Annual

Bank

Conference on

Development

Economics

Amsterdam, The Netherlands
May 23-24, 2005

Banking the Poor: The Pivotal Role of Financial Sector Development in Reaching the Millennium Development Goals

Jacco Knotnerus
Netherlands Financial Sector Development Exchange (NFX)

The World Bank

Buitenlandse Zaken
Ontwikkelings
samenwerking

ministerie van Financiën

Position paper

Banking the Poor: the Pivotal Role of Financial Sector Development in Reaching the Millennium Development Goals

World Bank Annual Bank Conference on Development Economics (ABCDE)
Date: May 23rd and 24th, 2005
NFX parallel session: Monday May 23rd, 17.15 – 18.30
Location: Royal Tropical Institute, Amsterdam, the Netherlands

Netherlands Financial Sector Development Exchange (NFX) is a public-private partnership that combines the financial expertise of several Dutch commercial and development banks with the know-how of three Dutch Ministries. This partnership aims to make this expertise available to counterparts in Africa, Asia, Latin America and Eastern Europe. NFX' focus is on building local capacity through technical assistance, training and dissemination of best practice. The overall goal is to create more inclusive and diverse local financial markets.

The members of NFX are Rabobank, ING, ABN Amro, Fortis, Triodos Bank, Netherlands Development Finance Company (FMO) and the Dutch Ministries of Finance, Economic Affairs and Foreign Affairs (Development Cooperation).

Contents:

Foreword

At NFX we believe that the financial sector is the backbone of economic development. Without a well-functioning financial system, neither aid nor local entrepreneurship can create the right conditions for long-term economic growth. Besides, local sources of finance and investment are more stable than external sources and leave countries less vulnerable to major swings in international capital flows and donor sentiment.

The UN framework for development is the Millennium Development Goals (MDGs). These goals are a set of targets for reducing poverty, hunger, disease, illiteracy, environmental degradation and discrimination against women agreed upon by UN Members in 2000. In January 2005, the UN Millennium Project, headed by professor Jeffrey Sachs, presented a report on the results of the MDG-program up to now. It is titled *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*. However, NFX feels that this report does not sufficiently acknowledge the role of the private sector in general, and the financial sector in particular, as a driving force in the effort to reach the MDGs. The members of NFX would like to take the opportunity of the World Bank 2005 Annual Bank Conference on Development Economics to present their view on the role of the financial sector in reaching the MDGs.

The first chapter is a general critique of the Sachs report, for which the Dutch Ministry of Foreign Affairs and ABN Amro provided valuable input. The other chapters are case studies, provided by NFX members, illustrating the necessity of financial sector development. The report reflects the views of the group of NFX members on the role of financial sector development in reaching the MDGs in 2015.

On behalf of NFX members,

Jacco Knotnerus,
Director

Banks to join the 'big push'

Early 2005, the UN Millennium Project Team, under the leadership of professor Jeffrey Sachs, published a long-awaited report on the progress of the Millennium Development Goals (MDGs). In his report, titled '*Investing in Development - A Practical Plan to Achieve the Millennium Development Goals*', Sachs explores the possibilities of reaching the goals within a realistic timeframe.

The millennium goals are a set of development targets, formulated by the United Nations in the year 2000. Although a lot of headway has been made since they were first published, the circumstances of people in many countries – particularly in sub-Saharan Africa - have markedly deteriorated over the past five years.

Central to the Sachs report, is the so-called poverty trap in which many countries find themselves. Caused initially by a lack of human and natural resources, the poverty trap leads to a sluggish economy, low taxable income and little or no foreign investments. The ensuing lack of funds often triggers environmental damage, overpopulation and a brain drain to the first world. This in turn will lead to more poverty, completing a vicious circle of deficiency.

To exit this trap, professor Sachs claims a 'big push' of basic investments is needed between now and 2015. Such a push would come in seven areas: raising rural productivity; tackling the disease burden; expanding education; financing urban development; mobilizing science and technology; achieving gender equality; and attaining regional integration. Development in these areas would eventually lead to economic growth, Sachs claims.

Right conditions

All parties united in NFX (Netherlands Financial Sector Development Exchange) strongly back Sachs' call to the international community to end poverty. Failure is not an option as far as the millennium goals are concerned; the lives of a billion people around the world are at stake. NFX also supports many of Sachs' recommendations to start the 'big push' as soon as possible. It agrees that governments, both in developing and donor countries, play an important role.

Governments in developing nations have a heavy responsibility to create the right conditions for economic growth. Often, an absent or non-enforced legal and economic framework is the key reason for the lack of growth. Donor countries can provide part of the investment needed for this 'big push' of basic investments to help countries get out of the poverty trap. To this end, NFX joins Sachs' call on all donor countries to gradually increase development aid to the level of 0,7 percent of GDP by 2015.

But vis-à-vis the role of the business community, the Sachs report limits itself to the conclusion that companies, through their contributions to the economy and the labor market, are important partners in the push to reach the millennium goals. Sachs also states that public-private partnerships, philanthropy and sustainable business principles can contribute to the MDGs. In short, professor Sachs sees the business community solely as a contributor, not a driving force.

NFX disagrees. Of course, governments and NGOs play an important role in creating the right conditions and supplying funds. But NFX is convinced that the private sector can and should play more than a supporting role. Increased aid can only account for part of the big investment push needed. The existence and development of businesses are crucial when it comes to poverty reduction. Because Sachs concentrates on governments rather than companies, issues like the right of ownership, liberalizing markets and the financial sector, access to banking and insurance facilities and a constructive financial policy are not addressed in his report. However, resolving these issues within the next couple of years is essential in reaching the millennium goals.

In developing nations, the promotion of a strong financial services industry is especially critical. Having such an industry creates the right conditions for entrepreneurs. Good financial services generate local savings, which in turn lead to productive investments. Furthermore, they will channel international streams of private remittances through the formal banking sector. Local savings – as professor Sachs himself states – are the most important and most sustainable source of investments in any country, even the poorest ones. The financial sector therefore provides the rudiments for income-growth and jobs creation. This, in time, will help countries reach the millennium goals.

Numerous studies have shown a direct cause-and-effect relationship between having a fully functional financial system and economic growth, stability and poverty reduction.

Having a reliable financial system in place will also mean people in developing countries have the opportunity to save for future investments, allocate their capital and reduce financial risks. It offers them the opportunity to close an insurance contract or participate in a pension-plan. Remarkably, research demonstrates that the poorest people have most to gain from access to banking services. Smallholders are a case in point. If they have access to savings and loans facilities, they have the chance to create a financial buffer and survive a bad harvest. The same goes for small and medium sized companies. These businesses in turn will have effect on larger companies and the economy as a whole.

Potential

Financial institutions throughout the developing world often face the same problems. Frequently, financial regulations are absent or not enforced; as a result international standards are not met. Governments apply credit controls, allocate capital or fix interest rates at unrealistic levels. And in some cases local banks lack long-term vision or shun rural areas and small companies; as a rule because they fear the difficulty of entering these markets. Consequently, many people do not have access to an efficient financial services sector.

That is why NFX feels that financial institutions and their supervisory bodies in the developing world need to be strengthened. Obviously, a good legal framework needs to be in place. And bank-managers need to learn new skills, such as market segmentation and product innovation. Too often, banks in developing countries use a ‘one size fits all’ concept when it comes to their product range. They will need to develop different products for different client groups based on financial needs. The question remains: how? Here are some simple principles that need to be implemented for successful development of these difficult, often rural and underserved markets.

1. Private financial institutions need to recognize the market potential of ‘banking the unbanked’. They also need to understand the needs and characteristics of consumers and small businesses within these segments and develop products and delivery mechanisms. ‘Mobile phone banking’ is a good example of innovative products to reach unserved groups. Development of new insurance products for rural areas, including micro insurance products and weather derivatives, is also important. This will require building alliances with local stakeholders, be it small financial institutions, NGOs or others.
2. Serving the poor goes far beyond microfinance. There are many other mechanisms to deliver financial services to the underprivileged, examples of which include postal banking, cooperative banking, electronic banking, payment services and using mobile phone networks.
3. Applying proven banking concepts, such as postal banking and cooperative banking in a developing country can open up new market segments in difficult environments. Even though the character of operations and markets of international banks may sometimes appear different from those in many developing countries, NFX believes that their experiences can be significant for the developing world.
4. Development banks such as IFC and FMO can play a crucial role in enticing investments of western banks in developing countries. Development banks can provide a capital buffer and can potentially use influence to reduce regulatory risks, thereby enabling commercial banks to inject capital and much needed expertise.
5. Multilateral banks and donors should primarily be active in “difficult” markets and market segments that cannot be reached easily on a strictly commercial basis by financial institutions.

On the next pages, NFX-members explain how they have used their experience and expertise to assist banks and other financial institutions in developing nations. These cases are the best possible proof that the private sector – especially the financial sector – can be of vital importance in reaching the goals set forth by the UN.

Rural finance: Principle Bank for Development and Agricultural Credit, Egypt

On the Banks of the Nile

Rabobank is assisting in the privatization of the Principle Bank for Development and Agricultural Credit in Egypt. As the world's leading agribusiness bank, Rabobank is an ideal partner for Pbdac, which operates in rural areas.

The roots of Rabobank are firmly planted in the Dutch countryside. Originally, Rabobank was a cooperative bank for farmers, a fact that explains why sustainable development plays such an important role in the bank's philosophy. Sustainability is key for Rabobank, not just at home, but also in developing nations. That is why it started the Rabobank Development Program (RDP). RDP supports rural and cooperative banks in developing countries with capital and know-how. With the help of Rabobank, these banks enter new markets and expand their range of products. A recent project is the reorganization of the Egyptian Principle Bank for Development and Agricultural Credit in Egypt (Pbdac). Pbdac is a state bank. But the reorganization will transform it into a modern privatized retail bank and improve access to financial services in Egypt's rural areas. The focus within Rabobank's target countries is on institutions with a predominantly rural presence, long-term viability and a need for substantial development support. In this respect, Pbdac is a perfect fit. With 1600 branches and some 30,000 employees, Pbdac is Egypt's largest rural bank. It serves over 3,5 million Egyptian farmers.

Impact

The pilot stages of the project took place in Al Fayoum province in Egypt. This region was chosen because it is expected the project to have the greatest impact there. In cooperation with Rabobank, the Al Fayoum branches developed new products that were implemented at a number of local banks. Furthermore, Pbdac and Rabobank developed new procedures for credit assessment. For instance, Pbdac used fixed interest-levels for different types of loans to different target groups. Together with Rabobank, Pbdac developed new methods of risk assessment. The Netherlands embassy issued a line of credit to bring these new products to market.
Furthermore, local banking employees were trained by Rabobank in all kinds of banking skills, such as credit control, marketing and customer relations. The best employees were trained as trainers, to spread the word among colleagues in other branches. Members of senior management traveled to the Netherlands to get first hand experience how Rabobank is structured. The managers also visited a Rabobank branch-office to see how it works in the community.
Rabobank was also involved in building a new information technology system. Pbdac is in the process of migrating to a computerized administration. Rabobank's IT department assisted in selecting the right systems.
On a human level, Rabobank and Pbdac focused on the role of women within everyday banking practice. As it turns out, women are meticulous about paying back loans and could therefore constitute an ideal clientbase. However, borrowing money can be complicated for Egyptian women, for example because they do not automatically have the authority to sign for collateral. Pbdac and Rabobank developed products allowing women to overcome that obstacle.
The pilot-phase of the project was concluded successfully. The concept that was designed in Al Fayoum is now copied to branches in Gizeh and Qalubiya provinces. The next phase includes a reorganization and privatization of the whole Pbdac organization. Rabobank has expressed an

interest in taking a stake in the Pbdac once it is fully privatized, but it is still too early to make a definite decision. The main priority is to implement the reorganization as agreed.

Cooperative

Egypt is not the only country in which Rabobank helps local rural banks to develop. As a cooperative bank, Rabobank feels an obligation to assist likeminded banks outside the developed world. But the progress of cooperative banks in many developing countries and emerging markets is frustrated by political interference. In many countries cooperative banks have become parastatal organizations instead of self-governing institutions. Luckily, some improvements have been made during the last ten years. Many countries relaxed their legislation, allowing cooperative banks to operate independently.

A positive development, because cooperative and rural banks in developing countries can play a very important role in delivering financial services outside the main cities. But in order to do so, cooperative banks need to adapt effectively to market conditions and create the appropriate scale and market position. This can be accomplished by consolidating existing small retail banks and non-bank financial intermediaries, like credit cooperatives, credit unions and microcredit institutions into one large cooperative. Rabobank can assist this process.

In a network organization, banks and other financial institutions can meet the market requirements, reduce local risks, ensure effective IT development and create efficiency. Within a network structure, it is advisable to have most procedures, products and operations standardized, while at branch-level there needs to be a sufficient mandate to deal effectively with local market issues and product delivery. Such a two-tier structure will increase efficiency and allow for better risk management.

Employment

Many see cooperative banks as the ideal solution for rural areas, because they have the network for the distribution of microcredits to poor farmers and smallholders. However, Rabobank feels strongly that not every rural poor person can be turned into an entrepreneur. When 60 percent of the population is engaged in some form of agricultural production, it is impossible to reap reasonable income levels from this economic activity, not even with adequate forms of financing. Many semi-subsistence farmers are not in their line of business by choice, but due to the lack of employment opportunities.

In Rabobank’s experience, creating employment is in many cases a much more realistic option. Targeting potential entrepreneurs and putting them on a fast track to develop their business, thereby creating employment opportunities, appears to be a more viable option. A financial service delivery mechanism is in this case only one of the needed support services. A critical point that needs to be made, is that it is widely recognized that there is a need for medium and long-term loans, needed for investments that increase and improve production.

Postal banking: Banco Postal, Brazil

Mail and money

There are nearly 500,000 post offices in developing countries. A truly unique retail network. Why not use it to bring banking services to people who are as yet 'unbanked'? Brazil leads the way.

No matter where you travel, a post office is always around the corner. Mail has been around for centuries and almost all countries around the world, even the poorest, boast a close-knit network of post offices. And here is the best news: more than 80 percent of the world's post offices are located in the countryside. This makes them exceptionally suitable for delivering financial services to rural areas of poorer nations.

Postal networks have a long tradition in rendering financial services. As early as the 19th century, European governments arranged the establishment of postal savings banks and postal giro institutions. Private banks failed to provide secure deposit and payment instruments to the general public, and post offices filled the gap. In most developed nations, postal banks grew into fully-fledged financial institutions. These days, postal networks provide on average 33 percent of the physical points of access to the financial sector in mature economies. They process on average 30 percent of the volume of payments and hold 15 percent of household savings.

In developing nations, the postal networks play a significant role too. A World Bank study undertaken by ING revealed that more than 600 million people in 68 developing countries use the post offices for financial services. Together they made 3.4 billion money transfers and held 370 million postal savings accounts with a total balance of more than USD 90 billion. Truly mindbogling figures. But the untapped potential of the postal networks to provide banking to poor rural communities, is even bigger.

Expand

In nearly all countries included in the research, some attempts are made to reform post office financial operations. Most want to expand the range of services with electronic payments, credit, mutual funds and insurance. Yet the very broad diversity in market conditions and regulatory and institutional environments call for specific approaches. These, experience shows, are neither simple nor easy to implement. Mainly because of the complex institutional environment of the postal networks.

Usually, postal financial services operate outside the reach of financial sector regulations. With a few exceptions, postal networks are not connected to (automated) clearinghouses, even though the postal networks process more than 50 percent of domestic small-value payments. Postal financial services in developing countries tend to enjoy several specific state privileges such as deposit guarantee and tax exemption. In return, postal deposits are mainly used to finance government deficits.

As a result, reform is slow. Until now, postal reform is not a priority on the development agenda of the World Bank, nor is it a primary concern of most governments. In more than 95 percent of all cases, postal retail networks and postal financial services are an integral part of a postal conglomerate offering a wide range of products such as mail, parcels and a retail network. Management is responsible for the whole of operations, not for lines of business. This means financial services are often not a priority and cross-subsidy practices are common. This especially applies to countries where postal organizations are operated as a government department.

Diagnosis

What can be done about this situation? First of all, a market analysis is needed. This would encompass a diagnosis of the postal network and its performance, a definition of required improvements and the design of a market strategy. Where available, long-term partnerships could be sought with other financial institutions. ING's study shows that private financial institutions in many countries want to form a partnership with the local postal operator. Such a partnership would have the purpose of providing a broad range of financial services through post offices. In 15 countries public-private partnerships for postal banking have already been implemented. Within the past decade, these partnerships have served more than 12 million - previously unbanked - people on a competitive basis.

Small implementation steps, such as building 'model' post offices and testing new financial services in pilot-projects, should follow this phase. Or launching new, yet simple services such as international remittances on a nationwide scale. Brazil is a very good example of a country where such a project was implemented successfully.

Banco Postal

The Banco Postal program is a long-term partnership between ECT Correios (Brazilian Post) and a private sector bank, Bradesco. The program is operational since 2002. Since 2004 all 5500 state-owned post offices provide a basic package of financial services. This includes ATM cards, accounts, deposits and microfinance. As a result of the program, more than 3 million previously unbanked Brazilians now have access to financial services, and keep a Banco Postal account. The postal bank is now fastest growing bank in household savings and small-value payment processing. It is market leader in microfinance, with more than 250,000 contracts closed. Banco Postal is also connecting to more and more international payments systems, such as Eurogiro and SWIFT, to facilitate transfer of funds by migrants. Plans to introduce insurance and pension products are at an advanced stage.

This program was prepared between 1998 and 2002 with assistance of the government of Brazil. A team of 25 experts lead by ING Postbank undertook a comprehensive research-program. It ranged from nationwide public research regarding consumer preferences for basic financial services, a detailed diagnosis of the ECT Correios and an analysis of the Brazilian payment system and banking sector.

Subsequently, strategic opportunities were identified for developing postal financial services. A stakeholder process involving the government, central bank, postal authority, trade unions and banks was undertaken. This lead to a change in the banking law allowing post offices and other retail outlets in Brazil to act as agents for financial institutions. It also provided input for refining the institutional model and business case of post offices. In 2001, ECT Correios invited banks to bid for the Banco Postal program in the form of a long-term - 8 years - contract.

The government's motivation to use the postal network for the delivery of financial services stemmed from the concern that more than 2200 mostly rural municipalities in Brazil were entirely excluded from access to banking services. The government wanted to improve this situation by using the ubiquitous post offices as a retail network. Looking back, one can only conclude that this plan has worked.

The Banco Postal program has spurred competition in the rural segment and other major retail banks have launched competitive initiatives. They have linked up with alternative retail networks, such as lottery agents, pharmacies and gas stations, to also reach out to the unbanked masses. But the program has had an even broader impact. In rural areas, the Banco Postal program resulted in increased market activity and in better access to information and communication services. A remarkable achievement.

Microfinance: Acleda Bank, Cambodia

After peace, the struggle for prosperity

Microfinance is crucial in building economies and enhancing social cohesion in developing countries. But specialized microfinance banks sometimes lack equity, long term funding, banking experience and strategic focus.

This is where Netherlands-based Triodos Bank steps in. Through investment funds under its management, Triodos participates in the share capital of several microfinance banks. Triodos also supports the governance of these banks by posting experienced managers to their boards of directors. This way, the Dutch bank, with offices in the Netherlands, Belgium, the UK and Spain, not only provides much needed financial backing, but also know-how and expertise. This method is effective in building up the financial sector in developing countries.

The philosophy behind funds under management is straightforward. In most places, microcredit is offered through small and sometimes financially weak NGOs. Yet, in order for microfinance to be sustainable and efficient, Triodos believes these NGOs must grow and become part of the mainstream financial sector. This approach has numerous advantages. A regulated financial institution can, for instance, offer deposits and savings accounts, services that are in great demand among the poor. Such products generate a steady influx of capital, creating a sustainable funding base for microfinance institutions. In addition, regulated financial institutions with clear ownership and governance structures are better equipped to deal with setbacks and problems. They also grow faster; thereby becoming more efficient.

Impact

Triodos invests in NGOs converting into regulated microfinance banks, such as Acleda Bank in Cambodia, K-REP Bank in Kenya and Findesa in Nicaragua. But also in greenfield microfinance banks such as Akiba Commercial Bank in Tanzania. Other examples include commercial banks adding microfinance to their product portfolio, such as Banco Solidario in Ecuador. So far, Triodos has invested in ten microfinance banks or institutions worldwide. All of these institutions are making an impact on the financial sector in their respective countries. They have become leading institutions offering a range of financial services to low-income citizens not served by banks before.

Usually, Triodos becomes a shareholder as an NGO enters a new phase of development. Many organizations start as ‘microcredit programs’ and then develop into fully functional financial institutions. During this transition, the former ‘program’ often has to deal with governance, supervisory or regulatory issues. But there are also new products to market and new banking tasks to perform, like treasury, risk management and internal audit. In this phase, Triodos, as a relatively small and independent bank, can assist. However, after a financial institution has reached a certain maturity, Triodos will usually sell its investment, either to local investors - private and institutional - or to a commercial bank. This is an opportunity for banks that want to enter an emerging market.

Cambodia

For an in-depth look at how this process works, let’s take the case of Acleda bank in Cambodia. After more then 30 years of violence, Cambodia has known peace since the beginning of the nineties. The UN-sponsored free elections of 1993 helped restore a sense of normality to the country, resulting in the rapid withering of the dreaded Khmer Rouge. Peace does not mean that Cambodia's problems are over, far from it. The country has a population of 13.3 million people, an estimated 85 percent of whom live in rural areas. It is one of the poorest countries in the world; GDP per capita was USD 284 in 2003 and 36 percent of Cambodians live below the poverty threshold.

Sustainable growth of the economy remains difficult after decades of war. Financial sector development in Cambodia poses a challenge to the government and private sector because the country's educational, financial and legal systems were completely destroyed by the former regime. With the help of the Asian Development Bank, the financial sector is being restructured. Main goals are to set up a competitive and sound banking system and a properly regulated financial infrastructure. Other challenges include the development of non-banking financial services in the areas of leasing and hire purchase, setting up an insurance sector and creating a capital market for long term investments.

Acleda Bank

Microfinance in Cambodia started some ten years ago with assistance of the international community. NGOs were set up to provide credit to Cambodians who returned from refugee-camps. Acleda (Association of Cambodian Local Economic Development Agencies) started in 1993 as a project of the International Labor Organization and the UNDP. The project later became an NGO and developed from a post-war relief program into a commercial bank with the largest retail network in the country.

In 2000 the National Bank of Cambodia issued a set of regulations as part of the new banking and financial institutions law that enabled NGOs to transform into licensed financial intermediaries. The new law incorporated a regulatory framework for microfinance, including a banking license allowing other services than credit, such as deposits and transfers. Despite Cambodia's stern country risk, Acleda managed to attract international investors and transformed into a Public Limited Liability Company in August 2000, receiving a specialized banking license in October that year. Its shareholders at the time included Acleda NGO, Acleda Staff Association, IFC, DEG, FMO and the Triodos-Doen Fund. In 2003 the total capital was increased by all investors from USD 4 million to USD 13 million, which enabled the bank to receive a full commercial banking license

Acleda has enjoyed rapid expansion of its business, achieving an average portfolio growth rate of 29 percent per annum since 2000. By the end of 2004 Acleda Bank's outstanding loans totaled USD 65.9 million. There are more than 122,000 borrowing customers of which 64 percent are women. Its market share in lending is more than 14 percent and continues to grow – making it the second bank in the country in terms of credit. Acleda currently employs 2,285 staff in a staggering 134 branches and offices.

Benefits for the financial sector

Acleda Bank is leading the development of the financial sector in Cambodia. It became the first bank to target small-scale entrepreneurs; and it developed into the first true retail bank of the country. Furthermore, it is the first and only bank in Cambodia to offer savings facilities in three different currencies to the rural population. This way 'hidden' money is brought into circulation again. Because of its widespread network, Acleda can offer money transfers and remittance services on a large scale throughout the country, increasing financial mobility.

Since it is the first retail bank in Cambodia, Acleda is setting the standard for the financial sector. It has adopted international best practices; among which are public financial audits and an annual report - now required by the Central Bank for all banks. Acleda has also introduced new financial products, such as payroll services, overdraft facilities, consumer finance and trade finance. But perhaps most importantly, it offers its services to the general public, not just larger companies or affluent individuals in the mayor cities. Not surprisingly, Acleda has become the first bank in Cambodia to be rated by an international bank-rating agency.

Trust

The investors in Acleda Bank wanted to build a bank committed to the entire Cambodian society. A tough job, since the regulatory framework in Cambodia is developing at the same pace as Acleda itself. Management has played a crucial role, steering the bank through the uncharted waters of the Cambodian post-war economy. Having international and long-term investors such as Triodos has helped, of course. It has enabled Acleda to position itself as a solid, reputable financial institution. As a result, Acleda bank won the trust of rural communities, hitherto not used to banking. And it is in these communities that the bank will help shape the future of Cambodia.

Microfinance securitization: Bangladesh Rural Advancement Committee, Bangladesh

The world's first microfinance securitization

Bangladesh is one of the poorer nations in the world with a per capita GDP of less than USD 400. The country is perhaps best known for the floods of the Ganges River that wreak havoc on rural areas every few years.

But hope springs eternal, also in Bangladesh. This underprivileged state on the Bay of Bengal is home to the Bangladesh Rural Advancement Committee (Brac), a national private development organization, established in 1972. Brac aims to alleviate poverty and empower the poor, especially women, in areas outside the cities. Brac promotes income generation, social development, healthcare, education and microfinance. The focus of this text will be on the latter. Remarkably, Brac is one of the world's largest NGOs, with total assets of more than 353 million US dollars. It is active in more than 65,000 villages across Bangladesh employing over 28,0000 staff-members and 34,000 part-time teachers. One of its key roles is to perform banking services for the poor and underbanked. Some 4 million Brac members use the NGO as a savings bank, depositing small amounts of money. After a member has established a financial track record with Brac, she or he becomes eligible for a microfinance loan. Loans are disbursed through an ingenious system of regional and local working groups in which members assess each other's applications.

As a consequence, communities make decisions in consultation with a Brac field officer. With good results. Lenders are meticulous about repaying loans; on average only 2 percent of loans are losses, against more than 20 percent for the entire Bangladesh banking sector. In June 2004, the total credit exposure of Brac amounted to USD 220 million, mostly minute short-term loans. Funding is mainly provided by member-deposits, loans and donor institutions. Brac has been profitable for many years; net earnings of Brac's banking activities in 2003 amounted to USD 12.3 million.

Breakthrough transaction

At this moment, Brac is in the process of creating a break-through in microfinance. In a first for the financial world, the Bangladesh-based NGO is in the process of securitizing USD 180 million in microfinance receivables. Securitization means selling loans or credits to a purpose-built company, which is financed through a loan or credit facility. As a result, the loans or credits can be removed from the balance sheet, which boosts capital ratios. The proceeds of the transaction can be used to finance new loans. Banks usually securitize mortgages, credit card receivables and other extremely 'solid' credits. But in this case, 180 million worth of microcredit loans is being transferred to a special purpose trust.

Brac is establishing this trust with the help of foreign partners. The transaction consists of two parts. First, Dutch Development Finance Company (FMO) shall in the first year purchase from the trust debt certificates in local currency for a total of USD 8 million. Simultaneously, FMO together with German bank KfW (Kreditanstalt für Wiederaufbau), shall guarantee Citibank Dhaka, which will provide funding and manage the accounts of the trust. With this solid guarantee Citibank will purchase debt certificates for the counter value of USD 22 million in local currency (Taka) from the trust.

The proposed transaction has a maximum tenor of one year, but all parties intend to establish five subsequent transactions up to USD 180 million. It is structured in such a way that it contains several integrated risk mitigants. For instance, Brac will replace all non-performing loans in the trust and there is 150 percent collateralization of receivables. Moreover, all parties have agreed on a one-month debt service reserve account (DSRA) at all times. Excess cash flow will be blocked in the trust for payment to FMO-KfW and Citibank if Brac cannot meet its contractual obligations. Through a recourse agreement with the funding bank, FMO and KfW will have a firm grip on the microfinance receivables in case Citibank calls the guarantee. All transactions are fully structured in local currency, thereby eliminating exchange rate risk for Brac.

Clear advantages

The securitization has some very clear advantages for all parties concerned. Foremost, it is a highly visible transaction and a first in the field of microfinance. Almost certainly, the Brac deal will act as a benchmark for other organizations involved in microfinance and pave the way for similar transactions in Bangladesh and other countries in the near future. Moreover, the structure of the trust makes it possible for the local financial market to get involved in due course. This means that FMO/KfW's guarantee would no longer - or to a lesser extend - be needed. The proposed transaction also fits excellently in official Bangladesh and World Bank programs for capital markets development. Furthermore, the project links microfinance to sophisticated securitization techniques, showing the world that poverty alleviation and high finance *do* go hand in hand.

The proposed transaction will have a major financial and economic impact in Bangladesh. Selling USD 180 million worth of loans to the trust means that more funding comes available for new loans. This enables Brac immediately to increase its activities, maintaining its robust rate of growth. The expansion of Brac's lending activities means creation of jobs within Brac and even more so within its rural client base. This in turn will generate additional income for the poor and very poor in Bangladesh. The target number of clients set by Brac is 5 million by year-end. To reach this target, more commercially based funding is desired. FMO and KfW are thus enabling Brac to maintain and accelerate this sturdy pace of expansion.

Risk and mitigation

Obviously, investing capital in a developing country like Bangladesh is not without risks. Below we summarize the major risks and explain how all parties concerned manage them.

FMO and KfW take a currency risk on the Bangladesh Taka during the tenor of the transaction. Over the years, the Taka has shown a steady depreciation against the euro and US dollar. A default scenario for Brac would most probably occur in case Bangladesh goes into a strong economic decline, resulting in a severely weakened Taka. However, FMO and KfW’s exposure as guarantors will quickly decrease due to the rollover and amortizing character of the facility. This results in a zero position at the end of each twelve-month period, after which this position is renewed, if all parties so desire.

The relatively high Bangladesh country risk is strongly mitigated by using local currency only (through FMO and a guarantee structure funded by Citibank Dhaka) instead of direct foreign currency loans. The latter would also not have been approved by the central bank of Bangladesh, which encouraged FMO and KfW to structure the USD 180 million facilities in Taka.

Credit risk

Brac lends to the poor and ultra poor in Bangladesh, largely without collateral, but with the advantage of substantial (mandatory) savings by its members. The credit quality of its portfolio is therefore excellent. FMO/KfW's portfolio will be a cross section of Brac's portfolio with exactly the same quality. In addition, Brac will replace all non-paying loans in FMO/KfW's portfolio by performing loans on a monthly basis, monitored by a trustee. Even without replacement of non-paying loans, FMO's calculations show the portfolio can handle a recovery rate as low as 59 percent.
Brac is monitored by the Bangladesh NGO Bureau, which in turn is accountable to the Prime Minister's secretariat. However, this responsibility will pass to the central bank of Bangladesh in the near future. Brac is a highly regarded institution and an important partner for the government through the various programs it conducts jointly with various branches of the Bangladesh government. It is therefore unlikely that the government would take adverse actions against Brac. Besides, Bangladesh's first securitization (securitized zero-coupon bonds for Industrial Promotion Development Co.) was approved by the SEC in November 2004, which clears the way for more and similar structures like the Brac securitization.

Bankruptcy

Finally, although the proposed deal is in essence a securitization (and therefore bankruptcy remote), the lenders and guarantors to the trust will be exposed to Brac risk. Brac will act as servicer and collect principal and interest on the loans on behalf of the trust and transfer it to the trust on a regular basis. Considering the 32-year positive track record of Brac and its very strong balance sheet, all partners regards this risk as acceptable.

Contributors

1. The Sachs report: comments and additions
Peter Schuurman, Senior Policy advisor for Private Sector Development, Ministry of Foreign Affairs (Development Cooperation)
Gerard Michels, International Relations Advisor, ABN Amro

2. Rural finance: Primary Bank for Development and Agricultural Credit – Egypt
Josien Sluijs, Senior Project Manager, Rabo International Advisory Services

3. Postal banking: Banco Postal – Brasil
Hans Boon, Advisory, ING Postbank

4. Microfinance: Acleda Bank – Cambodia
Marilou van Golstein Brouwers, Director International Funds, Triodos Bank
Femke Bos, Senior Investment Officer, Triodos Bank and Member of the Board of Directors Acleda Bank

5. Microfinance securitisation: Bangladesh Rural Advancement Committee – Bangladesh
Gerrit-Jan Brunink, Senior Investment Officer, FMO

Editor:
Philip Dröge, freelance journalist

NFX
Netherlands Financial
Sector Development Exchange

Visitors address
Anna van Saksenlaan 71
2593 HW The Hague

Mail address

P.O. Box 93060
2509 AB The Hague

t +31 (0)70 314 9790
f +31 (0)70 314 9774
e info@nfx.nl
i www.nfx.nl