Summary - The FSA is an original approach to assist the poor to manage their money. It combines the principles of an investment company that focuses on risk capital, financial returns, and shareholder value and that of community finance that focuses on proximity, social capital, user ownership, and outreach to the poorer segments of the community. The emphasis on an equity based organisational design is in sharp contrast to the more commonly known credit union model that emphasises savings and minimises the role of equity. The FSA also stands out in contrast to traditional credit-only donor driven NGOs in which there are no stakeholders comparable to the equity shareholders in the FSA. The FSA is the first community finance model that mobilises risk capital from investors by offering high returns while providing cost-effective and accessible financial services to the local community and thereby contributing to poverty alleviation. High returns are made possible because of the high demand for loans, commercial rates of interest, and ceilings on expenditure relative to earnings. Local ownership and high returns allow the rapid expansion of the equity base that can then serve for deposit mobilisation. Local ownership enables the institution to redistribute profits to local shareholders/customers as dividends or as capital gains through higher share prices. User-ownership brings commitment and loyalty to the institution, provides better incentives for good management, and nurtures social capital that contributes to raising equity and improving loan recovery. The FSA combines the advantages of user ownership together with modern governance, management and contract enforcement techniques to create an effective financial institution. These features are rarely achieved under the same roof in microfinance. The article explores the origins of the model, its distinctive features, key implementation issues, some of the lessons learnt to date and future directions for FSA development.

I. INTRODUCTION

The concept of Financial Services Association has been about eight years in the making. After an initial formulation period, the first FSAs were created in 1994 and the FSAs corresponding to the mature model date from 1997. The methodology was developed by the author as a way of addressing some of the shortcomings of rural credit, co-operative credit, and many microfinance programmes. After a slow and difficult beginning that involved convincing many sceptics and many organisations, the FSA model has become a new addition to the microfinance tool kit and has spread to eight countries in Sub-Saharan Africa. Its essential strength is that it is based on mobilising financial capital, social capital, and human capital from within the rural communities by combining traditional bonds and modern financial and management technologies for providing sustainable financial services. Before exploring the concept and its main features in detail, the article explores a number of issues in microfinance that are subsequently addressed through the FSA concept. These issues also enable the reader to better understand the relevance and the strengths of the model within the contemporary microfinance debates.

II. SOME ISSUES IN MICROFINANCE

Credit-led Paradigm

There is a growing recognition that returns to micro enterprise in the developing countries are quite high and the poor involved in such micro and small businesses (including

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1 - The concept was originally formulated and introduced by the author in 1994 through a pilot project in South Africa. The first published formulation of the concept was the author’s article in *Small Enterprise Development Journal*, June 1996. This updated and expanded version is to be published shortly in SED.
agricultural production) constitute a major market for financial services. It is further recognised that through a financial system approach involving adequate pricing, good financial management, and incentives to motivate repayments, financial services can be provided to the poor on a sustainable basis\(^2\). Different methodologies and organisational framework have been developed to provide or promote micro-financial services\(^3\). The dominant paradigm has been that of the “provision” of micro financial services by NGOs focusing on small amounts of loans to jointly liable poor group members for self-employment. These lending techniques operate without the traditional collateral and are designed to increase credit outreach to and ensure repayments through a standardised loan appraisal, monitoring, and recovery system\(^4\). The main criteria of success have been focused around the number of borrowers, amount lent, and repayment rates. The evidence on impact, however, is somewhat limited and, outside Bangladesh and Indonesia that appears to be the most active countries in terms of microcredit, the credit-led paradigm has had a more modest outreach\(^5\). The problem of information on impact is made worst because of the secrecy of NGOs regarding their own operations and the issue of verifying the claims made about outreach and sustainability. In most countries there is no national authority to monitor NGO standards and they are not obliged to provide standardised information regarding their operations and impact.

International donors concerned with poverty alleviation often use credit NGOs without worrying too much about future sustainability. There has been a major increase in the number of NGOs providing microcredit in many countries all funded by international donors and/or governments. Opening a microcredit NGO has even become a business in its own right and sustainability has in some cases been defined as how best one can mobilise donor funds. Clearly as long as there are social funds available from national and international sources, credit NGOs will continue to survive. The issue here is to what extent credit NGOs offer the best value for money for such social funds, how many of such NGOs are needed, what is the optimal scale of operations, and what is the start-up and accompanying costs to develop significant outreach. The strategic question for the future is whether or not microcredit NGOs are the most appropriate vehicles for having the best outreach at lowest cost and what are the alternatives to this model.

More recently, the analysis of microcredit programmes has revealed that the evidence does not always substantiate the claims\(^6\). Others have revealed some of the negative effects of this credit-led paradigm\(^7\). The pressure to lend by the providers and the constant renewal


\(^3\) For an original discussion of the distinction between “promoters” and “providers” of micro financial services see S. Rutherford, *The Poor and Their Money*, Oxford University Press, Delhi, 2000.


\(^5\) The example of Kenya is instructive. After fifteen years of microcredit programmes and over $100 million of donor money spent on these programmes, the total number reached is about 70,000 (author’s own field estimate). KREP that was probably the largest credit-led NGO in Kenya managed to reach only about 14000 clients since it was started. D. Hulme (see footnote 7 below) has reached a similar conclusion.


of loans has lead to over-indebtedness and social tension. The borrowers who want to leave the programmes are referred to as “drop-outs” as though they have failed their schooling. The emphasis is on constant renewal of loans and the permanent dependence of the borrower on the lending institutions. There is also evidence that third or fourth generation borrowers are likely to default as soon as they may no longer require receiving the next loan. The fact that microcredit methodologies do not use the voluntary savings record or collateral and fix arbitrary loan sizes regardless of individual needs is a contributing factor to this over-indebtedness. It may be useful to remember that traditional banks use the borrower’s savings record and assets as a measure of debt capacity combined with some indicator of future earnings. Without these fundamental indicators, and when lending levels become an objective of their own, it is not surprising that the credit-led paradigm has created a situation of over-indebtedness in some instances. Recent research in Uganda has revealed that many MFIs appear to have the same customers who are borrowing from one NGO to repay the others and who after several loans end up in a severely indebted position that usually leads to defaults with uncertain impact on the borrower’s net equity.

The focus on the provision of loans and loan recovery has existed in spite of the general recognition that savings are the “forgotten half of microfinance”. The poor do save and they themselves have developed a variety of indigenous and ingenious ways of managing their money. The savings dimension of microfinance however, is not yet incorporated in the operations of most credit NGOs. Legal obstacles for mobilising deposits have further contributed to dependence on external donors as the main source for funds. Some NGOs have tried to mobilise local savings through an involuntary savings programme as a condition for access to loans but such savings have not been large enough to replace dependence on external funds and legal obstacles have prevented the open use of these funds for loan making purposes. Some NGOs believe that mobilising deposits is expensive and risky with many legal and administrative obstacles and if they can continue to mobilise donor funds and build up an adequate equity base, they may not require mobilising deposits.

Credit Unions

Credit unions and Savings and Credit Co-operatives (the so-called SACCOS) have existed for much longer than the new generation of the microfinance institutions and have mobilised substantial levels of member deposits. Co-operatives or credit unions have been more successful when they have been employee-based in urban areas or in some instances when they have been crop-based in rural areas. The area-based community finance credit unions, however, have had a higher failure rate and have not taken root in developing countries. In all cases, however, the saver-dominated credit unions have had far better success than the borrower-dominated credit unions. Credit unions appear to succeed most where members have a regular and secure source of income. This justifies lending at a low

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9 - The examples of successful savings mobilisation schemes among the poor are not many. The principal example usually cited is that of BRI’s Unit Desas in Indonesia. The BRI’s model has however not been replicated widely for institutional and historical reasons that makes Unit Desas difficult to replicate. For an early analysis of the BRI Unit Desa model see M. Robinson, “Savings Mobilisation and Microenterprise Finance”, in Otero and Rhyne Op. Cit., Ch. 2. For a more recent analysis of a Unit Desa branch see M. Harper, Op. Cit, Ch. 16. For more recent success stories using various techniques from the informal money collectors and ROSCAs (e.g. SafeSave) see Rutherford (Op.Cit).
10 - For a clear and insightful discussion of why the poor save, how the poor manage their savings and how informal associations, pro-poor banks and MFIs provide or promote financial services see The Poor and Their Money, S. Rutherford, Oxford University Press, New Delhi, 2000.
rate of interest since the loan is usually guaranteed by the salary or the crop marketing deductions. The bulk of credit union lending activities is usually for consumption loans (consumer durable or emergency credit) and small business loans are not a prominent feature of credit unions due to the associated risks and the risk-averse attitude of members. The principal strength of credit unions is their focus on user-ownership and the emphasis on proximity, social capital, and member loyalty. The principal weakness of credit unions is their low rates of interest and the consequent capitalisation difficulties. Credit unions do not offer any incentives to their members to buy shares as a form of investment and therefore the only mechanism to increase capital is via retained earnings which are often non-existent or very limited. Poor capitalisation has prevented the co-ops to expand their lending operations because of the capital adequacy constraint. Poor capitalisation is also a result of low interest rate policies and the fact that by law co-operatives are basically “non-profit” and the “dividend-hungry” members are frowned upon.

**Deposits versus Risk Capital**

An alternative to deposit mobilisation is the mobilisation of equity (as opposed to debt). This option, however, has rarely been explored by NGOs. This approach could eliminate the legal obstacle for mobilising private funds since banking regulations are designed to protect deposits but do not cover risk capital that can go up or down in value according to the market perception and the intrinsic value of the institution. In spite of this potential advantage of risk capital as opposed to deposits as a means of avoiding the regulatory hurdles, most NGOs have not been in a position to raise private equity to replace donor funds. This is because the MFIs with NGO status are essentially ownerless and because of the lack of own equity, it has been usually difficult for them to raise private commercial fund as equity. To overcome this difficulty, most NGOs want to transform to a for-profit bank status so that they can mobilise deposits and equity as a long-term strategy.

**Commercial Banks**

Traditional banking methods with emphasis on branch networks, formal employment and security is not profitable in many rural environments because of pricing (interest rate) restrictions and the socio-political factors preventing banks to charge high enough interest rates to cover their rural lending costs and achieve adequate an return on their equity. Banks therefore concentrate largely in urban areas and deal principally with high net-worth customer, with salaried individuals in the formal sector, and with the public sector to minimise risks. Moreover, in developing countries banks usually achieve a good return on shareholder investments so that moving to rural areas and to a new market niche may not be on the agenda. Attempts to develop rural banks have had mixed results.

In Ghana and Nigeria, for example, the rural banks and the community banks have been developed along traditional banking principles. Because of limited scale and pricing restrictions, however, very few of such banks have actually managed to become profitable.

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11 - These observation are based on the author’s own observations of credit union activities in the developed and in the developing countries.


Interest rate restrictions on these rural banks has also meant that they become risk averse and tend to develop a low risk and low return portfolio with a substantial holding of treasury bills. They have therefore tended to mobilise rural deposits but have achieved only limited lending to rural borrowers. This has caused a drain of rural savings into urban areas. This appears to have also happened in the case of BRIs Unit Desas that have mobilised far more savings from rural areas than they have managed to lend to rural areas. Moreover, being government owned, the profits generated from the Unit Desas are taken by the BRI itself as there are no local shareholders. Commercial microfinance banks are now being set up in a number of countries and it remains to be seen how a commercial banking model could be adapted to operate profitably in rural areas.

Financial Liberalisation and Informal Finance

Liberalisation in many developing countries has not improved the outreach of formal financial institutions in rural areas. Many banks have in fact closed their branches as a direct result of liberalisation. The evidence shows that in fact after liberalisation it is the informal financial sector that has expanded due to the increased circulation of cash and the need for financial services. Informal financial arrangements such as ROSCAS (Rotating Savings and Credit Association) and ASCAS (Accumulating Saving and Credit Association) or SHGs (Self-Help Groups) are now extremely widespread. These arrangements perform well while small but because of management and governance problems have difficulty in gaining scale and institutionalising themselves. Once they move away from the instant redistribution of funds on the table (a basic ROSCA), and as soon as there is some accumulation (moving towards an ASCA), then the members face a permanent verification problem that can not be resolved without proper accounts, procedures, and accountability. Without a proper set of accounts, the members/depositors cannot verify if the system is working well enough to ensure safety of funds. Formalisation and institutionalisation with rules and accounts is needed once the verification problem caused by increasing scale becomes unmanageable through simple traditional methods. This is why one inevitable method of self-regulation by informal groups is the cyclical dissolution. Successful ROSCAs/ASCAs that can pay the money back (sometimes with interest) continue while those that cannot pay back are dissolved. This is an extreme but necessary form of self-supervision when there are no other means of verification. Mechanisms to assist informal groups to improve their accounts and accountability has not been on the agenda of the microfinance industry that has put singular emphasis on NGO graduation to regulated bank status (not a self-evident process by any means). The issues related to the institutionalisation requirements for the broad spectrum of micro financial systems in the informal sector have been largely ignored.


16 - In many informal systems, adequate financial management is an “experience” good as opposed to a “search” good. The distinction refers to the ability to verify quality ex-ante (through search) or ex-post (through experience). When the quality of a commodity is variable (the case of good financial management in informal financial systems such as ROSCAS and ASCAS), the measurement of management quality can be too costly for members (cost of regular audits) and often the only method to ensure verification is to dissolve the system before it gets out of control. The promotion of informal financial arrangements such as informal Self-Help Groups (or on-lending groups) and ASCAS must therefore be conditional on addressing the verification issue.

Interest Rates

Commercial interest rates in the informal sector are normally much higher than bank rates in most countries. Local money market rates usually reflect the local trading margins and the rapid turnover and rates of return as high as 5% to 10% per week are not uncommon in many parts. Many ASCAS appear to lend to their members at rates ranging between 10 to 20 percent per month. Studies of rural micro-commerce and micro-enterprise reveal that high rates of interest in the region of 10 to 20 percent per month is not a major issue for the borrowers since they can afford it. Access to credit is usually far more important than the cost of the loan. Field experience has also revealed that in rural areas it is the monthly rather than the weekly repayments that are generally the preferred method since weekly repayments diminish the working capital rapidly. High interest rates, however, have social acceptability limits even if they may be affordable by the borrowers. If outsiders (such as the major NGOs or banks) own the organisation, it is difficult to justify a high enough interest rate to achieve sustainability since the profits do not remain with the local community and the local customers may feel being exploited. Such social obstacles to charging commercial rates of interest by the MFIs are usually ignored in the usual technical or financial discussions of the role and importance of interest rates.

Microfinance Regulation and Supervision

There is general recognition within the microfinance industry that although some sort of regulation and supervision is required to ensure standards and protect the industry, the present prudential regulation for the banking sector is inadequate or inappropriate for microfinance institutions and microfinance portfolios. The main issues with existing banking laws are: (a) interest rate limits and barriers to entry, (b) minimum capital requirements; (c) authority to mobilise deposits (d) unsecured loan sizes without the traditional collateral, and (e) reporting and documentation requirements. A major issue that is highlighted by the literature is the questions related to governance and ownership of NGOs since they have no clear owners and the assets of the board members are not at risk and they may not provide additional equity if the need arises. Even when MFIs become formal financial intermediaries, often the shareholders may not be commercial shareholders but mostly international organisations and not-for-profit institutions and not private individuals or institutions with private equity at stake. In such cases, poor performers may ride longer than prudence would dictate. In other words, without significant resources at risk, investors lack the incentives to monitor the institution properly and this can be the case with ownerless NGOs. Moreover, once the shareholders are transformed into commercial shareholders without a social objective, the organisation’s policy may change and disconnect from poverty alleviation concerns.

18 - For a concise discussion and presentation of evidence from India and Kenya see Malcolm Harper, Profit for the Poor, Ch. 2.
19 - The weekly repayment method advocated by the Grameen Bank may therefore not be “best” practice for rural borrowers who may need the month for achieving the necessary turnover to repay their loan.
20 - See for example, Banking Services for the Poor: Managing for Financial Success, R. Christen, 1997, ch.3 and 4.
The literature describes a number of options for microfinance: (a) no regulation - where MFI is free to innovate – this is the situation of the majority of MFIs today, (b) self-regulation - as in the case of credit unions and other user-owned systems, (c) third party – giving the supervisory responsibility to a competent third party in cases where the superintendents do not have the technical expertise or lacks the interest to monitor the MFIs – this approach would allow the public regulator to only supervise the third party who in turn would supervise the retailers as in the case of BRI who supervises the Unit Desas, the municipal banks in Peru (a kind of franchiser control on the franchisees), and the Credit Union Rating Agency in Guatemala (d) existing law – through the application of the existing framework, (e) special law - regulation specific to microfinance as in the case of the PARMEC law for credit unions West Africa.

The user-owned MFIs are usually assumed to be self-regulating either as stand-alone units or as being under an apex organisation. The experience with self-regulation is poorly documented and at best very mixed. Most African co-operative apexes have failed to provide the necessary support and supervision to their members. The problem is that self-regulation offers no teeth for the apex organisation to enforce compliance. Unless the apex is externally supported, they often lack the technical know-how for adequate member supervision. Donor dependence on the other hand has the negative consequence of not making the apex accountable to the members. The difficulties associated with self-regulation have lead to a search for other viable options for the supervision of user-owned systems. In Guatemala, a Credit Union Rating Agency inspects credit unions that can, upon certification, display the agency’s logo in their premises as a sign of quality. Third party supervision of user-owned systems through certification, licensing, or franchising appears to be a promising way forward. It is the third party approach that is especially relevant for the FSAs as described later in this article.

II. FINANCIAL SERVICES ASSOCIATION (FSA)

Introduction

The Financial Services Association is a new and original addition to the microfinance tool kit and its essential contribution is to highlight the role of local ownership and of local capital in the development of sustainable microfinance. The FSA involves mobilising local savings in the form of equity capital in order to build-up a strong capital base, providing micro loans at commercial rates of interest, using the equity for mobilising debt in the form of savings deposits, and develop a broad range of other financial services such as money transfer facility, and insurance. It uses the available local information and knowledge (social capital) about its shareholders that are its sole clients for lending and loan recovery purposes. The building-up of FSAs encourages the development of local management capacity since the local people manage it with transparent and simple rules, a simplified but professional accounting system, and internal controls hence resolving the verification problem. The FSA being locally owned, financed, and managed, also addresses some of the key issues of ownership and governance in microfinance through the introduction of checks and balances in its governing and management bodies. The FSA allows a greater say to those shareholders bringing in larger equity and therefore establishes a

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22 - Author’s own observations of the credit union apexes in Togo, Cote d’Ivoire, Guinea, Kenya and Uganda.

counter balance from within the shareholders to counter the monopoly powers of the board and the management. This makes the FSA more accountable than traditional co-operatives where all members have one vote and member power is highly dispersed and therefore ineffective.

The FSA involves the separation of ownership and management since the elected board does not directly manage the institution but uses hired professional managers whose pay is directly a function of FSA’s income. The FSA supervision arrangements are based on the licensing/franchising approach that ensures quality control and sustainability (the third party approach). Once the minimum capital requirement is reached, the FSA can then graduate to become a full service local bank under the normal supervision of the country’s bank Superintendencies.

**Detailed Description**

**The Share-Holding System**

Individuals wishing to utilise the services of the FSA must be shareholders. The FSA does business only with its own shareholders rather than the general public and it is therefore a user-owned institution. A minimum of one share is required for joining the FSA. Shares are priced low enough to allow maximum participation by all adults. Shareholders can buy an unlimited number of shares with proportional voting rights and dividends. This rule is different from the usual co-operative rule that establishes upper limits for share ownership. The share-holding system also allows easy entry for new shareholders since shares can be bought at any time at the market price so that the institution does not become a closed club. The share price increase is a way of ensuring that new shareholders cannot enter and benefit from the accumulated reserves without paying a higher price as compared to the older shareholders. Share ownership is open to the public although only residents can borrow and can vote in the General Meeting. Non-resident shareholders are purely investors who consider the FSA to be an attractive investment fund. Shares that are older than one year can be sold back to the FSA at the end of the financial year at the market price.

The equity capital is entirely available for lending as soon as it has been mobilised. This is an important strength of FSA as compared with savings/credit co-operatives that need to wait a long period before the lending phase can begin. This is because the FSA initially focuses on mobilising risk capital and not on mobilising deposits. Lending from risk-capital is not subject to the same regulatory and prudential rules as lending from deposits since the shareholders are sharing the lending risks with the FSA. Shares, unlike deposits, may or may not be withdrawable at full value. Shareholders can buy additional shares and the benefits or losses are distributed according to shares. The share-holding system gives incentives to shareholders to hold additional shares as an equity investment, as well as keeping a close eye on FSA management, since dividends and share value are linked to performance and to the FSA’s intrinsic value. The remuneration of shares through dividends and capital gains is an important difference of design compared to co-operative arrangements in many developing countries that have fixed share prices and have limitations on paying dividends. Furthermore, the central role of equity in the FSA model means that the FSA is adequately capitalised hence benefiting from a safety net and better credit-worthiness, a characteristic which is often absent in similar grassroots organisations, co-operatives, and NGOs.
Share-holding by any one individual is unlimited although limitations are necessary regarding voting rights in order to ensure that the locally influential and richer people do not take total control of the FSA. Each additional five shares will give entitlement to an additional vote with a ceiling of 10 votes in the General Meeting per shareholder. The rule designed to allow a more rapid accumulation of the capital base while ensuring greater incentives for individual shareholders to participate in the governance of the institution.

FSA shares are negotiable in the sense that they can be bought and sold by shareholders without permission from the FSA. The market-based transaction of shares is a key difference between the FSA and a co-operative where, according to co-operative law, shares are non-negotiable. Moreover, the FSA has the obligation of buying back its shares (from those wishing to sell) once a year, after the financial audit, once its share price becomes known to the shareholders. In practice, the market for shares among private individuals is still undeveloped since, for the time being, shares can be bought at any time from the FSA itself at the official price and there is no reason for a new or an existing shareholder to buy from a third party. There have been instances when a shareholder wants to liquidate his shares earlier than the FSA buy-back time at a discounted price negotiated between the parties. The supply of FSA shares is not fixed and shares are being issued all the time. Once the FSA becomes large enough (relative to management capacity), then they can stop issuing new shares all the time and the share price can then reflect not only book value (as it is at present) but also the market demand for existing shares. The negotiability of shares has an important psychological value as it assures the shareholder that this is indeed an investment that yields a return and not just a sunk cost.

Governance and Management

The supreme governance body of the FSA is the annual general meeting (AGM) of shareholders that approves the constitution, discusses key policy issues, elects the officeholders, and provides legitimacy to the institution. The shareholders adopt the constitution and bylaws and elect the officeholders. Shareholders meets at least once a year to review progress to date, approve the previous year’s balance sheet, approve the annual budgets, discuss financial performance, and elects or dismiss any officeholder. The AGM elects a board of directors and an audit committee on an annual basis. The board has usually 5 members (at least two women) and the Audit committee has three members (at least one woman). The board members are the chairperson, the secretary, and three members of the credit committee. The audit committee has three members who are responsible for financial auditing, social auditing and customer care respectively. The candidates for the position of the chairperson are elected specifically for that post. The chairperson provides leadership and guidance but he/she is not involved in micromanagement. The board also appoints a credit committee from its own members (excluding the chairperson). The credit committee has the responsibility for the approval, monitoring, and recovery of loans and it is also in charge of borrower training. It also advises the board on loan policies, the rate of interest, and on appropriate investment and risk management strategies.

The functions of the audit committee are to ensure conformity to rules and regulation and shareholder orientation. The audit committee has no executive functions and it is not part of the board. Officeholders are paid according to performance and their salary is related to a percentage of FSA revenue. The essential point in FSA governance is to ensure real (not just formal) ownership by shareholders who must actively and regularly participate in discussing the policies and activities of the institution, ensure that information on key
issues is available regularly and in a simple form that can be easily understood by shareholders, that information is transparent, and that the board and the audit committee are working effectively to ensure adequate policy formulation, oversight, internal controls, and conflict resolution.

The board appoints a paid manager and a paid cashier (one of them should be a woman) for the daily operations of the FSA who are then trained in the FSA day-to-day management including administration and bookkeeping. This is a full time employment since the FSA is open every day (Monday to Saturday) during normal business hours. Before the lending operations begin, the managers and cashier are paid a small salary from the sale of passbooks. Once lending gets underway, their salary will be directly related to a percentage of FSA revenue. The manager reports to the board and the board reports to the general meeting of the shareholders.

**Accounts and Expense Control**

The FSA has a simple bookkeeping system based on a combined cash book/general ledger, personal ledger cards, a set of stationaries for different types of transactions, a loan tracking book, personal passbooks, and a minutes-book. All transactions are entered in the cash book/general ledger directly without going through daybooks that normally sum up daily transactions prior to their entry in the general ledger. This basic book is designed in such a way that the left side serves as a cashbook and the right side as general ledger. The manager and cashier and the members of the Audit committee are trained in double entry bookkeeping and are obliged to issue a trial balance to account for the sources and used of funds weekly. The general ledger is complemented by a personal ledger (control account) for each shareholder and the totals for general ledger and those in the personal ledger are controlled each month to ensure that all cash transactions can be traced to somebody’s account. The cashbook provides a running cash balance and every week the totals must be reconciled with the money in the safe and in the bank. These controls are designed to provide a simple yet effective accounting framework that can allow instant controls and prevent chronic financial mismanagement.

To ensure expense control, the FSA’s rule is that no more than half the revenue should go for expenses and at least the other half should be available as net profits. So far in most FSAs this ratio has been up to 40% of revenue. Of the amount available for expenses, the priority expenses such as rent, electricity, transport etc. are first deducted from the available gross revenue and it is from the remainder that 70% goes to the cashier and the manager, 15% to the board and audit committee members, and the residual is put as a reserve for stationary. This rule is aimed at ensuring that the FSA is profitable and that officeholders and employee are motivated to increase the organisation’s performance and revenue.

**Savings**

Each shareholder must open a savings account since to become a member, the shareholder must also buy a passbook that serves for recording his/her savings and loan transactions with the FSA. The savings accounts offered to shareholders respond to the need to have a money safe-keeping facility but the resources hence mobilised are not initially used for lending. Savings can receive some remuneration if there is a nearby local bank where excess funds can be deposited and can receive interest. In cases where the FSA does not have access to a local bank, savings cannot be remunerated as long as they are not lent. Customers
looking for returns on their funds are therefore encouraged to buy shares in order to receive annual dividends and benefit from increase in value. There is no maximum limit for deposits but there is a withdrawal commission usually fixed at 3% (or less) to pay for the costs involved in providing this service. The FSA can gradually offer a wider range of accounts with competitive rates if the corresponding services can be ensured via a link-Bank. Once the FSA starts lending from the savings, the interest rate payable would depend on the margin needed to make the service profitable.

**Loans and Interest Rates**

Loans come from FSA’s capital consisting of the equity raised from the sale of shares and from retained earnings. The board of directors determines lending terms and criteria including the interest rates, duration, eligibility and other conditions. The board includes a credit committee that appraises each loan application prior to issuing the loan. Loan appraisal involves an assessment of the borrower’s character, capacity to repay the loan, and collateral. The collateral has so far included land, house, and chattel such as television, motorcycle, bicycle, and furniture. Even land without an official title has been used as long as the owner agrees to provide a written statement, approved by the local councillor, that the land in question belongs to the borrower and that the land will be confiscated and auctioned by the FSA in case of default.

The loan is issued based on a loan agreement that specifies the amount, duration, repayment schedule, and the assurance that the collateral can be taken by the FSA without going to court. A guarantor must also guarantee the loan in case the borrower defaults and the security cannot be taken or that it is insufficient to repay the loan and the expenses of recovering it. The guarantor must have adequate collateral or reputation and should not normally be indebted to the FSA. Normally one person can guarantee only one loan unless the person is sufficiently wealthy and trustworthy so that the FSA can agree to issue more than one loan with his/her guarantee. Group lending has not yet been used by the FSAs although this is a possibility. Shares are not used as collateral although in effect they partially guarantee the loan. In this respect the FSA lending methodology is different from the joint liability group methodologies that do not require collateral.

Apart from small emergency loans for the granting of which the decision is delegated to the manager, the manager transmits all loan applications (with his/her recommendation) to the credit committee. The credit committee is also in charge of borrower training to ensure that the loan’s terms and conditions are well understood by the borrower before disbursement. To avoid relatively large loans to only a few individuals, no single borrower is allowed to initially borrow more than 10% of FSA’s capital and no more than 4 times the value of their shares. These ratios are modified and made more flexible as the FSA gathers experience and expands its financial resources. Loans are wide ranging including consumption loans and business loans. Lending starts through short term lending and gradually moves into term lending with increasing resources and experience of the FSA. To minimise insider dealings, the management organs of the FSA cannot receive any loans from the FSA during their first year in office and they cannot participate in the decision regarding their own loan.

The board determines the lending rates by reference to the local money market, demand for loans, and periodic consultation with their own shareholders. The interest rate is not determined by the shareholders in the general meeting and such a decision is not put to
vote. The experience with FSAs so far shows that the FSAs have adopted rates varying between 10% to 20% per month. Experience shows that through time and good performance, the FSA lending rates tend to come down. The rate of interest is calculated on a reducing balance basis. The calculation technique is very simple and can be taught to the manager in a short lesson.

Each borrower also contributes to a Loan Insurance Fund (LIF) which is 3% of the borrowed amount. The purpose of the LIF is to reduce the burden on shareholder capital for bearing the lending risks. On time repayments are rewarded by a bonus amounting to 1% of the principal.

**Loan Repayment and Recovery**

The FSA's local knowledge ensures good borrower selection (reducing but not eliminating the risk of adverse borrower selection). The identification of borrowers with the interest of the institution (through the share-holding mechanism) diminishes moral hazards and local informal pressure (other shareholders) reinforces repayment discipline. The uses of such informal techniques, however, are not sufficient for good repayments. The FSA has to ensure an active follow-up on loans and ensure adequate borrower understanding and commitment to the FSA as well as use formal enforcement mechanisms such as the police and the courts as a last resort. In many cases, the repayment may be made late or through partial payments. In case of late or partial payments, the FSA requires that at least interest be paid on time. Borrowers missing their payments receive three reminders in writing before the FSA commences recovery proceedings. As a last resort, the FSA can and does go to court to recover the loan. The wording of the loan agreement is essential in allowing quick court proceedings and decision in favour of the FSA.

**Profits and Dividends**

Each FSA undertakes an annual end-year audit to determine its net profits, decide on annual dividend payment to shareholders, and determine the new share price. There is no fixed policy on what percentage of annual profits should go to dividend as this would constitute a fixed obligation on the part of the FSA and it should be avoided. Dividend payments can increase as the FSA accumulates a larger equity but initially it has a symbolic function to demonstrate that shareholders can also get a cash payment over and above the increase in share price. The new share price after dividend is determined by taking 90% of the book value (or intrinsic value) and dividing the capital and retained earnings by the number of existing shares. The reason that the new share price does not reflect 100% of book value is a prudential one to avoid a complete de-capitalisation of the FSA in case every one decided to sell the shares back to the FSA. So far, however, very few individuals have actually used the share buy-back facility offered by the FSA. Usually, at the end of the year, because of the good returns, shareholders have tended to increase their share holdings.

**FSA as A Business**

The essential driving force of the FSA is return on individual equity. This is a key point that highlights not only service provision but also the critical role of individual and local ownership and incentives in ensuring sustainability. The FSA should not be conceived
primarily as a credit delivery mechanism to poor rural borrowers\textsuperscript{24}, even if this is one of its principal functions. The FSA is built upon the idea that because of high returns to small and micro enterprises, an equity driven (as opposed to a debt driven) approach can be more successful and can avoid the traditional problems associated with co-operatives and other community based financial institutions. The investors bring large sums of money in order to receive a handsome profit on their funds. This incentive and its consequences make the FSA radically different from all other microfinance methodologies. Moreover, FSA is a local business (a money shop) and not just a community service. In practice, it has a double bottom line (financial and social). It is a good business strategy that allows access by the poor to financial services and therefore contributes to poverty alleviation (a social goal). This is different from many development programmes with a well-elaborated social goal but without an adequate business model.

**Linkage with Financial Institutions**

Initially, links with banks are not needed. Local equity is raised through shares that are transformed into loans to FSA shareholders. It is a closed and expanding circle. Local money is recycled as local loans again and again. If the FSA introduces savings facilities (purely for safekeeping purposes, as it is initially not allowed to lend from savings), then the link with a bank may become useful. Initially, it may not be profitable for the FSA to offer interest on savings since the transaction costs can be too high for transporting money to and from the bank. Moreover, the FSAs own capacity to accept deposits is limited by the size and the safety of its premises. With large volumes, the safekeeping facility linked with a bank becomes commercially interesting for the FSA. Moreover, with large volumes, medium term deposit accounts (3,6,9 months) could be offered and the FSA benefits by offering a rate lower than the one offered to it by the link-bank. If the FSA introduces transfer/payment services, again the link-bank can become a necessary partner. In some FSAs, salaries are being paid through the shareholder’s FSA account via the link bank. Other money transfer services (with link banks) such as cheque cashing facilities or money orders from the FSA could be potential revenue earners for the FSA if it can establish sufficient volumes to justify the transport, insurance for money in transit, and the book-keeping costs. Most FSAs at the present are not offering these services but they all intend to do so. Finally, if saving deposits could grow to establish a permanent float (and if the regulatory hurdles could be overcome), then the FSAs could expand their lending activities considerably and the link-banks could provide liquidity relief when necessary. Other services such as insurance, if offered by the FSA, necessitate further linkages with financial institutions. Life insurance and commodity price insurance is also on the agenda and will be introduced on an experimental basis shortly by the FSAs.

**The Clientele**

The services are not intended to be targeted to any specific group, as the FSA is an all-inclusive approach. Those with money are linked to those who can invest it at high rates of return. In practice, the FSAs is likely to (and has attracted) the upper poor, the lower middle, the middle, and the upper middle as the majority. The very poor are not the majority and they shouldn’t be the majority anyway since a financial intermediary also needs the better-endowed individuals to get its capital. The very poor are not excluded however. The share price of about USD 5 is not a major barrier for most households. Rising share price can

\textsuperscript{24} - Unfortunately this has become a selling point by some FSA promoters who have not fully understood the concept.
be countered by periodic share splits to reduce the unit price. Small consumption loans of as little as USD 5 have been made to the very poor. Women represent on average about 30% of shareholders and borrowers (which is quite good for an all-inclusive institution). Some FSAs can go as high as 50% in women participation. The FSA is an investors-dominated institution who determines policy. The borrowers, however, have a strong voice in the AGM and there has always been a lively debate between the net borrowers (wanting to push down the interest rate) and the net savers (wanting to keep them as high as possible). This is not an irreconcilable contradiction but a permanent dialogue and the Board must make sure that the rate of interest is adjusted periodically and the tendency is usually downward. This is a gradual and natural lowering of the cost of capital hence benefiting a larger number of people.

Relevance of the Model for Regions outside Sub-Saharan Africa

The FSA is a universally applicable methodology in any area where: (a) there is an identifiable community, (b) where there is cash circulating, (c) where there is demand for business loans (e.g. in a purely salaried environment perhaps a credit union model maybe more suitable). Field work and interviews in central Asia (Azerbaijan and Kyrgyzstan) by the author has further confirmed that FSA could be quite successful in non-African environments.

Regulation and Supervision

The supervisory arrangements are one of the most difficult aspects of FSA development. Experience has revealed that FSAs need supervision on a permanent basis especially as they increase scale and cover larger areas. The main question for the FSA is how to establish a sustainable supervision system since they are too small and remote for supervision by bank Superintendencies. So far, all FSA programmes have relied on external donors to fund the promotion and supervision arrangements. Donor funded supervision however is based only upon the carrot and not the stick. In fact the stick has been lacking in all FSA programmes so far since the promoters have had no real power to impose compliance. Donor financed project implementation units can start off the FSAs, but this is not a sustainable arrangement since donor cannot pay indefinitely for FSA supervision. There is also a legitimisation issue. Why should an external body (e.g. the FSA promoting unit) have a say over the internal operations of a private financial institution?

The South African experience demonstrates that banks involved in providing financial services to the FSAs are not the appropriate external body for regulatory purposes since their interest is primarily to collect savings and to lend to the FSAs while training, internal growth and the equity base of the FSA is lost sight of. It is important that the interests of the third party regulator not be in conflict with the interests of the FSA. Promotion and provision of financial services are distinct activities requiring different competencies and care must be taken to avoid any eventual conflict of interest.

Some FSA programmes are introducing self-regulation and supervision through an apex organisation. Experience from co-operatives, however, shows that self-regulation through an apex has rarely been effective since members are not obliged to comply. Another option is third party supervision (as described earlier). This can be organised in a variety of ways.
In South Africa, the FSAs are regulated by a donor funded apex body recognised by the Reserve Bank that has granted the apex regulatory powers over the FSAs. Finansol, another FSA-based project in South Africa, is using a purely co-operative version of the FSA model. Finasol is both a franchiser and has received regulatory powers from the Reserve Bank. This mixture if a private transaction-based relationship and public powers is likely to generate undue power and authority on the part of the third party and should be avoided since it leaves the FSAs totally powerless to choose the supervision and training body of their own choice. In South Africa both the apex body of the FSAs and Finasol have received regulatory powers from the Reserve Bank although the FSA apex (as opposed to Finasol) is not a franchiser. The Finasol approach appears to be a monopolistic relationship and leaves no room for third party competition since it also has the power to close down a non-complying FSA. The Finasol version also centralises all book-keeping and financial transactions through a computer programme and the FSAs are likely to become just windows of an all powerful third party. It is also unclear what happens to FSA accounts if for some reason Finasol (third party) disappears.

Another approach is to establish a rating agency that provides certification (Guatemala). The agency trains, qualifies and monitors auditors to review the participating credit unions on a fee basis to ensure compliance with standards set by the agency. The Guatemalan body therefore appears to have largely a credit rating and certification function and problem-solving and support is not provided through the same relationship. This approach is premature for the FSAs since more than a purely audit function, they require training and support that should be combined with good regulation and supervision.

A third approach recently introduced in Uganda is a commercial licensing arrangement. The licenser provides a package including start-up support, training, and supervision in exchange for agreement on compliance with strict standards and a fee to cover the supervision and training costs. The licenser has a transaction-based relationship with the FSAs who are free to leave the contract, at the expense of loosing their certified status and support, if they choose to do so. The initial contract is for a period of five years at the end of which it is expected that the FSAs would graduate to a bank or MFI status and can be supervised by Bank Superintendencies as envisaged in the new legislation in Uganda.

The essential problem with franchising/licensing has been the redundancy of the franchiser’s services after a while and the question of generating enough revenue from the franchisees. Franchiser is usually successful when there is a premium associated with the name (e.g. MacDonalds) that ensures the users standard quality and attracts special niches in the market. A franchising relationship purely on the basis of know-how and operating systems does not seem to last for a long time although an expensive or complicated operating system could prolong it. Another issue is whether or not the operating system should be centralised or localised and who should control the financial information. A centralised approach would favour the franchiser but not the franchisee. But, a franchiser would probably not invest in creating the franchise system unless it can be centralised so that the franchisee could not simply walk away with the system. In any case, it is important that the licenser continues to provide valuable services for the licensee and that the public should trust and value the name. It is too early to make any definitive judgements on these various approaches. A voluntary association of the FSAs (AFSA), on the other hand, can also be developed for policy advocacy, exchange of information and FSA marketing.

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Lending to and Borrowing by FSAs

An important question is to what extent the FSAs can be used as micro loan retailers for banks and NGO wholesalers. The other side of this question is to what extent should the FSAs borrow? Given their strong equity and absence of debt, clearly they have a strong and unused financial leverage potential. Borrowing could multiply the lending capacity of the FSA by several times while raising the return on equity in proportion to the difference between the cost of borrowing and the rate of interest on loans. The choice between debt and equity for the FSA depends on a number of issues such as the costs and risks involved, the incentive effect on management, and the impact on the rate of interest as a result of increased availability of loan funds. The costs and risks involved refer to the fixed cost of borrowing, the risks of having a fixed schedule of repayment, and the risk associated with increased lending by the FSA. Although borrowing increases the expected rate of return, it also increases the risk associated with FSA shares due to increased level of lending and therefore could have a dampening effect on demand for shares. Moreover, borrowed funds could have a positive or negative effect on management depending on the source of funds. A commercial loan with scheduled repayments guaranteed by FSA equity can force the management to work harder and be more careful with loan decisions and recovery. A donor grant could degenerate into financial slack resulting in poor loans and organisational inefficiencies. Therefore the source of funds and contractual arrangement underlying debt does make a difference of impact. Another issue is that the increased availability of loan funds made possible through borrowing could lead to a lowering of the rate of interest and thereby a lowering of the overall return on equity.

First, no FSA should borrow in its first year of operation. The FSA must ensure adequate system development and training for its office holders and managers by using equity that does not involve an obligation to fixed repayment. Once this critical organisational asset in human capital and management is developed, then the FSA could consider external borrowing. Not all FSAs require more funds than what they already have. Some FSAs could lend more than what they have mobilised through equity in semi-urban trading or intensive cashcrop growing areas. In such active commercial areas, the FSAs could top up their existing equity funds with borrowing either by mobilising deposits or by just borrowing from a bank or an NGO. Promoting the FSAs with the predominant purpose of making them become the clients of a specific financial institution for receiving loans is likely to result in a slowdown of their internal growth and self-sufficiency over time especially if the financial institution has a say in the running of the FSA. This happened with the FSAs in South Africa that became just payment windows for the large banks with very limited internal lending operations. The conflict between internal growth and external loans is also sharply evidenced in the FINCA village banking model of internal and external accounts. FINCA and Freedom from Hunger have made a policy decision for eliminating the so-called internal accounts (a kind of mini FSA) since the growth of the programme loans or the external accounts were being jeopardised as the clients were more willing to borrow from their own internal accounts as opposed to engaging in external debt. An alternative to borrowing by the FSAs would be for them to receive direct equity investment by outside investors. For the time being, such investors are more difficult to find than bank/NGO

lenders. More experience with FSAs is required before these issues can find more definite answers.

**Legal Framework**

In view of the innovative nature of the FSAs (the shareholders are the exclusive customers), the existing company and co-operative legislation may not fully meet the FSA’s requirements. In some countries FSAs are registered as self-help groups, in others they are registered as companies, yet in others (West Africa they are just de facto associations (unregistered) with unlimited liability (a very risky arrangement). The co-operative model should be avoided because of its restrictions on the rate of interest, non-negotiability of shares and the caps on dividend payments – all going against the basic FSA model. The ideal situation is for registering the FSAs as companies limited by shares but with a special tax exemption status over the initial 3 to 5 years. The tax exemption could be obtained if the government can realise the potential benefits of FSA development and the fact that many government are actually receiving donor assistance to develop sustainable microfinance organisations. In some countries, the number of FSA shareholders may be too large for them to be acceptable as private limited liability companies. The issue here is that a company with more than 50 shareholders may have to be registered as a PLC and that requires a much larger capital, and it may have complicated audit and reporting requirements. The issue of 50 shareholders is not as difficult to resolve since there may be legal ways around it by regrouping the shareholders into a small number of groups who would be the official shareholders. Nevertheless, without tax exemption benefits, being registered as a company may have tax disadvantages. This needs to be weighed against the flexibility advantages of becoming a private company.

An alternative is to be registered as a company limited by guarantee (the form used by charitable non-profit institutions or most NGOs). The disadvantage here would be that the FSA is not legally allowed to distribute dividends and increase share price in negotiable shares since this would change its status into a for-profit organisation and would make it liable to tax. Moreover, non-profits have more difficulty in raising commercial funds because of the very limited nature of their liabilities as compared to a commercial for-profit company. Non-profits, however, are in a better position for raising grants from governments and donors and are exempt from company taxation. The choice of the appropriate legal form is therefore a strategic issue that requires careful planning and consideration of the various advantages and disadvantages.
III. Experience So Far and Lessons Learnt

Experience with the FSAs has proven very promising. Altogether there are presently over 160 FSAs functioning in eight different countries with over 50,000 shareholders and over USD 1.2 million in share capital and over USD 2.5 million in loan disbursements. These are located in South Africa, Uganda, Kenya, Congo, Guinea, Gabon, Benin, and Mauritania. The international donors who have financed the FSA projects so far have been DFID, IFAD, DANIDA, the Ford Foundation, USAID, and Plan International. In South Africa, the government (Department of Welfare) is funding the FSA project and the FSA apex body implements it. All donors, with the exception of IFAD, are funding the FSAs on a grant basis. IFAD is financing the FSAs in the above-mentioned French speaking countries through loan-financed multi-component government projects in which the FSA is the financial service component. In Kenya the project is being implemented by an NGO (KREP) and in Uganda by FSA International.

In all cases, the results have been impressive but not without problems. The above figures demonstrate the large amounts of capital and savings per shareholder in spite of the general belief regarding the poverty situation in rural areas. The FSAs in different countries are very different in terms of financial depth and programme sustainability and approach. Some are operating as area-based co-operatives (South Africa), some are self-help groups (Kenya and Benin), and some are companies (Uganda). Almost all the FSA programmes are donor funded and only in one case (Uganda) is there an emerging system to ensure long term sustainability without continuous reliance on donor funds through a transaction-based contractual relationship between the promoting unit and the FSAs. The FSAs in Uganda are the strongest in terms of capital mobilised and loans per FSA. All the other FSA programmes, although initiated and supported by the author in their early stages, have developed independently under different donor funding and implementation arrangements and have not always kept to the model described above. The lessons described below are from Uganda as the experience there is the one closest to the original model outlined above.

FSAs in Uganda

The FSA development in Uganda started in September 1997 under DFID financing through technical assistance from FSA International\(^28\), the agency that is now in charge of project implementation. To date there are 7 FSAs established all in the Masaka region. The limited number is because of DFID’s reluctance to increase the number before gaining sufficient confidence regarding the methodology. The demand from the communities for FSA development however is very strong. Table presented in Annex 1 provides the main indicators for the Ugandan FSAs.

The Start-Up Process

The start-up process consists of various phases. Initially, a field officer receives a request from a village for FSA development. The site is visited and a small promotion committee is established. The promotion committee must agree to mobilise a given number of shareholders and share capital and identify a suitable office location for the FSA. Presently the promoters require a minimum of 300 shareholders with about $1000 of equity before the

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\(^{28}\) - A consulting firm in the UK and in East Africa established by the founder of the FSA methodology, Dr. Ahmad Jazayeri. The firm is specialised in providing technical assistance, training, and implementation services for FSA development around the world. (fsaltd@cs.com)
FSA can receive any assistance. Once the number is reached and the shareholders have provided an office (usually a shop), a general meeting is called in which the bylaws are adopted and the officeholders (board and audit committee) are elected. The board will consequently appoint a manager and a cashier. Next step is for the chairperson to sign the licensing agreement with the licensing agency (FSA International Uganda). The agreement provides for mutual rights and obligations. The FSA agrees to comply by the FSA rules and regulations while the licensing agency agrees to provide a comprehensive package for FSA development and to train and supervise the FSAs over a five year period. The FSA also agrees to pay a fee (a fixed percentage of its revenues) to the licensing agency for this service. Subsequently, the licensing agency provides a safe, the stationaries, the bylaws and manuals and assist in improving the safety of the FSA office. Once this is in place, training of the board, the audit committee and the manager and cashier begins and lasts for several weeks. Each session covers a new topic until all the areas of FSA ownership, governance, and management are covered. The licensing agency supervises the FSAs with a minimum of one visit per month to assist in all aspects of FSA development including a monthly audit of accounts, of lending operations and of customer care. In addition to the general meetings, the FSA chairpersons meet regularly for discussion and exchange of information and experience.

Overall Performance

All the FSAs in Uganda are located in the Masaka district (about 2 hours from the capital) - a highly commercialised agricultural and trading area. As of end July 2000, the seven FSAs together had 2,646 shareholders with 1,017 women shareholders. Share price varies between $4 to $6. Total equity of the seven FSAs combined amounted to $100,000 (capital plus retained earnings). Total loans disbursed had amounted to $221,931 while total loans outstanding were $80,904. Total number of loans since start-up amounted to 3,287 granted to 1,421 borrowers of whom 430 were women. Savings deposits stood at $13,223 (deposits minus withdrawals). Total savings deposited however amounted to $155,000. The rate of interest varied from 10% to 15% per month calculated on a declining balance basis. Although late payments may be as high as 30% of loans in some months, the recovery rate is 98% as most loan are eventually repaid with interest. The loan loss provision has so far not been used. The accumulated loan insurance fund in most FSAs now amount to almost 10% of outstanding loans. All the FSAs are profitable with revenue exceeding costs by a multiple of two or three. The average operating costs was $255 per month and the average income $675 per month. Annualised Return on Equity (ROE) varies from a low of 21% to a high of 61%. The table below shows the basic characteristics of an average FSA that is 30 months old:

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An Average FSA in Uganda (July 2000)

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>No of shareholders</td>
<td>378</td>
</tr>
<tr>
<td>Women shareholders</td>
<td>145</td>
</tr>
<tr>
<td>Sharecapital (plus retained earnings)</td>
<td>$14,298</td>
</tr>
<tr>
<td>Capital per shareholder</td>
<td>$38</td>
</tr>
<tr>
<td>Savings</td>
<td>$1,889</td>
</tr>
<tr>
<td>Loans outstanding</td>
<td>$11,558</td>
</tr>
<tr>
<td>No of Loans</td>
<td>470</td>
</tr>
<tr>
<td>Average loan size</td>
<td>$134</td>
</tr>
<tr>
<td>Monthly income</td>
<td>$616</td>
</tr>
<tr>
<td>Monthly expenditure</td>
<td>$255</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>44%</td>
</tr>
</tbody>
</table>

(Source: Table in Annex 1)

Share Ownership

According to FSA rules, there is no limit on share ownership even though there is a ceiling on the number of votes (currently 10) that a shareholder is entitled to. In spite of the absence of any limit on share ownership, this has not resulted in concentration in few hands. The largest shareholder in any FSA has about 100 shares. The average shareholding (excluding retained earnings) is about 5 shares per shareholder (Table in Annex 1).

Lending Operations

To get an idea of cost of lending, a rough calculation can provide an idea of the costs involved. The ceiling for expenditure is 4% of revenue for all FSAs. This means that at the rate of interest of 10% per month, for a $100 loan, the cost for the FSA (excluding supervision costs) is 4 cents per month. Assuming a loan loss reserve of 2%, this raises the cost to about 6 cents per dollar lent. According to the above average actual figures, total cost per dollar lent was only 2.3 cents. This ratio compares favourably with long established microfinance programmes and even with commercial banks. Generally bookkeeping is relatively well done although additional training could reinforce FSA financial management. Women play a major role as shareholders, as borrowers, and as managers in most cases (see table in the Annex).
Average loan approval time is one week. The loans are about 20% for consumption purposes (school fees, medical expenses, housing improvements, etc.) while the other 80% are for financing a business activity such as local trading, local services, livestock raising (especially chicken), or agricultural production. Loans for agricultural purposes finance uses such as seeds, fertiliser, mulching, payment of labourers, and land preparation. In cases where agricultural cycle is longer than the loan cycle, the borrower must provide evidence of capacity to repay from other sources. This is an important point since it is often thought that only consumption loans are paid from general income while «productive» loans should be self-paying. The farmer often use one part of their farm to repay a loan borrowed for investing in a different part of their farm. For example, a loan for fertilising or creating a new banana plantation may be paid from sales of an existing mature plantation. The other business loans are in large part for trading purposes (mostly local trade such as buying and selling of mattoke (a type of plantain banana, which is a staple food in the south), beans, coffee, and stocks of food and drink for bars and restaurants, etc. A large FSA loan ($500), for example, financed the creation of a local market that has now become an important transit point for cars and buses to eat and to purchase local food items (sweet potato, mattoke, fish, etc.) before going to the capital. Women borrowers constitute about a third of the total borrowers. Many of the appointed managers are women showing the strong female participation in the process.

The duration of loans has been mostly for one to three months with a limited number of loans granted for up to six months. The monthly installment is the preferred method because it allows more liquidity to remain with the borrower. A month gives the borrower the necessary time to comfortably repay the loan and use the cash to generate more revenue. Cash flow analysis shows extremely high returns varying from 10% to 20% per week in the activities being financed. For example, trading in mattoke (cooking banana) by buying from the village and selling in Masaka or in Kampala can yield a net profit of 20% per weak. Stocking drinks in local bars and restaurants and the sale of medicine in the local dispensary can even have higher yields. Other profitable activities include re-selling cement, raising chicks, and growing vegetables especially cabbages and tomatoes. Demand for loans vary among different FSAs. Some are over liquid while others are short of funds. The availability of loans has encouraged more shareholders to join and the fact that the loan size is linked to the level of shares owned by an individual has encourages many individuals to increase their share holdings.

The small size of the loans so far provided by the FSAs allows for an effective competition with the local moneylenders and in most cases the FSA interest rates on loans are about the third of the money-lender rates. This substitution has rarely happened in the past credit programmes since loan sized have always been fixed at relatively large amounts and have been targeted at seasonal or longer term productive activities which do not satisfy the need for small and very short term loans usually provided by the moneylenders. Moreover, evidence shows that the FSA is effectively competing with the moneylender. Recent research in the Grameen Bank and other similar projects shows that group loans are not substituting the loans from the money lenders whose activities have not diminished in the these areas and in some cases group loans are used to pay back the local moneylenders and moneylenders loans to pay the group loans^{30}.

The FSA rates are generally higher than that of most other microcredit NGOs and this has lead to some competition in areas where the FSA and other microcredit NGOs operate. It

should be added, however, that the local ownership and the ease of access can often compensate
for the higher FSA rates and the customers are likely to continue with the FSA even in the presence of other micro lenders.

Income and Expenditure

The figures below are for income and expenditure for the April – July 2000 period.

<table>
<thead>
<tr>
<th>FSA</th>
<th>Income (US$)</th>
<th>Expenditure (US$)</th>
<th>Actual Net Earnings (4 months)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lukaya</td>
<td>3,800</td>
<td>1,446</td>
<td>2,354</td>
</tr>
<tr>
<td>Bukunda</td>
<td>1,787</td>
<td>630</td>
<td>1,157</td>
</tr>
<tr>
<td>Kkingo</td>
<td>4,303</td>
<td>1,636</td>
<td>2,667</td>
</tr>
<tr>
<td>Butenga</td>
<td>2,841</td>
<td>1,048</td>
<td>1,793</td>
</tr>
<tr>
<td>Kibinge</td>
<td>3,175</td>
<td>1,100</td>
<td>2,075</td>
</tr>
<tr>
<td>Katovu</td>
<td>1,257</td>
<td>608</td>
<td>649</td>
</tr>
<tr>
<td>Kisseka</td>
<td>1,758</td>
<td>693</td>
<td>1,065</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>18,921</strong></td>
<td><strong>7,161</strong></td>
<td><strong>11,760</strong></td>
</tr>
</tbody>
</table>

(Exchange rate: US$1=Ush1600)

The average monthly income varies from $ 314 for the younger FSAs to $ 1075 for the older ones. The monthly expenditure varies from $ 152 to $409. The rule followed by all the FSAs is to keep expenses under 40% of income (the April-July figure was 39.2%). Although this rule is generally adhered to, some extraordinary expenses such as paying for the general meetings or purchasing a means of transport has, in certain occasions, lead to an overrun of expenses above the authorised limit. On the whole, however, the FSAs are doing well for containing the expenses and ensuring that their operations yields enough profits to satisfy the shareholders. One drawback of this approach is that the salaries of staff and officeholders may increase too rapidly and they may get an excessive share of the FSAs income. One option is to establish a monthly ceiling but this would go against the idea of linking remuneration to performance. Another option is to establish a lower percentage of revenue as being available for expenses.

Important Issues

Loans

There are various operational issues facing the FSAs lending operations. The first issue is that of arrears. A loan is said to be in arrears if the interest or principal has not been paid on time. Arrears in the FSAs can vary from as little as one day to as long as several months. The overall arrears rate in July 2000 stood at 25%. These loans are all paid but usually with some delay. In a small number of cases arrears are affecting the principal repayments and not the interest since the borrowers in many cases maintain interest payments. In cases of on-time
interest payments, there is very little negative repercussion on the FSAs except, because the principal is not repaid, fewer new borrowers can benefit from FSA loans.

The causes for delays of high loan arrears rate are various. Drought and low coffee prices have taken their toll and have negatively affected repayments. Weak loan portfolio management in certain cases has also been a contributing factor. Below is a more detailed discussion of these issues:

(a) Drought and low coffee prices – the Masaka district as been experiencing a prolonged drought during the past year affecting both cash crops, livestock, and foodcrop production. Coffee prices have also been at a historical low. Prices fell from Ush. 1500 last year to as low Ush. 800 in July 2000. Coffee growers are an important part of FSA shareholders and low prices have been a major cause of arrears.

(b) Inadequate loan appraisal/approval – credit committee members may not always be following the loan appraisal and approval procedures laid down in their own manuals and training. Some loans may be approved based largely on the borrower’s declared capital and status or position with little verification of assessment and almost no analysis of capacity to pay. Some FSAs may not apply any loan graduation procedures and large loans may be provided to borrowers without a proven track record. The support unit has maintained a careful watch over loan repayment issues. A major contributing factor to the arrears issue has been weak leadership by some chairpersons allowing inadequate loan appraisal and quick approvals to continue with little or no loan monitoring. FSAs with more active and stronger chairpersons and audit committees have had a better loan appraisal/approval/recovery record.

(c) Complacency - There may be complacency and poor commitment by some of the credit committees (and some chairpersons) that may result in poor follow-up and non decisive action in case of serious arrears (more than three months). The complacency can be exacerbated by the opinion of some shareholders raising social considerations in dealing with delinquent borrowers (community failure to enforce the loan contract). In cases where the chairperson is also en elected politician, political considerations have come in and the FSA has suffered somewhat in terms of arrears. The FSA by-laws prohibit elected public officials to become an FSA officeholder.

(d) Infrequent use of the court system - Few loan default cases have actually been referred to the court even if the court’s summary proceedings could be swift especially in cases where the FSAs use a loan agreement with clear wording on the issue of collateral. The FSAs are not always willing to go to court against delinquent borrowers because of social reasons as well as the costs involved. In some cases, external encouragement and persuasion by the promoters has been useful to induce the FSA to undertake legal action. In other cases the police has been asking for money from the FSAs for assisting in loan collection. The promoters should have a retained lawyer to assist in serious loan recovery matters as this maybe too expensive for a single FSA. Some FSAs are hiring auctioneers who assist in loan recoveries for a percentage of the amount recovered.
Insufficient borrower training – Some borrowers have received loans without receiving prior borrower training. Lack of understanding of what is a loan has meant that some borrowers have borrowed too much and some borrowers too little. Moreover, not all borrowers fully appreciate the negative impact of the arrears on the FSA’s cashflow, dividend payments, and share price. The rule that prohibits any borrower to receive a loan without prior training is not always enforced.

Availability of Loan Funds

Apart from the arrears issue, some FSAs are facing shortages of loan funds while others are not lending up to capacity. This appears to be partly related to seasonal factors but also to where the FSA is located. In Lukaya, a small urban centre, the FSA is facing a shortage of funds and demand for loans exceeds supply. In Bukunda, on the other hand, there appears to be some competition between the FSA and other micro lenders lending at lower rates of interest. Bukunda has had a slower growth of loans as compared to some of the other FSAs. Kibinge had experienced occasional shortage of funds during the coffee season but has had a relatively large surplus cash position for the past six months. Refinancing arrangements for the mature FSAs may be available from various sources and the promoters should study the options together with FSAs. Another alternative is to mobilise savings more aggressively and begin to lend from savings. The net savings levels have not been a significant and stable source of funds so far.

Savings

Total savings deposits in all FSAs since inception have amounted to $155,242 while withdrawals have amounted to $142,020 giving a net savings float of $13,223 or an average of $1,889 per FSA. This is roughly about 19% of the FSA’s equity. In other words, shares (equity) have been much more significant (5 times) than savings deposits (debt) as a source of cash for the FSAs. The earlier ceiling (now lifted) on maximum savings (a shareholder could not deposit more than 10 times their savings) may have contributed to lower deposits although this ceiling is of importance only for overnight depositors who are mostly traders. This ceiling has now been removed. Some FSAs have introduced a 3% commission on withdrawals. Again this may have contributed to lowering the level of savings. Since savings are potentially an important source of cash for lending by the FSAs, these costs to savers will be gradually eliminated since the cost of providing the service would be recovered from the interest earned by lending the funds. The upcoming Financial Services Act in Uganda authorises member-based financial intermediaries to mobilise and lend member deposits to members themselves. The FSAs can qualify by being considered to be “member-based”. The project plans to introduce liquidity management training to the FSAs so as to enable the FSAs to prudently lend part of their savings deposits while maintaining adequate liquidity to meet withdrawal requirements.

Shares

The sale of shares represents the most significant source of FSA’s funds. The share price has generally increased by an average of 20% per year in all FSAs. The FSAs that are near to 3 years old have had a 60% or more share price increase. There is some concern that at this rate shares may become too expensive for the poorer individuals. It is therefore planned that as soon as share prices are doubled, the FSA would introduce a share split operation so that
each old share would be worth 2 new shares so that the unit share price would go back to a
more affordable level.

**Governance**

Learning to self-govern effectively is usually a long and difficult process. The FSA
must first learn to dispel the habits inherited from the co-operative past when a few
individuals would dominate the institutions and would take the lion’s share of the benefits.
The credit culture is also an issue. Previous government financed credit programmes that
were never repaid has created an opportunistic psychology among some borrowers by
thinking that nothing would happen if they did not repay. Quick and swift action against
defaulters is perhaps the most important institutional issue for the FSAs in their early years.

Sometimes the FSAs may be unwilling to change office holders in spite of poor
performance since the elected office holders may be persons of influence in the community.
Moreover, once the FSA reaches a substantial size there is always a danger of capture by
local politicians. The FSA meetings can become an easy target for being transformed into
political rallies. Keeping the politicians away is not always possible. Experience shows that
the danger of capture by local politicians is quite present and it could become a cause for
concern. Of course, the FSA cannot alienate the local politicians who are the elected leaders
of the community and separating the purely business orientation of the FSA from its potential
political use by the politicians is not always a simple task. The external promoters must be
themselves qualified to address such governance issues and assist the FSA in resolving such
issues in a diplomatic yet effective way.

Experience has shown that the larger shareholders have been instrumental in
replacing ineffective boards and managers and the rule that allows the larger shareholders
greater say in the general meetings has been a positive factor in ensuring good governance.
More generally, the most effective tool against bad governance has been shown to be
transparency and regular communication and consultation among shareholders. This is why
general meetings should be held more frequently not only to decide on major issues but also
to provide a means of communication, discussion, and above all of empowerment for the
shareholders.

**Promotion and Supervision**

In all FSA programmes so far, the FSAs have been promoted, trained, and supervised
by an externally funded donor through an implementing agency whose operating expenses
have been totally financed by a donor. This arrangement has been based on the underlying
idea that after 2 to 3 years of support, the FSAs can become independent and would no
longer require external supervision. Experience shows, however, that FSAs require
permanent external supervision as do all financial institutions. The issue is not related only to
governance and management know-how, which are scarce commodities and need to be
continuously upgraded and improved, but also to the questions of verification and of
credibility. The number of shareholders and the amounts of funds involved means that
internal self-regulation is necessary but by no means a sufficient element for ensuring
success. The poor history of banking and credit programmes in many developing countries
(especially in Africa) further necessitate a permanent third party presence to avoid the repetition of the past failures.

Until recently, the approach in Uganda was similar to the other FSA projects in other parts of Africa. The important innovation that has now taken place in Uganda is the creation of a transaction-based relationship through a commercial licensing agreement between the FSA promoters and the FSAs. The agreement is designed to ensure a long term sustainable partnership for FSA development. By entering into this agreement, the FSAs provide the necessary assurance to their shareholders that the FSA will be supported and supervised indefinitely. The service is provided in exchange for a fee that increases along with the FSA’s income. The objective of the agreement is to render the FSA, over a five-year period, independent of external grant support. The fees are initially insufficient to pay for training and supervision costs but over a five-year period, the relationship should become profitable for both sides.

**Lessons Learnt**

The main lessons can be summarised as follows:

1. Mobilising long-term financial savings in rural areas through a share-holding system can be effective and very popular.

2. Shares are a viable alternative to deposits for finding a stable and less risky source of funds for lending. Savings mobilised through the FSAs have been only a fraction of the equity mobilised through shares. The concept of a share is easy to grasp by most individuals even in very remote rural areas.

3. Small short-term loans (1 to 4 months) for amounts varying from $ 20 to $ 500 is highly demanded and appreciated by the rural population who is willing and able to pay commercial interest rates for this service. The loans can be repaid because the returns to micro business are high.

4. FSAs can increase the availability of micro loans and reduce the rate of interest significantly in areas where it operates.

5. A simplified but rigorous bookkeeping method (double entry) with three levels of cross-controls (cash, balance sheet, inventory) developed for the FSAs can be assimilated by the local FSA managers and auditors quickly and efficiently. The accounting method has proven effective in preventing fraud and providing up to date financial information.

6. The system of allowing more votes for larger shareholders has proven effective although constant vigilance is needed to guide the FSAs in the governance process. The ceiling on the number of votes (10) can prevent concentration of ownership in a few hands. Nevertheless, the larger shareholders have proven to be an effective counter weighing force against the independence of the board in ensuring that the FSAs are well managed.

31 - This is also a lesson from corporate history in the developed economies.

(7) There is a good supply of trained (or trainable) under-utilised human capital in
the rural areas that can be utilised for local management. This is not a major
constraint. The constraint of establishing an effective leadership with an active
board and a good audit committee is usually greater.

(8) Although proximity can substantially reduce the information costs associated
with loan appraisal, it cannot substitutes for a thorough verification of character,
debt capacity and collateral. Poor leadership can relax this discipline and lead to
poor appraisal and the consequent arrears. The community’s local knowledge and
networks (social capital) can succeed in lowering the transaction costs of
financial services but it can also fail!

(9) There is nothing automatic in community enforcement or in local knowledge and
proximity in ensuring co-operation and good loan recovery. The outcome very
much depends on the institutional set-up and the safeguards that can be
established to prevent free riders, moral hazard, and opportunistic behaviour by
the shareholders, the borrowers and the managers. Constant vigilance and follow-
up on the part of FSA management and shareholders is required to ensure an
steady increase in the FSA’s equity and good loan recovery.

(10) It is necessary to establish an effective contractual arrangement and a clearly
worded loan agreement underpinning the lending process together with action for
contract enforcement through informal pressure and formal enforcement if
necessary. Quick and swift action against defaulters is perhaps the most
important institutional issue for the FSAs in their early years.

(11) The presence of elected public figures in the board can be a double-edged
sword. Politics must be kept out of the FSAs if they are to succeed as a financial
institutions,

(12) A positive lesson learnt is that FSA works! It is probably among the few (if
not the only) outreaching mechanism for the provision of rural financial services
especially (but not exclusively) in remote areas with some proven success.

(13) The FSAs need training, supervision, innovation, and linkage services on a
permanent basis and the idea (author’s own optimism) that after an initial training
period they can operate on an stand-alone basis without supervision does not
appear to be the case.

(14) The FSAs are able and willing to pay for training and supervision if these
services are rendered adequately and cost-effectively. A licensing arrangement
between a service provider and the FSAs may well be the way forward. The FSA
development therefore offers the potential of a genuinely self-sustaining approach
to the provision of micro financial services for the poor.