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Drop-Outs, Graduates, Defaulters and the Excluded

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Abstract

This article reviews four issues facing MicroFinance Institutions (MFIs) worldwide, with evidence drawn primarily from Bangladesh, the cradle of group-based lending. 1. Recent research into drop-outs strongly suggests that members leaving MFIs are usually doing so because they are dissatisfied with the quality of financial services being offered by the organisation. Clients "shopping around" for the best services has also led to prevalent "multiple membership" of the same clients with different MFIs. Clients with multiple membership are absorbing huge costs in order to get access to the financial services they feel they need. 2. The old idea that members might "graduate" to survive without access to financial services is naïve: almost everyone, and certainly every business, needs access to places to store excess cash and to borrow money in order to smooth financial flows. Institutions dedicated to achieving "sustainability", do not want their most successful clients to graduate to become customers of the formal sector banking system. 3. Despite the rhetoric surrounding "group guarantee", neither peer pressure nor peer support are as effective as their advocates suggest - particularly after the first two or three loan cycles have been completed. On the other hand it has become increasingly clear that the single most effective deterrent for defaulters is the prospect of losing access to financial services - follow-on loans and savings facilities. 4. In the interest of involving the poorest, there has been a great deal of research into this issue in recent years, trying to differentiate exclusion by the members themselves and exclusion by the MFI and its staff. This division is arbitrary since it is the systems and (in particular) the financial services of the MFI which will determine whether members "self-exclude" or not. All of these issues are best addressed by designing high-quality, flexible financial services.

About The Author

Graham Wright has worked on training, systems design, research, and evaluation of both rural and urban MicroFinance Institutions for nearly fifteen years. He helped develop an influential Grameen-influenced MFI system in Bangladesh and has just finished providing long-term technical assistance in the Philippines, promoting self-help "Savings and Loan Groups" and linking them to the strong cooperatives. Graham is currently Senior Regional Microfinance Advisor for the UNDP/DFID ***MicroSave*** *project, Chair of the CGAP Savings Mobilization Working Group, and has been recently been made a Research Associate of the Institute of Development Policy and Management, University of Manchester.*

Disclaimers

The opinions expressed in this article are those of the author and not necessarily those of the institutions for which he has worked or is currently working.

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Drop-Outs, Graduates, Defaulters and the Excluded

Graham A.N. Wright

> "However, it is now widely recognized that not all poor household have been able to benefit from Micro credit programmes. There are three groups of such households: those who are active members but who are not improving their economic condition; those that initially join but subsequently drop out or become inactive as loan recipients; and those that never join" Greeley (1997).

Groups

This paper tries to examine the dynamics of groups formed to access financial services, and specifically, groups who agree to guarantee fellow group members' loans. It should be noted, that while this is the prevalent model in Bangladesh, and has proved remarkably successful, group-based systems are not the only way of delivering financial services. Most of the international Credit Union movement serving millions of members in a wide variety of settings throughout the world, the immensely successful Bank Rakyat Indonesia (BRI) which serves nearly 14 million clients, and many other financial service institutions do not use groups or group guarantee mechanisms at all. Nonetheless, in view of the world-wide use of group-based lending by MFIs, this paper will focus on groups, and their implications for those who leave them or are unable to join in the first place.

Drop-Outs

The number of drop-outs a MicroFinance programme experiences has profound implications for the viability of the institution and reveals a great deal about the quality of the financial services it offers to its clients. High drop-out rates cost the organisation dear. The groups from which members drop-out are destabilised and must recruit new (less experienced) members, who will qualify for smaller loans thus reducing the overall interest income for the institution. The members who have been with the organisation longer qualify for larger loans, and the newer, replacement members can only get access to smaller ones. Despite this, the newer members have to take a disproportionate risk and guarantee the larger sums taken by their fellow group members, adding further stress to the group guarantee principle (this is examined in more detail in "Defaulters" below). Furthermore, each drop-out is a lost client who has undergone lengthy, expensive training ("social preparation"). The new replacement members must either also be given this training on an individual basis, or join the system without the initial training regarded as so important by many MFIs. The former option of *ad hoc* training is extremely cost ineffective, and the latter, if indeed "social preparation" is so important, threatens to undermine the system. In addition, in the face of frequent or multiple drop-outs, some of the groups may disintegrate entirely. Finally, drop-outs often leave because they cannot (or do no want to) manage loan repayments. These drop-outs no longer attend the group's regular meetings, and freed of the group guarantee, and of the incentive of continued access to financial services (be they loan or savings facilities), are more likely to leave behind an outstanding, unpaid loan.

High drop-out rates often indicate a dissatisfaction with the financial services being offered by the institution. Members choosing to leave a financial services organisation generally do so either because the organisation is not providing them good enough services to warrant the (social and financial) costs involved, and/or because they have identified a better alternative.

Members expelled from a MicroFinance programme (for, of course, not all drop-outs are voluntary) are likely to be indicative of an even more complex bundle of factors. These factors include: client selection (or better said "de-selection") either by fellow members and/or by staff (as we shall see in

"The Excluded" below), the clients' ability to pay loans or even savings (again examined in "The Excluded") and clients' motivation to repay loan, which is in part, a proxy indicator of the level of satisfaction with the services (as we shall see in "Defaulters" below).

The increasing awareness of the importance of the number drop-outs a programme experiences has prompted a series of studies in recent years. In 1992, BRAC lost 10,2,814 (or 15.3%) of its membership, and another 78,725 (or 10.9%) of its membership the following year. Clearly, even when they are replaced, such client turnover may compromise the sustainability of a programme, particularly when the drop-outs were relatively long-standing members eligible for larger (and therefore for the MicroFinance institution seeking sustainability, more attractive and cost-effective) loans. Khan and Chowdhury (1995) collected information on the drop-outs' length of membership, and concluded, "The average years for which they had been members before leaving was 4.7 for males and 3.8 years for females." This strongly suggests that BRAC was indeed losing many of its older, more experienced, and cost-effective clients, and that only a part of the drop-outs arose from villagers joining on a test basis before concluding that BRAC's system was not meeting their needs or expectations.

It should, however, be noted that in these two years BRAC was undertaking a membership restructuring exercise. As Khan and Chowdhury (1995) stress "In order to extend services to larger number of households, only one member from one household was allowed to retain VO membership. In RDP's emphasis on women, the male members were asked to vacate their membership, which also resulted in disproportionately high dropout among male membership as reported in this study." This is, nonetheless, in marked contrast to the same study's observation that "Over three quarters of the respondents from among the discontinuing category reported that they voluntarily dropped out while a quarter was expelled. The proportion of those expelled was higher among males, while the proportion of those dropped out voluntarily was larger among the female members" Khan and Chowdhury (1995). We can therefore probably conclude that only a small proportion of the drop-outs arose as a result of the membership restructuring underway. More fundamental issues were driving members to drop-out of BRAC's programme.

As can be seen from the above, the reasons for drop-out are complex and in the words of Mustafa (1996) "appears to be multidimensional". Indeed, the unifying theme of the studies on the subject is that the reasons for drop-out are complex. Sixteen reasons for drop-out were catalogued by Hassan and Shahid (1995). Of these four related to social pressure (peer pressure over loan repayments, family disapproval/problems etc.), four to resource constraints (inability to finance weekly loan repayments, group fund not refunded, savings not available for withdrawal in emergency etc.), and four to the organisation (BRAC) itself (unpaid loan instalments resulting in the expulsion of the client, low interest on savings, member unable to count and sign her name and cancellation of membership while away). The remaining four were migration, death, joining another NGO and no access (as hoped) to Vulnerable Group Development cards.

Mustafa et al. (1996) noted in particular causes related to lack of easy access to savings, the excessive emphasis on credit discipline, the frequent policy changes and conflict among Village Organisation members. ASA's (1996) study noted "negligence of the staff/lack of staff quality and efficiency" which was identified in 56 (27.72%) of cases, low loan ceiling and "absence of multiple credit" identified in 151 (74.75%) of cases, and an additional 47 (23.27%) "members withdrew their membership as they disliked the savings rules".

Khan and Chowdhury (1995) also present an interesting table on "Reasons frequently cited for dropout and expulsion by gender" which shows a very high proportion of voluntary drop-outs being driven by the inflexibility of BRAC's system - in particular its savings facilities.

	% of dropped out members mentioned		
Reasons for voluntary dropout	Male	Female	Total
Group fund is not refunded	63.2	70.4	68.0
Savings not withdrawable in emergency	55.3	59.2	57.3
Other NGOs provide better facilities	36.8	52.7	49.8
Family Problem	11.8	45.0	29.3
Failure to repay loan	33.6	38.5	36.6
Reasons for expulsion			
Failure to repay loan	44.8	56.1	59.6
Irregular attendance in meeting	17.2	41.5	27.3

These high levels of drop-out prompt Hulme and Mosley (1997) to conclude, "Given the scale of "dropping out" (15 per cent per annum for the Grameen Bank, which is 300,000 members a year; 10-15 per cent per annum for BRAC, or 181,700 members, in 1992 and 1993) there may well have been significant under reporting of credit-induced crisis in most studies of finance for the poor". But although this may well be important for a minority, examination of the studies reveals a common dominant theme among the three quarters of drop-outs who leave voluntarily: dissatisfaction with the financial services being offered, and a belief that other NGOs offer better facilities (including crucially, how the organisation's staff behave with their clients). The majority of voluntary drop-outs are leaving their MicroFinance providers as a result of dissatisfaction with the services and products being offered.

One of the key determinants of drop-outs, often lost in the category "failure to repay loan" by these studies, is the insistence by field staff that clients take loans[1]. Irrespective of what official Head Office policy says, there is a clear understanding among most field staff that they should push out loans - often with little care for whether the clients need or can use them. In the words of one BRAC Zone Manager, "If we do not disburse loans how can we cover costs ?" (personal field notes, 1996). Similarly, PromPT's (1996) study of the perceptions of Grameen, BRAC, Proshika, ASA and other MFIs' borrowers, (using participatory rural appraisal and focus group discussions), found that many borrowers felt pressurised or sweet-talked into taking loans. Matin (1998) also notes, "MFI lending technology is insensitive to variations in household conditions. Most MFIs put all households on a treadmill of continuously increasing loan size and insist on a fixed repayment schedule.".

Additional evidence for this can be easily seen in the percentage of clients with outstanding loans at any one time. BURO, Tangail offers credit on an entirely voluntary basis, as and when the client wants it, and (subject to graduated ceilings) however much the client wants. As a result, at any one time only about half of BURO, Tangail's clients have a loan outstanding - although most do choose to take a loan at one stage or other (Wright, 1997 and Wright, forthcoming). By contrast, at any one time, almost all Grameen Bank, BRAC and ASA clients have loans outstanding. In the extreme case, ASA's loan policy dictates when the clients must take a loan and how big the loan must be with absolutely no reference to the <u>need</u> of the client for credit at that time. This policy has lead to a remarkable ability of ASA clients to manage their way round the system by on-lending, reciprocal agreements and cumbersome storage arrangements (Rutherford, 1995a). But clearly, managing one's

[1] Although there are suggestions that these practices may now be declining.

way around an inflexible, credit-happy system is not ideal, and so clients will begin to look at the services offered by other MicroFinance Institutions (MFIs).

BURO, Tangail - An Overview

As Of December 31, 1998

Organisation: BURO, Tangail has been operating since 1989, and is dedicated to the economic development of the poor, primarily in Tangail district, with the Mission Statement: **"To establish an independent, sustainable organisation dedicated to providing effective flexible and responsive financial services to promote self-reliance among the rural poor in Bangladesh."**

Through years of careful operations research, BURO, Tangail has developed and implemented a programme which emphasises the importance of savings as well a credit, and has become one of the more innovative and influential NGOs operating in Bangladesh.

Savings and Credit Activities: BURO, Tangail encourages potential clients drawn from the poorer “target” section of the community to form groups, encourages them to save, and provides credit to capitalise their income generation activities. By charging rates of interest designed to cover implementation costs and contribute to the capitalisation of the organisation, BURO, Tangail has developed a cost-effective and sustainable savings and credit system that by 2001 will provide financial services to around 100,000 members in a geographically compact area.

Members' Participation: The BURO, Tangail system encourages the members to participate in the planning, implementation and monitoring of the financial services and village development activities provided by the organisation, through participatory workshops, PRA and the Customers' Consultative Groups.

Scope of Operations: BURO, Tangail provides flexible financial services to 1,362 villages in Tangail district through 41 branches, which are managed from a head office located in Tangail town. There are a total of 448 staff who undergo regular classroom and on-the-job training.

Savings: In the year to December 31, 1997, net savings, including members’ emergency funds increased by 105% to US$ 797,858, and the weekly savings rate in mature branches continued to rise, and was significantly above (usually more than double, often triple) the projected/budgeted rate of US$ 0.125. In the year to December 31, 1998, net savings including members’ emergency funds increased by 14% to US$863,915. The declining rate in the rise in net savings arose from the lifting of the requirement to hold 15% of loans taken in savings account and the members’ need to withdraw savings to meet emergencies in the wake of the disastrous 1998 floods.

Loans: As of December 31, 1998 US$ 12,242,543 in loans had been disbursed, and US$ 8,106,841 had been recovered. The loan recovery rate further improved over previous years to 98.08% loanees with up-to-date repayment records (with only 1.03% of loans with repayment instalments more than 26 weeks overdue).

Capital Funds: As of December 31, 1998, donors had contributed US$ 2,210,180 (59%) of the total capital funds, and the 71,479 members had matched this with US$ 647,508 (17%) from branch profits and US$ 863,915 (24%) in their savings and emergency fund accounts.

Profitability and Cost Analysis: In 1998, BURO, Tangail made a profit of US$ 376,219 (excluding grants of US$ 272,680 (reflecting the high rate of expansion at present) and the cost of donated capital (imputed at 10%): US$ 193,377), and this brought the organisation’s retained earnings to US$ 647,508. Total expenditure for 1998 was 12.7% of the loans disbursed.

For details of this financial data, see “BURO, Tangail At A Glance 1993-98”

<u>BURO, Tangail</u>
Operations Research: Philosophy and Methods

BURO, Tangail is unique in Bangladesh since (unlike the other better known NGOs) it has always offered its members access to all of their hard-earned savings. BURO, Tangail is committed to further enhance and improve the flexibility and responsiveness of its savings and credit facilities to meet the needs of its members.

BURO, Tangail has developed a programme of operations research to improve the flexibility of the financial services offered by the organisation, and to ensure that these are responsive to the members' needs. The operations research agenda is guided by:

i) the results of the organisation's attempts to improve the members' participation in its organisational and financial services development, including the Customers' Consultative Groups, PRA-based monitoring and evaluation techniques, and workshops with members and staff - i.e. client-based, or demand-driven, market research;
ii) the reviews of external consultants; and
iii) examination of successful products offered by other informal and semi-formal financial services providers.

Detailed design, costing and pricing of new products is undertaken by the Finance Director and his staff in collaboration with the Programme Implementation staff prior to the start of pilot testing. Pilot testing of new financial service products is conducted in well-established branches close to the head office in order to facilitate effective training, intervention and monitoring. Staff from these branches are trained in the new products and the accounting systems necessary to track them, and the pilot testing begins.

Senior staff from the Programme Implementation and Finance sections of head office then make regular visits to review the progress of pilot testing in the field. They examine staff, implementation, accounting and organisational issues and make any necessary recommendations on product design. The Customers' Consultative Groups are designed to allow clients to provide feedback on product design. Once the pilot has been running for a while, staff in the pilot Branches work with senior staff from the Finance section to examine profitability and liquidity issues, and to revisit the costing analysis and thus pricing of the product.

This process is further strengthened by an operations research review team of MicroFinance experts (researchers, practitioners and accountants) drawn from outside BURO, Tangail, which conducts periodic reviews of the progress of the operations research programme, implementation issues, and clients' perceptions of the financial service products being offered, as well as ideas and options for further research.

Once pilot testing is completed (the period required to complete pilot testing of different products has varied with the complexity of the product, the success of the pilot test, the need for revisions to the design and pricing of the product etc.), successful financial service products are extended out to other branches as quickly as possible, in a phased approach.

BURO, Tangail
Operations Research Programme

Until 1996, BURO, Tangail offered limited deposit (maximum Taka 50 per week) and limited withdrawals savings products (under which clients could only access their savings if they did not have a loan outstanding). The organisation also offered a traditional Grameen Bank-inspired loan programme, offering loans repayable in non-negotiable 50 weekly instalments. As part of its commitment to innovation and to offering the best possible services to its clients, BURO, Tangail is now developing and implementing new financial service products. New components of the programme proposed for testing and implementation include:

Savings Facilities

1. **Open Savings Deposits -** offering unlimited savings deposit opportunities (now introduced in all 40 branches).
2. **Open Savings Withdrawals System -** allowing open access to members' savings subject to maintaining 15% of the value of any loan outstanding (now introduced in all 40 branches).
3. **Total Open Savings Withdrawals System** - allowing open access to members' savings irrespective of whether they have a loan outstanding or not (currently being pilot tested in 1 branch).
4. **Fixed Term Deposit Scheme -** offering higher rates of interest for longer term (2, 5 and 10 years) contractual savings agreements (currently being pilot tested in 2 branches).

Credit Facilities

1. **Supplementary Loan System -** offering additional loans to maintain members' working capital (currently being pilot tested in 1 branch).
2. **Simple Prepayment Facilities -** allowing prepayment of loans when members have excess liquidity (now introduced in all 40 branches).
3. **Line of Credit System -** offering an overdraft facility (thus overcoming the problems of rigid repayment schedules that are so unresponsive to many members' business cycles) (currently being pilot tested in 2 branches).
4. **Business Loans** - larger loans of Tk. 20,000 - 75,000 for the more successful entrepreneurs among BURO, Tangail's members (currently being pilot tested in 3 branches).
5. **Leasing Loans -** larger loans of Tk. 20,000 - 75,000 to finance the acquisition of fixed assets (currently being pilot tested in 3 branches).
6. **Flexible Loan Repayment System -** offering longer repayment terms for repayment of the business and leasing loans and to assist poorer members repay their normal "general" loans (currently being pilot tested in 2 branches).
7. **Short-term Providential "Hand" Loans -** offering 3 month loans for emergency needs (currently being pilot tested in 2 branches).

BURO, Tangail believes in the open exchange of information to further the development process. It seeks to disseminate the results and findings of the programme and operations research to other NGOs (through the Credit Development Forum an umbrella organisation of over 300 savings and credit NGOs in Bangladesh), and to donors and other interested parties (through the BURO, Tangail donor support group and CGAP) and regular publication of annual reports and working papers.

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It seems clear from the above that clients are "shopping around", "switching bank accounts", in search of flexible, quality financial services. In the words of Khan and Chowdhury (1995), "Other NGOs (Grameen Bank, ASA, Proshika, etc.) working side by side with BRAC in the same areas provided extra facilities to VO members. These included: less deductions from loan, higher loan ceiling, low interest rate, quick disbursement, etc. The study revealed that a good proportion of dropouts had enrolled themselves with other NGOs for better terms and opportunities." The MFI that wants to reduce its level of debilitating drop-out should carefully examine the services and products it is offering its clients and seek to improve them on an on-going basis.

Clients "shopping around" for the best services (or at least ones that meet their needs) has also lead to prevalent "multiple membership" of the same clients with different MFIs. In the Districts such as Manikganj and Tangail where many MFIs and NGOs are operating, villagers may be members of several organisations. Indeed, some estimates suggest that 40-50% of people in these Districts have multiple membership, and certainly PromPT's (1996) study found it a common phenomenon. Many MFIs and NGOs have reacted negatively to clients taking services from several organisations by trying to prohibit multiple membership. The reasons for this vary, it depends on who you talk to. The common official explanation is the fear that clients will take several loans from various organisations, use one loan to pay off another loan, and "over-stretch" their ability to repay. The less common, unofficial explanation is the MFIs' desire to maintain a monopoly over providing financial services to their clients, and a fear of competition.

But this all requires careful thought. In affluent societies, and indeed among the richer classes in Bangladesh, having several accounts is common (meeting a variety of savings and credit needs - current and fixed deposit accounts, housing or building society accounts, shares, hire-purchase accounts for appliances, a mortgage, credit cards and so on). This occurs because these different accounts or financial services meet different needs, and there are only limited additional costs associated with having multiple accounts and membership with these financial service organisations.

For the rural (and indeed urban) poor multiple membership has high cost. Multiple membership necessitates complying with multiple sets of rules and sitting in multiple (usually) weekly meetings, taking precious time away from pressing household and income-generation activities. In addition, many of the MFIs have membership and loan application fees. In short, multiple membership is not something to be entered into lightly - it costs time and money. Few clients will voluntarily take out multiple membership unless they are not getting all the services they need from a single organisation. In the same way that much drop-out is indicative of dissatisfaction with the financial services being offered, multiple membership also suggests that the client is looking for more, or that some MFIs/NGOs are offering services not available in others and vice versa. For example, several of its clients only save with BURO, Tangail which offers open-access facilities, while taking their loans from another MFI (say ASA or Grameen Bank) which offer credit at a lower interest rate (Abdullah et al., 1995). One of the most common complaints about the services on offer from MFIs is that the loan ceilings are too low for many members' businesses (Abdullah et al., 1995; Todd, 1996; PromPT, 1996; ASA, 1997). So these potentially good and lucrative clients are compelled to take out multiple membership in order to access two or more loans to make up the amount they feel they need. They then not only have to handle two (or more) sets of rules and meetings, but also the varying loan disbursement schedules. Once again clients find themselves forced to manage their way round inflexible systems.

Of course, in some individual cases the MFI managers are right to worry about "over-stretching" of clients' ability to repay, and over-ambitious clients. Indeed Matin (1998) found many households deeply in debt to local money-lenders (another form of multiple participation in credit markets) in order to maintain their weekly repayments to MFIs through the lean season and other periods of stress and cash shortage. Matin (1998) notes, "Some degree of cross financing is inevitable because of seasonal fluctuations in income and when coping with shocks (Wiig, 1997). But it can have a deleterious effect in the long run if households continuously manage loan repayment without having the ability to repay." Those interested in promoting open-access savings facilities would note that such facilities would provide a much better, cost-effective method for households to meet these short-falls and maintain the weekly repayment discipline.

However, there is an additional problem posed by offering client-determined loans. One of the most effective mechanisms used by MFIs to screen credit-worthiness is to insist that clients build up a credit history, becoming eligible for larger loans only when they have paid off smaller ones - it would probably be unwise to change this. Nonetheless it is clear that excessively inflexible systems may well be forcing clients into multiple membership. This presents a tremendous opportunity for MFIs committed to a more flexible, quality financial services approach.

On the credit side, if MFIs were able to better identify clients' needs, and those clients who could manage and effectively use larger loans, they could attract and retain those valuable clients, while also better supporting their businesses. Similarly, if MFIs were able to better understand and respond to clients' needs for savings products, they could attract more capital to fund the larger loans. When an MFI offers a <u>package</u> of quality financial services that respond to <u>all</u> the needs of its clients, they are much less likely to take out multiple membership, and more likely to be willing to pay a premium for the convenience of having all their needs met by one institution, in one meeting. It is this comparative advantage of BURO, Tangail's client-responsive system that allows the organisation to charge an interest rate on loans that is effectively almost double that of Grameen Bank or ASA - and still attract clients. Indeed BURO, Tangail experienced a drop-out rate of only 3% in 1997 - the majority of these drop-outs are likely to have been driven by migration (particularly as younger women members get married and move to their new husbands' villages).

Graduates

One of the reasons that is notable by its almost complete absence from these listings of grounds for drop-out is "graduation". A few years ago, there was a belief that credit programmes would give such a boost to the income of "beneficiaries" that they would "graduate from poverty". The dynamics of poverty dictate that the route out of poverty is neither linear nor absolute (Wright, forthcoming).

There were two schools of thought on "graduation". One held that after a limited number of benign (subsidised) loan cycles, the beneficiaries' businesses would no longer need credit. In retrospect, this was supreme naiveté, for there is scarcely a business in the world that does not use overdraft facilities to manage its way through the cyclical nature of the supply of its inputs and demand for its products or services. And vast international financial markets have developed round the need of businesses for capital for expansion. The other school, more plausibly, believed that poor clients could "graduate" with enough wealth and self-confidence to become the clients of formal sector banks. Indeed there are many MicroFinance programmes throughout the world seeking to establish Self Help Groups, Credit Unions or Village Banks and link them to formal sector financial service institutions. This is a more viable and desirable option for those NGOs (for example foreign ones) or Government projects/agencies not intending to stay and establish a permanent banking institution.

But (as we saw in "Drop-outs" above) for those NGOs seeking to establish permanent MFIs, these richer, more self-confident, potential "graduates" are the most valuable clients. For it is these clients that will often take the larger loans to expand or maintain the working capital their business or to finance asset acquisition. It is these larger loans on which the MFI will make the higher profit since the cost of administering the loan is almost exactly the same irrespective of its size. Indeed these longer-term, richer, more self-confident clients should be the better credit risks - although this is subject to debate (as we shall see in "Defaulters" below). And crucially, it is these clients taking larger loans that allow the MFI to finance the provision of smaller loans to poorer clients. The last thing that an MFI with its sights set on financial sustainability wants to see is these precious larger clients "graduating". Instead, MFIs should seek to retain them as clients by seeking to meet their needs through a range of client-responsive financial services.

Some express concerns that not "graduating" clients might lead to "mission drift" away from serving the poorer members of the community, and point to evidence that the larger MFIs in Bangladesh are experiencing this. Detailed analysis of this "mission drift" (see for example Matin (1998a)) shows that it arises not from the better off clients not leaving the MFIs' programmes, but from MFIs seeking sustainability going after it more aggressively and recruiting/inducting better off clients. Ironically, <u>not</u> graduating (or driving out) clients who have become "better off" gives the MFI an opportunity to "cross-subsidise" financial services to other less well off clients who they might not be able to serve on a sustainable basis.

Defaulters

"Peer pressure and peer support", "group guarantee", "joint liability", or "social collateral" are viewed as one of the cornerstones of "solidarity group" credit programmes. It is this part of the Grameen Bank system that has been most discussed and replicated as the basis for MicroCredit programmes all over the world. In some respects, the "success of group guarantee" is seen as "the magic of Grameen". But there are increasing numbers of commentators and practitioners who have come to the conclusion that while "group guarantee" may be important and work for the first few loan cycles, thereafter, it weakens and becomes largely irrelevant (Yaqub, 1995; Sharif, 1997). Other factors have been identified as critical, and amongst these, the continuing access to repeat loans (which is of course, implicit in the group guarantee system) is probably the most important (Berenbach and Guzman, 1994; Rhyne and Otero, 1994).

<u>"What Is Behind GB's Success ?</u>

1. *Close Relationship*
The close relationship that is developed between the bank and the borrower, and among the borrowers themselves, is a very important factor in the success of GB.
2. *Peer Pressure and Peer Support*
Formation of small five-member groups of the members' own choosing and federating the groups into centres, helps create the right kind of peer pressure at the time when a member tries wilfully to violate GB rules, and peer support at times when a member falls into any difficulty in pursuing his economic pursuit."

(Professor Md. Yunus, in Gibbons, 1992).

If peer support is likely to work anywhere, surely it must be in the mature (ten plus years old) Grameen groups in Tangail. But there Todd's (1996) work showed that, "Members *did* help one another out with repayment, since default of one member threatened the new loans of the other members in her group and the good name of the whole center. But this help had distinct limits. More general help for members in trouble was rare. … In these villages, the groups and centers pulled together in unity when their access to loans was a stake. Otherwise more primordial loyalties and support networks of family*, gusti,* and even *dol* usually took precedence."

Even if peer support only works in order to ensure continuing access to loans, could it be that peer pressure and the group guarantee principle, is more effective? Are the group members ensuring that defaulters pay? Jain (1996) notes that in the case of Grameen Bank, the group guarantee principle was the subject of much training and discussion, but that members who fell behind on repayments were usually visited in their households on an *individual basis* by the Bank staff.

Matin's (1997) work in old Grameen *kendras* (established in 1980) in Madhurpur found, "In all the centres in these four villages the repayment rate has fallen drastically and the numbers of inactive borrowers have risen. ... Many of the borrowers who have overdue loans have stopped repaying altogether, some are repaying part of their dues as and when convenient, and a few remain good payers. Those who still remain good repayers are getting new loans. Staff pressure and concomitant peer pressure is almost non-existent. The whole system is now operating on the basis of individual liability. ... Thus the only way in which joint liability works is via the staff pressure induced peer pressure which is directed at the centre to solve "*kisti* problem". This works as long as the "*kisti* problem" is manageable, that is when there are a few with "*kisti* problem", and when the "*kisti*" is small. But this is not sustainable. ... A point could be reached where eliminating the "problem borrowers" which is often to "clean" the centre becomes difficult as a borrower's overdue amount far exceeds her Group Fund contributions. As numbers of on-time repayers decrease, an "unzipping" effect is likely. This would render staff pressure induced peer pressure increasingly ineffective."

The "unzipping" effect[2] Matin refers to is when the entire group, and indeed often the entire *kendra*, burdened by excessive or multiple default, sees no further hope for continuing loans and elects to default *en masse,* thus causing the group or *kendra* (and the group guarantee that held it together) to "unzip". It is this risk that drives MFI field workers to continue to give loans to the good payers in the longer established groups or *kendras* - after all they have developed a long credit history - and thus to negate the group guarantee principle. And it is for this reason that, despite all the rhetoric, the effectiveness of the group guarantee principle is limited to the first few loan cycles.

In addition, from Matin's work, we can see that not only must staff induce "peer pressure", but also that "group guarantee" has a declining influence over time. Furthermore, the study also demonstrates that the "Group Fund" is playing a significant and important role as a "loan guarantee fund", and indeed, some commentators have suggested that it is better, honestly, labelled as such (Wright et al., 1997).

Yaqub's (1995) work on BRAC found other, related, problems with the group guarantee system. The longer members had been with BRAC and the bigger their loans, the less likely they were to accept the group guarantee principle. Yaqub attributes this to the fact that "GBF " (Group Based Finance) "relies ... substantially on the borrowers' lack of alternative sources of credit and social powerlessness." Yaqub goes on to conclude that clients involved in MicroFinance programmes gain experience, self-confidence, (and in some cases, like BRAC, education), and increased income and wealth too. These attributes enable clients to seek and find better alternatives and to absorb whatever sanctions are threatened by the MFI (or fellow group members) in the attempts to recover the loan. And so the group guarantee principle, which depends on the financial and social weakness of those involved, is compromised by the very positive outcomes that access to financial services and the

[2] A term first coined by Rutherford during 1992

MFIs' services promote.

There is one other area in which the "joint liability" may be stressed to breaking-point, and this too may offer explanations why "group solidarity" and "peer support" instead of increasing over time, appear to decrease. The problem is different loan sizes. As groups mature, in those MFIs that do not force their clients all to take larger and larger loans, different members take differing amounts of credit. In extreme cases, some members of a guarantee group may be taking loans ten or more times larger than those of their fellow group members. The members with smaller (or in some cases, no) loans must then assume joint liability for much larger loans than they are ever likely to take - and may be unwilling to do so. It is likely that their desire for continuing access to credit facilities will mean that they will assume joint liability in theory, but that they will feel little obligation to "group guarantee" in practice. Hence Jain and Matin's observation that with more mature groups, the joint is transmuted into individual liability - a reality recognised and acted upon by the Grameen field staff.

Rogaly (1996) also notes that, "Peer group monitoring has not proved necessary to other institutions seeking to do away with physical collateral. Chaves and Gonzalez-Vega (1996) document the use of character references and locally recruited lending agents by government-sponsored banks in Indonesia. The degree to which Grameen Bank employees themselves implement peer-group monitoring has recently been questioned, with the suggestion that the key to its high repayment rates are the weekly public meetings (at which attendance is compulsory) to collect loan instalments and savings deposits. These induce a culture of discipline, routinised payments, and institutional accountability (Jain, 1996)."

Once again, there is a consistent theme running through these apparently diverse studies. In common with the work of Todd (1996), Matin (1997) and Yaqub (1995) stress the importance to clients of continuing access to loans, while Jain (1996) puts emphasis on the disciplined weekly repayments as well as the transparent accountability of Grameen's staff as providers of financial services. It is not unreasonable to suggest therefore, that the more clients value and appreciate the financial services being offered to them, the more they will do to protect and sustain their access to those services, and therefore the less likely they are to default. And the better the quality of those financial services (both credit and savings facilities, and the manner in which they are delivered), the more the clients will value them.

It may be for this reason that BURO, Tangail, which has introduced innovations that are popular with its clients and more flexible financial services than the hundreds of other MFIs operating in Tangail - including Grameen, BRAC, ASA, Proshika and SSS (Rutherford and Hossain, 1997) - has a remarkably low default rate. As of December 31, 1997, only 1.05% of loans had repayment instalments more than 26 weeks overdue - of which many date back to the old BURO days. BURO, Tangail's clients appreciate the organisation's flexible financial services (and in particular its unique savings facilities and entirely optional loans), and therefore protect their access to these by repaying the loans they take on time.

The Excluded

The rhetoric surrounding MicroFinance remains extraordinary, and almost shameless. For years (and indeed, in many cases, still now) programmes blithely asserted that they were serving "the poorest of the poor". Part of this is because of the efforts to promote MicroFinance as a "cure all". But any MicroFinance Institution seriously claiming it reaches the "poorest of the poor" is either not monitoring its clientele properly, or simply being economical with the truth ... unless that is, the institution is offering revolutionary quality financial services that attract the poorest and destitute. Certainly none of the larger MFIs operating in Bangladesh are serving the poorest of the poor through their mainstream credit and savings activities.

> " … Habibah's criteria for the selection of new members explicitly excluded the poorest women in the village. "They should not be landed, but they should have some land - some house land and some vegetable land. They should not be extremely poor. Most important, they should be hard working, not just the wife, but also the husband. They should be experienced in goats and poultry and grow some vegetables."
>
> Conversations with the Branch staff put them closer to Habibah's definition of the rules. One told me: "We look for people who have some *profession*. They must have a source of business, like trading, or tailoring or cows. Landless, yes; but not *hopeless*."" (Todd, 1996).

In the words of Hashemi (1997) "It seems that Grameen Bank and similar credit programs have failed to target this group [the hard core poor] effectively, resulting in most of them remaining outside the micro-credit net. For the most part these people are so destitute that they consider themselves not credit-worthy. They do not feel that they have enough resources to generate incomes to pay back loans. They therefore "self-select" themselves out of credit program membership."

There is a large-scale debate underway as to <u>why</u> MFIs are failing to attract the poorest. It is a debate that is particularly important in the context of the on-going efforts to achieve institutional sustainability, for many are concerned that the donors emphasis of financial self-sufficiency may be prompting the MFIs to go up market to serve richer clients more likely to take larger loans. In the words of Hulme and Mosley (1997), "Worryingly, both BRAC-RDP and Grameen Bank recently appear to be moving away from working with significant proportions of the hard core poor and focusing their activities on the middle income and upper poor, rather than the most desperate." Both BRAC and Grameen have recognised this as an important issue and have developed special programmes in an attempt to address the problem.

In addition, most of the larger MFIs are studying this problem to examine the causes of the exclusion of the poor. "An exercise was conducted in four villages were Grameen and BRAC were active to determine the reasons for target group households not joining credit programs. It was found that out of 498 target group households only 284 (57%) joined Grameen and BRAC as members. The major reason for not joining (49%) was because people felt they would be unable to pay back the loan money and would therefore be stuck with debt for which they would eventually be forced to sell off what little possessions they still had. They refused to be burdened with still another debt. A quarter of the women did not join because of social and religious sanctions that dictated that joining credit programs would be a violation of social norms. Only 13% of the women said that they had actually wanted to join but were not accepted because other program members felt that they were high risks (their husbands were gamblers and would waste the money; they would migrate out of the village; they were not good money managers; they did not get along with others)." (Hashemi, 1997)

In view of the accusations that MFIs are increasingly forsaking the poor for the better off as the drive for sustainability gathers momentum, the studies conducted tend to try to differentiate between "self" and "programme" exclusion. In fact, as we shall see, the difference is limited: not only do programmes exclude clients, potential clients also "self exclude" on the basis of programme design.

BRAC asserts that "Programme-driven exclusion is of three types. First, it may be a response by other new members at the time of group formation to perceived risk of default which, if it occurs, may affect their own access to credit under joint-liability provisions. Second, it may result from programme staff who perceive that their targets and performance indicators will be more easily attained by focusing on "good" credit risks; they may also find it easier to start operations by utilizing the services of village leaders and this may result in effective exclusion for some because of local social and political factionalism. Thirdly, it may result from the limited size of the programme; too many people interested and not enough places available (Chowdhury and Alam, 1997)." But in the same article, the authors note that colleagues (Evans et al. 1995) found no evidence to support these interesting propositions. They concluded (perhaps somewhat wearily), "Despite this, one frequently hears the view that, with the renewed emphasis on accountability as programmes scale up and donors have more at stake, some form of programme-driven exclusion does occur" (Chowdhury and Alam, 1997).

Grameen Trust's research reaches broadly the same conclusion, "Only a few of the women said they actually wanted to join but were not accepted because other program members felt they were high risks" (Hashemi, 1997a). But another, related, paper goes on to make the not unreasonable observation that, "Actually what this is indicative of is not so much that Grameen is unable to bring all poor women into their fold but that micro credit may not necessarily be the way out for all the poor. Successful micro credit operation is strongly dependent on strict screening to ensure that money that is borrowed can be repaid. .... Thus, in order to ensure increasing disbursements and high repayments (the targets that are set up by programs) NGO field staff and group leaders may therefore end up screening the destitute out" (Hashemi, 1997b).

Greeley (1997) notes "Some ... anecdotal field evidence (Montgomery, 1996) does suggest that both staff and other members do seek to enforce exclusion for members who are in arrears and that these are the poorer members." One can scarcely be surprised that staff, who are evaluated on the basis of (*inter alia*) loan portfolio performance, and must take the time to follow-up defaulters, choose to exclude those they view as unlikely to be able to repay. And it would certainly be unreasonable to blame clients for choosing to exclude those who are seen as being unable to repay loans, but for whom they must assume joint liability. Would you formally guarantee a loan for someone who you viewed as a credit-risk ?

Alamghir, (1997) also reviewed this issue from the potential clients' perspective. He estimated that there were 1,553 members poorer than the members who had already joined the groups in the command areas of his 296 study *samities*. He then investigated why these poorer families did not join the groups, finding that of these 391 persons (25.17%) did not join because they would not be able to pay regular weekly savings, 228 (14.68%) did not join because they would not be able to pay regular loan instalments, 114 (7.3%) did not have any interest in receiving loan, and 108 (6.9%) did not like to attend weekly meetings. It is interesting to note that none of the explanations for not joining documented by Alamghir involved MFI's staff screening out the poorer families.

Thus while credit-oriented MFIs' staff may be screening out some of the poorest (for entirely pragmatic and legitimate reasons), it is the MFIs' policies that seem to play a particularly important role in the exclusion of the poorest. Not only are they unable to attend weekly meetings, and fear for their ability to make the weekly repayments, but also they even cite the weekly savings requirement as a mechanism that excludes them from risking taking membership in MFIs. Once again, there seems to be an opportunity to examine still more flexible financial services (for example entirely voluntary, open access savings accounts, without the weekly deposit requirements) to attract the poorest. This is an area worthy of operations research by the MFIs committed to quality financial services. But such a service would be expensive to implement, and whether it would be a cost-effective strategy for an MFI with its sights firmly set on financial sustainability is open to question.

Perhaps cross-subsidies are the answer. As the MFIs' clients become more experienced and take larger loans, and as the MFIs reach out to serve the not-so-poor, they may be able to use the profits made through this business to finance services for the poorest. Indeed, it might be argued that such a strategy might be an effective "loss-leader" to cultivate potential clients for the future in exactly the same way that the formal sector banks accept relatively small deposits from clients with potential in the future (for example students). Christen et al. (1996) certainly believe in this approach, "Some observers have argued for an exclusive focus on the poorest clients, with the objective of poverty alleviation. The data assembled here and arguments for financial leverage suggest that mixed programs serving a range of clients can also be highly effective in reaching the poorest. It is scale, not exclusive focus, that determines whether significant outreach to the poor is achieved."

Conclusions

There is compelling evidence to support the contention that a significant majority of "drop-outs" occurs because MFIs' financial services are inadequate or inappropriate to meet the needs of the very clients they are trying to serve. Drop-outs are expensive for MFIs, both in terms of money already invested that is lost as the member leaves, and in terms of lost potential future business from the member. MFIs seeking to develop permanent sustainable organisations should seek to improve the financial services they are offering in order to reduce client dissatisfaction and thus drop-out. Such a strategy is likely to prove cost-effective.

For those MFIs committed to creating permanent financial service institutions, "graduating" the more experienced and affluent clients into formal sector banking system is not a desirable strategy as it implies the loss of the most valuable and cost effective clients. Indeed, MFIs should be looking to tailor their services to ensure that they retain these high value clients.

It is also clear that distinctions between "self-" and "organisation-driven" exclusion of the very poor are largely arbitrary, for it is the <u>nature</u> of the financial services and the programme rules that accompany them that exclude the poorest from joining. In preference to "targeting the poorest" and trying to persuade them to join organisations offering inappropriate financial services, it is the services themselves that require revision and tailoring to meet the needs of the poorest, and thus to attract them into MicroFinance programmes.

There is also increasing evidence that the "group guarantee" system, while probably useful in the initial loan cycles, has a declining ability to secure repayment of loans. Continued access to follow-on loans has long been viewed as one of the most important incentives for clients to repay. Given the value that the poor place on having access to financial services (<u>both</u> credit and savings facilities), it is likely that the better the quality of these financial services, the more the poor will value access to them, and thus the more likely they are to continue to meet their obligations (including repayment of loans) to the MFIs that provide them.

For all these reasons, MFIs should pay (and indeed are paying) increasingly close attention to the nature and quality of financial services they offer. The trade-off between the quality of the services and cost of providing the services is a clear one, but getting the balance right is difficult. There is evidence that, to date, MFIs in Bangladesh have put too much emphasis on trying to implement standardised, inflexible low-cost, credit-driven systems when their clients are asking (and willing to pay) for a better quality and broader range of financial services.

Different Clients Differing Needs

On the basis of his work in Madhurpur, Matin (1998) counsels, "For instance, MFIs should consider individual liability lending to long time borrowers with good repayment record[s] and who now borrow large sums. Many of them are likely to have a large credit needs, greater risk-bearing capacity, an ability to provide collateral, and the necessary entrepreneurial skills to invest in productive enterprises. For them i) the group contract and the jointly liability system can be dispensed with, ii) different repayment schedules devised, and iii) loan applications screened after detailed project appraisals. While these measures are likely to reduce the overhead costs of lending more importantly, they would create right incentives for larger and regular borrowers to maintain high repayment rates. On the other hand, MFIs should mimic the informal sector when lending to poorer target group households by accounting for seasonality and providing i) repayment flexibility, ii) a ceiling on loan sizes, and iii) in kind loans."

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