

FINANCIAL SERVICES ASSOCIATIONS : THE STORY SO FAR

Consultative Group to Assist the Poorest

Douglas Pearce¹ and Brigit Helms²

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¹ Principal Economist, Markets, Finance & Enterprise Team, Natural Resources Institute
<http://www.nri.org/Themes/mfe1.htm>

² Senior Microfinance Specialist, CGAP Secretariat

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EXECUTIVE SUMMARY

The relatively new Financial Services Association (FSA) model was developed to address many of the issues related to access to financial services in rural financial markets in Africa. An FSA is a shareholder-based entity that operates at community level and provides credit and savings services to its members. The principal strengths of the FSA model are:

- i) FSAs are relatively low-cost and efficient, and can operate sustainably in low income, small or remote rural communities.
- ii) FSAs presently function with more streamlined support structures than the more complex support networks and apex structures of other financial service models for rural areas (such as savings and credit cooperatives).
- iii) The link between voting rights and size of shareholding offers the potential to address governance problems often encountered by credit unions and savings and credit cooperatives, which tend to be *borrower-driven* and can suffer from poor governance and unrepresentative management.
- iv) The scope for introducing a profit-related incentive structure, affecting staff (through wages), board and committee members (through profit-based remuneration), and all members (through dividends), could promote sustainability and good asset management.
- v) The FSAs' solid equity base gives them a comparative advantage over many other rural financial service providers in developing linkages with the banking sector.

FSAs nevertheless do face significant problems, such as:

- i) A risk of *capture* by dominant interests, who can manipulate a lack of awareness on the part of shareholders of their responsibilities and powers.
- ii) Limited scale, and restricted funds for lending.
- iii) An emerging tendency towards poor portfolio quality in many FSAs.
- iv) Limited product offerings and low outreach to poorer members of the community.
- v) Uncertainty concerning their legal status that hampers their ability to act as true financial intermediaries.

At this early stage of development of the FSA model, a number of questions remain: What are the most appropriate products for FSA clients? Can FSAs operate effectively in competitive environments? How can FSAs link to formal sector financial institutions for mutual benefit? What is the most appropriate legal and regulatory structure for FSAs? Are FSAs able to function sustainably without continued technical assistance?

Perhaps some of the more interesting outstanding issues relate to the role of donors in the future of FSAs. To date, the development of FSAs has relied on donor support and involvement. The FSA model is proving less effective in solving governance and portfolio quality problems than was at first hoped. Analysis is needed to determine whether providing further assistance would be cost effective. Individual FSAs are limited in size, and the resulting outcomes and impacts need to be weighed against the investment. Donors and other interested investors need to decide whether the FSA model offers sufficient advantages in terms of developing rural financial markets and providing access to financial services in unbanked rural communities to merit the required technical assistance costs and investment.

1. INTRODUCTION

Identifying replicable mechanisms for providing rural financial services on a sustainable basis in the more remote rural areas of sub-Saharan Africa remains a challenge. An environment characterised by poor communications infrastructure, low population density, high levels of illiteracy, low profitability and/or high risk of most rural economic activities, and relatively undiversified rural economies, is unattractive to formal financial institutions. As a result, rural clients tend to turn to locally-based informal sources of financial services, such as family, friends, moneylenders, self-help groups and savings clubs. Such sources, however, tend to be limited in scale (both geographically and financially), only lend for short periods of time, and in some cases charge very high rates of interest. Livestock, jewellery, and even social relations offer proxy savings and insurance services, but pose serious liquidity and divisibility issues.

The prominent challenge for such rural areas is to develop sustainable financial services that operate at the local level with an organisational model that allows for scale-up and replicability. A few isolated success stories have tended to depend on expensive and lengthy external technical assistance in their formation stage. The innovative Financial Services Association (FSA) model offers a lower-cost and potentially sustainable solution. Over 100 FSAs operate in sub-Saharan Africa, with over 30,000 shareholders and over \$1 million in share capital.

The FSA model was pioneered by the International Fund for Agricultural Development (IFAD). DANIDA and the UK Department for International Development (DFID) also play an important role in establishing and supporting FSAs, relying heavily on FSA International, a consulting firm founded by Dr. Ahmad Jazayeri, formerly of IFAD. Since 1994, FSAs have been introduced in Benin, the Congo-Brazzaville, Gabon, Guinea, Mauritania, Uganda, Kenya and South Africa.

The Consultative Group to Assist the Poorest (CGAP) wishes to explore the FSA model further, with a view to assessing its performance to date, identifying key components of the model and emerging issues, and assessing its potential for providing sustainable and accessible rural financial services.

This review reflects information available at an early stage in the development of the FSA model, with the oldest FSAs in operation for less than five years. The review therefore inevitably draws out areas needing further information, and notes that the FSA model as yet is characterised more by potential than proven achievements. This review draws initial studies and reviews conducted in Uganda, Kenya, and Benin, and on statistics produced by KREP (Kenya) and IFAD (Benin). This still rather limited data and literature base is supplemented by perspective from the experience of FSAs in South Africa, Congo, and Guinea, and by telephone and email interviews with experts.

2. THE FSA MODEL

2.1 Background and Context

The FSA Model was developed by IFAD to address three specific challenges: locally-based self-management, outreach and sustainability. FSAs are established at the community level, and are owned and managed by community members that buy shares in the FSA. In terms of outreach, FSAs can operate in unbanked rural communities that would not be viable for many other forms of financial service organisations. FSAs are characterised by simple systems and procedures, a limited range of financial services offered (presently low-technology savings and credit products),³ and a lack of a complex support structure. These characteristics enable FSAs to maintain low cost organisational structures and to rely on local management, and thus promote the sustainability of the FSA model.

FSAs were originally envisaged as locally-owned and operated financial institutions directly linked to formal sector financial institutions. The legal form of FSAs was initially conceived as somewhere between a shareholding company and a cooperative. This lack of clarity has been reflected in the present legal form taken by FSAs, which varies by country and by individual FSA. FSAs in Kenya are registered as self-help groups within the Ministry of Culture and Social Services, while in Uganda only 4 of the 7 pilot FSAs have been registered at all (either as companies limited by shares or companies limited by guarantee). FSAs in West Africa tend to be unregistered associations with unlimited liability.

The FSA model can be viewed in one sense as an initiative to apply microfinance techniques to rural areas, rather than emerging from an agricultural credit paradigm. From another perspective, the FSA model represents an attempt to build on the strengths of credit unions in rural areas, while compensating for their deficiencies. In many ways, the FSA model fits neither into the savings-first nor the credit-first approach, with both services offered, and offered more or less independently of each other.

2.2 Structure

Figure 1 presents a stylised organisational chart for FSAs and key external linkages, although the internal and external structure may vary between countries. The governance structure is fairly simple, relying on a General Assembly of shareholders, which elects a Board of Directors and an Audit Committee. The Board of Directors has the responsibility of the overall management of the FSA, while the General Assembly has the power to approve and confirm changes to policies, set interest rates, approve annual budgets and annual dividends, fix the share-value, and elect or dismiss any officeholder. The Board appoints a Manager and a Cashier, and nominates a Credit Committee from among its members. The Manager reports to the Board, and the Board reports to the General Assembly of the shareholders.

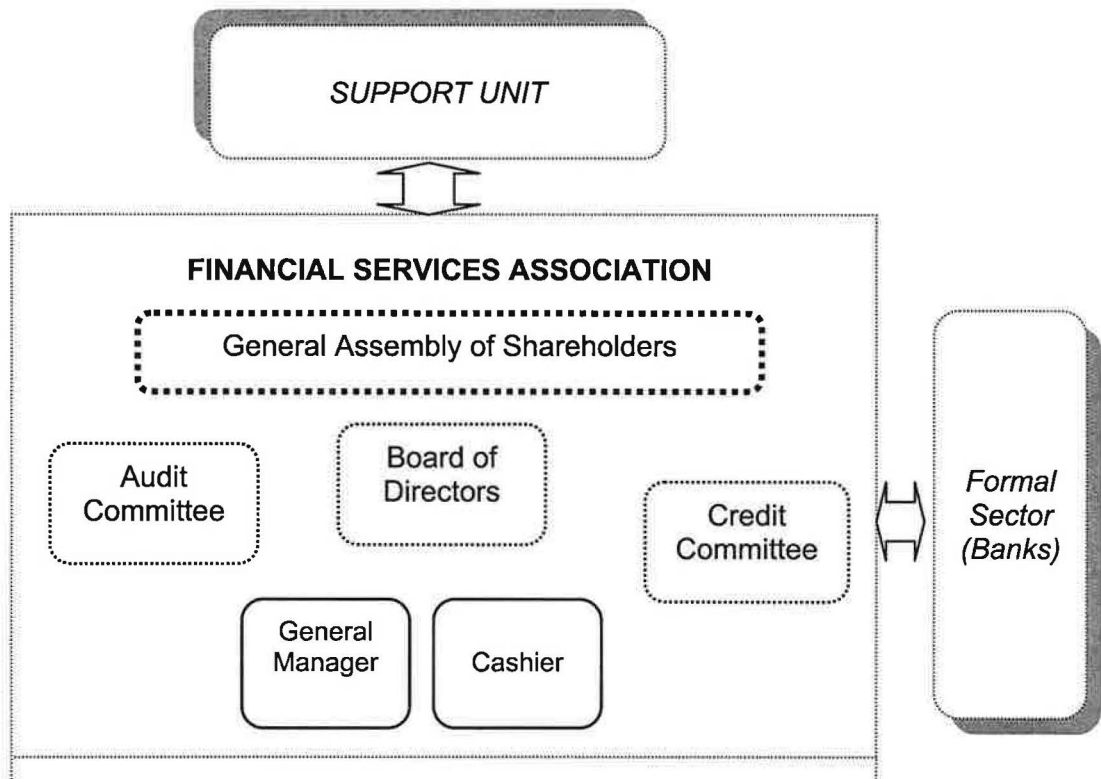
The donor-funded support unit provides services such as training, information exchange and centralised purchasing, as well as carrying out a monitoring role. The type and form of support unit varies by country, with K-REP (a leading microfinance bank and NGO)

³ Although some Kenyan FSAs have begun to experiment with product innovation, for example through introducing salary and pension payment facilities.

taking on the role of the support unit in Kenya, a local NGO carrying out this function in Benin, and a Project Management Unit (PMU) set-up by DFID acting as the support unit in Uganda.

Linkages to formal sector financial institutions were originally conceived as an important component of the FSA model. FSAs would first graduate to a financial intermediary for other financial institutions (for example undertaking the payment of salaries and pensions), and then move on to secure loans from other financial or development institutions and act as a local retailer. However, in most countries where FSAs operate, links with banks remain poorly developed.

Figure 1. FSA Organisational Chart



The profile of average FSAs in Benin and Uganda is presented in *Table 1*. The rural community-based nature of the FSAs is evident, in the scale achieved, outreach, and the size of average shareholding. The figures for average capital per shareholder, loan portfolio, and savings deposits for FSAs in Benin remain significantly lower than for the Ugandan FSAs, which may indicate that there are factors inhibiting the success of the Benin FSAs. It should be noted, however, that the Ugandan FSAs are on average older and more mature institutions, established in 1997, while a third of FSAs in Benin only began operating in 1999. This difference in operational age may partially explain the relative size differences between the two FSAs, as lending operations have not yet built up volume and poor initial financial FSA performance discourages higher levels of share investment.

Table 1. Profile of an average FSA in Benin and Uganda

	Uganda (Dec 99)	Benin (Apr 00)
Number of shareholders	299	244
Outreach	Max. 20 km	Max. 7 km
Capital	\$10,200	\$2,700
Av. Capital per shareholder	\$34	\$11
Loan Portfolio Outstanding	\$10,200	\$2,400
Savings Deposits	\$2,000	\$660

3. FSA PRODUCTS AND SERVICES

FSA offer savings and credit services, and rely on member share capital as the main source of funds. FSAs do not yet fit within the regulatory framework of recognised financial intermediaries such as banks or savings and credit cooperatives, and therefore the scope for on-lending from deposits is limited. While savings and credit cooperatives are generally *borrower-driven*, FSAs seem to be primarily *investor-driven*. While credit union and savings and credit cooperative policies tend to be favourable to borrowers, FSAs have relatively high interest rates on loans.

Since FSAs are not subject to such strong pressures to reduce lending rates, the rates charged by FSAs can - in theory at least - match supply and demand for funds more closely. Assuming that alternative pressures do not become dominant in FSAs, for example through the concentration of shareholding in a few investors, FSAs should be able to solve the rationing problem faced by credit unions by adjusting interest rates to balance supply and demand for funds.

Loan size is linked to size of shareholdings, with predefined upper limits of up to either 10% or 15% of the total loan fund, or \$200 in the case of FSAs in Benin. Shares in Kenyan FSAs are sold for 300 Kenyan Shillings each, equivalent to about \$4; the smallest loans may fall as low as \$10. Average loan sizes are higher, as larger shareholders often receive priority in accessing the limited FSA funds available for lending. The Ugandan FSAs report chronic shortages of loan funds, despite a fairly rapid turnover (four months is a common loan term).

FSAs use individual lending methodologies, although some FSAs are experimenting with solidarity group lending on a small scale. Required guarantees include pledged goods and guarantors, although a very broad range of goods can be pledged. Loans can be used for any purpose, but the short-term (terms are commonly between 3 and 6 months) and high-cost nature of the loans (with nominal monthly interest rates between 8% and 12%) means that loans are more suited to trading activities than longer term-investments (see *Table 2*). Common uses of loans in Kenya include school fees, trading and retailing and crop fertiliser, while in Benin FSAs cite agriculture, processing and trade as the most common uses for credit.

The relatively high interest rates on lending promote operational sustainability, and rapid access to loans may partially offset the potential disincentive of high financial borrowing costs. The loan analysis and approval process is facilitated by the small size of the FSAs and the narrow range of loan products offered (in many cases only one). However, limited available loan funds restrict access, as does the dominance of larger

shareholders, who, in some cases, monopolise the available funds through repeat lending to themselves.

FSA's do not value savings as a financial service and offer zero interest on deposits, while some charge transaction fees on withdrawals or limit the maximum size of allowable deposits. Only 26% of shareholders of Kenyan FSA's used deposit services as of November 1999, but this figure has since risen notably to over 40%. The ratio of deposits to loan portfolio for the FSA's in Uganda and Benin is only 20% and 28% respectively. This ratio between deposits and outstanding loans reflects the present situation where FSA's (except for some Kenyan FSA's) rely on share capital for loanable funds, and have not yet progressed to financial intermediation of savings.

The terms for deposit facilities offered by FSA's encourage the temporary deposit of traders' earnings rather than longer-term savings accumulation. By providing safe and secure storage for temporary deposits, FSA's play a role in the functioning of the local market system. In theory, FSA's could price such a facility at a more realistic level, to reflect the costs of providing the service as well its value to traders.

Linkages with banks are not being sufficiently utilised to provide savers with a return on their deposits. Bank branches in towns could be used to store the deposit funds, both in sight accounts (for reasons of security) and in fixed term deposit accounts (to earn a return on the funds), and K-REP has assisted several Kenyan FSA's to store idle deposit funds in fixed term deposits. A few Kenyan FSA's – again with the assistance of K-REP – have started to use deposit funds to invest in government securities. The unproductive utilisation of deposit monies characteristic of the majority of FSA's may reflect a mutually reinforcing dynamic, where low deposit levels discourage FSA's from incurring the costs of transferring funds between the community and the bank branch in town, as well as a general lack of financial expertise and awareness on behalf of FSA boards and management.

Existing limits to organisational and managerial capacity notwithstanding, research on the financial service needs of the FSA shareholders would assist the development of a set of products more tailored to varying client profiles and needs. Low levels of uptake of deposit facilities and the below-expected lending performance, should be examined. FSA's need savings products that meet their members' demand to increase the levels of deposits. However, this objective will remain unattractive to FSA's unless they are able to secure returns on those funds that cover the costs associated with offering improved savings products. Enhanced links with banks and cooperatives could offer the means of earning returns on deposits. Agreements with regulatory authorities that place FSA's within regulatory and monitoring frameworks, and facilitate the mediation of member savings, would also provide an increased incentive for FSA's to offer improved deposit facilities.

Table 2. Financial Services ^a

	FSA's Uganda (Dec 1999)	FSA's Kenya (June 2000)	FSA's Benin (April 2000)
Loans			
Average Outstanding Loan Portfolio	\$10,200	-	\$2,400

Maximum loan size	Not > 15% of FSA loan fund	Up to 4x share investment & not > 10% of FSA loan fund	Min.\$20 Max \$200
Average loan size	-	\$41	\$40
Maximum loan term	9 months	3 months for 1 st loan then 8 months for next	4 months
Average loan term	3 months	3 months most common	1-4 months range
Interest Rate (nominal annual)	144% ^b	120%	96%
APR	205%	127%	139% ^c
Loan Methodology	Individual loans	Mostly individual loans. Small % group loans	Individual loans
Deposits			
Average deposits outstanding	\$2,000	\$1,500	\$660
Nominal interest rate on deposits	0%	0%	0%
Charges on withdrawals?	3% on each withdrawal	Some FSAs charge small transaction fees (between 5-12 cents)	-
Vol. Deposits/ Vol. Loans outstanding	20%	-	28%

^a FSAs are young institutions, with those in Kenya, Uganda, and Benin only being set up since 1997. Studies with data on FSAs are relatively scarce, and the data presented in Table 3 and elsewhere in this review reflect the available information.

^b One FSA has reduced its nominal annual interest rate to 120%

^c The available literature and data does not indicate whether FSAs in Benin calculate interest payments on the declining outstanding balance or on a 'flat' basis. It is assumed that the 'flat' method is used, as is the case for the Ugandan FSAs.

4. OUTREACH

Table 3 presents some key outreach indicators, with some background information on the country included to give a wider context to FSA performance.

Table 3. Outreach

	FSA Uganda (Dec 1999)	FSA Kenya (June 2000)	FSA Benin (April 2000)
GNP/capita	\$310	\$350 ^a	\$380 ^a
Population Density (/sq.km)	105	51 ^a	54 ^a
Institution Profile			
Date earliest FSA established	1997	1997	1997
No. FSAs	7	43	47
Total Shareholder Equity	\$71,600	\$171,000	\$126,000
Total Loans Outstanding	\$71,300	-	\$112,000
Total Deposits Outstanding	\$14,100	\$64,000 (net balance)	\$30,800
Clientele			
No. shareholders/members	2,091	9,000	12,100
% women	25-40% (est.)	45%	40%

^a Kenya and Benin figures for GNP/capita and population density are for 31 December, 1999.

FSAs seem to offer good potential for scale-up. The rate of growth in the number of FSAs is particularly notable. In Benin, a total of 47 FSAs have been established in the last four years, while in Kenya the figure is 43 over the same period (although only seven have been set up in Uganda). Between 1997 and April 2000 over 6,000 loans were disbursed by the 47 FSAs in Benin, for a total of \$421,000. The Benin FSAs had a total amount of paid-up equity of \$126,000, while the figure for the Ugandan FSAs was \$71,600. The 7 FSAs in Uganda had a total loan portfolio as of end-1999 of \$71,300, while the outstanding loan portfolio for FSAs in Benin as of April 2000 was \$112,000. These comparisons between FSAs in Uganda and Benin indicate that rapid growth in numbers of FSAs has been a feature in Benin, while in Uganda the growth in scale of individual FSAs has been more significant.

While individual FSAs are still relatively small, the scale they have achieved is impressive when compared to similar rural finance models. Self-managed village savings and credit associations (CVECAs), viewed by some as a rural finance success story, operate in similar rural areas to FSAs, and are community and membership-based.⁴ Established over a fourteen-year period, CVECAs have 260 members on

⁴ CVECAs exist in Mali, Burkina Faso, Madagascar, Sao Tome, and the Gambia.

average, a loan portfolio of \$7,700, and deposits of \$3,200. After less than four years, an average FSA in Uganda has almost 300 shareholders (377 in an average Kenyan FSA), a loan portfolio of over \$10,000, and total deposits of \$2,000.

The type and level of financial service utilised varies according to the profile of the FSA member. Loans may be accessible to all - depending on suitable guarantees and collateral being offered - but the size of loan is linked to the size of an individual's shareholding. The size of loans received therefore tends to be larger for better-off clients.

Both the poorer and wealthier sections of the rural communities appear under-represented within the membership of FSAs. Initial reviews of FSAs seem to indicate the following pattern, using a subdivision of village members under the categories rich, upper middle, lower middle, and poor:

Rich: Few join the FSA, as they believe that it is not a sound or secure financial institution, and they can afford to take their money to banks in towns. The wealthier village members often demand larger loans than the FSA can provide, so those that do join tend to do so more as an investment with future dividends in mind.

Upper middle: Need working capital to expand their businesses, and therefore buy shares to access loans. Less interested in savings.

Lower middle: More interested in savings (or safekeeping of funds) facilities than shares, which are too illiquid to be used in emergencies. Also interested in loans, but may not have the required collateral.

Poor: Rarely join FSAs, as the need to invest share capital and pledge guarantees to access loans is both demanding and potentially onerous.

A breakdown of the clientele of the FSAs in Benin suggests that 44% of small shareholders have accessed loans, while this figure rises to 68% of small-medium shareholders, and falls to 29% for medium-large shareholders.⁵ These data confirm that larger shareholders are more interested in dividends on share investments than in accessing loans, and may help explain the persistence of high interest rates on loans: increased income from lending activities contributes to higher dividends.

Early studies also indicate that, at least in Uganda, there is some overlap between users of FSAs and users of banks, a feature that may result from the early stage of development of the FSAs, with better-off persons in the community joining first. A comparative study of rural finance institutions assessed the profile of the clientele of FSAs in East Africa as similar to that of savings and credit cooperatives in the same region. On the other hand, those FSAs located in more remote areas likely reach out to unbanked populations.

⁵ Small shareholders are defined as having 1-5 shares, small-medium as having 6-10 shares, and medium-large as having more than 11 shares.

The FSA model was envisaged as being open to women. FSAs generally have at least two women on the Board, and one of the two staff members, the manager and the cashier, should normally be a woman. However, women's participation levels fall below 50% (comparable to those of CVECAs, and higher than the 15-20% typical of East African savings and credit cooperatives). Women participate at much higher levels in village banking programs. Also, the 'African Small' group of microfinance institutions that report to the MicroBanking Bulletin (2000) show an average rate as high as 92.5%.⁶

The relatively low level of participation of women as FSA shareholders may reflect socio-cultural factors, combined with more restrictive access requirements for loans than in alternative informal savings and loan mechanisms. Women may also prefer to save small amounts in a *tontine* or other club-based group that provides rotating access to credit, rather than saving in an FSA, CVECA, or similar organisation.

In order for FSAs to achieve greater scale and outreach, product diversification is needed, with products more tailored to the needs of the wider FSA membership. This can be achieved in part through improved links with formal financial institutions. Improved links with banks could enable FSAs to offer money transfer services, the payment of pensions and salaries, and other links to banking services. The costs of offering more attractive deposit facilities could be offset by the increased returns with banks or cooperatives, financial investments, or through on-lending deposit funds. The role of the support units is a key one, as FSAs require initial assistance in negotiating and managing links with formal financial institutions and offering more complex financial products. The diversification of services on offer would help extend and deepen outreach to poorer clientele.

⁶ The nine 'African Small' institutions have loan portfolios of less than \$1 million, and low average loan balances compared to FSAs.

5. INSTITUTIONAL SUSTAINABILITY

FSAFs can reach profitability in a relatively short timescale, generally within the first two years of existence. While *financial* sustainability is very much attainable by FSAs, providing that minimum levels of scale are achieved and that loan losses are kept under tight control, long-term *institutional* sustainability depends also on factors such as:

- The level and type of competition from other financial service providers
- The strength of internal governance structures
- Links with the formal financial sector
- The significance of donor support

5.1 Financial Sustainability

FSAFs reach cost recovery levels in a relatively short period, as shown by the key sustainability indicators in *Table 4*. Many of the Kenyan FSAs generated a profit within the first two years of operation, before key non-cash expenses such as loan losses or depreciation are taken into account. A K-REP audit of FSAs in 1999 indicated that some FSAs face losses as a result of bad debts, while others show good profitability, leading to an increase in share value.

FSA loan portfolio quality appears poor, even at this early stage in the development of the FSAs. Portfolio at Risk figures average about 25% in the Ugandan and Kenyan FSAs, although these figures are somewhat unreliable, due primarily to the low level of systems capacity in many FSAs and relatively untrained staff and Audit Committee members. Initial problems have been encountered with inadequately skilled staff and Audit Committee members, and associated weaknesses in accounting and reporting practices. Cases where Board members abuse their positions by falling behind on loan repayments and even 'rolling-over' loans, have been noted in Ugandan FSAs. Poor initial loan analysis by the Credit Committees can lead to problems with loan repayments, and in some cases the Kenyan FSAs did not follow procedures laid out by K-REP.

Operating efficiency seems good, with operating costs for each unit lent already comparable to CVECAs (Kenyan FSAs record an operating efficiency figure of 0.18 compared to 0.17 for CVECAs). Jazayeri of FSA International projects that the cost per dollar lent by FSAs falls from \$0.23 in the first year to as low as six cents in year five. Not only does the FSA model seem to offer relatively efficient lending, it also promises less complex support structures than those needed by CVECAs or credit unions (such as FECECAM, the Federation of Agricultural Savings and Loan Cooperatives, in Benin or KERUSSU, the Federation of Rural Savings and Credit Cooperatives, in Kenya).

The profitability figures achieved at this early stage in the operation of the FSAs in Uganda and Kenya confirm the expectation that FSAs can achieve a respectable return on assets and equity, considering the low operating costs, high effective interest rates for lending and zero interest rates paid on deposits. However, while the FSA model has been seen as relatively *low maintenance* in the sense of the amount and length of external assistance needed, recent studies on FSAs in East Africa indicate that external support is more fundamental to the success of the model than was first thought. Technical assistance is costly, and if the cost of the technical assistance was factored

into the sustainability calculations, the FSAs' financial situation would appear less optimistic.

Table 4. Sustainability Indicators

	FSAs Uganda (Dec 1999)	FSAs Kenya (April 2000)
Sustainability		
Operational Sustainability (total revenue/total operating costs)	173%	126% ^a
Efficiency		
Operating Costs/Amount disbursed	n/a	0.18
Profitability		
Return on Assets	21%	31% ^b
Loan Portfolio		
Portfolio at risk	23% (1 day)	24%

^a When defaulted loans are not taken into account, the figure rises to about 200%.

^b Return on Loan Portfolio, rather than Return on Assets. Figures are for 10 of the 43 Kenyan FSAs only.

5.2 Competition

FSA rates on loans and deposits appear to be uncompetitive compared to other financial service providers (such as savings and credit cooperatives and Rotating Savings and Credit Associations, or ROSCAs). As a result, FSAs might struggle in competitive environments to attract those wishing to borrow or save. However, it appears that in the Kenyan case the majority of members of the FSAs also use services of other financial service organisations, such as informal savings clubs, ROSCAs, NGOs and even commercial banks. This use of multiple services suggests that FSAs can also function in environments with competition from other financial service providers, although further investigation in other countries is needed to confirm this. The types and terms of services offered by FSAs may be more important than the existence of competitors. FSAs offer rapid access to loans, an important potential link to the formal financial sector, a place to keep deposits, and a source of larger loan amounts (depending on shareholding size).

Those interested in a longer-term relationship with a financial service provider may favour the ability to 'buy in' to the FSA through share investments and the link between voting rights and shareholding. Better-off members of the community may be increasingly attracted to invest over time, as FSA profitability improves. FSAs offer the potential to earn an attractive rate of return on relatively small amounts of share capital, in an environment with a limited range of investment opportunities. However, improved terms on deposit facilities and access to banking services offered through links with the formal financial sector would go a long way towards making FSAs more attractive to the wider community relative to competitors.

5.3 Governance

One of the principal strengths of the FSA model is that it retains the advantages of a membership-based structure while offering solutions to some of the governance-related problems common to credit unions or savings and credit cooperatives. Appendix II contains a more comprehensive comparison between the FSA model and savings and credit cooperatives.

Voting rights in FSAs vary according to shareholding, thus strengthening governance within the organisation. Cooperatives or credit unions can face the problem that the elected director and contracted management do not represent the interests of the membership. Where voting rights are dispersed equally among many members, as in credit unions, it is costly for all members to frequently monitor the decision-makers, and most owners lack the skills and information required to do so effectively anyway.

While this problem can to some extent be addressed by enforcement of institutional rules that define the roles and responsibilities of the actors involved in the governance of the credit union, the FSA model goes further. Linking voting rights to shareholdings allows those with a larger financial stake in the institution to have a greater voice and influence within the FSA, unlike the case of credit unions. This type of representation should lead to more effective governance, as the greater incentive that these shareholders have to monitor and influence decision-makers is to some degree matched by their capacity to do so.⁷

The for-profit nature of the FSAs offers the opportunity to introduce profit-related incentives for management and board performance, and dividends to reward shareholders. FSAs in Uganda and Kenya have exploited this potential, introducing commission-based remuneration for Board members and staff. At the close of the financial year, the profit made by the FSA is apportioned between reinvestment in the FSA, operating costs, and dividends. Mature FSAs in Benin typically allocate 20% of annual profits to dividends.

Notwithstanding the proportional shareholding structure and profit orientation, the reviews of experience to date in Uganda and Kenya suggest that the FSA model may still suffer from many of the governance problems that commonly affect credit union models. Key internal governance issues noted include:

- Possible risk of capture by educated and erudite village elite
- Dominant chairpersons, and conflict between boards and managers
- Board and/or staff taking decisions without approval of the membership
- Board and staff members having loans in arrears
- Limited loan funds dominated by a few, loans being 'rolled-over' by larger shareholders, and concealed delinquency problems

The following appear to be the principal causes of these governance problems:

⁷ Kenyan FSAs limit voting rights to a maximum of ten votes per shareholder.

- A lack of awareness on the part of the General Assembly of their responsibilities and powers, with members not fully understanding the rules and regulations of the FSA
- A lack of transparency, particularly with regard to lending decisions
- Poor understanding of the potential link between delinquency and poor financial performance of the FSA
- Inadequate internal monitoring and supervision

The degree to which blame should be attached to internal factors (FSAs not functioning properly, poor internal supervision), or to external factors (a lack of external monitoring and supervision) needs further exploration. The presence of incentive systems, procedures and controls, and a link between voting rights and shareholding, should combine to promote good governance. Therefore, a breakdown in the intended *internal* functioning of the FSA model would seem to be the primary factor behind such problems.

5.4 Formal Sector Linkages

Currently, FSA links with the banking sector are either non-existent or still in the early stages of development. Links with banks and credit unions could allow FSAs to offer access to insurance services and term deposits, payment transfer services, and payment of pensions and salaries. It is only in Kenya, with the assistance of K-REP, that this potential has begun to be explored. This is due in part to a lack of financial sector knowledge and familiarity on the part of FSA management and board members. Many FSAs also express scepticism about the formal banking sector, and several FSAs in Uganda have lost money and suffered a consequent drop-off in new shareholders after commercial bank partners closed down. FSAs face travel, time, and transaction costs in dealing with banks, and the volume of transactions needs to be sufficiently high to make linkages worthwhile.

Banks, on the other hand, may not place sufficient value on the collateral offered by FSAs on potential loans (although FSAs are in a relatively strong position as regards equity and associated low leverage), and may simply not see the benefit of the effort and cost involved in setting up linkages with FSAs. Until FSAs become larger and more widespread, and perhaps also until there are increased levels of competition in the banking sector, this situation may continue.

Bank linkages are more developed in the case of the South African Financial Service Cooperatives (FSCs), which are a variant of FSAs. FSCs are linked via an electronic funds transfer system to the formal banking sector, and their clients can transfer funds between urban bank accounts and rural FSA accounts. This represents an important first step towards providing access to banking services in rural communities. FinaSol, an association established in 1999 with the specific purpose of promoting and supporting FSCs, has played a key role in this linkage. FinaSol provided the technical support and funds to ensure that FSCs have the systems and personnel capacity needed to link with banks. Higher levels of innovation and competition in the South African banking sector may help explain the unusual level of interest in FSAs on the part of commercial banks, although the role of FinaSol may be equally important.

Individual FSAs that develop close linkages with the formal financial sector may effectively become payment windows for banks. In such a context FSAs risk losing their

internal organisational dynamics. The influence of the link bank may overshadow that of the General Assembly and Board, and the focus of the FSAs may well shift from providing savings facilities and access to loans, to providing banking services on behalf of the link bank. However, the value of an extension of banking services to an unbanked rural community may equal or exceed the value to the community of the limited range of services being previously offered by the FSA. This is an issue that merits further study.

5.5 Legal and Regulatory Environment

The legal nature of the FSA model will need further clarification, since key features of the FSA model do not fit within standard banking and cooperative regulatory and supervisory structures. FSAs are similar to banks and other shareholder-owned companies, as they are shareholder-owned and for-profit. In this sense, FSAs may fit under Company Laws, with the Companies Registry Agency and the Securities and Exchange Agency (or their equivalents in each country) the appropriate regulatory agencies. Those Ugandan FSAs that have registered have done so as companies limited by shares or guarantee. However, such a designation would curtail any plans for intermediation of savings by FSAs in the future, and limit FSAs to lending and investor-oriented activities. Further, the capacity and interest of such agencies to regulate small rural-based FSAs is also questionable.

On the other hand, FSAs also resemble informal self-help savings and credit schemes, as they are small in scale, community-based, and offer only a limited range of financial services. Indeed, Kenyan FSAs have registered as self-help groups under the Ministry of Culture and Social Services. Kenyan FSAs can on-lend savings to members, and although in most cases they do not on-lend significant amounts of savings, one Kenyan FSA has decided to use 25% of its savings to supplement its loan funds. It may therefore be that reform of financial sector regulatory agencies and laws to accommodate FSAs may not make sense.

CVECAs offer another model. They also differ from cooperatives and credit unions, as the General Assembly of a CVECA is composed of all the members of the village, not only the members of the CVECA. CVECAs are regulated under the PARMEC law, which governs mutual and cooperative savings and credit institutions.⁸ Non-cooperative institutions can sign five-year agreements with the Ministry of Finance, entitling them to conduct business and place them under government control. CVECAs have taken advantage of this provision. This arrangement is 'negotiable', and depends more on the goodwill of the Ministry of Finance than on the actual provisions of the law. Such an arrangement offers hope for a solution to the regulatory situation of the FSAs, but may not be ideal due to its uncertain legal position.

A further alternative entails conversion to the cooperative model. This option offers the primary advantage of rapid acquisition of a legal form that allows financial intermediation of deposits, up to now a major weakness of the FSA model. However, FSAs would lose many of their distinctive and innovative features upon conversion. Some of the central features of the FSA model were designed specifically to address problems with the cooperative model, as has been discussed elsewhere in this review.

⁸ The PARMEC law was developed by the West African Central Bank, and applies to the West African Economic and Monetary Union (UEMOA) zone.

No existing framework fits the FSAs perfectly, and specialised laws may not be practical or beneficial. Country-specific research and consultations are needed to determine suitable legal and regulatory frameworks for FSAs that allow for financial intermediation while preserving the unique features of the model.

5.6 Donor Support

The FSA model would seem to promote good asset management and effective governance, and to allow FSAs to function successfully with only limited initial donor-funded assistance. FSAs have received much lower levels of technical assistance and donor funding than some other financial service models in rural Africa that are considered as success stories. The CVECA model for example, was developed with donor support over a period of more than ten years. However, initial and ongoing donor support has proved essential in developing the FSA model and establishing individual FSAs. Participatory analysis in Benin revealed a close link between the success of the FSAs and the intensity of follow-up provided by the donor-established support unit. Recent studies for DFID on FSAs in East Africa indicate that technical assistance may be needed for several years, and that external monitoring may always be needed.

The FSAs' status as for-profit and shareholder-owned institutions may eventually address the current loan portfolio quality problems. Those FSAs with significant problems will either respond positively to a situation whereby losses persuade shareholders to withdraw their investments, and institute the necessary reforms, or they will close. In other FSAs, as the membership and management become familiar with the FSA model, the situation may improve on its own. There is a close connection between share dividends and profit-based salaries and benefits on one hand, and on-time loan repayments on the other. As understanding of the FSA model increases among shareholders, as shareholders become more active in General Assemblies, and as management and staff become more competent in their roles, loan portfolio management and repayment performance may improve. However, to date it seems to be largely those FSAs that have received technical assistance for training staff and raising awareness among members that have made progress in improving portfolio management and reducing loan losses.

Much of the donor assistance has come through local NGOs or through support units, rather than directly to FSAs, thus increasing the cost-effectiveness of the assistance and avoiding the potentially prohibitive cost of providing individualised assistance to each FSA. K-REP has actively supported the development of FSAs in Kenya, with financial and technical support from DFID. K-REP carries out the initial market research and programme promotion, contributes to capital expenditure in the first year of operations of an FSA, and provides technical assistance (initially assisted by FSA International). DFID has directly supported the Ugandan Project Management Unit (PMU) and external technical assistance from FSA International. A local NGO in Benin, SYFIPRO (Système financier de Proximité), acts as facilitator for the FSAs and prepares other NGOs for the task, with support from IFAD through its PAGER and PROMIC projects. IFAD covers initial equipment and building costs, and SYFIPRO provides training and monitoring for the first three to four years of each FSA's existence.

IFAD estimates that the total direct cost of establishing an FSA in Benin equals about \$12,600, including the costs of building the office, buying equipment, and providing technical support. This figure may exclude a portion of the indirect costs incurred, such

as the market research done prior to FSA location and development of training materials. The average cost for setting-up an FSA in Kenya has been estimated at \$5,000. K-REP records an average figure of \$15,900 per FSA for the costs of its support and assistance to the FSAs in Kenya over their initial years of operation. A high-end estimate for the full cost of setting-up a FSA, including indirect costs, is provided by Jazayeri of FSA International, who estimates a figure of \$60,000 for establishing FSAs and taking them to full autonomy (i.e. the stage where they could pay for technical services on their own).

While the figures for donor support may appear quite low, FSAs are relatively small entities, with average share capital of between \$3,000 and \$10,000 and outreach of under 300. More detailed cost-benefit analysis is needed, comparing donor investment to the resulting outcomes and impact. Alternative methods of financing the establishment of FSAs, and the provision of technical support and training, need to be explored. Three possible solutions are outlined below:

- i. Provision of initial technical and material assistance by the support units as a loan, which is then repaid by the FSA to the support unit on reaching profitability. A donor would cover only the costs of establishing and capitalising the support unit.
- ii. Ownership of the support unit by FSAs, with membership fees covering the costs of operations. This would help ensure that the support unit remained responsive to the FSAs' needs, and would assist in promoting its sustainability.
- iii. Creation of a 'franchisee-owned franchiser', or AFSA (Association of FSAs), as advanced by Jazayeri, and similar to the franchising system developed by FinaSol with Financial Service Cooperatives (FSCs) in South Africa. An AFSA would provide the training and supervision package for a fee, and sometimes for an equity position in the franchisee's business. The franchisees – the FSAs – would agree to maintain standards and to respect the brand name. The AFSA could offer the same range of services as the support unit, with an improved incentive for ensuring that FSAs operate effectively. The FSAs could swap a percentage of their shares for shares in the AFSA, and pay a percentage of their monthly income for services.

Experience to date would suggest the following valid areas for donor intervention and support that ensure a positive benefit/cost relationship and avoid the distortion by donor funds of the FSA model:

- Assisting in initial market research and/or in determining suitable market conditions for the establishment of FSAs.
- Providing training and technical assistance to support units.
- Researching the financial service needs of the FSA shareholders.

Donors could usefully fund research that explains the low levels of uptake of savings deposits by FSA members, and that assists FSAs to offer a more diversified range of financial services. Action research could explore and develop low cost and straightforward deposit and loan products that appeal to a wider section of the rural communities where FSAs operate. Examples include loan products that meet the needs of the poorer segments of the FSA membership, or savings products that promote capital accumulation and investment. If the introduction of more attractive savings products led to increased volume and longer-term deposits, then FSAs would have a greater incentive to invest a proportion of the deposits. This dynamic in turn would constitute an important initial step towards developing linkages with the formal financial

sector. As FSAs grow in volume, more formal market mechanisms for the exchange of members' shares could be developed, thus providing further incentives for good governance and good financial performance.

There may also be a case for re-thinking the FSA model, and introducing stricter controls on board elections, board and management borrowing, and the independence of management/board relationships. Further research is needed into such internal governance issues. It may be that the structure of shareholders' voting and lending rights should be revised to ensure that the needs of the whole membership are represented, without over-diluting the positive incentives for share investors.

The following areas are less valid for donor support, and may even cause harm:

- Providing technical assistance and support directly to FSAs.
- Developing complex, bureaucratic, and/or expensive support structures and networks.
- Subsidised credit lines to FSAs for on-lending.

An effective support unit is important to maximise the cost effectiveness and impact of donor support. Donors need to push support units towards sustainability from an early stage, to avoid external dependence and prolonged or excessive donor funding. Support units should be flexible and streamlined, with complex support structures avoided (such as those associated with CVECAs and the Credit Union networks found in West Africa and elsewhere). The relationship between FSAs and support units should be *transaction-based*, with the support units responding to demand from the FSAs rather than to donor policy. Mechanisms for charging for support units' services and for allocating costs need to be further developed and more widely introduced.

Donor support in the form of subsidised credit lines to FSAs would risk distorting the structure of ownership and incentives within the FSA model. One of the strengths of the FSA model is that sources of funds can be shares bought by members of the community, savings (depending on legal and institutional capacity issues), and loans from commercial sources, backed by the FSA's own equity and assets. External subsidised funding would lead to artificially high returns ripe for capture by the more influential clients, or to unsustainably low interest rates on lending. The influence of the donor on the FSA's policies and management might also grow, at the expense of the shareholders' interests.

6. ASSESSMENT AND IMPLICATIONS FOR DONORS

FSAs offer increased access to financial services in relatively remote or small rural communities. They improve the outreach of the financial sector in rural areas, add depth to the rural financial market, and offer potential solutions to governance and sustainability problems. FSAs have the potential to operate sustainably in rural areas not covered by existing microfinance institutions (MFIs) and cooperatives. FSAs can achieve financial sustainability relatively rapidly, although important caveats remain concerning the need for a healthy loan portfolio.

Donors and potential investors wishing to examine the FSA model more closely may also be interested in: 1) the type of services offered, 2) the current and potential scale of

outreach, 3) the profile of those who benefit from FSA services, and 4) lingering questions on governance. As yet, FSAs have offered a restricted range of services. FSAs presently rely on members' capital as the principal source of funds, and mostly lack the technical and organisational capacity to broaden the range of services offered.

Improving the range and terms of financial services offered makes good sense for both commercial and development considerations. By increasing the volume of transactions while maintaining efficient operations, FSAs could become more competitive by offering more favourable rates to savers and depositors while still ensuring investor returns. Access to banking services – through linkages with the banking sector – would also be an important competitive advantage for the FSAs.

Individual FSAs may never grow substantially in scale, as they are limited by the population and economic activity levels of the rural centres in which they are located. Scale-up in terms of numbers of FSAs should perhaps be the key measure, rather than increases in the size of individual FSAs, and in Kenya and Benin an impressive number of FSAs have been established over the preceding four years.

FSAs are shareholder bodies that exist for the benefit of the shareholders, not explicitly for the poor or for any other group. FSAs are principally *investor-driven*, reflected in high interest rates for borrowers, and zero interest rates for depositors. To date, FSAs have concentrated their efforts on the provision of expensive short-term credit to those who can offer collateral. The poorer sections of rural communities have tended not to join FSAs, and levels of participation by women are low relative to other community-based financial service providers.

FSAs offer a simple yet potentially strong governance structure, and the scope for incentive-based remuneration and reward systems that promote good asset management and profitability. However, many FSAs face significant problems with poor or distorted governance and poor portfolio quality. These problems may be due to poor technical capacity within many FSAs, and to low levels of awareness among many FSA members of their rights and responsibilities. Continued external technical assistance and monitoring may be needed in many cases to address these problems, although the cost of this needs to be compared carefully with the potential resulting benefits and impacts.

Donor credit lines and grants for on-lending would be an inappropriate means of donors encouraging scale-up, as these would dilute community ownership and distort the strong incentive systems that underpin the model. Donors wishing to support FSAs should instead concentrate on improving the FSA model, focusing particularly on the products and services offered, and the governance structures. Donors should strengthen the support units so that they can provide more effective technical assistance and training. Mechanisms should be developed to reduce the need for donor support to the support units over time, increase their sustainability, and reduce the level of donor subsidies needed for FSA start-up costs.

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APPENDIX II: SAVINGS AND CREDIT COOPERATIVES VS. THE FSA MODEL

	S & C Cooperative	FSA
Ownership structure	Registered under the Cooperative Laws or under the Bank and Financial Entity Laws	Registered as civil associations or companies
Profit Orientation	Non-profit but aiming at sustainability	For-profit
Share sale/valuation	In some cases shares may be redeemed at their nominal value, or alternatively shareholders wishing to leave simply net their shares off against remaining loan balances	Shares can be sold at market value, which depends on the FSA balance sheet (although lack of secondary markets at present inhibits this). FSAs agree to buy back shares after a specific period of time.
Dividends	Low or nominal	Can be higher
General Meetings	Typically only Annual and occasional Extraordinary General Meetings	Annual plus Quarterly General Meetings
Voting Rights	One person one vote	In many cases (not all), depends on number of shares held (with a pre-set maximum)
Board remuneration	Usually voluntary	Remunerated on the basis of profits made (in many cases)
Management remuneration	Fixed salaries or voluntary	In many cases linked to profitability of the FSA
Access to Loans	Loan amount usually directly linked to amount deposited.	Loan amount linked to size of shareholding.
Interest Rates	Generally relatively low interest rates for both savings and loans	Very low (if any) interest on savings, and relatively high rates on loans.

Source: adapted from DFID (2000)