Formal-informal financial linkages: Lessons from developing countries

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Abstract

Despite significant innovations in rural and microfinance over the years, millions of people around the world do not have access to financial services. Can strategic linkages and alliances between financial institutions help resolve this problem? Thanks to funding from the Ford Foundation several researchers set out to answer this question. Our results drawn from 12 case studies conducted in eleven countries in Africa, Asia and Latin America indicate that financial linkages are increasingly used by formal financial institutions (public or private) to target rural clients. A wide variety of less formal, often rural financial institutions are the linkage partners. Initial evidence indicates that the partnership seem to afford both partners the opportunity to overcome a weakness in what they can achieve on their own. But does this initial appeal translate into anything sustainable and/ or replicable? Although it is certainly too early to tell, financial linkages, while promising, are difficult to set up and manage, require strong less formal as well as formal institutions and seldom result in a significant expansion of financial services beyond credit.

Introduction

In spite of considerable innovations in microfinance in recent years, millions of people in the world still do not have access to basic financial services. The vast majority of those without access reside in developing countries, particularly in rural areas where it is more difficult and costly to extend these services. Although progress has been made on how to supply rural financial services in a sustainable way, no agreed body of best practice is yet available in designing institutions and products to meet the demand of this more challenging clientele (Christen and Pearce, 2005; Nagarajan and Meyer, 2005).

We may soon see a change in this regard as many organizations today actively support experiments, innovations and research in rural finance. A promising area that is attracting much attention is the *linking* between formal and less formal institutions as an alternative way of expanding financial services into rural areas. Over the last couple of years, the Ford Foundation, USAID and the World Bank have sponsored studies to examine the nature and outcomes of financial linkages (Miller-Wise and Berry, 2005; Gallardo et al., 2005). The results from the Ford sponsored study, coordinated by FAO in Africa, Asia and Latin America are presented in this article; and linkage cases from India, Indonesia, the Philippines and Mali are also featured in this same issue of the journal. Results from this research will published in a forthcoming book in 2006 featuring all 12 in-depth case studies.

In the scope of the study we set out to examine linkages that result in expanded access to a broad array of financial services, not just credit. To accommodate this objective, we defined a *financial linkage* as any mutually beneficial partnership between a formal and a less formal institution that results in the expansion of rural financial services. This "expansion" does not just refer to reaching more of the same clients; but strives to provide access to previously unserved segments of the rural population or to broaden the variety or improve the quality of financial products and services. Cases investigated in Africa, Asia and Latin America show a rich variety of such financial linkages. These linkages take many forms and no single circumstance is sufficient to *explain* the emergence of various types of linkages or the reasons why specific institutions enter into linkages. Some linkages are spontaneous and market driven, such as when a large urban commercial bank lends to a cooperative or NGO that specialises in rural lending. Other linkages are sponsored, such as when donors support the creation of wholesale apex institutions for lending to small rural retail institutions. Some linkages

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emerge out of compliance with regulations, such as when an insurance company links with rural microfinance institutions (MFIs) as a way to meet its quota of life insurance sales to rural customers. Sometimes small institutions seek linkages with larger ones to gain access to their more abundant resources and expertise, while larger institutions want to link with smaller ones that are closer to and more knowledgeable about the demands of a specific rural clientele for financial services. Some linkages are expected to be permanent because they serve the long-term business interests of both partners. Others, however, may experience a natural lifecycle in which they are designed, serve a purpose for a time, but then disappear because regulations, markets, institutions, or clients change.

Linkages can have positive outcomes at the level of both financial institutions and rural clients. Through linkages, financial institutions may be able to expand the scale and scope of their rural operations resulting in greater profits and better financial and institutional sustainability. New clients may be reached and existing clients may be offered a broader and/ or cheaper range of financial products and services. Negative impacts can occur when subsidized new entrants crowd out established institutions. Exclusive contract requirements within a linkage may also impede experimental linkages with other institutions that would generate new products and services.

In the following sections we present our research rationale and framework, provide an overview of the different linkages examined in the study and discuss key research findings. We conclude the article with some final observations and recommendations.

Research rationale

The theoretical literature on financial linkages is based on modern economic theory explaining information and enforcement problems of credit markets and how they result in a relevant mismatch of resources and abilities between formal and informal lenders (Armendáriz de Aghion and Morduch, 2005; Bell, 1990; Fuentes, 1996; and Varghese, 2005). On the one hand, formal financial institutions have extensive infrastructures and systems, access to funds and opportunities for portfolio diversification permitting them to offer a wide range of services. However, they are further removed from rural clients, making obtaining adequate information and enforcing contracts difficult. In contrast, informal financial institutions operate close to rural clients, possess quite good information and enforcement mechanisms and are typically more flexible and innovative. However, they are constrained in the services they can offer since informal institutions lack resources and infrastructure to serve clients beyond a small geographic area, resulting in highly concentrated loan portfolios.

On the surface linkages between formal and informal financial institutions appear to have much potential in overcoming the persistent information and enforcement problems that increase transaction costs in rural credit markets. Although this potential has not been demonstrated in a *significant* way in practice, we are beginning to see some successful innovations in this regard. At least in Asia the most prevalent example of practical experience is the linking of self-help groups (SHGs) to banks, often referred to as *linkage banking*. The standout case in the region is in India, where the National Bank for Agriculture and Rural Development (NABARD) since 1996 has reached 1.6 million SHGs, representing 21 million members, through its extensive network of 41,082 branches (www.nabard.org). In addition, we are seeing the emergence of commercial banks and apex organizations linking to less formal institutions, such as microfinance institutions (MFIs), savings and credit cooperatives and in some cases NGOs to increase their supply of funds. And we are beginning to witness linkages between the formal and informal financial sectors resulting in services beyond credit, like insurance, deposit, money transfer and payment services.

In our review of the literature, however, we found very little theoretical, empirical or case study research that examines formal-informal linkages that go beyond credit provision. This fact, and the common understanding that the rural poor need a broad array of financial services to enhance their asset building and poverty reduction outcomes, led to the rationale for the research reported here.

Research framework

Using case study methods we set out to increase our understanding of financial linkages that help improve rural peoples' access to savings, insurance, money transfer and payment services as well as *credit*. The research was structured around four general areas of investigation:

- linkage partners' motivations for linking;
- mechanics of establishing the linkages, with a particular focus on contract design, risk mitigation strategies and conflict resolution measures;
- linkage impact at the institutional and client levels;
- regulatory environment and its impact on fostering or impeding linkages.

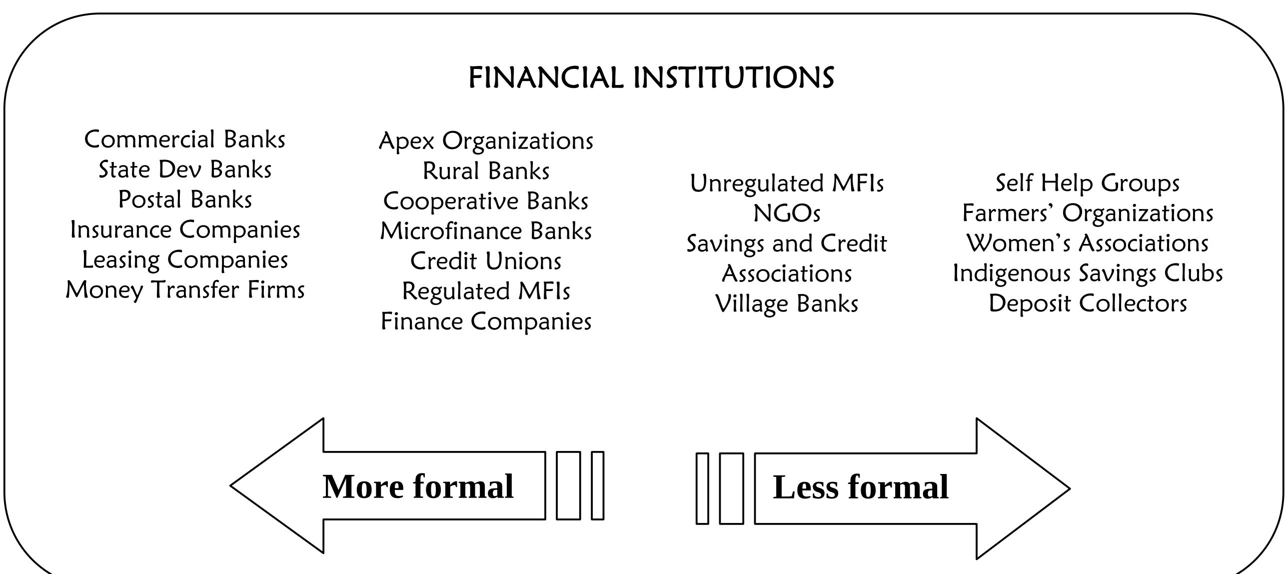
As mentioned, in the scope of the study we defined a 'financial linkage' as any mutually beneficial partnership between a (more) formal and a less formal financial institution (see continuum below) that results in the expansion of financial services in rural areas. We examined linkages that expand ***financial outreach*** in one or more of the following ways:

- reaches ***new*** segments of the rural population not traditionally served;
- improves the ***quality*** (terms and conditions) of existing products and services;
- broadens the ***variety*** of products and services available, e.g., insurance, transfers, etc.

The segment of the rural poor population considered in this study included smallholders; rural non-farm microentrepreneurs, rural households, small traders and local organizations and associations, and any previously unbanked rural people, such as subsistence farmers and women. It did not include medium to large scale farmers who typically have access to formal financial services.

The microfinance literature indicates that a range of approaches exist whereby financial institutions intermediate a transaction with the aim of reducing transaction costs. In fact, as indicated by Johnson (2001), a variety of institutions are created (we present these in a continuum below) to enable the transmission of financial information and transactions. According to Johnson all the institutions existing along this continuum represent *solutions* to the problem of financial intermediation – how to match the supply and demand of funds. Not only the institutions, but the relationship between them is designed to address information asymmetries, resolve enforcement problems and reduce the cost associated with the transaction. Linkages afford the players, both formal and less formal, the opportunity to overcome a weakness in what they can achieve on their own.

Figure 1: Continuum of Formality



In-depth case studies conducted by the research team, in conjunction with local researchers, provided the basic information used in this study. A common framework was developed to guide this work; however, some departures from the framework occurred during field interviews to accommodate the specificities of the case. Successful cases in Bolivia, Costa Rica, Honduras, India (two), Indonesia, Kenya, Mali, Peru, Philippines, Rwanda and Tanzania comprise the global review. They were chosen because they *generally*:

- demonstrated success in expanding access to underserved rural market segments;
- were based on cost covering principles, or had clear exit strategies if they were externally supported;
- had been in existence for two or more years;
- added to the diversity of linkages types.

In spite of these similarities the cases are rather heterogeneous, which complicates preparing a summary analysis and synthesis. However, the richness of the emerging issues and lessons drawn from these cases would have been missed if a more narrowly defined linkage framework was used in the selection of the case studies.

Descriptive overview of linkage types

Numerous linkages, established for many reasons, were identified in this research. Some simply reflect a financial transaction between the partner institutions, for instance, liabilities are issued by one of them and acquired by the other. Some linkages were created to *facilitate* some type of transaction for the clients. In the scope of this study we grouped financial linkages into the following two broad categories as defined and shown in Figure 2 below:

- *Direct financial linkages* refers to linkages between financial institutions in which the main purpose of the linkage is to help less formal institutions *diversify* their sources of funding, *expand* their loanable funds and/or *balance* liquidity shortages and excesses. A typical example of this type of linkage is a bank or apex organization offering bulk loans to MFIs for on-lending to clients.

- *Facilitating linkages* refers to linkages between institutions in which the formal institution “hires” the less formal institutions to act on its behalf. In these types of linkages the less formal institution has two ‘constituencies’ caring about his behaviour (Conning, 2002). On the one side are the rural clients who enter into contracts with the institution via the local, less formal agent. On the other side is the formal institution itself that the less formal institution is representing. In these cases, funds flow from the clients through the partners, or the other way round, to facilitate remittances, payment of utilities, and mobilization of deposits or even facilitating loans. Typically for these types of linkages, fees are paid by one partner to the other for the service rendered. Facilitating linkages are more recent and innovative ways of extending services beyond traditional micro and rural finance savings and loan products. An example from this category is a private insurance company linking with MFIs to extend life insurance products to rural clients.

Figure 2: Typology of case study linkages

	AFRICA				ASIA				LATIN AMERICA			
	Kenya	Mali	Rwanda	Tanzania	India		Indonesia	Philippines	Bolivia	Costa Rica	Honduras	Peru
	K-Rep Bank, SACCOs and MFIs	BNDA and MFIs	Peoples Banks and Self Help Groups	CRDB Bank Ltd., SACCOs, Community Banks and NGOs,	ICICI, MFIs and Self Help Groups	AVIVA Life and MFIs	BPD and LPDs	PCFC, Rural Banks and MFIs	FADES and various partners	Finca Costa Rica, commercial banks and , MFIs	Covelo Foundation, MFIs and producer organizations	Arariwa (NGO), Confianza (EDPYME) partners
Direct Financial Linkages												
Bulk loans and credit lines	x	x		x	x		x	x	x	x	x	x
Savings	x	x		x			x			x	x	x
Facilitating Linkages												
Credit			x		x					x	x	
Insurance						x						
Deposit mobilization									x			
Money transfers									x		x	
Payments									x	x	x	
Salary/pension disbursements									x			

Abbreviations
BNDA: Banque Nationale de Developpement Agricole
PCFC: People's Credit and Finance Corporation
BPD/LPD: Indonesian Regional Development Bank and Community Based Village non bank Financial Institutions
FADES: Fundación para Alternativas de Desarrollo
SACCO: Savings and Credit Cooperatives

As one can easily see in Figure 2 the range of linkage actors reviewed in the global review is quite diverse, with the more formal actors represented by private and public commercial banks, apex organizations, and a commercial microfinance bank on the one hand and more informal actors being self-help groups, village banks, savings and credit associations, financial NGOs, and rural/community banks on the other hand. Actors that also play a significant role in financial linkages include insurance companies, money transfer firms, utility companies, and even government departments involved in the disbursement and/or collection of salary and pension payments. The rest of this section gives an overview of the range of linkages identified during the research, while the following section, on research findings, uses a number of themes to assist us to better understand the dynamics of linkages.

Over the last 4-5 years many private banks and insurers have entered the microfinance market by establishing direct financial and facilitating linkages with less formal actors. ICICI Bank, India's second largest commercial bank partners with MFIs in unique ways to extend credit directly to Self Help Groups (SHGs) in rural areas (Harper, 2005). ICICI's preferred method is to use MFIs as facilitation agents to help screen and monitor SHG borrowers. ICICI reserves bulk lending to the best performing MFIs. AVIVA Life India, a leading global insurer, uses MFIs to expand life insurance products to rural people. And in limited cases some MFIs even act as formal retail agents for the company which allows them to offer life insurance products to the general public (Pathak, 2005). In Tanzania, CRDB Bank Limited, a private bank has aggressively entered the market by offering MFIs a range of financial services from long and short term loans and credit lines to various payment and transfer instruments (Piprek, 2005). To do this the bank has set up an entire microfinance unit dedicated to the development of this new market segment.

State-owned development banks continue to engage in partnerships, mainly through direct financial linkages with less formal institutions. In Mali, the Banque Nationale de Développement Agricole (BNDA) has a long history of serving less formal institutions through bulk loans and lines of credit as well as savings accounts to help institutions like Kafo Jiginew, the largest network of savings and credit cooperatives, and CVECA-ON, a large village bank network, deal with cash flow variability and/or portfolio expansion. In Indonesia, the provincial bank in Bali, Bank Pembangunan Daerah (BPD) plays a significant parenting role for customary village banks (LPDs) by offering staff training as well as monitoring and supervision services since they have chosen not to come under the umbrella of the central banking authority. BPD also provides the LPDs with normal savings and loans services that help the smaller institutions manage their liquidity more effectively.

Public, private or community owned apex organizations continue to play a significant role in expanding financial services in non-traditional markets through direct financial linkages. In the Philippines, the government-owned apex organization, PCFC, partners with numerous microfinance players by offering wholesale credit and training to them. Through strict selection criteria backed by strong capacity building mechanisms, PCFC has been instrumental in mainstreaming microfinance in the Philippines. In Honduras, a private first and second-tier organization, Covelo Foundation, offers bulk loans and lines of credit to MFIs and plays a significant role in strengthening MFI internal systems and controls to improve self-regulation mechanisms. In Rwanda, the community owned apex, Union des Banques Populaires de Rwanda (UBPR), through CARE's financial and technical assistance and its extensive network of Peoples Banks, is able to penetrate further into rural markets. For the first time, Peoples Banks are extending services to SHGs, a segment which is outperforming its traditional clients of salaried workers or well established farmers and traders.

Privatized microfinance banks, incorporated firms and financial NGOs establish linkages with various actors in an effort to expand the scope and scale of their businesses, enabling them to survive in competitive, maturing microfinance markets. Fundación para Alternativas de Desarrollo (FADES), a non-regulated, non-government organization in Bolivia, strategically created a number of inter-institutional linkages allowing them to offer their clients an array of services, such as deposit and money transfer facilities, bill payment and salary and pension contribution collections (Gonzalez-Vega and Quiros, 2005). In order to become less dependent on donor funds and conditions, Finca-Costa Rica incorporated itself into a business and promoted the incorporation of each village bank in the late 1990s, paving the way for all units in the network to establish relationships with commercial lines of credit and other financial services. In Peru, Confianza, a regulated MFI, accesses lines of credit and bulk loans from commercial banks and donors as a way to increase and diversify its sources of funds

(Leon, 2005). In Kenya, the recently privatized microfinance bank, K-Rep Bank, links with various MFIs and SACCOs as a way to minimize costs and further its business (Sabana, 2005).

Research findings

Synthesizing the results of 12 comprehensive but diverse case studies from 11 countries in a meaningful way is challenging. For the purpose of this article we organized our findings around the following six interrelated themes that can improve our understanding of the nature of financial linkages:

- Motivation behind the initial creation of the linkage;
- Contracting mechanics and their effectiveness in dealing with risk, conflict resolution, and profit sharing;
- Linkage outcomes at client and institutional levels;
- Role of capacity building in establishing and sustaining linkages;
- Financial system develop and the potential for linkages;
- Unforeseen, positive and/or negative linkage consequences.

These themes represent an expansion on the general research areas initially identified in the research methodology. We added some themes (last three bullets) since they emerged as important issues during the analysis. Also, the impact of the regulatory environment on the linkages relates to all the themes.

Linkage motivation

One of the significant observations emanating from the research is that linkages between two financial institutions are rarely *spontaneous*. The evidence indicates that the direction of or impetus for the linkage is often from the more formal to the less formal, and the driver or motivator for the linkage is often external rather than internal or spontaneous. For example, the initiative of the People's Credit and Finance Corporation (PCFC) in the Philippines to wholesale loans and provide institutional development and training to a range of MFIs was certainly not spontaneous. PCFC was created and capitalized by government in 1995 with the objective of lending to the poor. This policy driven mission was further strengthened when in 1997 the National Credit Council formulated a microfinance strategy. Amongst other measures, this limited the role of government in directly supporting MFIs. *Legal and regulatory changes* unleashed a demand for PCFC funds and allowed MFIs to bypass several deposit taking and other Central Banking regulations impeding their growth. They could do that by operating under the PCFC lending guidelines.

ICICI Bank in India might appear to have taken a deliberate decision to link with partner MFIs to increase its outreach to the poor. However, this seemingly internally driven linkage was initially motivated more by the imperative of regulatory compliance, after acquiring new banking assets rather than by autonomous action. The so-called priority sector targets, which require all commercial banks to lend at least 40 percent of their net credit (at an interest rate not more than 4 percentage points above their prime lending rate) to priority sectors - rural areas, small industries, exporting firms, housing and agriculture – forced ICICI Bank to take initiatives to reach further and deeper into 'priority areas'. While it is often claimed that a "larger social purpose" (Banerjee and Duflo, 2004) seems to inspire Indian banking, the initial motivation in the ICICI case still seemed to be compliance rather than a social objective. It may turn out that ICICI has made the happy discovery of profitable new markets due to its acquisition of assets in unfamiliar territory. Its capacity to apply unorthodox and sophisticated solutions in these circumstances may prove a lasting contribution to linkage methods.

Contracting mechanics

Inherent in any investigation about linkages between financial institutions are issues of contract design and how issues like risk, profit sharing, conditionalities and conflict resolution are resolved. Risk mitigation of the loan portfolio is an important yet complex component in designing linkage contracts, especially when MFIs *facilitate* loans to SHGs and individuals. ICICI Bank is furthest along in this area as it has designed a range of risk mitigation mechanisms. For example, ICICI requires MFIs to open fixed deposit accounts in the amount of 8 – 15 percent of the total value of the MFI loan portfolios purchased by ICICI. The required amount varies according to the perceived quality of the portfolio purchased. ICICI also provides MFIs with overdraft limits amounting to a percentage of loans purchased, which the MFIs are required to use to cover any loan losses. For their most popular partnership programme of loans facilitation, ICICI holds fees earned on *facilitated loans* in a separate account with ICICI until the debts are fully cleared. The Bank also accepts third-party guarantees from younger MFI partners engaging in facilitation linkages.

Revenue and profit sharing more often relates to the *facilitating linkages* cases, where one institution acts on behalf of another institution by facilitating deposit mobilization, insurance, and payment and money transfer services. We found that in all of the facilitating linkage cases some sort of payment for services does exist; however, the amounts appear to be best guess estimates of what the institutions think might cover the costs rather than being based on formal costing methods. This finding is a logical outcome for new business delivery models for which some time is needed to set up information systems which allow permit the institution to collect and analyze cost information correctly. Almost all less formal institutions lack the necessary systems to cost accurately these new activities; and only the most sophisticated less formal institutions are just beginning to collect information on the volume and dollar amounts of services per branch, to calculate revenues, such as FADES in Bolivia, and BASIX in partnering with ICICI and AVIVA Insurance Company in India.

Conditionalities embedded into the linkage contract, typically by the formal institutions, are often binding on their less formal partners. In the cases reviewed, we observed that some MFIs were compelled to accept restrictive terms and conditions from funders. MFIs often do not have a choice but to accept these conditionalities, since their own regulatory status prevents them from accessing capital through deposit taking or straight loans. Such conditionalities included requirements on use of bulk loans as in the case of a donor channelling funds through BNDA to the CVECAs for producer associations in Mali; PCFC, the government owned apex requiring its MFI clients to use a preset lending methodology, the Grameen model; BPD, the provincial bank in Bali requiring its partner LPDs to save only with their bank only; and FINCA/Costa Rica being pressured to accept requirements on interest rates, staffing and equipment purchase decisions. While well-established MFIs have come a long way in dealing with distorting conditions that limit their flexibility and growth, many still grapple with how to handle these more subtle issues. We observed MFIs leveraging their partnerships to broker better conditions as in the case of the LPDs in Bali which wanted to deposit their excess liquidity with other banks that offered better rates and hours of operation; stronger, well established MFIs in India negotiating bulk loans from ICICI rather than acting as facilitation agents; and FINCA/Costa Rica radically breaking away from the traditional institutional model by incorporating itself to achieve more flexibility in accessing 'condition free' sources of funding.

Linkage outcomes

Any financial linkage between two partners must have a measurable outcome. The effect of the linkage on the partners was observed and reflected on, but more importantly, we asked if the linkage resulted in access to previously unserved segments of the rural population or a bigger variety or improved quality of financial products and services. The latter is more difficult, and the timing of the study did not allow for thorough measurement of the outcome of the linkage on the clients. However, while rigorous impact evaluations are needed to confirm our findings, we observed that financial linkages do expand the amount and nature of financial services in rural areas as reflected in our discussion below on client and institutional outcomes.

Client level

Linkage arrangements between formal and less formal financial institutions certainly expanded financial outreach into rural areas. Over a million clients have received loans from institutions linked to PCFC funding in the Philippines. More than 20,000 individuals living deep in the rugged countryside of Rwanda now access credit and other financial services of the Peoples Banks on a regular basis, and many group members are leveraging their creditworthiness to open personal accounts. In Tanzania, CRDB has reached close to 80,000 new rural clients through 157 SACCOs by offering loans, savings and money transfer services. Unfortunately our research did not have access to baseline data to ascertain to what degree these clients included new segments of the rural population. What we could measure is the improved quality brought about by linkage conditions. Self help group clients in India have been empowered by their partnerships to interact direct with other banks, negotiating better terms and conditions for the products and services received.

We found *some* evidence on linkages that broadened the variety of products and services. In Bolivia, Costa Rica, Honduras and India well-established MFIs with an explicit strategy of improving and expanding client services, are offering an array of integrated services. They have advanced well beyond simple direct financial linkages to interacting with a plethora of diverse actors to provide life, livestock, weather and health insurance, money transfer and bill payment as well as pension and salary payment services. For example, more than 200,000 clients now have access to life and other insurance products because of AVIVA's partnerships with several MFIs operating in rural India. In Bolivia more than 25,000 former and new clients can transfer and receive money from Santa Cruz and can receive pension payments and pay electricity and phone bills in branches much closer to their homes. Many of these services are delivered to fill gaps in the market, and it might be that other financial service providers, such as insurance companies, or commercial banks, claims this role for themselves, once the MFI linkage has demonstrated that such financial deepening is possible.

Institutional level

We could more fully observe the impact of the linkage arrangement on the *institutions* involved. An example is FADES, the non-regulated Bolivian NGO which entered into a dozen strategic linkages with private and public sector organizations in an effort to increase its rural outreach. Between 2000 and 2004 a very rapid expansion of its branch network caused FADES to experience a decline in the average number of rural clients per branch; which motivated them to find innovative solutions to sustain their extensive branch network. FADES decided to opt for linkages with several non-financial institutions, and offered to facilitate electricity payments, pension transfers and to sell several utility cards on behalf of government institutions. This broader array of services led to an increase in the flow of people at the branch, it ensured a flow of funds at the branch level that reduced the need for transfers within the network, and the fees charged were sufficient to pay for several expenses at the branch, such as the cashier's salary and electricity and water bills. These innovative linkages have the potential of developing into major sources of revenue, thus contributing to FADES' overall sustainability (Gonzalez-Vega & Quirós, 2005).

From the Philippines case study we learnt that PCFC linked with several MFI partners in order to maximize rural outreach. One of these, CARD, established a rural bank, CARD MRI (Centre for Agriculture and Rural Development-Mutually Reinforcing Institutions) in 1997. It became one of PCFC's 'accredited' MFIs and could benefit from PCFC's investment and institutional credit lines. By its own admission, CARD MRI credits PCFC with its 1.4 million clients and 101 percent financial self sufficiency (end 2004). PCFCs credit ceiling (up to $4.56 million), was never quite sufficient, and this encouraged CARD MRI to supplement the PCFC credit line with external funding and to strengthen its own ability to generate deposits. This, plus PCFC's on-going institutional support, through institutional credit lines and the training and refresher courses offered, enabled CARD MRI to reach financial sustainability.

Capacity building

One should not down-play the role that capacity building plays in fostering linkages between different institutional actors. We observed the need for capacity building on two important levels. First, and the most obvious, there continues to be a significant need to build the capacity of informal actors, to enable them effectively to manage the traditional business of savings and credit, if they are to engage with commercial banks, apexes and insurers, etc. On a second, deeper and more interesting level, we observed a huge need for strengthening MFI capacity in the mechanics of building and maintaining these linkages or partnerships with new partners. Training is needed in the following areas: how to evaluate and select good partners, how to design and negotiate partnership contracts, how to select and train new and/or old staff to develop and manage partnerships, how to set up new components of MIS to account for the revenues and costs associated with new business lines, and how to evaluate properly the costs and benefits of partnership.

Of the twelve cases reviewed more than half had an explicit component to build the general managerial capacity of the informal actors. In the case of Rwanda, CARE International organizes and trains SHGs on savings and credit operations. In the Philippines, PCFC through its partnership with CARD NGO provides training course to MFIs and others wanting to access wholesale funds but fail to meet the necessary precondition to do so. In Tanzania, CRDB tries to ensure the health of its partner clients by offering a training program based on specific partner needs, such as MIS, portfolio management and loan appraisal. And in the cases of BPD-LPD linkage in Bali and Covelo in Honduras we see more of mentoring and supervisory role happening between the more formal and less formal institutions. However, none of the cases have included explicit assistance and/or training intended to help the less formal actors engage more *effectively* in the partnerships; however, we did observe much experimentation and leveraging of learning (or *learning by doing*) by less formal institutions to establish more suitable partnerships with commercial banks and insurers in India and Bolivia.

Financial system development and the potential for linkages

The development of a country's financial system dramatically affects the potential for financial linkages. In countries where formal and less formal institutions are both weak, the potential for linkage is extremely low. In contrast, in countries where formal and less formal institutions are both strong the potential for linking is quite high. Conning and Kevane (2002) use the analogy of islands (institutions) linked with bridges (transactions), and indicate that: "Where financial intermediation is more developed, a dense network of actual or potential bridges across islands will be in place". They continue to indicate that "bridging the gaps" between the local, informal partners and the national, formal partners is something that will increasingly happen, as a country develops.

Using formal-informal and strong-weak dichotomies to describe the financial systems in the countries reviewed a few cases can be highlighted to demonstrate the potential for linkages. For example, in Rwanda, where both the formal and informal financial sectors are relatively weak the potential for linkages is extremely low. The Peoples Bank was in fact the *only* financial partner option for CARE to consider in the entire country. A case in which the potential for linkages is higher is in India which has a strong formal financial sector, but a relatively weak informal sector. In fact, building the capacity of MFI partners seems to one of the biggest challenges facing both ICICI Bank and Aviva Life in the country. In contrast, in Bolivia where the informal sector is thriving, it is difficult for an MFI like FADES to find a reliable formal partner for mobilizing deposits.

Unintended consequences

We observed that financial linkages are often created for a particular purpose, but the eventual effect of the linkage may include some unforeseen positive and/or negative consequences. The case studies from India offer two examples of positive externalities: AVIVA, an international insurance company, is linking up with MFIs that demonstrate a comparative advantage in effectively servicing rural clients. One of their partners, Bhartiya Samruddhi Finance Limited (BASIX) decided to provide its rural clients with insurance policies after an impact assessment revealed the need for a comprehensive set of financial services; including savings, credit and insurance. While the AVIVA partnership exceeded expectations, one of the unforeseen but *positive* externalities was that BASIX has become a full-fledged retail agent of AVIVA, accredited to sell basic life insurance products to the general public, and not just to their microfinance clients.

Similarly, another Indian linkage, this time from Bharat Integrated Social Welfare Agency (BISWA), generated unforeseen *positive* results. BISWA is one of the MFIs selected by ICICI Bank to disburse its loans to hundreds of self help groups and individuals. ICICI carefully selects its partner MFIs by rating their management capacity and their ability to facilitate the relationship between ICICI and its clients. Being selected by ICICI benefited BISWA in more ways than one. As well as enabling BISWA to retire many of its other loans and increasing its ability to serve its clients, the main but unintended benefit to BISWA has been its enhanced credibility among banks such as ABN-AMRO, HDFC and SBI. Many of these are now keen to provide bulk loans to "well-established" institutions such as BISWA, at competitive interest rates (Harper, 2005). The ICICI Bank linkage has effectively enabled BISWA to do business with ICICI Bank's own competitors.

Negative consequences or pitfalls not initially foreseen are often caused by subsidies. Subsidies, whether from donors or governments, to formal institutions to expand or deepen outreach can result in "creaming-off" existing MFI clients, crowd out potential entrants in the market and/or discourage "savings" culture within an MFI. An example from the case study material comes from Mali, where BNDA, a government-owned agricultural bank, has been the main intermediary offering financial services to MFIs. BNDA is involved with two major linkage models: CVECA-ON, which links up with BNDA (and many donors) to expand its portfolio, and Kafo Jiginew, a network that expand by relying on its own savings. Kafo Jiginew uses the BNDA linkage mainly for liquidity balancing. Both networks operate in comparable environments; there is not much difference in terms of total assets per individual member; and both have access to banks. However, virtually all members (96 percent) of the Kafo Jiginew cooperatives save, and they save significantly more (US$ 90 per member) compared to the members of CVECA-ON, less than half of whom (44 percent) have a savings account, with average savings per member just US$ 32. Clearly the main difference is that CVECA-ON is highly dependant on donor funds while

Kafo Jiginew is self-reliant. The unintended negative consequence of the Donor/BNDA/CVECA-ON linkage is that on-going donor generosity leads to MFI complacency.

Conclusion

Increasingly, the microfinance industry is enriched by innovative efforts to combine the comparative strengths of different types of institutions – as the on-going debate around commercialization of microfinance illustrates (Harper and Singh, 2005), or the new idea of franchising (www.microfinancegateway.com/content/article/more/25234), or the more recent research into assisting the victims of disaster through MFIs. This research on financial linkages is a contribution towards finding sustainable solutions to the information and contract enforcement problems that impede financial intermediation in rural areas.

How can linkages between formal and less formal financial institutions help expand rural financial services? The twelve cases studies examined herein offer a shopping bag full of options, from commercial banks using the infrastructure and local knowledge provided by MFIs to reach self help groups, to large international insurance companies gaining thousands of clients by linking their insurance products to every loan that an MFI makes. While the first example increases the availability of finance, the other widens the product range available to the rural poor. Clearly, linkages offer mutually beneficial solutions for both formal and less formal financial institutions.

The case studies were selected to ensure that we highlight key examples from different continents and included a wide range of linkages. We see this as an important first step in documenting the linkage options and lessons learned. Based on our experience we can make the following observations to help foster further reflection, debate and research on the potential role linkages play in expanding a range of services into rural areas.

- Given our initial findings about these financial linkages, we recommend more focussed attention and effort in the piloting and experimentation in establishing linkages and strategic alliances, especially in countries where the *potential* for linking is high. This could include the testing of different types of contractual arrangement, creating accounting system add-ons, and using advanced internet and telecommunication technology securely to share the necessary business information needed for improving the efficiency of partnerships.
- Much more attention should be placed on developing *facilitated linkages* that help to broaden the range of financial services in rural areas that go beyond credit, such as insurance, deposit, payments/disbursements and money transfer services. The services with the most potential for expansion are deposit, payments and money transfer services in which, once the right systems and procedures are in place, are relatively easy to manage.
- In tandem with experimentation, additional efforts are needed to build the capacity of (less formal) institutions to enable them to actively engage in partnerships with (more formal) actors, where they exist. This could include assistance on how to select good partners, to design appropriate linkage contracts, to develop adequate procedures to handle the new line of business, to hire new or train existing staff to manage and develop linkage partnerships, to use cost-benefit methods to accurately assess the profitability of new services or products, and to develop integrated MIS systems that account for new business as a result of linkages.
- To improve the richness and depth of the research, and ultimately the lessons learnt, the linkages and partnerships should be studied when they have further evolved, especially the more recent innovations that have resulted in significant expansion of new services in rural areas, such as insurance, bill payment, remittance and money transfers, etc.
- Natural extensions of this research should include more rigorous analyses such as cost-benefit and client impact studies of the more promising cases reviewed

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