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From **MICROFINANCE** to **INCLUSIVE** **BANKING**

Why local banking works



Reinhard H. Schmidt, Hans Dieter Seibel, and Paul Thomes

From Microfinance to Inclusive Banking

Why Local Banking Works

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List of Abbreviations

ACPC	Agricultural Credit Policy Council of the Philippines		[German Association of Savings Banks]
ADB	Asian Development Bank	DTMFI	deposit-taking microfinance institution
ADEMI	Association for the Development of Microenterprises	DTVF	deposit-taking village fund
AFI	Alliance for Financial Inclusion	DZ Bank	Deutsche Zentral-Genossenschaftsbank
AG	Aktiengesellschaft [stock company]		German Central Cooperative Bank
APMAS	Andhra Pradesh Mahila Abhivruddhi Society	EACB	European Association of Co-operative Banks
APRACA	Asia-Pacific Rural and Agricultural Credit Association	EBRD	European Bank for Reconstruction and Development
avg.	average	EDC	electronic data capture
BAAC	Bank for Agriculture and Agricultural Cooperatives of Thailand	eG	eingetragene Genossenschaft [registered cooperative]
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht [German Federal Financial Supervisory Authority]	eGmbH	Genossenschaft mit beschränkter Haftung [registered cooperative with limited liability]
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung [German Federal Ministry for Economic Cooperation and Development]	eGmuH	Genossenschaft mit unbeschränkter Haftung [registered cooperative with full liability]
BoG	Bank of Ghana	EU	European Union
BoL	Bank of Lao	EUR	Euro
BPD	Bank Pembangunan Daerah	FAO	Food and Agriculture Organization of the United Nations
BPR	Bank Perkreditan Rakyat	FAS	Financial Access Survey
BRI	Bank Rakyat Indonesia	FINCA	Foundation for International Community Assistance
CAMELS	Capital Adequacy, Asset Quality, Management Quality, Earnings, Liquidity, Sensitivity to Market Risk	FMO	Netherlands Development Finance Company
CAR	capital adequacy ratio	FS	financial services
CARD	Center for Agriculture and Rural Development	G20	Group of Twenty
CCF	Cooperative Central Fund	G8	Group of Eight
CEO	Chief Executive Officer	GASCA	Greater Accra Susu Collectors Association
CGAP	The Consultative Group to Assist the Poor	GCSCA	Ghana Co-operative Susu Collectors Association
CMAC	Cajas Municipales de Ahorro y Crédito [Municipal Savings and Credit Banks]	GDP	gross domestic product
DFID	Department for International Development of the United Kingdom	GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit [German Agency for International Cooperation]
DGRV	Deutscher Genossenschafts- und Raiffeisenverband [German Cooperative and Raiffeisen Confederation]	GPFI	Global Partnership for Financial Inclusion
DM	Deutsche Mark [German Mark]	GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit [German Agency for Technical Cooperation]
DOEN	The DOEN Foundation	HIID	Harvard Institute for International Development
DSGV	Deutscher Sparkassen- und Giroverband		

X List of Abbreviations

ICBA	Independent Community Bankers of America	OECD	Organization for Economic Co-operation and Development
IDB	Inter-American Development Bank	OJK	Otoritas Jasa Keuangan [Financial Services Authority of Indonesia]
IDR	Indonesian Rupiah	ORP	operational restructuring plan
IFC	International Finance Corporation	PACS	Primary Agricultural Credit Society
IFI	international financial institution	PCF	People's Credit Fund
IFPRI	International Food Policy Research Institute	PCH	ProCredit Holding AG & Co. KGaA
IKP	The Indira Kranthi Patham poverty reduction program	PISCES	Program for Investment in the Small Capital Enterprise Sector
ILO	International Labour Organization	PLPDK	Pembina Lembaga Perkreditan Desa Kabupaten
IMF	International Monetary Fund	PPP	Public Private Partnership
IPC	Internationale Projekt Consult	PR	public relations
IPO	initial public offering	PSBC	Postal Savings Bank of China
JLG	joint liability groups	RBI	Reserve Bank of India
KfW	Kreditanstalt für Wiederaufbau [German Reconstruction Loan Corporation]	RCT	randomized control trial
KGaA	Kommanditgesellschaft auf Aktien [partnership limited by shares]	ROA	return on assets
km ²	square kilometer	ROE	return on equity
KWG	Kreditwesengesetz [German Banking Act]	ROI	return on investment
LAK	Laotian Kip	ROSCA	rotating savings and credit association
LDR	loan-to-deposit ratio	RWTH Aachen University	Rheinisch-Westfälische Technische Hochschule Aachen [Rhenish-Westphalian Technical University of Aachen]
LPD	Lembaga Perkreditan Desa	SAVIX	Savings Groups Information Exchange
LWU	Lao Women's Union	SBFIC	Savings Banks Foundation for International Cooperation [Sparkassenstiftung für Internationale Kooperation]
MACS	Mutually Aided Cooperative Society	SBV	State Bank of Vietnam
MCID	Micro Credit Innovation Department	SCI	Service Corporation International
MENA	Middle East and North Africa	SCU	Savings and Credit Union
MF	microfinance	SDC	Swiss Agency for Development and Cooperation
MFA	microfinance association	SERP	Society for Elimination of Rural Poverty
MFI	microfinance institution	SG	savings group
MIS	management information system	SHG	self-help group
MIV	microfinance investment vehicle	SHPI	self-help-promoting institution
MIX	Microfinance Information Exchange	SKS	SKS Microfinance Limited
mn	million	SMEs	small and medium enterprises
MRI	Mutually Reinforcing Institution	SWOT	Strengths, Weaknesses, Opportunities and Threats
MSEs	micro and small enterprises	TSB	Trustee Savings Bank
MSMEs	micro, small and medium enterprises	UGX	Uganda Shilling
NABARD	National Bank for Agriculture and Rural Development of India	UN	United Nations
NBFI	non-bank financial institution	UNCDF	United Nations Capital Development Fund
NDTMFI	non-deposit-taking microfinance institution	UNDP	United Nations Development Programme
NDTVF	non-deposit-taking village fund		
NERI	National Economic Research Institute		
NGO	non-governmental organization		
NPL	non-performing loan		
NRLM	National Rural Livelihood Mission		

US	United States	VO	village organization
USAID	United States Agency for International Development	VSLA	village savings and loan association
USD	United States Dollar	WGZ	Westdeutsche Genossenschafts-Zentralbank [West German Cooperative Central Bank]
VAPCF	Vietnam Association of People's Credit Funds	WOCCU	World Council of Credit Unions
VF	village fund	WSBI	World Savings Banks Institute
VND	Viet Nam Dong		

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Foreword

Half of the world's population lives and works in the informal economy – not by choice, but by necessity. In the language of economists, poorer families in developing countries are consumption-smoothing households and capital-consuming, self-employed entrepreneurs at the same time. As a result, they need a broader range of financial services to manage inevitably irregular income and expense spikes, accumulate working capital, build assets, and mitigate risks. Lacking better alternatives, they often resort to informal financial mechanisms, such as money-lenders, pawnbrokers, and rotating savings clubs, which can be very unreliable and expensive.

At the same time, an increasing body of evidence shows how appropriate financial services can help improve household welfare and spur small enterprise activity. There is also macroeconomic evidence that economies with deeper financial intermediation tend to grow faster and reduce income inequality.

Against this backdrop, policy makers around the globe are embracing formal financial inclusion as an important soft infrastructure ingredient for social and economic progress. The G20 has made financial inclusion one pillar of its development agenda and some 50-plus countries have made explicit financial inclusion commitments. More recently, the World Bank Group has called for universal access to basic transaction services as a building block for economic development by 2020.

As emerging markets countries develop and deepen their financial systems, there may be lessons to be learned from the formalization of financial intermediation in today's highly industrialized countries. The German Financial Inclusion story is one example. There, new types of local, community-based financial institutions started serving customers in the very late 18th century for the same reasons we have seen microfinance institutions and other non-conventional providers emerge much more recently in developing countries: because the predominant commercial banks of their time pretty much catered to government, big business, and wealthy patricians, leaving the vast majority of the working population excluded.

The German *Sparkassen* (loosely translated as savings and loans institutions) and somewhat later the *Genossenschaftsbanken* (cooperatives) introduced a safe way for farmers, artisans, low-income workers, domestic employees, traders, budding entrepreneurs, and everybody else to deposit money and get credit. Early on they introduced long-term savings to help provide for older-age in the absence of the yet-to-be introduced public pension systems. They accompanied the Industrial Revolution throughout the 19th century, built trust and capital through three regional wars, predating modern German unification in 1871. Laws were written, regulations introduced and by 1913, before the outset of World War I, every single German family had a savings and transactions account.

As they draw lessons from this experience, the authors of the study presented below highlight the importance of decentralized inclusive financial systems, anchored in the community, understanding their customers, and lubricating the local economy. They point to the historic economic success that this system has brought about and to the recent, relative stability it ensured. About 70 percent of German retail deposits today remain with these local, community-based institutions that continue to be at the center of economic life in small towns and municipalities.

The world has of course changed since the rise of the German *Sparkassen* and *Genossenschaftsbanken*. New institutional set-ups and technologies allow for new ways to reach people faster and more cheaply. But, the underlying imperatives to understand and serve customer needs, to be trusted in the community, and to serve the larger purpose of helping people improve their lives and realize their economic potential remain the same.

Read on and draw your own conclusions about the elements of the German story that might be applicable to the financial inclusion challenges in a different time and under different circumstances.

Washington, July 2015

*Tilman Ehrbeck, former CEO of CGAP,
now a partner at Omidyar Network*

Preface

Microfinance is a diverse and difficult socio-financial phenomenon. It is difficult to define, to understand, to perform, and to implement. The last decade in particular has seen the gamut of emotions regarding it, from hype to disenchantment and from microcredit to microfinance – the latter term having been coined back in 1991 by Hans Dieter Seibel, one of the authors of this book. Another landmark was the establishment of the Consultative Group to Assist the Poor (CGAP) in 1995 as a think tank first of the microcredit movement, then of the microfinance movement which succeeded it. The topic entered the global arena of public and scientific discussion upon the awarding of the 2006 Nobel Peace Prize to the Grameen Bank and its founder, Muhammad Yunus.

In fact, the more promising an approach is, the ruder the awakening will be when disappointment sets in, and the more difficult it becomes to evaluate existing institutions. In the extreme case, insiders today generally negate the suitability of the microfinance approach; others assume the position that organizations aiming to provide inclusive financial services can be successfully run only as nonprofit enterprises, operating on permanent subsidies. For some time these evaluations have been prompting the microfinance community to consider new ways to diversify and optimize the original business model. Nevertheless, it seems that, in general, too little systematic knowledge has flowed into the design of microfinance models and projects.

This study on microfinance represents the findings of an interdisciplinary team of authors. It picks up on past experiences, describes and analyzes them, and merges them into a fresh interpretation of microfinance, widening the scope in the sense of the CGAP graduation approach. In doing so, it seeks to learn from the past, presents options, and tries to define parameters of success and failure. The authors have studied the subject in manifold ways. Hans Dieter Seibel, a retired professor of sociology at the University of Cologne, and Reinhard H. Schmidt, a retired professor for international banking at the University of Frankfurt, have worked in the field for many years, both as practitioners and as theoreticians with long publication lists. To extend the scope of observation and add a long-term perspective, Paul Thomes, a professor at RWTH Aachen University and an expert in banking history, has added a comparative analysis of examples from the era of European industrialization. At that time, savings banks and credit cooperatives started to play an important role in change management, especially in Germany, with the emergence of these institutions being a kind of microfinance revolution in its own way. Of course, the historical case studies must not be seen as a template to be adopted one-to-one in the present day, although attempts have been made to copy historical European role models and they often have been cited (uncritically) in the microfinance literature. But the present time is different indeed, and so are cultures and people. However, the latest trends in microfinance, espe-

cially in the context of the discussion about sustainability, seem to confirm that it is well worth looking at all the different methodological solutions and models that the past and the present have at their disposal.

The authors are convinced that their holistic approach has the potential to deepen general knowledge about microfinance and to generate among the parties involved a better mutual understanding, which has frequently been obstructed in the past by cultural and other differences. Financial participation, understood in the context of its importance, intentions and effects, is comparable to people participating in energy supply and transportation infrastructures. In light of the current global challenges, the ultimate objective must be inclusive and reflective societies which address challenges together in a partnership of equals. Optimized microfinance concepts – in the sense that they are better culturally adapted – might contribute to the achievement of this ambitious aim.

Designing, structuring, and writing the present text was a joint endeavor. However, roles have been assigned, reflecting the three authors' main fields of interest. The main author of Chapter I, which offers a general introduction, clarifies concepts and provides an economic background of today's microfinance, is Reinhard H. Schmidt. Chapter II, on the history of savings and cooperative banks in the long 19th century, is the domain of Paul Thomes, the historian among the trio of authors. The main contributions to Chapter III, which is essentially a collection of case studies of large microfinance institutions and programs that aspire to be inclusive and development-oriented, were authored by Hans Dieter Seibel, with Reinhard Schmidt as an additional contributor. The final chapter, Chapter IV, which provides a summary and outlook, is then indeed a joint endeavor. In spite of this assignment of roles, all chapters have been jointly discussed among the authors at great length in order to create coherence in terms of substance and, to some extent at least, also of style.

The work underlying this book has been generously funded by the German Federal Ministry for Economic Cooperation and Development [*Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung*] and two organizations belonging to the German Savings Banks Finance Group, namely the Savings Banks Foundation for International Cooperation [*Sparkassenstiftung für Internationale Kooperation*] and the Academic Sponsorship of the Savings Banks Financial Group [*Sparkassen Wissenschaftsförderung*]. For their confidence in us and for their financial support, we owe a great debt to these two organizations.

The person who oversaw the work at the Savings Banks Foundation is Dr. Ilonka Rühle. Her continual support and encouragement, as well as her valuable contributions to the substance of our text, are by all standards outstanding. We are grateful for all she has done to bring this book into being and, as we hope, with successful results at that. Our gratitude to Dr. Rühle goes far beyond what would be due merely to her formal role.

Since we are not native English speakers, we also needed support to improve the linguistic and stylistic quality of our original manuscript. We were really fortunate to have Ms. Grace Tasch and Mr. George McElheny to help us out in this respect. Their competence both as translators and editors with a long-time focus on microfinance made them our ideal partners. We are deeply indebted to them for their outstanding work.

Bonn, March 2016

*Reinhard H. Schmidt, Hans Dieter Seibel
and Paul Thomes*

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