ROSCAs and ASCAs are of almost universal use, in poor and not so poor communities worldwide. The most commonly used colloquial names to refer to them in Latin America are: *turnos* (turns), *ruedas* (rings), or *rondas* (rounds). Other more specific ones are: *pasanaku* or *pasanacu* (Bolivia), *cuchubal* (Guatemala), *tanda* (México), *vaquita* (*whip-round*) (Argentina), *natillera* (Colombia), *polla* (Chile), and *pandero* (Perú). In Venezuela and in some Caribbean countries, they are usually called a *SAN*. Other names however are also used: *susu*, *rueda*, *vaca*, *bolso*, *vaquita*. In Africa, some common names are: *yangue* (Guinea), *susuo* (Gambia), *dart* (Morocco), *stockvel* (South Africa), *upatu* (Tanzania), *chama* (Kenya). In Asia: *dhukuti* (Nepal), *kou* (Japan), *chit funds* (India), *arisan* (Indonesia). In Arabic: *komiti* and in French: *mutuelles* or *tontines*. This variety of names shows how widely this mechanism is used.

An example will help to better understand how they work. Imagine that a group of twelve people gather and each one is committed to payment shares of 100 mu per month for a period of twelve months. That means that every month they would get a total of 1,200 mu each. But instead of saving that amount until the end of the year, the total amount collected each month (1,200 mu) is given by turns to each group member. Thus, only one person receives 1,200 mu in each period. In an ideal cycle, it is assumed that each of the twelve members will receive 1,200 mu, corresponding to all their dues,

²³ In English: Rotating Savings and Credit Association (ROSCAs).

²⁴ In English: Accumulating Savings and Credit Associations (ASCAs).

²⁵ To better distinguish ROSCAs and ASCAs, see: Bouman, F. J. A., 1995. Rotating and accumulating savings and credit associations: a development perspective. World Development and O. Hospes (eds.): Financial Landscapes Reconstructed: The Fine Art of Mapping Development. Westview Press, Boulder, 1994.

sometime in the year. Of course, those who receive payouts during the first months are committed to continue putting 100 mu per month until the end of the cycle, regardless of whether they have taken their turn or not. Usually, turns are raffled at the beginning of the cycle but we have also found that they are often exchanged, and even sold, according to the interests and convenience of everyone.

In another common form of these mechanisms, several people take upon the responsibility for organizing and keeping the mechanism operating. In Venezuela and elsewhere in the Caribbean they are called *saneros* (runners of a merry-go-round), whereas in the Dominican Republic they are known as *madre san* or *mamá San*; and in Colombia this person is called “*tesorera natillera*” (treasurer in a village small savings circle). In any case, the person who organizes the mechanism allocates the time for each group member to receive payment, usually based on the knowledge he/she has of members, so that the best payers take the first turns. However, personal preferences of the organizer play an important role. On other occasions, the turns are negotiated among all members together.

Time-periods to pay may vary and be of more or fewer months, and maybe even just be limited to days. When it comes to, for instance, daily-income groups, it is quite normal to find that the time period for payout is thirty days and someone may get his/her turn on a daily basis²⁶. Again, we can see here that the model is very flexible and adapts to the specific needs of each group, which is an important advantage over formal models.

As mentioned above, these are the basic savings and loans mechanisms most used worldwide. Stuart Rutherford, a renowned expert on the subject, said these are "the most efficient and

²⁶ Stuart Rutherford, in cited paper: “The Poor and Their Money. An essay about financial services for poor people” (p. 26), describes how this instrument operates among the “rickshaw workers”, in Bangladesh. Rickshaws are a sort of taxi pulled by individuals. Although their price is low, the poorest do not have the means to save to buy one. A group decided that its members would place a certain amount on a daily basis so that when put together it would be equivalent to the cost of a new rickshaw. Each day then, a new one is raffled off among all those who have not taken their turn yet. Thus, in the end, everyone will have his own vehicle. Obviously, the first winners shall commit to continue contributing but without the right to participate in the raffle, so as to give the chance to all to be owners of their working instrument.

inexpensive tool for financial intermediation”²⁷. Their origins are ancient and difficult to trace. The oldest references are the so-called *kou* in Japan and the well-known *chit funds* in India. In Latin America those recognized as the oldest ones are the *pasanaks* in Bolivia, and the *tandas* (rounds or series) in Mexico. In specialized literature they are known under the name of African *tontine* or *tontina*, supposedly after a Neapolitan banker named Lorenzo Tonti (1602-1684), who invented a loan system with a similar procedure.²⁸ Apparently some westerners in Africa, especially French-speaking, gave that name to the ancient practice of raising money and distribute it in turns by rotation to start a specific project, the so-called *esusu*²⁹ or *susu*. It is also known under this name in some populations in Venezuela, especially in the northeast of the country, where most African slaves arrived during the colonial period.

Originally, these ancient mechanisms were not used for monetary or financial transactions, but in order to join efforts to accelerate specific tasks such as crop harvesting or house building. Through this group-based practice, people organized to perform tasks that individually would be very difficult to perform or would require much time. Based on the same principle of payouts turn order, a group gathered in order to finish a particular task requiring the involvement of many people, faster and better. As with individual lending to relatives or friends, every individual who has received support is bound to take part later on when someone else needs help. For the purposes of this paper, we will refer only to the monetary arrangements used under this system.

The basic models described above give rise to a range of forms that are difficult to record and classify. One of them consists in setting up an additional contribution which goes to the hands of the organizer, as payment or reward for taking the trouble of collecting the money, especially among those who have already won the payout. In this case, members do not put 12 installments but 13 (following the previous example: 1,300 mu instead of 1,200 mu) and the additional

²⁷ Stuart Rutherford, op. cit., p. 22.

²⁸ Study and reflection group on Africa, (*Gerafrica*): African savings and loans associations in Catalonia: types and forms of informal financial practices of immigrants. Final Report, Universidad de Lérida, September 2007, p.16.

²⁹ The name *esusu* seemingly belongs to Nigeria's Yoruba language. See: Idem.

contribution is for the organizer. In Venezuela, this practice is widely used by wayúu communities³⁰ in the west of the country.

In another similar form, each member puts an additional amount to his/her contribution in payment or reward to the organizer. Again, as in the above example, each member would pay 110 mu and not 100 mu in each time period, but 100 mu would go to the hands of the one taking his/her turn and 10 mu to the organizer. Under this scheme, we would be dealing with *negative savings*, since the saver pays for the right to safekeep his/her money instead of receiving benefits and this often occurs in the formal system as well.

Indeed, although the idea of "paying" to save may surprise many higher-income people, in most countries with high inflation the interest earned on savings accounts is lower than inflation rate. Therefore, in the mainstream or formal system there is also *savings with negative value* or what is commonly referred to as: *negative real interest rates*. When there are important macroeconomic distortions, bank savings usually have a negative value. Therefore, "paying" for saving is not an exclusive condition of informal financial practices of low-income communities, but of the entire society.

In another form of this mechanism, the organizer does not charge any money, but he/she takes the first turn in the cycle. This is frequently the case, when a person in the community has an urgent need for money and organizes one of these mechanisms as a means to obtain it quickly. Thus, taking the first turn, that person secures obtaining the funds urgently needed for either the purchase or payment of any goods or services or simply to start any productive investment. Of course the ability to organize one depends heavily on the credibility and leadership that this person has within the community. This is one reason why some organizing leaders make great efforts to ensure the whole process is carried out properly. Otherwise they would lose their prestige as organizers and would not have the opportunity to use this mechanism again when needed.

As seen, the above described forms operate as an instrument of savings and credit simultaneously: saving, for those who need to

³⁰ The *wayúu* or *guajiros* are indigenous populations native of the Guajira peninsula facing the Caribbean Sea, who inhabit territories in the border area between Venezuela and Colombia.

accumulate money for a given period of time and, therefore, they take the last turns of the cycle; and credit, for those who receive the first payouts. From a financial standpoint, it makes sense that most people would like to use the first turns, since there is less risk and are the most profitable, but in fact it is not so. In many cases, people join the group hoping to have the last payouts in order to build up the funds they need. Again, here we have the need to seek mechanisms that force people to save and keep their savings at the proper distance. Thus, we find that those who need to save prefer to take the final turns of the cycle, while those who need credit readily prefer the first turns.

Another frequently recurring scheme is that of turns for payouts that are not drawn, but put for “auction” or “sale” instead. In that case people bid an amount which, depending of course on the economic urgency of everyone, will be higher or lower. The extra money earned at the auction, *i.e.* the bids to acquire a payout turn, is distributed among the remaining partners, as a kind of gain or reward for waiting time. If the order of payouts is already established, a person can also acquire extra money by giving his/her turn to someone else. This variability just reflects the participants’ needs, especially of those using the last turns, in an attempt to maintain the value of money over time. Intuitively, one seeks to protect the amounts being pooled against depreciation from inflation.

In another variation, the money is not delivered in its entirety to one person but to several members of the group and not necessarily in turns of rotation. In this case, we are rather talking about Accumulating Savings and Credit Associations (ASCAs). These are very similar to the ROSCAs, but the supply of money is based on other criteria and the amounts of contributions are not equal for all. In most cases the amounts and frequency are set according to the needs of group members. In many cases, the user of the funds pays an interest rate for the use of money, while in the ROSCAs the money is usually granted in turns of rotation and no interest is paid³¹. In the ASCAs, the amounts contributed may not necessarily run out in a given period of time, but they may continue to build up and be lent indefinitely.

³¹ As pointed out, some ROSCAs do not charge interest, but payouts are auctioned by paying an amount which is later distributed among partners under different criteria. This means, in a certain way, paying interest.

There is a bolder form: group members can use the collected money to “sell” it to others outside the group for any amount. In many cases, the extra money obtained for this “sale” goes to the person taking the turn at that moment, if the mechanism is a ROSCA. But in ASCAs, the money is distributed according to different criteria. “*Selling*” here means lending to those who do not contribute on a regular basis – namely, to those who are not part of the group – and charging interest or a fee for this service. In turn, the outsider is required to repay the purchased amount plus interest as may be set. This is a risky mechanism, and hence it is not as common as the one limited to saving group members.

Classification of informal group-based savings and/or loan mechanisms described here is not aimed at being exhaustive. Certainly a wide variety of such mechanisms used by poor communities across the world is not included, as there are so many ways of creating these rotating savings associations, with varying amounts, time-periods and objectives. For instance, there are those made among traders having a certain level of income, university students, members of private clubs, small shopkeepers in street markets, craftsmen, drivers, and government employees, among others. With this classification, we just want to review their operating methods and highlight to what the extent they are used, in order to design alternatives to remedy many of their limitations.³²

To develop financial products and services of higher quality and versatility, it is essential to recognize the existence and importance of these mechanisms. The lack of reliable statistics accurately showing the volume of savings and loans operated by these mechanisms does not mean that they do not exist. A brief approach to savings and loan instruments operating in low-income communities around the world gives a clear idea of the extent and the large-scale of this phenomenon.

³²Other associations operate with mechanisms different from those described here so far and manage huge amounts of resources. They are usually found mainly in emigrant populations, especially Africans, who create groups that raise funds with the purpose of financing projects in their home towns. Many of these projects are not individual but community-based, such as installation of water wells and water pumps, electrification of villages and hamlets, etc. For the purposes of this work, they do not deserve as much attention since they are not essentially related to savings and credit operations.

In many countries, these mechanisms continue to be ignored, even in an attempt to wipe them out by establishing regulations that do not respect traditions or the particular financial needs of the people using them. Indeed, arguing that savers need to be protected and informal savings should be prevented - principles to which, of course, we agree - regulatory systems have been set out to outlaw or at least make legal operation difficult for these cultural practices in nearly all countries³³. Our position is contrary to this trend: we want to show the wide variety of informal financial mechanisms, rescue their positive aspects and understand how and why they are so widely used and multiply out of any control in low-income communities. In principle, we saw that they best fit their communities' needs. Such practices must therefore be analyzed, improved and enhanced, both from the economic and social point of view, so that their users have greater and better opportunities to access quality financial services.

³³ This protection often calls for formal models which are not so safe either, and often lose millions of dollars from the public which has deposited them as savings, bonds, mortgages, shares and trusts.

IV. Lessons from informal mechanism

*“What gave us more confidence
was that we were going to
run that community bank by ourselves”.*

Shareholder of a Bankomunal in Jusepín
State of Monagas, Venezuela

In spite of their shortcomings and limitations, informal mechanisms involve very useful elements to build better and more effective financial services for low-income communities. We will make an effort to review in some depth some of those elements that we consider positive, so we can consider their utilization within methodologies that can be applied in the poorest segments of population. Achieving this goal is not a small task: it is a real change in the way informal savings and loan mechanisms have been traditionally viewed.

1. Communities do have capital

The main, most evident and richest lesson from our study of informal practices is that *communities do have sufficient capital to fund at least many of their applications for loans*. This finding is the basis for the idea of designing a methodology focused on self-financing as an alternative for people who have to pay a high financial cost for having access to microcredit.

Whenever people get together to organize a *tontina* in Africa, or a *rueda* (round) or a *giro* (turn-around) in Latin America, they merely demonstrate that significant amounts of money can be raised in their community. The traditional trend has been to perceive the poor as “absolutely poor”. For many this would mean that there are no funds available, but in most cases, this is a mistaken view. That a sector of population is poor does not mean they do not have economic resources of any kind. It may mean that resources are scarcer than in high-income segments, but not that they do not exist. Indeed, there are very few examples where poverty is so serious that there are no small surpluses that may be gathered, even temporarily.

Even the poorest segments of population, as shown in “Portfolios of the poor”, are capable of saving a small percentage of their income: “We found that most of the households, even those living on less than one dollar a day per person, rarely consume every penny of income as

soon as they earned. They seek, instead, to “manage” their money by saving when they can and borrowing when they need to”³⁴. Such a possibility, though temporary, is essential to keep afloat when income is low and irregular. The amount of resources operating in informal transactions is strong evidence that there is certainly local capital in those communities.

Several examples of informal self-financing models used across the world can be mentioned, especially in Africa and Asia. In India, for instance, self-help groups (*SHG*), registered to receive financial support from government, have around 75 million members. And while these funds go to the banks and only a part of them are used directly for credit within the communities, such amounts show the huge quantity of resources they have on their own. The *xonchoi xamitis*, or savings committees, are indeed massive in Assam, a region in northeastern India. In the absence of formal models, these committees are true financial service providers in the area. In Bali Lembaga, the *Lembaga Perkreditan Desa* (LPD), a semi-formal model of self-savings groups, serve nearly 95 per cent of communities in the country³⁵.

The VSLA³⁶ savings model, which is starting to be used by major NGOs, also shows that in small local communities there are funds that can be raised in savings and used for loans, without resorting to mainstream banking. The use of local capital in Latin America is also unquestionable. For example, FINCA International implemented a community-based village banking model in several Central American countries, and, although funds came mainly from external resources to the community, day after day more savings were pooled, that could be used for self-financing.

The model developed by FINCA Costa Rica – and which we studied in the mid 1990s – used the purchase of shares as a mechanism to raise local capital, in addition to savings. This allowed using local funds as sources of financing for longer periods. Since timing for investment in shares is not the same as for savings, loans could be

³⁴ Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, op. cit., position in PC Kindle: 58.

³⁵ Hans Dieter Seibel: “From Self-help groups to village financial institutions in Bali”, in: Kim Wilson, Malcolm Harper, Matthew Griffith, op. cit., page 35.

³⁶ This is the largest Self-Finance Model used with around 2 million users. For further information, visit: www.vsla.net.

granted for longer periods. But although in both experiences intermediation of external funding was the primary resource for credit, Finca Costa Rica began to see that the capital built by the community itself allowed financing a significant portion of local demand for credit.

Many of the loans used in these Central American projects were allocated for agricultural purposes and required more funds than those that could be raised locally. Over the years, however, and due to the increasing internal capitalization of community organizations, the capacity to fund projects with longer maturities and amounts increased to the point that now many community organizations only use their own funds to finance their activities.

In several countries in Central America different new methodologies are beginning to be used to form savings groups. This demonstrates again that sufficient local capital does exist for turning self-financing programs into reality, including in very poor countries, such as Haiti³⁷.

If to all above-mentioned examples we add the great number of informal savings and loan mechanisms operating in different regions in the world, but which have not been studied and do not appear to be effectively recorded in any program, it is clear that most *communities do have sufficient capital to finance a significant portion of local demand for loans with their own funds*.

2. Credit services should not be limited to productive activities

Informal mechanisms are tailored to the needs of poor people basically because their designs, highly popular and deeply rooted in community, stem from these same needs. The people living in these communities have very different requirements, which are not limited to income-generating activities. The *tontines*, the *susús*, the *ruedas* (rounds), the *vacas* (pooled money), the *cuchubales*, seek to address the needs of the community and not just those related to business activities.

Normally, in these mechanisms no one even raises any questions as to the allocation of the pooled funds. In most cases the funds are usually made available for a variety of activities. Many use them for paying out debts to moneylenders, buying any kind of products, paying a variety

³⁷ For further information on these groups, see *idem*.

of services, buying utensils, home appliances, building materials, medicines, giving financial support for children who are pursuing studies or who want to start small businesses, for clothes, animals, cultural celebrations, parties and religious celebrations. In summary, for practically anything that is within the scope of users' needs, desires, and ambitions.

The fact that these informal sources of financing are not limited to support micro-entrepreneurial activities is a key element that makes them useful and necessary. Credit needs of the population (poor or rich) go far beyond the needs of microenterprises. Therefore, attempting to achieve access to this multiple service for all appears to be a basic principle of justice, as a way for citizens to fully exercise their economic rights. In this sense, *the right to access credit services should not be restricted only to productive projects.* As said before, to be able to make frequent financial transactions for activities of all kinds is a continuing need in almost all low-income segments of population. Economic survival is closely linked to the ability to access funds to finance any kind of activity and not just the productive ones. The particular nature of these economies obliges to seek diverse sources of income not always generated by activities that are typically fundable by the microfinance industry.

On many occasions, obtaining a credit for buying medicines or paying a health-care service is more important than for starting a small business. Similarly, a small credit providing temporary access to food or shelter can make the difference between whether the children can continue studying or not, whether the proceeds from harvests are preserved or should be cut for selling in times when prices are low. It can even make the difference between surviving or not. If we want to provide quality financial services that suit the specific needs of the poorest segments of population, their economic dynamics need to be understood and the conditions under which loans are granted need to be made more flexible, covering many different activities.

In the formal model, two reasons justify the trend to fund only business activities. The first is that loans of this kind are granted in relatively higher amounts than those intended to serve daily life needs such as payment of some bills, buying food, fuel, etc. The second one is the assumption that this micro-entrepreneurial funding yields enough resources to ensure they will be paid back. In other words, granting credits for income-generating activities should make their repayment easier.

Without denying it is so in many cases, the truth is that usually income earned by poor households comes from very diverse sources, and not only from micro-enterprises. Very often the fact that households carry out multiple varied activities to diversify their sources of income is not taken into consideration: men and/or women work in a micro-enterprise, but probably one of them does something else; children may also build funds or families may live together with other relatives who contribute with money. This is a basic survival strategy in such cases, and perhaps only highly vulnerable families rely exclusively on a small business or those having small companies capable of absorbing all their members into useful labor. Therefore, a household's creditworthiness cannot be measured only in terms of its micro-entrepreneurial activities.

Microfinance has been criticized because it is almost exclusively engaged in credit and neglects the crucial need for savings. But it may also be added that their loans are limited to financing business activities. In many countries where, for instance, the formal banking system is required to place a certain percentage of their loan portfolio in microfinance, financing not-for-business activities is explicitly prohibited. Nevertheless, according to *Portfolios of the Poor*³⁸, research conducted in Bangladesh "shows that credits taken supposedly for micro-enterprises are used for other purposes"³⁹. This limitation of traditional microfinance models is not only due to a lack of vision or understanding of the market, it is also due to the costs involved in analyzing, documenting, delivering and collecting credits for non-business activities, which usually require small amounts of money. Financing all these activities is usually very expensive for formal banking services, but it is not a problem for informal mechanisms at all. It could be said then that no matter how much effort is made by the banking process, there will always be people and activities that

³⁸ Those working with traditional microcredit know that the business purpose claimed is not always the real one, and that the loan could be used to address other various needs or expenses. Credit officials usually know when the customer is hiding the true reasons for their application, but as their salaries are paid according to the credits granted, they are not likely to report such unrevealed purposes.

³⁹ Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, op. cit., 10 position in PC Kindle: 1975 ; 2114.

streamline the mechanisms and serve markets formal institutions cannot serve because of the low amounts and terms of payment required⁴⁰.

One of the great advantages of local models of self-financing is the low cost of transactions, regardless of how small are the amounts requested, or of how often disbursements and payments should be made. This feature allows people to easily access credit services without going through the complexity and expenses imposed by microfinance institutions and banks.

We will show that the new microfinance we are suggesting, based on self-financing, does not imply suppressing other formal models, but, on the contrary, it completes them. Both models can and should complement each other. The traditional model should focus on productive activities providing funding in the amounts and in the terms required to cover the costs of transactions, whereas the *Other Microfinance* described later should be focused on financing small amounts (both productive or non productive) and in short deadlines. It should also promote mechanisms to boost savings and households' capital build-up.

It is not a matter of promoting non banking microfinance, but definitively relying on the self-financing capacity of the poor, as shown by the use of so many informal mechanisms, and integrating all these practices into a chain of financial services suppliers that complement each other and make the financial system more efficient.

⁴⁰ Again, costs are and will remain important. It is not a coincidence seeing that strong criticism appears of microfinance programs is occurring, since the rate users pay is really high. Very recently Mohamed Yunus himself criticized the course taken by the microfinance industry and considered the high rates most of these institutions charge worldwide as unfair. See: Muhammad Yunus: "Sacrificing Microcredit for Megaprofits". The New York Times, January 14, 2011. (http://www.nytimes.com/2011/01/15/opinion/15yunus.html?_r=2&hp) and Alex Goldmark: "Muhammad Yunus Responds to Microcredit Loan Shark Claims". Good Business, January 15, 2011 (<http://www.good.is/post/muhammad-yunus-responds-to-microcredit-loan-shark-claims/>).

3. Financial transactions must be simple and suit people's needs

Simplicity of operation is another element that favors the widespread use of informal mechanisms and that must be taken into account for developing new models. Many of these practices do not require any type of data storage, nor complicated management and accounting. Just a list (written or memorized) of who has received money and who is to receive it suffices. Thus, a guiding principle for these informal models is simplicity-minded management⁴¹.

A major limitation in the process of providing access to banking services has been the complexity of operations, especially in rural areas with low level of education. It should be recognized that a great effort has been made to improve these complexities and microfinance institutions (MFIs) have come a long way, but certainly procedures are still very complex. Perhaps it will be very difficult to simplify them further within the framework of regulations of banking and MFIs. These complexities are not only related to requirements, paperwork, forms, but also to schedules, distance, time for transactions, treatment given by staff to customers, mechanisms for granting and raising funds, and, in short, to countless practices very hard to simplify within the regulatory structure of the mainstream or formal system, both for banks and for MFIs.

Their capacity to suit users' needs is another advantage of such self-financing informal mechanisms. Both for loans and for savings, rules and conditions are set forth according to the particular conditions of economies where they operate. In the case of savings, for instance, the model's flexibility allows virtually anyone to save and although in some cases the amounts set forth tend to exclude some poorer people, almost nothing prevents the creation of different groups with lower amounts or savings with distinct ranges of amounts, major and minor, so that everyone can participate.

⁴¹ Methodologies for recording information cover a wide range of possibilities. From the simplest ones, such as those developed by VSLA in Africa, where almost everything is recorded in the memory because they often use fixed amounts for savings and for credit, through the more complex ones, as in some of our *Bankomunales* (village banks), where information may be automated. Whatever their complexity is, being local informal mechanisms, usually with few members, simple operation is one of their common features.

Moreover, savings frequencies are adapted to the needs of the groups. Hence, it is common to see that deposits or savings are set according to the flow of income of those people taking part in the groups. If they are communities or groups with daily, weekly or even monthly income – or even longer periods - fund raising will be adapted to that reality.

This adaptation also applies to credit operations. Whereas in formal mechanisms disbursements and collection must meet established conditions according to the needs of the financial institution (with the purpose of cutting down on costs and comply with regulations), in informal mechanisms collection and disbursements are adapted to the flow of income and expenses of users. Thus, for a formal institution, arrears may imply sanctions by regulatory agencies, but in informal mechanisms that may mean just a small fine. For a formal bank, arrears on credit repayment usually have important consequences, whereas for informal mechanisms, consequences are generally less important. Arrears are usual when income is not regular. Therefore, a financing model for people with this kind of income should be flexible enough to accept this reality without affecting normal operation of the mechanism.

Delinquency rates are the bane of all formal microfinance institutions since they usually entail important consequences not only for capital turnover rates but also for the ranking allowing them to raise more funds, and above all for the penalty by authorities. This strictness of formal institutions is pretty hard to deal with and it will always be difficult to adapt to irregular income patterns that prevail in poor communities. A truly useful financial model must include these flows of irregular income, so that arrears or defaults can be overcome without major problems.

4. The local dimension simplifies procedures and reduces costs

The most used group-based informal mechanisms – such as the ASCAs and the ASCAs - in nearly all cases operate at a *local* (particular and limited) scale. This dimension is essential for providing quality financial services since it facilitates, simplifies, and cuts down the costs of many transactions. In the context of this book, *local* means the closeness among people who share a particular social space. In this sense, it is not limited to specific geographical locations or territories, but also spaces for harmonious relations resulting from common

social, cultural and economic activities. A professional association or members of a religious order or cultural group are, in this sense, local.

One of the most important aspects to be drawn from this is the acquaintance with customers. In stable groups, where people have lived in harmony with others for a long time, this knowledge makes financial transactions easier, especially credit transactions. It is natural that people who interrelate with each other know the personal characteristics of their peers and their economic, financial and administrative activities. These are key issues when deciding whether to grant or refuse a loan to a particular person. Any formal financial institution, without local grass-roots knowledge, would require much time and money to develop such customer knowledge, while for informal mechanisms that operate at this level, this task is relatively simple and inexpensive.

In general, groups that share the same territory, even in urban areas, perform similar economic activities related to the geographical areas where they inhabit. For example, it is customary to talk about communities of fishermen, farmers, ranchers and miners to refer to the main economic activity being developed in those places. It is also customary to find that the origin of many urban areas lies on the development of particular economic activities, such as industrial sites, factories, oil fields, among others. This situation not only makes it easier for people to know, to a variable extent, the characteristics of businesses performed by their neighbors, but also enables them to critically evaluate whether carrying out a particular economic project is feasible or not.

Moreover, harmonious relations in living together allow having certain awareness of inhabitants' personal characteristics. Group members normally know whether or not someone is a reliable, good-working, responsible person. We already mentioned that informal mechanisms, in particular those of a group-related nature, rely on the knowledge and trust prevailing among their users. Usually, people lend money or organize a RASCA or an ASCA or a savings club only if they know each other well enough.

Proximity also makes financial processes easier, especially those related to collection, because tracking down debtors is simple. I drew one of my first lessons on real – not theoretical - microfinance from a FINCA Costa Rica community-action worker. Using jocular language,

the young credit official told me about the hardship he endured as a collector of small amounts of money in peasant communities, a work he performed using a motorcycle. Some inhabitants in the area devised a monitoring system to detect and alert on his presence, so that debtors could hide or disappear during the time he was there for collecting. They knew that, for the collection obligations in other communities, the credit official would return only once a month. This way they could delay their payments for that period. The community worker then found a way to thwart the clever alarm system and arrive without being noticed: he left his motorcycle in a neighboring community, so that the noise could not give away his presence, and then he got on a horse, disguised as a peasant. This way he could surprise debtors during their daily work and collect the money.

Whereas it is true that this is not the most common attitude of debtors (at least not debtors of FINCA Costa Rica), those working in microfinance, especially in rural areas, know how hard it is if the collector comes from elsewhere. The costs of this task are so high, as compared with the amount to be collected, that each new visit will make the operation less profitable.

The local scale also reduces the time to perform transactions. This is highly appreciated by the community, especially by women. People value not only lower costs, but also simple and quick operations. Thus the concept of value refers not only to the financial aspects, but also and above all to the non-financial ones. Among them, perhaps the most important one is time, but also transportation costs to get to places where deposits can be made, finding where to leave the kids in the meantime, etc. The local scale can turn out to be very efficient at managing non-financial costs. This should also be a very important variable to be considered when designing quality financial services for low-income populations.

Associative and/or community-based mechanisms, many of them used by traditional microfinance, have also proved that peer pressure is one of the most effective means of collecting credits in populations where setting forth collateral is not viable. For this, relations living together are important as they make it much more likely to start a true group commitment, as there is an ongoing relationship between those who provide and those who receive the loans.

It can be said, thus, that structuring a sound credit portfolio requires knowing economic activities, individual, moral, and financial conditions of customers, as well as debtors' individual creditworthiness. And the local proximity is precisely and naturally what provides that knowledge.

It is important to note that if a bank agency opens a local customer service point in a poor area, this does not mean that banking has reached the local community. As noticed above, it is not a matter of simply taking the formal model and transferring it to the community. We insist on the fact that there is an issue of incompatibility between traditional formal financing and the needs of the poorest, expressed among other things, in the economic costs and opportunities.

However "local" a bank agency may be, it is involved in the mainstream operating and regulatory system, forcing them to set up terms and conditions that make it hard for them to reach the local scale and serve poor people's needs. Having a local bank agency would certainly make the financial process much easier, but costs involved will also increase. And while those costs could possibly be justified in densely populated areas such as urban centers, rural communities with fewer inhabitants can hardly afford them.

The financial services that poor communities need may be much simpler and cheaper than those provided by the complex mainstream formal system. It is unnecessary, or at least inefficient, to attempt to provide financial services with the same formal structure to a housewife in a poor rural community as to a large global corporation. It makes no sense to implement the same model for such different financial needs. The requirements of a housewife living in a rural community in Asia or Latin America may be met more efficiently with local structures and at lower costs. She does not need, for instance, a financial service linked to the stock market, or to international currency exchange rates or a plastic card used to make purchases in great cities across the world. For her, relying on simple mechanisms for receiving a credit or placing her savings would suffice.

Of course, we do not intend to deny privileges to anyone. Neither do we mean that low-income people do not deserve such a variety of services. What we try to emphasize is that they do not have to pay for those services if they are not useful for them. But the reality is that the formal system works as a globally interconnected whole, and society

generally pays a high cost for supervision to monitor their complexity. However, it is unfair that everyone should bear the costs, if only a few have access to the many services provided by the formal mainstream system. Making the formal financial system more efficient and equitable thus requires reviewing who should pay for the complex systems of supervision and control, and which users must pay for each type of service. It does not seem fair that a housewife should pay for the operational infrastructure of a complex, global financial institution, when she only needs basic services in order to save her money and / or receive a small credit.

5. By creating financial capital it is possible to build social capital

As said before, informal financial mechanisms, especially those group-based, have very ancient historical roots, and date back to a time even before the emergence of money. A study on popular savings banks in Catalonia says:

“Among rural activities, farmers gathered to work in turn in each other’s field. Groups of people also got together to help each other for building their houses. These various activities helped strengthen ties of solidarity, reciprocity, support, mutual aid, mutual consideration and cooperation [...]”

In fact, over time, since the emergence of the monetized economy, great changes occurred in the different practices performed by African peoples. The most important driving force of these changes was the emergence and the introduction of the use of money in different cultures. This means, a “monetization” of African societies. Therefore, monetized and non-monetized activities will coexist, parallel to each other. As goods were continuously traded and mutual aid was given for different tasks, the use of currency became part of the circuit. In the second half of the 20th century, anthropologists such as Bascom (1952), followed later by Ardener (1964), described well-structured groups of people in some countries in sub-Saharan Africa, who usually got together to pool money. The total amount of this money was given in turn to each member of the group, according to a well-defined and clearly established

period. The purpose was to help each group member to start a project, often personal, or for the group”.⁴².

Thus, we see that the underlying reasons for forming these groups are not just of a financial nature. Many savings clubs, ASCAs or ROSCAs set forth mandatory meetings. For many users, they also serve to establish social relationships, thus building a tight network of trusted relationships and commitments. For some, these ties are very strong and are transferred from generation to generation.

An illustrative example of this is the functioning of self-financing communities (SFC) created in Europe and which we will review in detail later on. In these groups, the main reason to become partner, as reported by some of their members, is not access to credits but sharing in community with others.

In this regard, notes Barou, who conducted a thorough study of African communities in France: "the need to get together is also explained by the specificity of the African personality, which makes that the individual only fulfills himself being within a group, and in turn, the individual ensures [the] group's unity"⁴³. But this need for getting together is practically universal, and is not limited to African cultures.

In poor areas, especially rural, organizing community groups has historically been necessary to overcome difficulties and to fight against nature. Perhaps this is another reason why, even if formal financial services do exist, people continue to use mechanisms allowing for socialization.

In interviews we have conducted, many partners of the *Bankomunales* – an induced informal mechanism that will be discussed later on - explained that while their organization is important to access financial services, it also develops social activities. In fact, most of the work performed by *Bankomunales'* stakeholders is entirely volunteer work.

⁴² Gerafrica, A Study and Reflection Group on Africa: "African popular saving in Catalunya: Types and forms of underground immigrant economies". Final Report, Lerida University, September 2007. Page 16.

⁴³ J. Barou, *Travailleurs africains en France. Rôle des cultures d'origine*, PUG, Grenoble, 1978, p. 8.

One explanation for this phenomenon could be that people who take part strengthen their leadership within their social group, achieving prestige, social recognition, training and personal development. And this is as important as having access to financial services.

In other cases, especially among migrants in Europe, who lack social support networks in their host countries, people seek companionship, affectionate relationships, human linkages, rather than economic support, to help them find a social environment in which to better perform.

One of the ways in which the importance of the social or group is expressed in the use of these mechanisms is that many users understand the value of what is collective to manage to save, especially women. In the cited work of Rebecca M. Vonderlack-Navarro and Mark Schreiner: *Women, Microfinance and Savings*, this phenomenon is studied and widely documented. That work shows evidence that women attend meetings of ROSCAs, ASCAs or savings clubs because such events put peer pressure on them to save. Being compelled to save within a group serves as an excuse for not giving in to the constant pressure and demands of husbands, children and relatives to spend the money.

Informal practices designed to manage financial resources strengthen social ties, which is one of their greatest strengths. These ties are intended not only for mutual help, but also for the generation of community-based dynamics, which are crucial for building up social capital.⁴⁴ The work performed by Audes Jiménez, a member of the Ashoka⁴⁵ network in Colombia, also shows the importance of society and community-related aspects of these mechanisms. For several years, Audes has been developing a project for self-financing groups in Barranquilla and Cartagena. However, the main subject matter of her work is not financing, but social involvement of populations displaced

⁴⁴ For example, in our experience with the Bankomunal model described later, the discussion of economic issues, such as interest rates, affordability, and return on equity, are usually accompanied by an analysis of social and community issues, of which peaceful conflict resolution and through consensus is one of the most important ones.

⁴⁵ Ashoka is one of the major networks of social entrepreneurs in the world. For further information, please visit www.ashoka.org, and for Audes Jiménez González, Founder of *Aprodefa*, Social entrepreneur and fellow member of Ashoka, visit www.ashoka.org/fellow/3704. www.aprodefa.com.

due to the armed conflict in Colombia. Her methodology, apart from obviously helping give easy access to financial services, also strengthens the integration and conflict resolution work conducted in the settlements where these people live.

In conclusion: the way in which the social component becomes essential in the functioning of informal mechanisms is another aspect that should be taken into account when designing new financial models. People tend to cluster to address various needs, and access to financial services is one of them, but in response to these economic problems, the social aspects are very important and it would be shortsighted not to take them into consideration. *Using the need for financial services to build up social capital on economic capital is another lesson learned from these informal practices.*

V. Problems of Informal Mechanisms

*“With tontines, we have to start over every year.
With the SFC, a growing capital is built little by little
and this means that we do have long-term savings”*

*A SFC stakeholder
Barcelona, Spain*

Informal financial mechanisms, despite their strengths and the lessons learnt from them regarding the type of financing needed by the poor, do have problems. But these are problems that can be solved. Some people think they have worked well that way for years and that they should not be modified. But in our experience, if some changes and controls are introduced, millions of people using them could have more reliable tools to meet their needs for financial services.

Users of these services would certainly be happier if they could rely on higher quality financial instruments for proper support of their financial operations, reducing their risks and reducing their constraints. Not precisely for being informal but because they do not provide sufficiently reliable, permanent, comprehensive and quality services. The authors of *Portfolios of the Poor* point out: “The poor households we met make actively employ financial tools not despite being poor but because they are poor”⁴⁶. If something better was available, they would surely use it.

The truth of the matter is that these funding mechanisms have a number of flaws and defects that need to be corrected if we are to offer better alternatives to the people who use them. Let’s analyze, from our point of view, some of the most noticeable inefficiencies of many informal mechanisms.

1. Insecurity

Money insecurity is, in our opinion, the main weakness of informal practices. Most of the instruments described here are unsafe, in the sense that the funds they pool can easily be lost, either because they are stolen or because someone does not comply with the agreement.

⁴⁶ Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, op. cit., position in PC Kindle: 387.

When it comes to individual savings mechanisms such as the so-called “safe box”, or credits from relatives or friends, insecurity occurs as the diversion of money by the holders of the funds, not only for a lack of moral conduct, but because these persons are also subject to conditions of economic uncertainty, and it is normal to be tempted to use them to cover any emergency.

Thus, although we do not know of any specific study to determine the amount of resources that are lost or diverted from their original purpose, in the interviews we conducted with users of these mechanisms we see that many report to have lost their money, or at least had to wait longer than scheduled to get it back, because the money guarder used it to cover a personal emergency.

Even though indeed the knowledge and trust in the person to whom the credit is granted helps minimize the credit risk, it does not mean that recovering the money is no longer in danger. Knowledge and trust are good and necessary, but not sufficient.⁴⁷ More transparency and security need to be provided to users. We do not intend to criticize these practices or undervalue their importance as a generator of trust and community ties. We just note that in many cases the money is diverted from their initial purposes, and users are compelled to wait longer than scheduled to recover the money or, even worse, they may lose it altogether. Apart from social and cultural values worth preserving in these practices, insecurity and its consequences are factors that need to be improved.

People also report loss of their savings with the mechanism we have called “the hidden money pot.” It often happens that a close relative subtracts funds out of the hiding place without the owner's permission, for instance. Different daily-life circumstances, when revenues are scarce, often generate behaviors that cause money to be not so “safe-guarded”. It is common to interview people, especially women, who report thefts by their husbands or close relatives, often with physical violence. Providing lower-income people with instruments to replace these individual savings mechanisms, and under better conditions, is very important if we want to help them overcome poverty.

⁴⁷ Trust and mistrust are key elements. Both should co-exist. Therefore, new models should be developed to build trust, but without simple-mindedness. Monitoring should be part of the process to generate trust.

In the case of group-based mechanisms, risks are higher. Savings clubs, for instance, are permanently subject to loss of money because of willful misconduct committed by those having the responsibility for collection and organization, due to similar reasons: theft and diversion of funds. Sometimes funds may also disappear without explanation, resulting in the loss of the money for virtually the entire group, at least partially.

In ASCAs and ROSCAs, where payouts are delivered in turns or are lent to members or third parties, risks of loss are even higher, though not for the same reasons. In this case, money is unlikely to simply “disappear” since no particular person has the responsibility for accumulating it, but it is distributed in turns among stakeholders or it is allocated as loans. However, the danger is that group members, especially those who have already taken their payouts, do not comply with their installments as appropriate, or poor administrative controls allow for theft of funds.⁴⁸

If these practices are to be improved, a first priority is to develop tools that help solve their inherent insecurity issue. But perhaps the key to this is not in external oversight mechanisms, as in the case of the formal system, but in internal mechanisms such as self-control and self-monitoring. This involves training and educating users to better understand the reasoning of the processes they use and thus enable them to monitor more adequately the use of funds.

Whereas insecurity for funds is an all-important weakness of informal mechanisms, designing future models (regulated or not) should include instruments to solve this deficiency as a priority. Even though full security may be not possible to achieve, since even streamline formal systems have not succeeded in that, security levels need to be increased for the sake of users’ peace of mind. At this point, a great effort should be made to ensure that the transformation of informal mechanisms that may be made provides a high level of security to users. Poor design may entail very negative consequences that, instead of helping to overcome poverty, contribute to sustain it.

⁴⁸ Insecurity is also present in the formal banking system. However, the really dramatic thing is that these cases involve losses of immense amounts of resources that affect the lives of millions of people and payers themselves are those who ultimately pay for them.

2.- Uneven distribution of risk

Consider also that in the ROSCA model, risks are unequal and unfair. Those with the first payout turns receive money virtually without provision of any collateral, while the last turns guarantee almost all of the funds received. This system of risk sharing among users does not contribute to improving the model's operational ability. If the first ones to receive the payouts do not comply with their commitment to pay their installments, the last ones will lose money, or at least will have to wait until the first ones pay in order to be able to receive the full amount. As previously discussed, for the first ones the mechanism is a credit since they receive the entire payout before paying all contributions to be pooled. But for those having the last turns, the mechanism is savings, since they have to pay all installments in order to receive the full payout. While the first one in turn receives all without paying any contributions, the last one receives just what he/she has contributed.

In the ASCAs, where money is not handed in turns but is instead lent to associated members upon request, risks tend to be better distributed since not all the accumulated money goes to only one person but to several people. Unfortunately, loans are often concentrated in just two or three members. It would be important to apply a model to distribute risk among a larger number of members.

In savings and loan associations lending money to third parties, risk is usually of 100% per credit operation, since these are people who do not belong to the savings group. That is to say, they do not deposit installments and use the funds at a given time without having made any contributions whatsoever. When money is used exclusively by the people who make contributions, installments allocated to each stakeholder, once they are deposited, are an important guarantee and thereby risk is reduced. But when money is lent to people not belonging to the group, there is no guarantee at all. This is one of the reasons why this loan model is rarely used or at least is not very common.

Therefore, an important improvement to informal mechanisms is to introduce rules and procedures that contribute to better distribute the risk. To that end, concentration of money in a few hands must be avoided and the portfolio should be distributed. Likewise, a collateral system should be established among group members in order to

minimize the effects of non-payment, either temporarily or in full, of credits.

3 Don't keep value of saving

Due to the lack of profitability and as a result of inflation, money depreciation is remarkable in all of these mechanisms. Almost all of the informal mechanisms described above fail to preserve the value of funds over time. This phenomenon has a very negative impact on households using them. The inability of many models to make the most profitable return on money, from any point of view, is indeed a constraint and a great disadvantage as compared to other more cost-effective financial models.

The lack of instruments contributing to increased yield on invested money is a disadvantage that affects the development of households as it ends up impoverishing people more and more, especially in economies with high inflation rates. Its effect on the poor is a well documented topic which will not be discussed in this paper.⁴⁹ However it is relevant to highlight the disadvantages for low-income households to not have access to better quality financial services ensuring them a proper return on money⁵⁰.

With informal individual and group-based savings mechanisms it is practically impossible to achieve a return on savings, since in many cases funds are not used for income-generating purposes. In individual savings mechanisms, the money is usually deposited without earning any compensation (interest). In savings clubs or in the ROSCAs, no compensation is received for depositing the money either. Only in mechanisms whereby money is used for funding loans, or where

⁴⁹ For an analysis of the effects of inflation on inequality indexes, see, Aleš Bulíř: *Income Inequality. Does Inflation Matter?*, IMF Working paper, January, 1998, International Monetary Fund (<http://www.imf.org/external/pubs/ft/wp/wp9807.pdf>).

⁵⁰ In *Bankomunales* methodologies we established mechanisms that allow users to decide on the return of their money, so that at least they can expect to preserve its real value in the future. Income volumes depend on each group's decisions, but the important thing is to have instruments that allow users to make their decisions on this point. Moreover, keeping the value of money is providing users with financial education. This topic will be discussed later in more detail.

people bid to have turn payouts, which is in fact a way to charge interests, is it possible to obtain funds to reward money accumulation.

One of the simplest ways to preserve the value of money over time is to invest it in credits. But, of course, transforming savings funds into credit funds increases risk, and if the transaction is not properly made the money earned on inflation may be lost in security. Given this situation, it is logical to introduce methodological resources in informal mechanisms allowing use of the money saved to give credits and have a return on it without substantially increasing the risks.

The structure of the operating model of the whole financial banking system is based on the so-called *financial intermediation*. In other words, formal banking has managed to achieve substantial profits for years by attracting resources through savings, which are transferred to others in need. The primary contribution of the banking system is raising money not being used productively (savings) to invest it with higher value where needed (credit). To ensure these gains and protect the resources of savers, the formal financial system has a number of instruments regulating the conditions under which loans are granted, thus ensuring (at least theoretically) their recovery and the generated income.

We all know that this is not always the case, and that the frequent formal financial system crises are usually associated with phenomena such as inadequate investment, lack of risk assessment or simply embezzlement and corruption. Savers keep their money in banks, hoping that the official surveillance system ensures their safety, but unfortunately in many cases this assumption is not true. Sometimes administrative irregularities occurring in the formal banking system also cast doubt upon the efficiency of regulatory and control mechanisms. The recent *subprime*⁵¹ mortgage crisis is just another

⁵¹ High-risk mortgages, known in the United States as *subprime mortgages*, were a particular kind of mortgage intended to finance home acquisition by customers with low credit ratings. Therefore, their risk level was higher than the average of other credits. The difficulties arising from subprime mortgages led to a big economic and financial crisis unveiled around August 2007 and which is still affecting the world economy. In Spain, it was known as the “Ninja crisis”.

example of the long history of mistakes and embezzlement of funds in banks' performance since their inception⁵².

But despite insecurity, also present in formal models, credit is one of the most important ways to achieve return on savings and boost its use. In so doing, it is invested in activities where theoretically it would be more useful. Thus, credit is the most advisable financial instrument to make use of funds built up through informal mechanisms.

The traditional strategy, however, has consisted of transferring funds to the mainstream formal sector, but there may be a most effective choice. The great fundraising ability of some local informal mechanisms can be used to meet the credit demand in those populations, if their users themselves are given training to manage and administer them properly. By developing reliable methods and providing training to those who use informal mechanisms, replication of intermediation functions of formal mechanisms at a much less complex local level would be possible.

The great difficulties of the formal system in serving these areas would be overcome and the complex routing of money through their institutions would be avoided.

Care must be taken to achieve the security level of mainstream formal models (commercial banking and microfinance banks) within informal mechanisms and at the same time, advantage must be taken of the enormous capacity of informal mechanisms to mobilize resources (human and financial) in order to develop profitable and secure financial instruments. Changes should be made so that funds mobilized in informal instruments are used to meet the credit needs of dwellers themselves and thus preserve their value over time.

4. Short-term cycles

Another negative aspect of informal mechanisms, especially the group-based ones, is the duration of operations' cycle. It is usually very short and hinders making more stable financial operations in order to achieve a real positive impact in users' economy. The maximum period of operation of any of these collective practices is rarely longer

⁵² For extensive information on some of the major crises in the financial system, see: Niall Ferguson, *El triunfo del dinero* (The Ascent of Money), Editorial Debate, Barcelona, 2009.

than twelve months. Groups are usually dissolved once the cycle is completed. Even though another cycle may be started, normally the full amount of the funds accumulated during the period is distributed among members (either in turns, as in the case of ROSCAs, or it is handed in to users, as in savings clubs). Only in a few ASCAs, funds may be kept for longer periods or even for several years. This may be a strength for ASCAs as compared with other shorter-term mechanisms. But despite this positive aspect, in this mechanism too, security and risk are to be enhanced and training of users should be favored so that they make a proper use of it⁵³.

For low-income households, accumulation of capital is essential. But for that purpose, durable and permanent practices for raising money are needed. This requires redesigning informal mechanisms in order to provide services for longer terms and promoting capital formation for their users. In *The Poor and Their Money*, Rutherford states that “financial services for the poor are there to help them get hold of large sums of cash usefully when they *need* the cash or have an *opportunity* to investment it.”⁵⁴ In other words, the poor, just like other better-off segments of population, use financial services to compound small flows of money to larger sums and thereby producing a significant impact on their quality of life.

Therefore, either by means of savings or credit, terms should be extended to allow households to buy goods or services that really make a difference in their lives. Housing and education programs, for instance, require loan or savings periods longer than those normally provided by informal mechanisms. But consolidating large sums through mechanisms with a schedule that do not exceed a few months is not easy. On the other hand, too long periods for repayment space out the turns for receiving payouts – affecting the need to have funds available when needed – and increasing the normal risks of transactions. To have longer cycles and achieve higher capitalization, these practices require an important transformation favoring the extension of terms without increasing the risks.

Another argument in favor of extending the effective duration of groups is that by providing a somewhat institutional framework for

⁵³ *Bankomunales* (village banks), in their simplest form, as discussed in next chapters, are based on ASCAs model.

⁵⁴ Stuart Rutherford, *op. cit.*, p. 10.

the mechanism at a local level, financial records may be created for facilitating people's full transition, if needed, to streamline formal mechanisms. Thus, enhanced informal mechanisms may become a sort of "regularization school" for users. This approach would allow those who do not want to extend their terms and / or installments to continue to use informal services, but those who require "going up" on the financial scale, may easily use their experience within informal mechanisms to access other opportunities within formal banking.

Increasing operating periods for group mechanisms such as ROSCAs and ASCAs, however, may entail undesirable consequences. One of the most important ones is a trend that, when the amounts of savings and loans increase, the groups having higher economic power within communities become more interested in participating and end up taking operational control of the mechanisms. In these cases, rules and procedures are often set up, resulting in the exclusion of the poorest. A well-designed version of the mechanism may contribute to the model's continuity and, at the same time, to the increase in the number of users with higher and more stable income, and to bring support to people with lower and less regular income levels. Another negative consequence to be taken into account is that transactions will become more complex and more controls will be implemented inasmuch as more funds will be accumulated and cycles will be longer⁵⁵.

Thus, if informal mechanisms are to be redesigned, they must ensure easy capital build-up for households, in an attempt to attract and make short or long term investments in order to allow significant accumulation of money, but without the model ending up being more exclusive of those who need the most, nor representing a significant increase in management complexity.

⁵⁵ The VSLA model avoids maintaining savings groups for long periods. Groups are dissolved in a period of less than twelve months. Groups may restart if members so decide, either with the same persons or with different ones. In *Bankomunales*, on the contrary, groups are intended to be permanent and a profit-sharing system has been designed to facilitate the process, which of course makes operations more complex. This is due to the fact that each model emerged from a particular reality, seemingly reflecting it.

5. Limited opportunities

Informal mechanisms do not boost resources to generate real opportunities for people who use them. If the mechanism is by turns, for instance, each person must wait for his/her turn and has no means to take advantage of economic opportunities he/she may get in the meantime. And if that turn is over, and the person needs an additional capital to buy a particular good or service, he/she cannot resort to the same mechanism to borrow the money she/he needs. Instead, she/he will have to start another round or simply do without. Many users support the turn system as a savings mechanism rather than a credit one. In practice, however, it turns out to be restrictive in both cases. Savers, for instance, view saving as an expense or investment they need to do at a given time. But, since not all people make their contributions on scheduled terms, and payouts may be delayed, the opportunity is missed on many occasions. Unfortunately, this is not the only consequence. In fact, as the amount received cannot be spent for the specific purpose for which it was meant, it is eventually spent on unnecessary things⁵⁶.

When asked why they make such an effort to participate in this kind of financial instrument if it does not work properly, many people say it is because they have no other real possibilities for saving or getting a loan. If they could rely on an equally simple model, allowing them to better seize economic opportunities, without the complexities of formal banking, they would surely use it.

In subsistence micro-enterprises, for instance, the possibility to access funds on an ongoing basis, especially to solve cash flow problems, is highly valuable. But outside the business sphere, poor households with irregular income require financial instruments providing quick and easy access to both credit and savings. Therefore, improving these

⁵⁶ The case of a stakeholder in a community in the state of Monagas, Venezuela, may serve as an example. She planned her turn so as to have the funds at a specific time when a neighbor had promised to sell her a plot of land to start building her humble house. When time came to purchase the property, the money was not available and the neighbor sold it to someone else. Unfortunately, she said that she ultimately ended up spending the money on minor things and regretted to that she had saved money for months, but eventually the money vanished in unnecessary things. This is a very common experience.

informal mechanisms with methodological models that ensure a continuous flow of resources would be helpful.

This is an important limitation of group savings and credit systems. Their operational structure for both savings deposits and credit operations may turn out to be very stringent. In ROSCAs, the turns to access payouts may be an important limitation. And though ASCAs are more flexible for credit, since they do not stick strictly to the turn system, the amounts of money to be saved are normally fixed and continuous. This can be a major constraint for many people in the community. Constraints of these mechanisms may lead low-income people to use several informal mechanisms at the same time. This phenomenon, however, has consequences on the effectiveness of the service used. These failures may be substantially corrected by establishing more flexible access conditions, both for savings and for building up capital for credit. This is not an easy task, but enhancing these models will have a great impact on the lives of millions of people.

6. They do not generate financial education

One of our preferred phrases is that credit and savings are tools that are too attractive for use only as economic instruments. The need to access these services is so great that it could be used to enrich financial work. Practically no informal financial mechanism – though some of them involve a strong social component and form important community organizations, as the *tontines* in Europe – involves educational elements supporting economic development of people⁵⁷.

Whereas access to financial services is important to create opportunities for improving their finances, financial literacy is a valuable tool to support families in getting out of poverty. It is also a real antidote against fraud, usury and speculation to which lower-income people are normally exposed in both informal mechanisms and in some formal institutions. Financial literacy is essential as a tool

⁵⁷ Many models induced by NGO-like organizations have additional training programs in various areas, such as health. However, our aim is to incorporate, within the framework of the same methodology of *Bankomunales*, practices that improve the financial literacy of users. This point will be discussed later in the chapter devoted to these institutions.

to fight these evils, since this is where people can find the tools to pursue and fully exercise their economic rights.

Finances are an absolutely essential aspect in the life of states, companies and individuals. That is why it is inconceivable that such an important and vital matter for all has been left in the hands of a few elites, supposedly knowledgeable and skilled, who in turn are supervised by other institutions who manage them as they please⁵⁸.

There is a widespread lack of financial literacy across society, and not only in low-income population segments. This lack of knowledge is based on the assumption that finances are particularly complex and require special and sophisticated expertise to be understood. However, our working with communities for years, teaching how to create and manage local financial institutions (*Bankomunales*), has shown that with little effort it is possible to simplify those concepts and teach them to people, so as to help improve individual and group economic operational ability.

From the point of view of society as a whole, financial literacy also becomes a priority. The current financial crisis is just one among hundreds of crises regularly occurring around the world. Niall Ferguson shows that since 1870, around 148 major financial crises have occurred. And major means those that have lowered a country's GDP by at least 10 per cent⁵⁹. These phenomena have led millions of people into bankruptcy. A review of the history of economics and world finances shows that crises are not scattered or occasional events but rather outstanding and nearly everyday events.

Recurrence may result from the presence of a group of "experts" trusted by another group of "inexpert people" within. A common feature to all economic crises is "disguising" reality with technical contrivances that mislead the public, companies and state regulatory bodies. Reviewing the history of finance is finding the same phenomenon almost every time.

⁵⁸ This lack of financial knowledge is becoming increasingly clear. In recent years, indeed, it has generated important campaigns to boost training programs in this area, such as those deployed by different central banks in Latin America. Unfortunately, the contents of many of such programs are still very traditional and are almost exclusively focused on the use of formal services whereas most people use informal mechanisms.

⁵⁹ Niall Ferguson, op. cit., page 364.

In an attempt to avoid falling victim to these tricks, society has established a number of regulatory instruments to monitor and supervise banks. However, as shown by Ferguson in his above-mentioned book, crises continue to occur and are usually based on widespread deception in a particular segment of population. The more financially educated people are, the more chances they have to uncover the shams on time, and the more likely it is to avoid such crises.

For people using informal mechanisms, financial literacy is even more important because people can be trained not only to avoid falling into the so frequent traps, but also to properly analyze the services and products normally provided by these practices. Thus, people could distinguish whether a financial transaction is - or is not - the best choice at a particular moment. Beyond the urgent needs they may have, and having no other alternative within reach, people would be able to better understand the benefits and drawbacks of such transactions.

Financial education is also key to overcoming poverty, as there are a number of myths, values, beliefs and attitudes in low-income population segments that do not contribute to generating economic wealth. Quality training in economic topics, structured not only on the basis of theoretical aspects but also based on practices widely used by people, would contribute significantly to improving the ability of these sectors to address and solve their financial difficulties.⁶⁰

Our proposal consists in incorporating some simple but effective elements in informal models of financial education. This work requires designing and a lot of effort, but the benefits may be enormous. These

⁶⁰ An example of how we provide training in economic topics in *Bankomunales* and attempt to make people learn to value their assets can be seen in some of the exercises we do with groups. One exercise asks people to assess their financial assets with some level of accuracy. It is remarkable that more than 90% do not count their house as an asset, being that this is indeed their main asset, which accounts for the savings of their entire life. The reason may be linked to the fact that the concept of house (infrastructure where they live) and household (group of related people living together) are mixed. A person who is not able to distinguish those two concepts to count his/her assets is less likely to use financial resources to generate wealth than another one capable of perceiving the difference between the affective value of the home and the economic value of the building or infrastructure where his/her family lives.

educational elements, in addition to teaching important financial concepts such as inflation, depreciation, profitability, investment and risk assessment can also induce reflections and transform values, beliefs and unrealities associated with the term “money”, so that instead of being a complex concept and "psychologically unmanageable", it can become a manageable instrument for people.

To complete the review of the limitations of informal mechanisms, we can say that the lack of transparency, deceptions, low profitability of accumulated funds, poor ability to generate long-term economic opportunities and limited action on educational aspects are common features in most cases. They are built on the basis of trust, and though this may be beneficial at times, on other occasions they may be highly detrimental. The willingness of participants and the reciprocal obligations are not always fulfilled and, in many cases, they are betrayed. Trust is necessary, but not sufficient. For the whole system to be safe and the money to be properly recovered, a methodological design is needed to provide certainty to users. It is there, in that combination of methodological rigor and operational flexibility, where the key to success lies. If better quality financial instruments are to be provided to low-income communities, these elements should be merged efficiently.

Modifying these mechanisms, introducing improvements and inducing their use, are a crucial task. Its effects can be very valuable to society. Knowing that people have been using informal mechanisms since time immemorial and that these have been tremendously helpful in their financial transactions is not enough. They have important limitations that must be overcome by means of carefully designed mechanisms providing greater security, transparency and education to their users.

VI. Is Banking the Answer?

*Professor Yunus showed the world
that poor people can be financed.
We are showing that they can be self-financed.*
A Fundefir volunteer

Access to banking has been the answer given by society in providing financial services to the poor, especially through microfinance models. Undoubtedly, this has been an important resource, though limited because, among other reasons, it is focused on credit rather than in savings and only supports micro-entrepreneurial activities. As previously discussed, in low-income segments of population, either in rural or in urban areas, few small businesses and even fewer entrepreneurs require credits that truly justify operations with formal banking⁶¹. Many of the transactions and sums of money these people need may be served with current informal mechanisms and that is why people make extensive use of them.

The main purpose of this work is precisely to draw attention to the likelihood of changing the view prevailing for nearly four decades, and paying more attention to self-funding, a particular feature of informal mechanisms. We know from our experience that even in areas with high banking rates, informal practices persist and are widely used. In communities with access to formal services, a high percentage of the population still makes extensive use of informal mechanisms since these have features efficiently adapted to the particular needs of low-income people. Likewise, in countries where a powerful microfinance industry exists, the use of informal mechanisms is recurrent, contrary to expectations. Out of the 42 people studied in Bangladesh by researchers of *Portfolios of the Poor*, 30 had access to microfinance institutions' services. However, all 42 used other types of informal mechanisms⁶². In Bolivia, where the microfinance industry is widely extended, most interviewed people reported having credits from

⁶¹ Nano entrepreneurs are herein referred to subsistence entrepreneurs served by *Bankomunales*. These differ from what is traditionally understood by micro or small entrepreneurs, as the amount of credit they need for their operations can be easily provided with local and informal mechanisms, without the need to enter the formal system complexity.

⁶² Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, op. cit., location in PC Kindle: 630.

microbanks, but also continued making widespread use of other credit services, including many of informal mechanisms described above.

The formal banking system experiences a number of difficulties in reaching wide segments of population, especially in rural areas. In spite of the recent introduction of innovative technological instruments such as mobile banking, formal banking will not succeed in serving them efficiently by only providing access to bank services. The truth of the matter is that cost issues do matter, and very much. This has raised strong criticism towards microfinance programs since the price users pay is very high.

Very recently, Muhammad Yunus himself condemned the path taken by microfinance businesses and deemed unfair the high interest rates charged by most of these institutions. Yunus stated that they should not charge more than 10 points on the cost of funds, *i.e.* more than 10 additional points on the cost of the money they took in. Whereas the cost of funding (paid by the institution for the savings, plus management fees) is 5 percentage points, then the rate to be paid by microcredit borrowers should not be higher than 15 per cent. In more technical terms, the *spread* should not be higher than 10 per cent⁶³.

Reactions to his stance broke out instantly. Several representatives of leading microfinance institutions argued that with this spread they could not cover their operating costs and obtain reasonable rates of return ensuring sustainability. Moreover, in the last few years a new strategy emerged for obtaining funding for microfinance operations, which worsens the issue of costs and favors new criticism. Now an attempt is made not only to raise funds with savings from the public, but also through the purchase of shares in the stock market. The model has been implemented with strong success in India, by SKS Microfinance⁶⁴. This is one of the fastest-growing microfinance institutions across the world. Its partners are a large list of corporations, investment funds and major NGOs in the world. At

⁶³ See: Yunus, Muhammad: "Sacrificing Microcredit for Megaprofits", New York Times, January 14, 2011 (http://www.nytimes.com/2011/01/15/opinion/15yunus.html?_r=4&hp). On this topic in Spanish, review Lucy Conger: "Yunus Tiburones y costos". (Yunus, Loan Sharks, and Costs). Interamerican Development Bank. Lima, June 1 2010 (<http://www.iadb.org/Micamericas/section/detail.cfm?language=Spanish&id=7230§ionID=SPCAL>)

⁶⁴ See <http://www.sksindia.com/>

present, the company has nearly six million clients, with around 1,670 agencies across 19 states in India. In 2010, the company made its debut at the Bombay stock market with a public offering of shares. Its designers justify the application of this model by arguing that it is the only way to obtain sufficient capital to meet the very high demand for microcredit in India. According to these spokesmen, in 2008, in India alone, demand exceeded supply by more than 40 billion dollars. But this new model has also raised much criticism. For instance, Muhammad Yunus questions it on the grounds that “this is an idea that is repulsive to me. He continues, saying that: “Microfinance is in the direction of helping the poor retain their money rather than redirecting it in the direction of rich people”⁶⁵.

The discussion is complex and it certainly should be deepened. Choosing between sustainability and social impact is difficult. But criticism of the SKS Microfinance model may be extended to the general model of raising savings from the public, although much of that public are the dwellers of the villages where the Grameen Bank operates, a community development microcredit bank founded by Yunus. Mobilizing the poor's funds to banking through savings, and then returning them in loans granted by the banking system is often an expensive, inefficient and unnecessary procedure and, in some cases, it may also be described as "repulsive" as Yunus says, due to the high costs to be paid by microcredit borrowers.

These models are based on the assumption that the source of funds for financing is mostly public savings and / or the stock market. From this point of view, the only possible way of using the money is through access to banking services. Moreover, with few exceptions, the microfinance trend has been to move away from the needy to focus on transactions involving higher amounts in order to cover their costs⁶⁶. This trend reflects the real difficulties in serving low-income populations.

Despite all the development that has been achieved and the incorporation of innovative technological mechanisms, microfinance

⁶⁵ Erika Kinets, “SKS Launches India’s First Microfinance IPO”, ABC News/Money, Bombay, July 28, 2010.

(<http://abcnews.go.com/Business/wireStory?id=11270209>).

⁶⁶ For further discussion on this point, see MicroBanking Bulletin (<http://www.themix.org/publications/microbanking-bulletin>).

works on the premise that the higher the amount of a transaction, the lower the transaction cost, and the lower the amount of a loan, the greater its relative cost. For formal institutions, a credit for \$1 involves similar or even higher transactions costs than one of \$1,000. Hence, it will always be cheaper to lend \$1,000 than to lend \$1. In order to offset these costs, the person receiving \$1 should certainly pay amounts making the operation sustainable and therefore the rate to be paid will certainly be higher than the one to be paid by a person borrowing \$1,000.

Apart from high interest rates, there is another very complex issue: over-indebtedness. Unfortunately, providing the poor with access to financial services has come with a terrible process that we have called “credit sale”. In order to justify and make operations on a sustainable basis, many formal microfinance institutions promote the ill practice of granting credits left and right without regard, with the purpose of achieving high volumes of transactions allowing for profitability and sustainability. Microfinance institutions often have an army of credit officials, usually well-trained young people, whose salary and efficiency are measured by the number and the amounts of credits granted to poor people.

In this case, as in others, financial sustainability jeopardizes the principles that gave rise to this practice. And under the excuse of granting credits to the needy, not only are abuses committed in charging interest rates, but the “sale” of debt is promoted, bringing about negative rather than positive results⁶⁷. Pressured by cost and sustainability issues, microfinance institutions generate over-

⁶⁷When we learned of the Finca Costa Rica program nearly 20 years ago, an army of young people on all-terrain motorcycles went out on Monday morning to tour the country to place and collect the receivables that the institution operated. On Friday afternoons, they could be seen returning to report and when they did not meet the established goals, their anguished faces were touching. This pressure on loan agents was but the effect of another one exercised by aid workers to reach the alleged sustainability goals. Many agencies directed by developed countries still set similar goals, not realizing that this would make microcredit nonsense. Fortunately, the program's director, Maria Marta Padilla, a woman with great social sensitivity, decided to turn away from this path. For many years, based on the experience we developed in Venezuela, the focus shifted to self-financing and, although we lost touch with this institution, we know that most of their groups are more engaged in the task of educating and training rather than in placing funds and collecting.

indebtedness to people. The recent microfinance crisis in India (a country with, as pointed out, the largest microfinance programs in the world), and its major impact⁶⁸, is partly due to this misguided practice of seeking sustainability by promoting credit sale. In an interesting article⁶⁹ on microfinance crisis in India, Lydia Polgreen and Vikas Bajaj reflect, for instance, statements by Vijay Mahajan, Managing Director of Basix, an important organization promoting credits among poor people. He acknowledges that some lending institutions have sprung out and “in their strive for rapid growing [...], they accumulated more and more credits in the same geographic area [...], and this led to increased indebtedness, and, in some cases, even to suicides”.

All these findings show the need for alleviating economic pressures of microfinance institutions. As a matter of fact, somebody must pay the costs, since it is true that for these institutions it is really difficult to meet financial needs of the poorest at reasonable prices. The increase in interest rates they charge for credits is a clear sign of their problems. Criticism leveled against the global microfinance movement today focus on the actions taken by these institutions, justified on their operating costs.

We believe, on the contrary, that there is no need to bring the poor into formal mainstream banking. If we succeed in modifying informal mechanisms to make them safer and more efficient, poor people could have quality basic financial services, bypassing formal banking complexity. It makes no sense to continue making huge and costly efforts for the services provided by formal financial institutions to reach lower-income populations, if these can be served locally with

⁶⁸ This crisis has been discussed by the world's major newspapers. See, for instance: Aurelio Martínez Estévez: “Yunus: tres problemas, cuatro pecados” (Yunus, three problems, four sins) (http://www.elpais.com/articulo/primer/plano/Yunus/problemas/pecados/elpepueconeg/20110327elpneglse_11/Tes), Vikas Bajaj: “Luster Dims for a Public Microlender” (<http://www.nytimes.com/2011/05/11/business/global/11micro.html?ref=muhammadyunus>) y Neil MacFarquhart: “Banks making big profits from tiny loans” (<http://www.nytimes.com/2010/04/14/world/14microfinance.html?ref=muhammadyunus>).

⁶⁹ Lydia Polgreen and Vikas Bajaj: “SKS Launches India’s First Microfinance IPO”, In 4change (<http://www.im4change.org/rural-news-update/india-micro-credit-faces-collapse-from-defaults-by-lydia-polgreen-and-vikas-bajaj-4435/print>) .

their own resources and self-management. It is nonsense to continue investing in formal services if people still make extensive use of informal ones, though having the possibility of choosing the former. It makes more sense to enhance informal mechanisms and combine both ways of providing financial services so that needs can be met at more reasonable costs and more efficiently.

In analyzing the financial needs of a housewife in a rural community in any Third World country, we can see that they could be met by means of simpler mechanisms than those provided by mainstream formal systems. The same operating platform cannot be used to serve an international corporation and a housewife in a rural area in Venezuela, Senegal or Indonesia. It is almost like trying to kill an ant with a cannonball; even though it will eventually be killed, the costs of the operation would be nonsense.

In fact, the operation and supervision of the formal financial system is costly. Not only for the direct contributions to be made by taxpayers to support monitoring systems, but also for the prices paid by society whenever, for any reason, a regulated financial institution goes bankrupt. We are not talking about widespread bankruptcies in times of crisis, but about permanent interventions by governments to bail out formal financial institutions in difficulty. As said, a global corporation requires services justifying those expenses, but a housewife would not. A modified and enhanced, self-managed and self-financed informal mechanism could provide that housewife with services as good as those of formal banking, or even better, and at much lower costs.

Therefore, the strategy used to provide access to banking services should be reviewed. Cooperation and financial assistance institutions that have promoted banking as a solution for more than three decades should assess the impact of their achievements. Their efforts have been important (in 2007, the microfinance industry reached the dreamt figure of 100 million low-income clients). But this figure should be considered to be relatively small as compared to the population served by informal mechanisms at significantly lower operating costs.

We cannot be satisfied yet. We insist, there are a very large number of people that still require higher quality financial services and that can hardly be served by means of banking. Improving informal

mechanisms will allow for reaching many more people and, therefore, have a positive impact on the quality of life of millions in the poorest segments of population. Attempting to do so is better than compelling to burdensome formal financial models.

VII. The Other Microfinance

*We are very fond of you, Salomon,
but, why do we pay interests to Fundefir,
if we can lend our own money
and earn those interests ourselves?*

Partners of Robledal community *Bankomunal*
Margarita, Venezuela

For us the *Other Microfinance* means willfully introducing informal financial practices. The microfinance model we use in this case is not intended to replace mainstream banking, but to change group-based informal mechanisms to promote local self-management groups that tap funds from their members (either as savings or as investment) and use them to fund their own credit needs directly, without using capital other than the one coming from the group itself.

The *Other Microfinance* takes traditional mechanisms used by low-income populations as a starting point but introduces a new methodology to enhance them and add value to the financial services they provide. Therefore, by this expression we mean the use of informal traditional practices now induced by individuals or institutions seeking to improve them to give users more confidence, security, opportunity, transparency and financial training.

For about 15 years we have been operating in communities under this approach, making it easier for people to self-manage their financial needs. A review of informal practices developed as models induced by institutions or individuals will show a very rich diversity focused on different aspects depending on the particular needs of each population: savings, credit, education or community-related issues.

We are not interested in showing the changes induced by the different models being used, but rather in pointing out the effectiveness of this new vision of microfinance and the room it is making as a non-banking alternative way to provide quality financial services to millions of people.

VSLA's model, for instance, is intended to promote savings, as it is considered to be a basic service more important than credit itself. In

the *Bankomunal* model, promoted by the authors of this book, savings are also boosted not in the traditional way but through what we call *micro-investment*, as it also encourages financial education. Other models combine both practices.

Based on the variety of methods existing nowadays, we make this first attempt to show common features to all these initiatives and say that there are *Other Microfinance* mechanisms. And we do so because we think it is important to move forward on this new path.

We are not trying to say that our model is better than the others. Simply, it seems to us that telling our experience may be useful to enhance other models already in use and to encourage other organizations seeking alternatives to bring financial services to economically disadvantaged populations. We believe that providing financial services to the poor is so crucially important and the need so great that any experience that can contribute to improving the situation of millions of people who may never be reached with formal banking should be fully popularized.

Moreover, the *Other Microfinance* does not stand for a sole model, as there are different realities that require particular solutions. Flexibility is a major advantage of informal mechanisms and thus users can adapt them to their needs, and hence their widespread use. By relying on various induced mechanisms of true quality and applicability it should be possible to consolidate values like security, transparency, utility, relevance and education in using these financial services.

To open the debate we are proposing, here are the principles which, we believe, should be part of any initiative within what we call *the Other Microfinance*. We do not consider this an exhaustive or definitive list. It is rather an invitation to create a shared understanding. Hence, we encourage all those who think they can make contributions to supplement or discuss our principles. Nobody is obliged to adopt them, or seek to disqualify practices with which they do not fully comply. Our purpose is just to put forward a framework for working together later on.

1. Principle of self-funding

Using funds from users themselves as a main source of financing is a basic principle of the *Other Microfinance*.

These resources can be raised through savings or investments, or a combination of both, provided that they come from the people who adopt the model.

In our view, mechanisms whereby the money belongs to third parties or where accumulated local funds are redirected towards banks and are then returned as loans to the same groups are not of the same nature.

In a different microfinance, funds do not come from third parties nor do they end up in the mainstream formal system. Rather, users themselves play both roles: suppliers of funds and credit borrowers.

2. Principle of self-management and social integration

Organizations or mechanisms providing savings and credit services of this *Other Microfinance* nature should be self-managed. Organizers and users of an induced mechanism can be trained, counseled or guided, but management – and hence, decision-making – is the responsibility of their members, just as they take upon the benefits or losses that may result. Perhaps they should pay for the advice, but the model's operation is managed by the owners of capital, that is, group members.

This is an essential feature of new microfinance models since induced mechanisms are neither welfare programs nor local financial institutions intermediating in funds management between the community and those who supply them (governments, public or private banks, NGOs, community-cooperating agents). The methodologies used may have different styles of self-management. However, they all seek the widest possible participation of groups in management and decision-making. Efforts should be made to share knowledge among users, so that involvement and decision making are based on real and effective participation⁷⁰.

Moreover, induced practices should make sure that people integrate respecting their particular cultural values while avoiding discrimination by sex, race, religion, political opinion or otherwise. Thus the very

⁷⁰ A strategy for sharing knowledge among members may be limiting the number of partners to no more than 30 or 40 people. In larger groups, knowledge tends to be focused on a few individuals, which jeopardizes true self-management.

methodology of the new microfinance models must introduce new features in order to promote equity and inclusion, taking local culture into consideration.

3. Principle of safe and transparent methodologies

The *Other Microfinance* models should implement methodologies to transform traditional informal practices to provide users with more security.

Security means that group members know that their funds will be safeguarded against fraud and embezzlement. There is no guarantee that such things will never happen, but the induced model *must have appropriate self-control and self-regulation features*. Thus, if the methodology is properly implemented, users can trust they will not lose their money.

This principle is very important because we should not encourage unsafe practices that could further impoverish people being served. We insist in that deception, theft and diversion (as often found even in formal regulated models) may always occur. But it is important for users to know that *if they follow certain rules and regulations that are part of the induced methodology*, there is a very high degree of assurance that their money will be safe⁷¹.

4. Principle of ownership of earnings

Another key element in this new Microfinance model is the ownership of returns, if any. In self-financing models, users can decide whether or not their funds generate profits, but if there are gains, they must be the owners.

We repeat: profits or gains from loan operations do not go to outside institutions, but to the owners of the funds, *i.e.* the group members. Under this scheme, the strong criticism due to high interest rates is irrelevant. Those who provide the capital are at the same time those applying for loans and are the beneficiaries of the profits generated from interest.

⁷¹ This same principle applies in formal regulated institutions. But scams occur, as well as theft and embezzlement. The most one can say is that formal institutions must meet regulatory standards and, if this happens, the public can feel confident enough that their funds will not be lost.

5. Principle of financial education

The operating processes of induced methodologies should be part of financial education. This should not be limited to learning concepts. They should also include a change in values and attitudes toward money. That would help people channel efforts towards wealth generation. In the *Other Microfinance* models, as the cost of financial operations is low, investment can be made in training without jeopardizing sustainability. And as a matter of fact, the only real cost of induced mechanisms is the money invested in teaching people to be their own “bankers” and to manage their local microfinance organizations.

Low-income people make efforts to access both savings and credit because they badly need those services. A clear sign of this is that in some informal mechanisms people even have to “pay” for saving. And in the case of credit, they accept to pay skyrocketing interest rates and have to go through true “ordeals”.

This being the case, would it be possible to use as much motivation to get something beyond just a business transaction? We think that the great interest of people for having access to these services may lead to true financial education. Thus, induced methodologies add value to traditional mechanisms.

6. Principle of multi-purpose finance

A new microfinance should not only promote savings but also credit for multiple purposes (that is why we talk more about microfinance than microcredit). Financial services intended for low-income populations should give support to activities of any kind: consumption, income-generation and household capital build-up, regardless of how small the amounts may be.

A paramount conclusion of the Book *Portfolios of poor*⁷² is that poor people need to develop models to finance different activities and not only entrepreneurial or income-generating activities.

Poor people not only need money to invest but also mechanisms to help them overcome irregular income flow in general, because, as we have seen, the main feature of poverty is not just the lack of income

⁷² Daryl Collins, Jonathan Morduch, Stuart Rutherford, Orlanda Ruthven, op. cit., Chapter 6.

but, above all, irregular income. Hence the importance of having adequate financial services allowing for saving and access to capital (credit) whenever this is missing.

Moreover, the costs of this new microfinance allow for granting such loans on a sustainable basis. In fact, one of the great advantages of the *Other Microfinance* is precisely its ability to fund a diversity of activities, as operating expenses allow many more types of financing.

7. Principle of sustainability

This new form of microfinance must seek financial sustainability. But here a distinction must be made between the sustainability of grassroots organizations and that of institutions inducing the use of financial mechanisms.

In nearly all models we know of, sustainability of grassroots organizations is ensured from the very beginning of savings and credit activities, as internal management operating costs are so low that they can be covered with volunteers or with earnings from financial transactions. In many cases, there are no expenses, since models are so simple that they require very little management. In other cases, where management is more complex, funds coming from transactions by the group itself are sufficient to cover operating costs.

Another quite different matter is sustainability of training programs for using methodologies induced by institutions. In fact, training and monitoring groups do have a cost, but here we refer to sustainability of local groups and not to sustainability of training programs for using such methodologies⁷³.

⁷³ Due to strong criticism to microfinance in recent times, the old discussion on sustainability arises again. We believe the key issue that should be discussed is its poor orientation. When using funds from the public (savings, stocks, bonds) requiring return, someone must pay the costs and profitability for third parties. It is naive to assume that microfinance mechanisms are unprofitable, and thus condemning them to failure. Formal microfinance must be focused on activities, amounts and terms that effectively allow it to be sustainable over time. In our view, it is nonsense to want to force banking on populations who may use cheaper mechanisms better suited to their needs. The *Other Microfinance* does not seek to replace the traditional one, but to complement it and make it more efficient.

The discussion on how to sustain programs to induce self-financing methodologies is very interesting⁷⁴. At present, several strategies are being tested: some focus on payment of fees by users; others, on simple methods for using the same development principles that have led to the so widespread replication of informal mechanisms, such as word of mouth, for instance. In some cases, the use of new communication technologies is promoted in order to reduce the costs of training and process monitoring of groups using induced methods. The final solutions will surely come from a combination of all these elements.

⁷⁴ For a discussion on different sustainability and cost-reduction strategies, see: Hans Dieter Seibel: "From Self-help groups to village financial institutions in Bali", in: Kim Wilson; Malcolm Harper; Mathew Griffith, op. cit (Chapter 3).

VIII. The Bankomunales

*If there had been a Bankomunal here
when our parents were young,
everyone here would have been able to study and
we would not have had such hard times when we were kids*

Partners of Bankomunal “Las Charas”
State of Sucre, Venezuela

1. History

In Venezuela, until nearly 1995, the state used to provide funding to the agricultural sector directly, through public institutions that were specialized in these matters. After a continuous process of macro-economic reforms started that year, many such bodies disappeared and it became necessary to devise new financial schemes to serve this sector. In the reform process, the *Fondo de Crédito Agropecuario* (Agricultural Credit Fund) (FCA⁷⁵, as per its initials in Spanish) requested of Salomón Raydan, an expert in farming development, specialized advice to design a funding program intended for countrymen.

As part of this advice, various alternative farmers’ funding models were studied and we came across FINCA Costa Rica and FINCA International community banks. Both started as a community financing institutions working with external funds from different sources: private and public banks, international cooperation, and governments, among others. The external funds were lent directly to community organizations or to farmers themselves, and NGOs acted as intermediaries. In both cases, raising local money was used as a savings mechanism (FINCA Costa Rica also used it for investment) rather than a true source of funding, since NGOs’ sustainability was based on intermediation of external funds.

⁷⁵ The old Agricultural Credit Fund was changed and now it is named “*Fondo de Desarrollo Agropecuario Pesquero, Forestal y Afines*” (Fondafa) (Fund for Agricultural, Fishing, Forest and Similar Activities)

The pilot program⁷⁶ started in Venezuela in 1997, with a project involving two components. A financial component, lead by Salomón Raydán representing the FCA, and a training component under the responsibility of a Venezuelan government foundation called “Fundación Ciara”⁷⁷. This pilot program was intended to replicate FINCA Costa Rica’s model, but with external resources from the old Agricultural Credit Fund.

The funding component started by taking in small deposits from community members, with the later addition of external funds from the government. But, as usual, the amounts from the State, intended for credit, were delayed. In this situation, being in charge of implementing the financial component of the program, Raydán, in accordance with *Fundación Ciara*, decided to grant loans with the funds raised in the community, without waiting for external resources from the State Fund.

As the project went on, it became increasingly clear that local funds could fully meet local demand for credits. We also began to discover that people were using their own mechanisms to provide savings and loan services among themselves. This showed the existence of local capital that could be used as a funding source, without resorting to external funding. This was a very important lesson that subsequently led to establish a model based on the exclusive use of funds from the community.

When state funds finally appeared, group capitalization slowed down, delinquencies increased significantly, and internal unrest reached unmanageable levels. This occurred repeatedly in existing groups and showed that, in a country with a deeply-rooted paternalistic system like Venezuela, using outside money may bring more problems than benefits.

The experience was deeply mobilizing and Solomon Raydán decided to leave the leadership of the pilot project to start a new model that *solely and exclusively uses funds from the community as a source of financing*.

⁷⁶ Referred to as *Proyecto Piloto del Sur del Estado Anzoátegui* (Pilot Project of Southern Anzoátegui State). The name we gave to community organizations was “Cajas Rurales” (“Rural savings banks”)

⁷⁷ For further information, visit: www.ciara.gob.ve.

Thus, the Rural Financing Foundation (FUNDEFIR)⁷⁸ began operating, together with the model now referred to as Bankomunales, discussed later.

This method of using solely local funds caused bewilderment and some thought it would not be possible⁷⁹ because local demand for credit would always be higher than the supply that could be provided with community's own capital. Indeed, by using local funds for lending, local funds uptake was boosted, since profitability was intended for the community itself and was not intended to compete with external funds mediated by NGOs. When external resources are lacking or are not expected, accumulation of money by local groups tends to be higher, because users themselves organize local capital build-up, encouraged, among other things, by profitability and the likelihood of increasing credit amounts.

Later, in 1999, the Inter American Foundation (IAF)⁸⁰ offered financial support to FUNDEFIR for training new groups. But without FUNDEFIR requesting it, in the agreement it set up a *revolving credit fund* with the money that the IAF would provide⁸¹. Despite our objections, we had to accept the agreement and in fact we created the fund. Months before, we had begun to create groups with our own personal funds⁸². Two of them had already started credit operations using the money from the community itself. To our surprise, a few

⁷⁸ The Foundation was legally born a few years ago with the support of a group of private entrepreneurs, but for various reasons was unable to operate in the development of any project.

⁷⁹ An FAO consultant wrote to warn of the foolishness of this model and said that, in his experience, the exclusive use of local funds would have no future, since it was impossible that the demand for loans in poor communities could be met with equity capital. According to him, this was tantamount to saying that the poor were not poor.

⁸⁰ For further information, visit: www.iaf.gov/index.

⁸¹ Revolving Credit Funds mentioned here are normally grant funds. Although they must be paid back to donors, they must be lent to project beneficiaries while trying to charge enough interest to sustain and expand them. They are "revolving" because the money is recovered and re-lent and does not return to donors. The revolving credit funds were very famous at that time and still are widely used by aid agencies and donors.

⁸² Money was not intended to grant credits, but to pay the cost of transportation, materials, and promoters, i.e. to go to the community to train groups.

days after granting the first revolving loan (external), as agreed to with the IAF, leaders of a *Bankomunal* we had created came to our offices to pay back the loan. They were bringing a short hand-written letter whereby, in a very respectful but determined way, they explained that, despite the affection they felt for our foundation, they considered it was "silly" to have to pay interests to FUNDEFIR for their money when they could earn those interests if they used their own money for loans⁸³.

In this situation, later on we managed to convince the IAF to cancel the revolving credit fund project and allow us to use those resources to create and train new groups. Since then we gave a new twist to the model we learned in Costa Rica and focused on the exclusive use of capital from the community.

Naturally, local funds still had to prove to be sufficient to meet local demand for credit. After a few months, not only was it evident that the local money supply, attracted by interest earnings, exceeded demand, but also that almost all groups began to run surpluses. Paradoxically, this led to a problem later on, as they came to accumulate such large amounts that their management turned to be a real risk. To address the situation we had to make changes to the methodology in order to balance supply and demand of local resources, and avoid surpluses.

Criticism and comments on this model soon appeared. It was argued, for example, that such a methodology could be applied only in high-income countries such as Venezuela, where poverty was much lower than in other countries. Eleven years later, we have seen that it has been replicated in ten countries⁸⁴, with very diverse groups: emigrants in Spain, countrymen and fishermen in Venezuela, urban communities in Brazil and Colombia, as well as in rural scattered populations in Senegal, Dominican Republic and Haiti. No doubt that all these cases

⁸³ Indeed, funds contributed by IAF were not refundable and interests paid for credits could only be used to increase the revolving fund. However, from the community's point of view, interests were paid to FUNDEFIR, whereas community members could earn them directly using their own money.

⁸⁴ Only in four countries have we achieved relatively large projects; in the other six countries we have developed only very small pilot projects, but they have served to prove model's viability.

have proved that most of the local demand for credits can be met with funds from the community itself.⁸⁵

2. Methodology

What is the foundation of the *Bankomunales*' model? Let us start from our daily experience as employees or contractors to explain it.

It is not strange that we sometimes have to cover an emergency or simply take advantage of a business opportunity just at the moment when we have not yet been paid what we expect to receive. It may also happen that we receive extra income just when we do not need to use it. If we are not referring to large amounts, when we need extra money, we usually get financing by borrowing from a family member, requesting a cash advance, with a credit card or by using our savings, accumulated with that income we did not need to spend when received.

This experience shows that our income flow does not always match our payment flow. At times, we have a "temporary money shortfall" and must resort to financing. On other occasions, on the contrary, we have a "temporary money surplus" and we save to have our money available whenever we need to pay for extraordinary expenses.

In every society or group with a certain level of economic diversity, there will be simultaneous surpluses and temporary financial needs. For example, in a community a farmer who grows beans generates gains in harvest seasons, but has financial need during sowing seasons. At the same time, another farmer who grows root vegetables – or someone else with a different economic activity, say, a storekeeper – will also have surpluses and needs at different times.

⁸⁵ Similar models, with or without connection to FUNDEFIR, are used in many countries. FINCA Costa Rica, for instance, has deployed a large program in Central America using funds only from the community. Other institutions are developing this model in Peru, Bolivia, and Ecuador. Self-help groups in Asia and Africa are other examples showing that local funds may better meet the credit needs of communities themselves, and that in only a few particular cases do they need to apply for external credits. The same thing applies to nearly three million people benefiting from the VSLAs in Africa and Asia. For a review of several experiences based on taking in equity, see Kim Wilson, Malcolm Harper, and Matthew Griffith, op. cit.

The logical thing to do, then, is develop a secure mechanism to harmonize this local supply and demand of money, without having to resort to external sources of financing. Most informal financing mechanisms in communities result from these temporary needs for credit and savings. And *Bankomunales* are an attempt to achieve harmony between temporary supply and demand of funds, taking as a starting point the fact that communities or groups have sufficient human and economic resources to develop their own savings and credit mechanisms. In short, it is an attempt to reproduce the financial model at a local scale. The key to achieve this goal is to develop a secure and profit-yielding mechanism that, on the one hand, encourages collection of funds and, on the other hand, provides credit at reasonable costs.

In *Bankomunales*, the mechanism for taking up funds is achieved through a concept we call “micro-investment”, whereby partners invest by buying shares of their organization, at the time and in the amount they may wish. This investor capacity is what entitles partners to be eligible for credits. Only members may buy shares and receive loans, and thus they are both borrowers and investors at the same time. It is very important to emphasize this, since as an investor you want to maximize your investment and as a borrower you want credit costs to be as low as possible. If an eligible borrower has both needs, the cost or interest rate will tend to be balanced almost naturally. Whereas our task is to develop a model favoring access to financial services, we want to do so within a framework of justice and not under speculation parameters. *Bankomunales* are organized under these financial premises. Now let's see how in detail.

3. Shares

Acquisition of funds for granting loans in *Bankomunales* is made through the sale of shares of the organization to all those wishing to become a member. This fund up-taking mechanism has been called “micro investment”⁸⁶.

Micro-investment facilitates the understanding and use of financial concepts (such as risk assessment, management efficiency, cost-

⁸⁶ An initial version of this mechanism was already being implemented by FINCA Costa Rica when we learned of their model. There, the purpose was to get funds at longer terms than savings contributed by countrymen, since, normally, the latter were placed at very short terms (up to three months).

effectiveness, among others) and makes users play an active role in monitoring their organization's functioning and management of their money.

We then see the opposite of the traditional passive position of a depositor, for whom profitability is ensured without having to worry about management by the institution where his money is deposited.

Users of micro-investment understand in practice that the return or profit on investment depends on credit management efficiency. From passive depositors, they become active investors.

Thus, when a person decides to join a *Bankomunal*, they initially purchase shares as a way to earn the right to obtain credit. As they understand the concepts related to their position as an "investor", they will use their temporary surpluses to invest in buying shares. They will realize that though a rate of return is not guaranteed, they will earn more profits than by saving the money "under the mattress". We have known of many stories of members who have changed their spending patterns for the opportunity offered by their Bankomunal to "save" through this investment mechanism. As an example, consider a phrase by a partner in Venezuela: "What I used to spend in cigarettes, now I use to buy shares, I smoke less and I am a banker".

Every partner has the freedom to decide when and how much stock shares they want to buy. There is no obligation of fixed-term or periodical contributions, they are determined only as local credit demand may require. Similarly, when the partner needs to withdraw all or part of their investment, they may make a request whenever they want under the sole condition that the funds should be available (they usually are but for a relatively short term of between 1 and 7 days).

The methodology provides tools to balance the amount of shares held by each member, as well as to analyze whether or not to sell, in order to avoid generating surpluses that could be stolen or that, if not granted as loans, may decrease shares' profitability. Under this approach, group members do not save but invest instead in the Bankomunal. Profits are made on money supply, while credit demand is met at reasonable costs.

4. Credits

Two features stand out in the Bankomunales credit model. The first, we repeat, is that credits are not granted to third parties but solely to members. The second is that the amount granted to each member is directly proportional to their investment in shares⁸⁷.

When relating the amount of investment to credit, the value of applicant shares represents a deposit or collateral, thus minimizing the risk of loss of money due to “bad debts”. The ratio represents the risk level that groups wish to take: the greater the risk, the greater the number of shares to be required as collateral; and the lesser the risk, the fewer the shares. This condition may vary. Groups change as borrowers and their credit history are known. Additionally, the system provides fiduciary guaranties, whereby another Bankomunal partner should “endorse” the credit applicant by pledging his/her shares or part thereof as collateral.

This investor/client couple helps regulate another issue in providing financial services to the poor: the interest rate. If you act as an investor, you will surely be interested in earning high rates, but since at the same time you are a Bankomunal client, you will be interested in lowering them down. Thus, the mechanism is self-regulated, as your wishes as an investor should be in line with the ones you have as a client.

Moreover, credit granting is not subject to any turn-based system, as in ASCAs. The only requirement is to comply with the conditions set forth in the rules and regulations previously agreed upon by group members. This flexibility, which allows users to take advantage of the economic opportunities that may come up at any time, as well as quick and easy access to credit, puts the Bankomunal model in a position of advantage over natural (not induced) informal financial mechanisms and also over the formal ones. This means making the best of both worlds. Speed, simplicity and adaptability of informal mechanisms are combined with the security and opportunity of the formal ones.

⁸⁷ This apportioning is set by groups according to their convenience. However, in almost all cases the ratio is 1 to 5. That is, it is possible to obtain a loan in an amount which is five times the value of one’s shares. Some groups, especially European (SFC), normally use a ratio of 1:3 or 1:4.

5. Profit Allocation

In the Bankomunal model, earnings on interests charged for loans, *i.e.* the accrued dividend, are distributed among partners in direct proportion to the investment they have in the organization.

The nominal interest rate value is set up in operational regulations and, as already explained, there is a tendency for self-regulation resulting from the dual role of partners as investors and clients.

This “double game” of paying interests and, at the same time, earning dividends results in much lower effective rates⁸⁸ of interest charged in Bankomunales than in other microfinance models. In other words, the money paid by a loan recipient for interest returns to them in part or in full, depending on their indebtedness level when receiving dividends accrued on their investment. During the first year of operation, profits are accumulated with the purpose of capitalizing the organization. After that period, dividends are distributed on a monthly basis among partners according to the number of shares each member owns. Thus, all shares acquired in month 1 will receive their earnings in month 13, those of month 2 in month 14, and so on.

This method of calculation and monthly distribution of dividends not only facilitates learning important financial concepts such as *yield*, *profitability* and *risk*, but also operationally allows Bankomunal to keep running without stopping credit operations to accumulate funds for distribution of earnings⁸⁹. In addition, the monthly distribution allows for a flow of money among partners that actually turns out to be a planned savings mechanism.

The distribution of earnings generated with this methodology is essential, because, unlike other models, Bankomunales are distributive, not cumulative. This is no small thing, at least from the point of view

⁸⁸ Calculation of the real rate for each loan is difficult since it depends on the frequency and level of indebtedness of an individual, which may be very variable. Every person, depending on his/her needs, spends more or less time in debt, but his/her double capacity as client/owner reduces the value of the credit rate as it is relatively compensated with payment of earnings.

⁸⁹ Some groups, especially Muslim groups, may opt to not charge interest as this is considered to be against their religious principles. We try to safeguard the value of money over time. However, we are respectful of decisions made by the groups in this sense.

of the formation of values about money, finance and individual property rights. In many financial organizations where funds actually belong to users themselves, as in credit unions, earnings are accumulated for long periods of time and are generally used to purchase assets for the organization, but not to benefit individuals. In a Bankomunal, instead, priority is given to the individual and not the organization, as individual property rights are very well defined and the acquisition of assets whose ownership is not clearly established in individual terms is avoided.

It is so because *the Bankomunal is not primarily an institution but a method that seeks to operate with the smallest possible number of assets*. This will avoid what some critics of traditional credit unions or savings cooperatives call the "propensity to spend": the well-known bad habit of many credit union officials to spend union gains in assets instead of simply distributing them among partners.

6. The model's operation

The Bankomunal model has evolved over the years, as it should. Therefore, although all Bankomunales share some common basic principles, different formulas have been developed in accordance with the reality of the communities in which they operate.

Transverse principles have been discussed earlier, and they can be summarized as follows:

- The funds intended for credit allocation are collected through partners' micro-investment.
- Organizations are completely self-managed.
- Credits are granted for any lawful purpose, and only to partners in proportion to their investment in shares.

But, for operations, efforts are always made to ensure that the organization has an "institutional" capacity, represented by persons who embody and guide the organization's functioning. Thus, the first groups we formed, many of whom are still working had a board comprised of: a president, a vice-president, a cashier, an accountant, a secretary, a comptroller, and a credit committee. This board was responsible for making the Bankomunal work in meetings that could

be held on a weekly, biweekly or monthly basis, depending on the volume of transactions generated and group preferences.

Over the years, we have learned that usually this way of operating the organization may turn into a weakness, as most operations were under the authority of the board's members only. Therefore, the know-how was concentrated in the people who were part of the board. Moreover, operational meetings were not always conducted publicly. This has undermined transparency of the funds' management. This has led us to develop another operating model that helps ensure the implementation of a transparent, democratic, simple, educational model and adds value to financial transactions.

In this new model, there are two elements. First, the operations are conducted *only* in public meetings called "operational meetings". Their frequency is determined by the volume of operations of the organization and group preferences. Secondly, these meetings are carried out by performing *functions* - not *job positions* - that members exercise on a volunteer and rotating basis.

This change was meant to distribute and simplify the functions previously performed by the board, so that they could be performed by all group members attending the meetings, even those with minimal prior training. By dividing and simplifying the operational ability, any partner may perform his or her duties without prior complex training.

This mechanism allows for a more transparent administration of funds, since all transactions are made publicly. Therefore, any member may supervise them if so desired. At the same time, any member can be trained voluntarily to perform a diversity of tasks, and this know-how is not exclusive to a particular group.

The Bankomunal representation is thus under the responsibility of a board, consisting basically of a chairman and a secretary, elected by the members' general meeting, and who hold their positions for the time set forth in the rules of procedure. However, the Board only *represents the formal authority of the organization, but does not perform operational functions*. These may be performed by any partner (including managing officials), but on a rotating and voluntary basis – we repeat – not as positions but as functions.

Groups are then free to set up different functions. Like, for example, functions of coordination with other community groups or of training new members. But basically the methodology requires establishing five essential functions:

1. Credit Function
2. Checking Function
3. Cash Function
4. Accounting Function
5. Updating Function

With this operating model, knowledge is distributed amongst a larger number of group members, thus preventing concentration of know-how in small elites who normally lead these processes.

Apart from the "operational meetings", there are "assembly meetings" attended by all owner members (shareholders) and where the ultimate authority is vested. These meetings are held according to the group's preferences, but we recommend holding them at least once a month, although older groups tend to hold meetings on a bimonthly or quarterly basis. In the assemblies, major decisions are made through simple majority vote. It should be added that every person is entitled to one vote, regardless of the number of shares they own.

7. Rules

Setting the rules is very important for the proper functioning of Bankomunales. When the organization starts operations, facilitators discuss them with the group, using a questionnaire as a guide methodically developed for this purpose. At that time, their nature, importance and impact on the operation of the organization are explained, but also considering that, ultimately, the groups themselves are the owners of capital and are those who run all the risks. Consequently, it is up to them to set the final rules.

In Bankomunales, there are basically two types of rules: organizational rules and operational rules. We can point out the following:

1. All operations (lending, selling of certificates, payment of installments, etc.) must take place at *shareholders' meetings*. NO transactions must be made out of such meetings.
2. At all members' meetings, at least five (5) *basic functions* should be performed: Credit, Checking, Cash, Accounting and Updating.
3. Functions in partners' meetings are *rotating* and may be performed by any partner voluntarily.
4. No member shall hold more than 10 percent of the total of shares of the Bankomunal.
5. The amounts of loans are tied to what is owned in shares in a 1 to 5 ratio. In other words, credits may only be granted in amounts up to 5 times what a member has in shares, though, as explained above, some groups may decide that this ratio should be 1 to 3 or 1 to 4.
6. The return on shareholders' equity is calculated on a monthly basis, but paid out individually every twelve months from the date of purchase. That is, one year after it was bought each share receives a payment equivalent to twelve months of generated earnings. From this date, a new annual cycle of accumulated earnings payable restarts, and so on until the stock is liquidated by the partner at some future time. In other words, the shares purchased in January will receive their earnings in January of the following year, those purchased in February, in February of following year and so forth, month by month.
7. Any outstanding debt with Bankomunal of any member who withdraws will be deducted from their shares and profits.
8. All credits must have at least one guarantor who must be a Bankomunal member.
9. All credits must be secured, at a rate of not less than 40 percent of the total amount of the loan, including shares and those of those of the guarantor (20% each).
10. No member standing guarantor may withdraw their shares when held in support of the credit of another partner until the amount

due is less than the value of the shares owned by the partner who applied for the credit (principal debtor).

11. Cross-guarantors are not accepted, *i.e.* a person stands guarantor for another person, who in turn stands guarantor for the former.
12. Only members may change the rates, terms and loan amounts by majority vote in a general meeting.

Once these rules are set forth, the group adapts them to its own realities and needs: for example, the percentage of collateral may be somewhat higher in some cases (50 percent). Others choose to distribute profits only once a year and not throughout the year, as we suggest. The number of guarantors can also be higher in some groups. In short, the establishment of rules is a recommendation that should normally be adapted to the needs and preferences of the groups.

But it is very important to let them know that the methodology is designed in such a way that an unsuitable variation in conditions would have a direct impact on essential issues, such as profitability, time required to obtain credits, excess capital... Thus, the model itself involves mechanisms to "warn" users on the need to review some of the measures they have taken.

There is another set of rules with very simple and frequent variations. In general, they concern mechanisms for admission and withdrawal, dates and venues for meetings, rates, terms and amounts, and penalties. In this way, rules can be adapted as groups deem the changes to be important for their operation, as long as they respect the principles of equality, equity and inclusion. This ability to adapt the conditions to the needs and preferences of groups is a way of preserving the flexibility of informal mechanisms in a more secure, transparent and educational model. In other words, Bankomunales combine the distinctive elements of informal mechanisms, so suitable for people's cash flows, with more rigorous methodologies typical of formal models.

IX. Advantages and added value of Bankomunales

*With the Bankomunal I learnt
to count money, to really count it.
To know exactly how much
came in and came out
how much I could borrow and how much I could pay.*
Partner - Bankomunal “El Guapo”
State of Miranda, Venezuela

In recent years, diverse new methodologies have mushroomed to improve informal mechanisms, making them more secure and transparent. The purpose is to optimize the quality of financial services provided to populations who use them. Various institutions – national and regional governments⁹⁰, and small and large NGOs – have set out to address this task⁹¹.

Our interest here is to show areas where, in our opinion, Bankomunales enrich informal mechanisms to turn them into safer, more transparent and profitable mechanisms while providing financial education.

We believe this is our humble contribution. But no doubt a deep analysis of other induced models will be very important, since it would help extend and deepen the understanding of such mechanisms, which would surface more elements to help design even better financial instruments for poor people.

In Chapter 5 we pointed out some limitations of informal mechanisms, especially credit and savings associations. Below, we will try to show to what extent the Bankomunal model succeeds in

⁹⁰ Self-help groups (SHG) boosted by the Indian government, for instance, are group savings instruments, but those funds are not granted directly as loans to partners. They are directed instead to regulated banks, which decide, according to their criteria, to grant credits or not. However, there is a variant: this model still uses the banking strategy. Although we believe that the most reasonable thing to do is let communities use their funds for self-financing, without intermediation of the formal system, this model is still a transformation of informal mechanisms for developing better ways of using microfinance.

⁹¹ For further information on different programs, see: Kim Wilson, Malcolm Harper, and Matthew Griffith, op. cit.

overcoming some of such limitations and provides a simple, high-quality model with an important added value.

1. Security

Protecting the funds is essential to enhance informal financing mechanisms. And security must encompass avoiding fraudulent dealings, theft by third parties or losses arising out of uncollectible. In the Bankomunal model, this is achieved through the group's self-control or self-regulation. To that end, we have developed two strategies.

The first: avoiding excess cash on hand that could be stolen by third parties or managed fraudulently by the custodian of the funds. For this purpose, funds available for credit from the acquisition of shares and accumulated earnings are mostly granted as loans. But we have developed methodological strategies to enable groups to protect un-invested cash.

For example, in some cases, the accumulated money is not placed in credits because the conditions imposed by partners are very strict: a 1 to 3 shares-to-credit ratio, strong requirements for collateral as to the number of shares owned by other partners who stand guarantor, or very short terms for repayment. Under these conditions, it is understandable that many members decide not to use the Bankomunal as a funding source. But the consequences are soon reflected on Bankomunal's performance, as whenever the demand for credit drops, profitability also drops simultaneously. This situation leads almost automatically to analysis and reflection. A review process begins, often leading to changes and easing of credit conditions. This also helps to educate people, a key element in our methodology.

Credit demand may also drop due to the local economy itself as, for instance, there may be periods during the year when income increases and people do not require credits. In such a case, the lack of demand will lead to analyzing the situation and measures will surely be taken. One measure may be to stop taking in of new funds by restricting the sale of shares until surpluses are invested. In other words, no money supply is received until required by credit demand.

Whatever the strategy, the aim is to balance money supply with credit demand so as to avoid excessive accumulation of cash. The fewer funds accumulated in a few hands, the lower the risk of losing them. If

this occurs occasionally, it would be usually solved by distributing this surplus among several partners, taking care that this amount is small so there is no temptation to divert it to other purposes⁹². In this way, the risk of loss due to either theft by third parties or fraudulent dealings by the person in charge of safekeeping the funds is reduced. Thus, supply and demand are gradually brought in line.

The second strategy in providing security is a system of guarantees to reduce the risk of losses due to non-payment. As said, every person receiving a loan owns a number of shares that can never be less than 20 per cent of the amount requested (1:5 ratio). In other words, for someone to get a loan, he or she must have in shares at least 20 per cent of the total amount requested. Moreover, all applications for a loan must establish a surety or guarantor, who should be a member of the same group, securing at least another 20 percent of his or her shares. This means that, in all cases, at least 40 per cent of the loan is secured.⁹³

2. Transparency

To ensure transparency in operation, we have designed several strategies.

The first one: democratizing knowledge for all to understand the functioning and financial nature of their organization. This allows them to actively participate in the decision-making process and validation of decisions, and helps them understand the submission of accounts. As previously mentioned, the system of rotating and voluntary functions helps distribute this knowledge.

The second one: making transactions in a public meeting, in the presence of members wishing to attend, either to make any transaction or simply to participate. When we started implementing our program,

⁹² The VSLA methodology and some others solve this problem with a small box with three padlocks. Surplus funds are placed there until the next group meeting. A similar attempt has been made in Venezuela, but many of the groups refused to adopt this practice as too risky, because professional thieves, husbands and family members and / or neighbors could steal it. In any case, this is a measure that can be taken in some cases to reduce the risks.

⁹³ It is normally more than 40%, since earnings on shares are part of the collateral. Apart from this system of guarantees, traditional microfinance mechanisms are used, such as funds building up, peer pressure, regular collection mechanisms, etc.

we made the mistake of letting some operations, such as granting credit or paying installments, be made without the presence of all members. That gave flexibility and partners were very pleased as, if they needed a loan, they could just file their application to what we called the "credit committee", who then analyzed it and decided whether it was appropriate to grant the loan or not. If the answer was positive, the partner would just go to the "cashier" and receive the money. Additionally, cashiers were authorized to receive credit payments or sell stocks. Thus, the service was almost personalized. But these practices entailed serious and perverse consequences: theft, fraud, concealment of information, among others. We then decided to adopt the methodology of the model developed in immigrant communities in Spain, where all transactions are made during one and the same meeting and in the presence of the majority of group members. The mechanism became more and more stringent and many members complained. However, it was definitely more advantageous to gain security and transparency⁹⁴.

The third strategy is the submission of accounts. This is done through a simple yet comprehensive system of recording accounting and administrative transactions, which allows easy reviewing and auditing of partners or third parties. The way operations are recorded allows for detailed review of the administrative and accounting history of the organization, in order to guarantee its members the truthfulness of transactions carried out by the group. These records must be reviewed and validated at the end of each meeting, in order to avoid accumulating too much information such that it cannot be reviewed due to the lack of time. These are simple but secure and periodically reviewable operations. The normal way of doing this is through a procedure we call "final double-checking of accounts" to be given at the end of each meeting"⁹⁵.

⁹⁴ Many groups, especially those operating in the traditional way in Venezuela for years, did not adopt these changes, arguing that they felt confident about the way they had been working so far. Nevertheless, we invite new groups to follow this model. Of course, as they are completely separate organizations, they decide what is most appropriate. In practice, many of the first groups have combined elements of the new and the old model.

⁹⁵ We insist on an accounting model adapted to each particular situation. For example, the one we have applied widely in Latin America has taken particular characteristics in Senegal. In that country the "Banque Sare", the name given to the groups there, uses a much simpler system which, however, allows for

3. Permanent access to credit and savings

As noted in Chapter V, in most informal mechanisms accruals are handed over to participants at predetermined turns or are raffled. Hence, users can not always use this mechanism to seize business opportunities or cope with emergencies as such circumstances often clash with the order of turns. With the *Bankomunales* model, anyone may apply for a loan or increase the amount of the loan one has at any time as required, provided that one complies with group requirements and cash is available on hand. This way they can address contingencies or special investment opportunities as they arise without waiting for a turn.

4. Flexibility in the amounts and terms according to the possibilities of each partner.

Credit needs normally vary among members of a group. Some, especially those with business activities, are constantly applying for loans; others do so occasionally because they use the Bankomunal for saving and obtaining credit at the time of an event. The frequency of applications then depends on the nature of the activities that partners want to finance and their preferences.

Having diverse business activities, savings and credit needs can be combined within the group so that those requiring permanent funding may obtain it and those requiring occasional credit, too. With the Bankomunal way of operation, members' savings and credit needs can be combined.

As a result of the progressive increase in loan amounts and payment deadlines, as well as the share/credit ratio system, the amount of money a partner may request depends on the number of shares they have. Therefore, every person can invest more if they want more credit or save more if they can afford to do so. But credit needs are not always the same, and hence the same partner does not always get into debt for the maximum amount of money available as per the

operations monitoring and preparing an audited balance. We think that in communities with better education levels and access to information technology, the methodology should seek to induce the use of such resources. Simplicity or complexity of a model's operation should be suited to the capabilities and possibilities of the group.

number of shares they hold. Instead, they simply request the required amount at a particular time, within the possibilities given by the number of shares they hold.

In Bankomunales, the "financial growth" (increased amounts and terms) occurs gradually as, on the one hand, sufficient confidence is generated within the group so that every partner invests more money in shares; and on the other hand, the knowledge of the client increases their credit limit. As discussed later on, this means that along with the "economic growth", a process of financial education occurs. Going beyond mere economic transactions, this is in fact the ultimate goal of this methodology. Again, both for savings and credit, the Bankomunal model is flexible enough to allow an adequate flow and is adapted to the needs and opportunities of each person⁹⁶.

5. Generating returns on savings

In Bankomunales, the money contributed by partners when buying shares is put to yield returns on the interests paid for the loans requested. This profitability will largely depend on the Bankomunal performance as a credit provider to its members, *i.e.* on its efficiency to place and collect granted loans. And the interest on loans, as noted, is set by partners themselves, who by playing the dual role of Bankomunal owner/borrower, tend to regulate the rate almost naturally.

Earnings are distributed in proportion to the money invested, *i.e.* the number of shares held by each partner. This encourages the purchase of shares (savings) because the more you invest, the more you earn. This mechanism also allows having members from very different economic levels, since those who have less money can invest less, but probably will have less ability to pay and therefore may not be subject to very high credit amounts. Similarly, those who have more money and can invest more will surely have greater ability to pay and request larger amounts when capitalization allows it.

At this point, it should be noted that in order to avoid concentration of capital in a few hands and prevent the mechanism from becoming a disguised system of "money lenders", no one person can have more than 10 percent of the total shares. Furthermore, as no one has voting

⁹⁶ For instance, as to credits, as the group builds up capital, the Bankomunal will be able to grant loans for higher amounts and at longer payment terms.

rights based on the number of shares held (each person has one vote), no one can impose conditions for economic reasons that have not been previously approved by a majority of members, whatever the amount that has been contributed.

Thus, with harmony, Bankomunales yield benefits to their owners. A current need for personal credit is served with one's own funds and neighbors' funds, whereas the value of savings is preserved with the interest paid on loans. In other words, everyone's temporary savings can be put to yield profits while serving the temporary credit needs of neighbors and vice versa.

6. Long-term capitalization

Bankomunales were designed to persist over time and establish themselves as microfinance community organizations that grow as the organization is capitalized, but they are also a process for training users to manage their finances more efficiently, leading to a better understanding of economic and business processes.

Bankomunales are essentially created to satisfy two demands from low-income communities: access to credit and savings services, and financial education for their users. This educational process is based on learning by doing, meaning that it develops at the same pace as the Bankomunal's financial growth or capitalization.

Capitalization occurs as users progressively "discover" the social, organizational and financial advantages of their Bankomunal. When confidence is generated in the group and the financial rationale of the method is understood, people invest in buying more shares, which in turn increases the amount of loans, and thus results in holding more investment. This process allows groups to strengthen as microfinance organizations, since their product offering grows as its loan fund grows with the selling of more shares. At the same time, financial growth consolidates financial knowledge in individuals that allows them to better manage their money and develop, in some cases, microenterprise activities.

In the case of savings, progressive capitalization allows partners build up significant capital to make a real difference in their lives. As to credit, progressive capitalization helps form credit funds that are relevant for these groups. This provides them with a range of larger amounts and longer payment terms that foster people's development,

either because they engage in business activities that allow them to increase their income, or because they improve their housing, education, and health conditions.

This is a great advantage of Bankomunales over other informal savings mechanisms that operate for relatively short periods. Since although these groups may form over and over again with equal or higher savings amounts, it would be difficult for them to achieve financial capitalization levels equivalent to the development path described above.

7. Risk distribution

A basic rule when starting a Bankomunal is to set a maximum credit amount. This must be respected even if an applicant holds a number of shares entitling them to a higher amount. The purpose of this rule is to distribute risk efficiently amid partners. The maximum amount never exceeds 15 percent of the total funds available for credit. Therefore, the total credit fund may never be held by one or a few people, as in the case of turn-allocation mechanisms.

Credit amounts are distributed in such a way that if someone does not pay, only a relatively small percentage of the total fund may be lost⁹⁷. With this system, it is very difficult for a Bankomunal to close down because someone fails to pay. It could happen if several people do not pay, but not because only one fails to comply with his/her obligation to pay, as in the case of ROSCAs⁹⁸.

Diversifying loans held in few hands, along with the system of guarantees provided by the methodology, makes the Bankomunal a much more secure instrument than any other informal system, either native or induced.

⁹⁷ Remember that, as explained in the section on Bankomunal guarantees, at least 40% of the total amount of a loan is always 20% secured by the shares held by the borrower and 20% by those of the guarantor.

⁹⁸ Apart from the above-mentioned guarantees, Bankomunales normally set up a small risk fund accumulated in accounting records for cases of “uncollectible”. This fund is normally deducted from retained earnings on shares. The withholding rate depends on the group’s decisions, but it is usually lower than 5% of earnings per share.

8. Financial education

Education and training is one of Bankomunales' key elements. This is one of the major differences between Bankomunales and informal practices and other self-financing models: groups are a financial education tool which allows users to understand and manage economic concepts and topics usually restricted to professional economists, specialists or experts. Simplicity is important, but the education is no less important. Hence, we attempt to combine them.

We believe that to overcome poverty it is essential to change the way people relate to money. But here we do not refer only to administrative or accounting issues, undoubtedly essential, but also to the values, beliefs and views in relation to wealth. This concerns more what we might call the psychology of money rather than its lack and administration.

Beliefs and values are often concealed behind the way we think of money in our culture. They make us lose the sense of reality and ignore its true potential. This relationship, in our experience, shows a complexity that does not always favor the individual or collective generation of wealth. Educating financially does not mean just learning a few things about finance, but reflecting on the possibilities money can bring as a means of exchange.

The Bankomunal methodology does so by transforming money into an everyday instrument that can be understood and managed. But, as it is also an issue that is becomes routinely discussed, it loses its somewhat "taboo" nature⁹⁹. This sort of demystification, so to speak, is achieved when individuals, especially the poorest, manage to understand that money is an instrument for change and that worrying about having it and managing it well is not sinful.

⁹⁹ This idea of personal finance under secrecy and anxiety that arises when dealing with money-related issues became evident to me after a remark by psychiatrist Pablo Raydán. Apparently, in general for psychotherapy patients, male or female, it is much easier to talk about their fears, passions and sexual complexities than to say how much money they earn or how they manage it. Money matters seem to be the great taboo. For a better discussion on the subject, see the book by psychiatrist and economist Axel Capriles: *El complejo del dinero* (The Money Complex). Agoras Collection, Editorial CEC /Los Libros de El Nacional (The books of El Nacional newspaper), 2011.

In the Bankomunales model, money is not only literally "put on the table", issues concerning its use and management are discussed publicly within groups. It is usual and customary for people to discuss and decide on interest rates, deadlines for repayment of loans, difficulties of repaying installments, the importance of generating and distributing profits, and the ability to invest and borrow considering family income and expenses¹⁰⁰. We think that working out accounts and talking in a straightforward way about money, even though in many cases this involves airing personal issues, facilitates perceiving it as the tool it is and, therefore, transforming it into a reality that people become more aware of.

In our experience, with the Bankomunal methodology, low-income people learn to count and manage money from the privacy of their emotions, and value it as appropriate. This is a deeply transformative process that educates people from the financial point of view, but in a much more profound and personal way. Certainly, systematic studies are needed to delve deeper into the subject, since our findings are based only on the work we have performed with particular low-income populations. But we want to draw attention to certain aspects that may be of interest to people and institutions that, with more rigorous tools, can extend these inquiries¹⁰¹.

The methodology, as mentioned, strives to help people acquire financial knowledge which so far seemed alien to them, an issue they

¹⁰⁰ In Chapter 2 of *Portfolios of the Poor* there is a section called "Lack of privacy" showing how important it is for poor people to keep information confidential. This results in the value they give to formal or informal financial models, depending to a large extent on the degree of privacy they provide to the individual. Of course, our model seeks to respect that privacy. However, an effort is made to encourage individuals to discuss the subject of money openly and bluntly. Many may prefer to be discreet, but eventually most of them lose that fear and begin to openly discuss even the most personal information. We think this is a positive change, as it contributes to perceiving money as an instrument and helps lose the moral view, in most cases, which does not contribute to generating economic wealth. While the model preserves privacy, it seeks to avoid any feelings of fault in worrying about money.

¹⁰¹ An approach to the subject can be found in: José Luis Colmenares: *Bancos comunitarios. Una oportunidad para el aprendizaje y la autonomía social. Cendes, Serie Estudios del Desarrollo* (Community Banks. An opportunity for learning and social autonomy. Cendes, Development Studies Series), Caracas, 2006.

perceived as restricted to specialists, and with no connection to their realities. They do not learn this in workshops on finance, accounting or administration, but in implementing the model, because practice requires it. To form and manage their Bankomunal, people take on functions that oblige them to analyze, understand and internalize economics concepts. We believe that this is the way profound changes in perception can occur, and this creates a real financial education.

Thus, we speak of *micro-investing*, because we want to mobilize people's resources while simultaneously training them on key issues such as investment and risk. We note that playing the role of investor transforms the way people perceive of themselves as economic subjects. It may not happen in all cases nor immediately - it depends on each individual - but in the long run our methodology tends to generate conditions more favorable to increasing income. Doing rigorous research would be important and much needed, as said, to confirm or reject these perceptions.

Being an investor, being a banker, earning profits on one's own money, while collectively helping, are lessons that transform, without any doubt, the perception of money. A low-income person who relates to money with a feeling of guilt - "It is easier for a camel to go through the eye of a needle, than for a rich man to enter into the kingdom of God" is not the same thing as a person who is proud to be an investor banker and who supports with his or her funds their own development and that of their neighbors'. The willingness to produce, from these two visions of money, is not the same. Playing the role of investors enables people to understand that money is an instrument that can yield dividends. This helps elucidate the concepts of investment, risk and profit, which are essential to generating positive attitudes toward the production and support of economic wealth.

The way interest rates are fixed is another example that illustrates the relationship between education and financial practice. When people have to give real value to their money over time, they are obliged to analyze and internalize concepts like inflation and depreciation. This may take some time, but in the usual discussion on rates, devaluation of money will surely come up and members will eventually begin to take this concept into account. In many economies, people feel the effects of inflation in their everyday life, but having to analyze it as the only objective way to fix interest rates helps make the concept more

understandable and closer to them. Understanding what inflation is and not only experiencing it, produces essential changes in the way people perceive and manage money. Our Bankomunal model makes those experiences possible for its members.

Another key element of the model is the analysis of the ability to pay, both of the group when deciding on amounts and terms, and of individuals when they decide to apply for a loan.

The model provides that people should keep records, in a very simple way, of their income and expenses (usually in a written format, although some people do it mentally). The purpose of this is to force this reflection, to enable the individual himself to set the amount of the credit for which he may apply. Obviously, he must submit his proposal to the group, which, on the basis of the knowledge it has of the individual and its own experience as an economic entity, decides whether the requested amounts and terms are suitable to the interests of the group and to the applicant. This helps raise awareness of the real economic capabilities of members and, above all, contributes to create an adequate reality principle in relation to money¹⁰².

Financial education is crucial in the fight against poverty. A model for providing access to informal financial services that consciously introduces elements to financially educate its users while these use it and manage it, has a tremendous added value. If during this educational process, some of its operational simplicity is lost, the final gain justifies it fully.

9. Building social capital

The Bankomunal model's social component also improves the potential growth of community groups that adopt it. Agreement and consensus are essential to functioning. The way decisions are made, accounts are presented, issues are discussed, conflicts are resolved, sanctions are applied - the way in which the organization works in general - is designed to involve as many people as possible, to make decisions democratically (all partners have equal voting rights, regardless of their principal amount invested) and to distribute knowledge as fairly as possible among members. The purpose in so doing is thus to *turn financial capital into social capital*.

¹⁰² For further information on this topic, see: Salomón Raydán, op. cit.

It is worth noting that this is not always possible and depends largely on the nature of groups, their culture, their customs, the individuals involved, but at least the design is intended for this purpose. Experience makes us think that after trying different options we have accomplished an efficient model for achieving this aim, but perhaps more rigorous research is needed to show if that purpose is always fulfilled.

Money and financial services provided by this model create possibilities to achieve the transformations we value the most in FUNDEFIR. No doubt most Bankomunal partners have the key aim of obtaining access to savings, credit and investment -and fortunately the model is able to provide them - but for those of us who induce the use of this model, the essential thing is that the simple financial transactions generate social capital¹⁰³.

¹⁰³ Some FUNDEFIR members had extensive experience in working with low-income community projects, which often failed. In developing Bankomunales, we were surprised at their usefulness as an instrument for community organization. The original idea was to create a model for providing access to financial services, but its potential for bringing wills together and building social capital has been perhaps the most valuable experience.

X. The Worldwide Movement of the other Microfinance

I wish there were millions Bankomunales.

*Let's hope all world's poor
could have a Bankomunal*

Partner of Bankomunal Boca del Pozo ,
Margarita Island, Venezuela

Efforts to bring financial services to the doorstep of many more people in the world had focused, wrongly, on expanding access to banking, without understanding that many of the informal models can perform this function safely, efficiently and at very low costs. But more and more people and institutions have been applying innovative, informal methodologies, seeking to recover and enhance many informal financial practices, in order to favor millions of people who are currently excluded from formal financial services offered by traditional microfinance and who otherwise would never be reached.

We, the authors of this work want to drive an international movement that promotes self-financing as a new way of carrying out microfinance. We maintain that in the financial informality, especially in collective mechanisms, there is a rich variety of traditional practices that, if enhanced, can be a high quality, highly economical solution to bring appropriate financial services to the neediest, without having to go through the complexity of the formal banking or traditional microfinance institutions.

This movement is not against traditional banking models, or against traditional microfinance systems. It is a movement that seeks to give greater consistency and efficiency to the entire financial system, and complement the efforts made over nearly four decades to bring the privilege of quality financial services to the vast majority of the world's population.

One of the first tasks of this movement is to detect, analyze and disseminate new microfinance experiences that can be recognized by relevant public and private bodies. Great efforts should be made by academia and cooperation spheres to conduct a deep and rigorous study of those experiences and turn them into truly proven methodologies.

Just as the traditional microfinance movement succeeded in mobilizing great spokespersons, including celebrities, royals from around the world, politicians and businesspeople from different levels, the *Other Microfinance* movement today should gather different wills to give a real boost to this new way of using the powerful tool that microfinance means.

Surely more and more methodologies with similar principles will become known every day, and so, with many joining in, we could bring quality financial services to millions of people excluded from this privilege. We have no doubts that very soon social network will be used to promote this type of self finance methodologies and the movement will not only reach poor communities but larger sector of the middle class that will developed a new type of banking, using they own network of families and friends.

True justice in the field of finance will be achieved when all the world's inhabitants have access to quality financial services at low costs and can thus fully exercise their economic rights. Self-financing, combined with formal microfinance and banking can help this dream come true.

Appendix

Export of the Bankomunal model to Spain

Jean-Claude Rodríguez Ferrara
*We had an emergency fund,
But we have emergencies every day,
That's why it's better to create an SFC.*
Partner of *El Intento* SFC,
Girona, Spain

History of microfinance models in Spain

So far European countries have been lagging behind in implementing microfinance methodologies, especially in groups. In recent years, a number of organizations have sprung up to provide micro-financial services, but they are still far from reaching the levels achieved in other regions.

In Spain, despite some particular efforts¹⁰⁴, it could be said that microcredit programs formally started in 2001. However, in a few years they have captured public, private, academic and social interest.

Pioneer organizations in Spain were: *Acción Solidaria contra el Paro*, *Asociación para la Financiación Solidaria*, *Caja Inmaculada* (CAI), *Coop 57*, *Federación Española de Entidades de Empresas de Inserción* (FEEDEI), *Fundación Internacional de la Mujer Emprendedora* (FIDEM), *Fundación La General*, *Fundación Laboral Banco Mundial de la Mujer* (WWB), *Fundación Un Sol Món*, and *Instituto de Crédito Oficial* (ICO).

Microcredit promoter institutions in Spain can be categorized as follows:

- Social entities that perform financial intermediation operations with savings or alternative funding entities providing microcredit on the savings of other individuals or legal entities.
- Social entities that do not perform intermediation financial operations with savings, but where microcredit comes from

¹⁰⁴ Some people/social entities of altruistic nature made loans without charging interest. They were not established programs but rather specific occasional actions depending on the promoter's capital availability.

non-repayable funds raised as donations or grants-in-aid or from agreements with financial entities.

- Private credit entities whose microcredit funds come from banks.
- Public credit entities where microcredit funds come from the market and risk is shared with other private credit entities.

Unlike other microcredit programs in southern countries, in Spain microcredit is mostly individual. The loans amounts are much higher and interest rates are generally below market average. They are basically granted for productive activities, and collateral is usually the micro-entrepreneur's business plan itself, and the backing of a social entity.

The only outstanding experience in group lending methodologies based on community bank models is the one conducted by the Grameen Bank in Spain in conjunction with *Fundación ICO* (Official Credit Institute Foundation). It is an experience where individual credits are granted for microenterprise initiatives, but include a training component and group meetings. Funds are granted by savings and loan associations.

Preliminary Steps in Bankomunal implementation in Catalonia

In January 2004, with the support of *Fundación Un Sol Mon* of *Caixa Catalunya*, the author of this chapter travelled to Venezuela to experience first-hand the Bankomunal methodology developed by Solomon Raydán through FUNDEFIR organization in Venezuela. As a result of this visit, the possibility emerged for replicating the model in Catalonia, with the aim of extending it later to other places in Spain and Europe.

Preliminary field work conducted in Catalonia led to the conclusions that there were three possible ways to get in contact with groups potentially interested in creating Bankomunales.

a) Social entities in Catalonia: The so-called Catalanian NGOs, and especially those working with marginalized populations in developing projects in Catalonia, represent an important source of groups likely to be interested in this type of community models. The so-called

“beneficiaries” of these entities, especially those receiving a monthly salary, could organize a Bankomunal that would belong to them. They could apply for loans, not necessarily for business purposes only, as they could also be intended for consumption needs. Providing collateral would be very simple, since the entity pays them a salary and partners could pay back in installments deducted from that salary.

b) Groupings of Immigrants. There are many groupings of immigrants in Catalonia, especially those drawing together people of the same nationality. Some of these groupings have the legal form of an association, but many of them are informal groupings and therefore are not registered with any registry office.

c) Parishes. The network of parishes existing in Catalonia is all too well known. It provides access to virtually any place in the Catalonia region. Nowadays, some district parishes bring groups of immigrants together, mostly from Latin America or of Catholic tradition.

2. Research on Bankomunales

Research work on the sources

After analyzing this previous study on possible sources for future Bankomunal partners, the following step was to visit organization representative of each of the three groups.

In interviews with the leaders of each one of these sources, an attempt was made to determine the degree of community organization, community leadership, existing non-formal sources of financing, the level of conflict relations within groups, and then designing a strategy for starting a Bankomunal.

a) Social entities in Catalonia: Although social entities initially showed interest in the model, as they really addressed the needs for small credits requested by beneficiaries - for instance, as salary advances - three basic complications set in:

- Some entities felt that implementing a group lending model would mean an increased workload for them, without any financial compensation.

- Some entities have traditionally provided paternalistic assistance to beneficiaries, who are now called users. This new model represents a change in view, and a resistance to change occurs.
- Many people served are not eligible to become Bankomunal partners, as they stay for a short time in the neighborhood.

b) Immigrant associations: Many groupings of immigrants in Catalonia have their own ways for financing partners. They create turn-allocation systems, own insurance funds¹⁰⁵, or resort to informal moneylenders in the neighborhood. These systems are based on full trust among members and do not involve any kind of formality, as may be a formal control of income and expenses.

Moreover, some partners have access to microcredit through social entities. However, only micro-entrepreneur partners may have access to these funds, as long as they have a business idea. Besides, they are high credit amounts and require a long waiting period.

The key in dealing with these groups was thus detecting how they were getting funded and, checking if the model was an efficient one, offering them the possibility of starting a Bankomunal. The Bankomunal could solve their urgent financial needs, a possibility that no formal bank or fund could offer. Perhaps these needs could be served with a credit card, but the interest rate charged is very high. The Bankomunal could provide them with a cheaper financial service, and, as added value, benefits are returned to the community. It could be viable with immigrants without identity papers, as long as they have a real sense of community belonging, willingness to remain in the area, and minimum income.

Among all difficulties found, two can be mentioned primarily:

- The group leader may be a negative leader, who prevents the group from conducting activities that are not under his control. Moreover, if the leader was organizing a turn-allocation system, the group may be paying him for organizing the system, and therefore

¹⁰⁵ Usually, especially in African immigrant communities, each partner makes an annual contribution. In so doing partners build a fund intended for financing emergency situations that any of their members may face.

he had no incentive to transform this informal system into a Bankomunal.

- Immigrant groups showed a high level of distrust toward initiatives not coming from someone of their nationality.

c) Parishes: Amid parishes with a high rate of immigrant parishioners, some parish rectors organize informal actions for granting very small credits based solely on the trust in the person and according to capital availability.

Moreover, many were interested in conducting activities with communities of recent immigrants, especially in projects creating community ties.

The main difficulty found was that some parishes had immigrant groups, but these were not sufficiently cohesive and united.

General conclusions of field research

Field research of low-income people in Catalonia shows that:

- Low-income people have financial needs - productive and non-productive - throughout the year.
- Low-income people do have savings capacity if they have access to the necessary mechanisms to keep their savings safely and if they receive compensation for them.
- Many people have difficulties in accessing formal banking, especially for small and unsecured credit operations.
- Many communities are already conducting experiments in providing financial services to their members, but in an informal and unstructured way, and where the ultimate beneficiaries are few.
- Some entities that support groups with these characteristics have already identified the need for this type of funding initiative, but they do not have a structure to carry it out, nor they know of successful models implemented in Catalonia.

In short, once the market need and the target audience were identified, we decided to promote the concept. For this purpose, we relied on the

counseling of Solomon Raydán, director of FUNDEFIR Venezuela, who transferred the methodology to Catalonia. We also benefited from the financial support of *Fundación Un Sol Mon* of Caixa Catalunya.

Prior to the promotion, three decisions were made:

- Registering an association: “*Asociación de Comunidades CAF*” (“SFC Communities Association”), encompassing activities for developing the Bankomunal model in Catalonia.
- Replacing the name *Bankomunal* for that of Self-Financed Community (CAF, as per its initials in Spanish), which best suited the vision we had for future groups and that differed from the original Venezuelan model in the adaptations made in line with the Catalanian context.

3. Promotion of the model

The process from model promotion to inauguration of the SFC is carried out in five stages:

- First contact
- Interview with community leaders
- Presentation to the community
- Writing the rules of procedure
- Inauguration

First contact

In all cases, a first contact with community leaders was made by telephone. The objective of this first contact was to arrange an appointment with them.

The main difficulty found at this stage was locating community leaders, their distrust, lack of decision-making or lack of ability to admit that they are not interested in the model.

Interview with a community leader

An interview is conducted with interested community leaders to explain the model and gather the following information about the community:

- Is there an organized community?
- Does the community hold meetings on a regular basis?
- Is there a leader in that community? Is he or she a positive / negative leader?
- Are members settled down in the neighborhood?
- How do people usually get financed?
- Are they of the same nationality or of various nationalities?
- Have they previously implemented any examples of community funds?
- Does the association or parish usually give loans or grants to people? If so, how does it do this?

The purpose of this phase is to present the model to the community. For doing so, a date should be set and the community leader should be provided with an information document to be explained to prospective stakeholders.

Some difficulties encountered in this phase are similar to those found during the previous phase; distrust by leaders toward external elements in their community and their lack of decision-making, or little drawing power over the group. Another problem is the difficulty to arrange a date for making a presentation to the community, because it required prior consensus with other group members.

Presentation to the community

The aim is to present the model to a representative group of the community to set a date for drafting the rules of procedure together with stakeholders.

Frequent objections arising among community members can be grouped into five types:

- First objection: "I have no income."
- Second objection: "I'm just temporarily in this neighborhood."
- Third objection: "I need credits in higher amounts."
- Fourth objection: "I have no time to participate in anything."
- Fifth objection: "It does not inspire confidence: extra money, payment arrears, you promoters".
- Sixth objection: "It does not seem trustworthy to me because of potential defaulters."
- Seventh objection: "We already have a turn-based funding system."

An SFC (or CAF) cannot solve the first two objections, because they mean that the group does not have the necessary profile. As to the third objection, an SFC is not the ideal funding model, at least initially, but with patience over time it can provide larger loans, although never likely to the level of a mortgage, for example. The fourth objection does not conform to reality, because participation involves spending very little time, usually a monthly meeting.

Concerning the fifth objection, some points must be made clear:

- Capital surplus: surplus capital after the monthly meeting is too little, because the money tends to be in the hands of credit applicants. However, a solution is having a person working as acting treasurer, and payments and credits being made in the parish. Also, the excess cash from each meeting can be kept at the headquarters of the association or someone may take the safe-box and someone else keeps the key. Other groups may choose to open a checking account in the name of three people.
- Payment arrears: guarantees are not tangible, but they do exist. They determine the level of security, which is based on acceptance by other partners to act as surety for loans with their shares. However, it should

be made clear that an SFC is a risky activity, and hence losses may occur if it is not managed rigorously.

- Promoters: it should be clear for the group who are the promoters of the model, what their interest is and who is providing support.

Regarding the sixth objection, it is true that the credit turn-allocation system¹⁰⁶ solves many problems for people. But in such a case, it is advisable to explain the following advantages that the SFC model has over credit turn-allocation systems:

- In the SFC model, members can borrow money whenever they need it, and not when they get their turn in a drawing lot. They may also ask for a loan as often as needed, and not just once a year. With an SFC, members can seize opportunities that may arise, instead of only meeting needs.
- In the SFC model, the capital of the whole community increases, while in the turn-allocation system, credit is always for the same amount.
- The SFC model provides more security, since a person who has received a credit continues to be motivated to continue putting in more money and to stay involved. It provides more guarantees in case of non-payment.
- The SFC model promotes savings. Partners may contribute capital whenever they want and in the amount they may wish, instead of a mandatory fixed amount each month.
- The SFC model creates a sense of community and provides financial education.
- The SFC model allows for earning profits on the capital they have contributed to the fund. These earnings are generally much higher

¹⁰⁶ In the credit turn-allocation system, twelve people make a fixed monthly contribution to a fund. A draw is held every month for the accumulated capital of these twelve people, and one person gets the loan. The next month there is another drawing lot. Obviously the people who received the loan in previous months can no longer participate. The operation is repeated twelve times. Sometimes the operation is even repeated thirteen times; in this case the money is intended to pay the person who organized the chain.

than those they would get elsewhere. That money earned is distributed fairly according to the money contributed, and not only to one person who has organized it, since all are involved in the organization without incurring in any expenses.

- The main difficulty encountered during the presentations was the low turnout. In any case, the presentation was made if the number of attendees was not less than seven people. On several occasions, more than one presentation had to be made or the meeting had to be put off for another date to ensure better attendance.

Drafting the rules of procedure

After the presentation to the community concerned, the rules of procedures of the SFC are set forth in a second meeting with the group.

In this session, financial and organizational group training is provided for setting up the basic rules of operation, which establish the conditions of the organization.

Although there are a number of aspects to be considered during the session for drafting the rules of procedure, concrete results on these issues depend on the decisions groups may make and hence differences among various rules set by the groups are usual. This is part of the adaptation groups must experience in order to meet their particular needs. Listed below are some of the most relevant aspects contained in the rules, with the caveat that there may be differences from group to group.

a) *Shares*: All groups set the share price at ten Euros. This figure allowed for a fairly quick capitalization¹⁰⁷ while preventing anyone in need from being left out of the group. In addition, it is a "round" number that facilitates subsequent calculations. However, for admission, members usually set up a minimum contribution. This contribution – as stock purchase - was set at an average of 26 Euros (2.6 shares) in the first groups.

Some groups - 50 per cent - did not set the maximum number of shares that a member was entitled to hold. Other groups fixed 39

¹⁰⁷ In Venezuela the share price is usually around one dollar and a half per share.

percent of share capital as the upper limit. This is because they did not want a single member to be able to take over the whole SFC.

Most groups decided that profit distribution should take place once a year, usually in December¹⁰⁸.

b) Credits: The average minimum credit fixed by groups at baseline was 60 Euros. This is because no group wanted to make arrangements for overly small loans. As for the maximum credit, most groups set a percentage of the total capital. Initially this may be up to 47 percent on average, but the intention was that as the group built up capital, the risk would be better distributed and that average would drop to below 25 percent of the total capital stock. In this way, several loans could be granted to different partners at the same time.

The average maximum term for paying off the loan was four months. Here the classic microfinance methodology is applied. It recommends short payback periods, but as there is increasing capital and higher amounts are lent, the period for repaying will normally be larger.

Interest rates varied from one percent to two percent per month, depending on the needs of the group and the competition groups may face. Interestingly, the groups with lower-income partners tended to set a higher interest rate, knowing that partners did not have access to formal sources of financing. Some groups, especially those with members of the Muslim faith, tended not to charge interest, though they set fines for payment delays.

The relationship between stocks and credits – leverage - was set at an average ratio of one to four¹⁰⁹. This means that members could request four times the investment they have in the SFC. In this case, this secures 25 percent of the credit.

As to guarantees, their average was 37.5 percent of the requested capital. That is, if asking for 100 Euros, 37.50 Euros must be secured. These guarantees can be stocks or surety with shares of other partners.

¹⁰⁸ In Venezuela, most groups distribute profits when shares are due; that is to say, if a share was bought in January it receives its dividend in February next year. In this way, profits are distributed progressively throughout the year. In that country only a few groups distribute their profits once a year.

¹⁰⁹ In Venezuela it is normally of 1 to 5, though some groups reduce the risk and fix it at 1 to 3 or 1 to 4.

In case of default, all groups set forth that if a payment was delayed, the concerned member must pay double the interest rates he or she should rightfully pay in the month.

c) Member's Meetings: Except for one case, groups decided to set meetings on weekends, preferably within the first two weekends of the month, since it is when they had more capital. For the admission of new members, in addition to paying for the minimum purchase of shares, most groups stipulated that two full members had to recommend their admission.

Except for one group, SFCs required all members to attend. In that case, non- attendance was penalized a fine of 2.3 Euros on average.

In SFC Boards, the majority - 56 percent - of members were women. In the position of president, only 25 percent were women. In contrast, the position of accountant -which requires increased workload and responsibility were mostly - 87.5 percent - women.

3.5. Inauguration: Once the rules of procedure were drawn up, we proceeded to the inauguration, which took place at a later meeting. At that meeting, after approving the rules unanimously, starting capital was set up through the purchase of shares by partners. Once the capital was put together, the first credits were granted.

4. Start-up and follow-up of activities

At the first meeting after the inauguration, a new process of growth and group consolidation started. This process involved a series of activities:

- Financial training to members of the organization, through practice, to teach them how to regularize all financial, administrative, accounting and functional processes. Special emphasis should be placed on developing financial criteria, on the administrative, accounting and organizational management of the institution through a specific training program.
- Internalization of the functions and operations of the SFC by directors and partners, aimed at the consolidation of the group.
- Developing a plan of financial and administrative sustainability of the local organization, designing a series of workshops and

strategies for providing the community with expertise in order to ensure long-term organizational sustainability.

This is an ongoing process during the execution of the project to establish a monitoring and external control system for permanent review and classification of organizations for better serving them. This objective does not seek to replace the local supervisory and internal control responsibilities that every organization must have, but to support this process, through the standardizing of accounting and management processes that facilitate self-assessment. As groups make progress in acquiring that knowledge, visits become more occasional and issues are solved through distance communication means such as the Internet or by telephone calls. The aim of this new process is for organizations to endure and provide quality services to members.

5. Challenges Ahead

Growth in quantity

One of the challenges the SFC model is facing is first its expansion across Spain and later across Europe. For this purpose, several strategies have been designed and are being carried out:

- Expansion to new community groups: in addition to immigrant groups, SFCs are being created with other groups: the mentally ill, school children, young people at risk of social exclusion, entrepreneurs, etc.
- Introduction of the methodology to other organizations / networks: after learning the VSLA spreading experience (see www.vsla.net), we are training technicians from other organizations with a strong presence in neighborhoods and with access to trusted communities: Red Cross, Caritas, Red Acoge, immigrant federations, etc.
- Simplification methodology: to ensure that the methodology is transferred virally, by word of mouth, simplification as much as possible has been necessary. At present, only four prewritten formats are sufficient to manage the SFC. Furthermore, operations can be started after only two two-hour sessions.
- Use of technology: we are developing a mobile phone application for anyone to learn the methodology by simply downloading it from the Internet.

Growth in quality

Moreover, after the creation of these communities, which get together initially through microfinance, organized member individuals can receive better services and be part of the economy as consumers of products and services. Aside from creating a network among themselves, these communities are better able to pressure governments and negotiate with companies. The donor/recipient relationship changes to a producer/consumer relationship. Sometimes the community can be a producer/consumer at the same time. Their needs can be studied, and hence companies and governments can adapt their products and services to this large segment of population with little ability to pay.

The idea is to introduce new services to groups, whether developed by the group itself or through alliances with companies. Some of these new services have already been tried: emergency funds, life insurance, time banking, access to greater amounts of credit, venture capital funds, etc. For this purpose, a social network must be created, where members can share problems and solutions, best practices, and ideas for new services.

6. Conclusions

1. Micro credit schemes in Spain show significant differences as compared to those in developing countries.

Microcredit in Spain is mostly individual, and so far there have not been many significant group lending experiences. The loan amounts are much higher than in countries in the south, and interest rates tend to be below market rate. These microloans are primarily aimed at productive activities, and collateral is usually the microenterprise business plan itself, and the backing of a social entity.

2. In Spain there is a need for small loans for different purposes.

The field research prior to launching of Self-Financed Communities showed that there was a need for very small loans for various needs, not just for productive activities. The average credit amount – less than 500 Euros - granted by organized SFCs so proves it.

On the other hand, there is a very low-income segment of population that had never applied for credit for fear or because they unaccustomed to it, and once they see the viability and simplicity of access, they start using this new financial service. It could be said that this results in a "banking" process of low-income people.

It has also been shown that people can and want to save small amounts. SFCs have given them the opportunity to have a place to save on a regular basis.

3. The Bankomunal model can be replicated in Europe.

Contrary to what many experts argued, it is possible to use group methodologies in a European country like Spain.

In addition, many parallels arise as to group models developed in some Latin American countries:

- The levels of delays in payments during the first months of operation are extremely low. This is surprising considering that guarantees are based on trust among partners and that these are people with very low income.

In most cases, there is a balance between capital supply and credit demand within groups. In some cases, even excess liquidity is observed at moments, up to the point that an external fund may distort rather than strengthen the methodology.

- Groups can only be organized in communities with a certain level of cohesion, staying in the region, and with minimal income. Partners themselves do not accept starting the group if these conditions are not met.

- Microcredit business profits can be distributed among partners themselves, who show the ability for self-management as a group and quickly reach self-sustainability.

- Women take a leading and majority role within groups.

4. To replicate the Bankomunal model in Catalonia, some adaptations had to be made.

Creating an SFC in Catalonia is the first experience in replicating a Bankomunal model in a European country. Not even in Latin America were groups created with immigrants, or people of different nationalities¹¹⁰, nor with people with mental illnesses. This has required certain adaptations.

- Adapting the methodology to different cultures - for example, Senegalese people make all decisions in assemblies, without resorting to a voting process - and to different personal situations. For example, the mentally ill do not accept guarantors, as there is a great mistrust among them.
- The number of members required to start an SFC is lower than in a Bankomunal. In the SFC model, a group of six people has started a group - on the Latin American model twice that number would be required - since capitalization is higher in SFCs. In any case, partners state that it is preferable to start with a cohesive group and then expand. In no case is the group larger than thirty people.
- A territorial tie is not necessary for group cohesion. In Catalonia, partners reside at distant places, far from each other, which is not usual in Latin American communities.
- The time required to create an SFC is lower in Catalonia; it is reduced to two sessions in some cases. This is due to the short time available for individuals, and partners' higher level of education.
- Meetings are held on a monthly basis, and financial transactions such as credit granting, payment of installments and purchase of shares are made only during those meetings,. In the Bankomunal model, these transactions are made on a weekly basis or even on a daily basis, but from the experience in Spain, the decision was taken to change the model and to use the one developed in that country, concentrating all operations in a single meeting, although groups decide how frequently these meetings take place.

¹¹⁰ In Spanish SFCs there are partners of very different nationalities: Peru, Spain, Honduras, Ecuador, Colombia, Guatemala, Germany, Italy, Uruguay, Paraguay, Argentina, Chili, Venezuela, Morocco, Senegal, Portugal, Dominican Republic, and Equatorial Guinea.

- There are more possibilities for providing groups with new entrepreneurial services, as the Catalanian business sector is larger than those in many Latin American countries.
 - Immigrant associations and parishes are two key sources for creating new groups. In Latin America, sources are neighborhood associations, community leaders and parishes.
 - SFCs' growth in membership is lower than in Bankomunales, although, again, the experience in Spain has shown that with smaller groups (30 people) better operational control as well as a better distribution of knowledge can be achieved. Therefore, the new Latin American model seeks to prevent groups from growing beyond 40 people.
 - People join the group to have access to credit, to save or earn more for their money. But there are other non-economic reasons that drive a partner to become member of an SFC, such as having a place to go in case of emergency or the feeling of being part of a community and thus having a one-to-one relationship network.
 - The SFC model has proved to be efficient both for people with low income and those with higher income¹¹¹.
5. The SFC can be the basis for creating a community organization and achieving integration of disadvantaged groups.

SFCs are stable and interesting organizations for members, as they are based on real needs, on partners having an individual motivation to join, and on a high sense of belonging. They are self-sustainable from the first operating day and their management is very cheap. Hence, they have a great ability to get coverage.

Unlike other organizational models, attendance at meetings and participation are high, partly because it is mandatory and partly because the decisions made affect them personally as owners and as customers. The money turns to into an instrument for unity and trust building.

¹¹¹ In Spain, experiences have been conducted with middle-income groups, such as professionals and university students. In Venezuela groups have been created with social organizations such as the Venezuelan Network of Ashoka Members, as well as with companies' employees.

The SFC is a training school in community organization and financial education. This suggests that, in the medium term, this structure can be exploited to perform other activities of interest to the community. Some companies might be interested in providing their services to those communities in the future.

Moreover, newcomers to western countries are often displaced, ignored by the host society. Additionally, they cannot find a job easily, nor do they have a relational network they can join in a natural way, and receive the same services as any inhabitant. Immigration is an exponential growth phenomenon that has to be dealt with using exponential solutions. Existing groups already represent a great instrument for integrating immigrants and newcomers to the country, or those who need to be part of a relational network, which gives them self-worth through the confidence shown by being granted a credit.

Furthermore, in the current trend where trustful social networks are weighing more and more heavily and yet where there is a growing distrust as to traditional banks, a method such as SFCs' will possibly find an increasingly large market.

The SFC experience in Spain, as well as that of Bankomunales in Venezuela, shows that there is local capital, able to meet a significant part of the domestic demand for credit without the need to resort to the mainstream banking strategy. Furthermore both experiences allow us to see that the mobilization of these resources and their placement in credits may be conducted with a simple, secure, sustainable and educational methodology.

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