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Sustainable Microfinance for the Poor: History and Principles of Linkage Banking

Microfinance utilizes different strategies to improve poverty-oriented financial intermediation. On the one hand, new financial intermediaries are created, such as poverty-oriented banks (e. g., the Grameen Bank), cooperative banks, or micro-banks (e. g., the Cameroonian Cooperative Union League or the Mutuel Communautaire de Croissance in Cameroon). On the other hand, existing organizations such as non-governmental organizations (NGOs) and endogenous self-help groups (SHGs) are up-graded – *or in the case of commercial banks down-graded* – to improve their poverty-oriented financial market outreach. If up-graded SHGs and down-graded commercial banks meet in the process of financial transaction, linkage banking is the result. Stöckli and Gugler (1998) describe the various approaches to microfinance and relate them to the concept of social intermediation.

History of linkage banking

The concept of linkage banking is rooted in research by Seibel (1984) on informal finance in Nigeria. The Asia-Pacific Rural and Agricultural Credit Association (APRACA), and the African Rural and Agricultural Credit Association (AFRACA), took the initiative to promote the concept in 1986 and 1987, respectively. Linkage banking evolved first as a rural financial intermediation strategy, but it is similarly applicable in urban environments. Based on initial pilot project experience in Indonesia and subsequently in the Philippines, Thailand, Burkina Faso and Nigeria, the approach has spread to many other countries, most recently to Vietnam and Uganda (Seibel, 1997).

Guiding principles of linkage banking

Linkage banking is a form of financial intermediation that combines the best traits of the formal and informal financial sectors. It relies on existing financial intermediaries such as commercial banks in the formal sector and endogenous SHGs in the informal sector. The informal sector displays organizational and institutional advantages that reduce the information and risk costs of financial intermediation. Nevertheless, the informal sector is regionally and economically confined. The formal financial sector's potential strength lies in its economic capacity to transform the financial assets of its clients regionally, socially, and sectorally. It faces limitations, however, since its organizational and institutional framework does not correspond to the socio-economic realities of the poor (see also Stöckli and Gugler, 1998). A series of guiding principles for linkage banking have emerged (Kropp *et al.*, 1989; Kropp and Quiñones, 1992; Seibel, 1997):

(1) No new financial intermediaries! Work with and through existing formal (e. g. commercial banks) and *informal (e. g. SHGs) organizations.*
(2) Emphasize savings mobilization.
(3) Link savings mobilization with access to credit services. This means that credit is always a fixed multiple of previously mobilized savings.
(4) Employ market interest rates to savings and credit transactions.
(5) Promote substitutes for classical credit collateral, e. g., joint group liability.
(6) The target group can be any group in the population that does not yet have access to financial services in the formal financial sector.
(7) *Assist in the graduation process* involving participating SHGs.
(8) Strive for simple, fast and timely service.
(9) Create incentives for timely loan repayment, e. g., debtor graduation programs.
(10) Strive *first for operational* and late for financial self-sufficiency.
(11) Finally, respect the target group (clients) participating in linkage banking.

There are two principal dimensions of linkage banking. These are (1) the organizational linkage between informal *SHGs and formal financial intermediaries*; and (2) the financial linkage between savings mobilization and credit allocation.

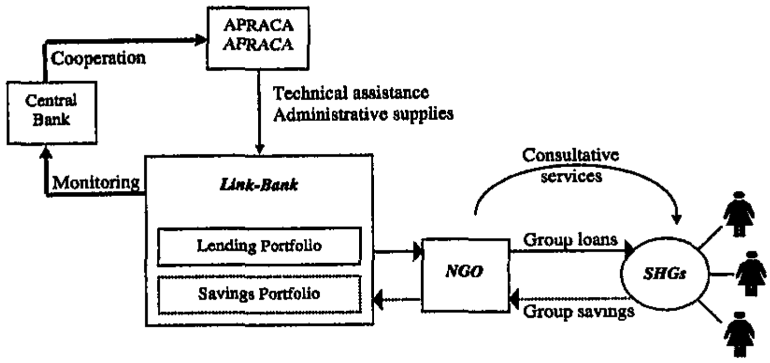
Organizational and financial linkage

The organizational linkage between informal SHGs and commercial banks often proceeds in an evolutionary process. At the beginning, banks set up an indirect linkage to SHGs with an NGO as the facilitator. In time, direct linkages between banks and SHGs may evolve. NGOs normally *continue to provide consultative* services to the members of the SHGs in various socio-economic fields, but no longer act as facilitators. Finally, members of SHGs may gain direct access to the financial services of the link-bank. Experience has also shown that the effectiveness of implementing linkage banking can be greatly improved by incorporating leading agencies and decision makers in the financial market – for example, the central bank in the implementation and monitoring process (Getubig, Remenyi, and Quiñones, 1997; Seibel, 1997). Figure 1 illustrates the indirect linkage banking concept. It shows that an *NGO collects savings from the*

SHGs and deposits them in the bank. Based on the deposited savings and the joint liability of the SHG members, the bank then provides credit as a certain multiple of the deposited savings. The loan is transferred to the groups via the NGO, and the SHGs then extend loans to their individual members. Concurrent with its function as a financial service facilitator, the NGO normally continues to provide consultative services to the SHGs in the agricultural sector or in other relevant areas of socio-economic development.

NGO loses its role as facilitator. Banking transactions take place directly between the link-bank and the SHGs. Nevertheless, the NGO may continue to provide its non-financial consultative services to the SHGs. The ultimate objective of providing financial services to the poor is to expand and secure their income base. If the poor are capable of expanding and securing their income base and become less poor, and as the formal financial sector becomes more efficient in dealing with this market segment, i. e. by applying linkage banking strategies, the less poor should eventually become direct clients of the formal financial sector without being organized in SHGs.

Figure 1: Indirect linkage banking



It is also interesting to note that the implementing agencies, e. g., APRACA or AFRACA, normally do not provide financial incentives but primarily technical assistance to the participating link-banks. The participating banks often support facilitating NGOs in their newly adopted financial intermediation role. At the same time, the NGOs build social capital at the SHG level. Social capital is the result of social intermediation. It reduces the barriers between the formal financial sector and poor clients. As Stöckli and Gugler (1998) pointed out, social intermediation reduces the transaction costs of financial intermediation and should thus be an integral part of microfinance.

As the link-bank gains experience in dealing with depressed segments of the financial market such as the poor, indirect linkage banking may be transformed into direct linkage banking. The

Strengths and weaknesses

Finally, some of the strengths and weaknesses of linkage banking should be summarized. It ought to be pointed out that no single weak or strong parameter is decisive in determining success or failure in a particular linkage banking case. It is the relative weight of one parameter in comparison to the others that is important. Linkage banking can strengthen the domestic financial market and its poor clientele through: (i) expansion of clientele outreach and social capital; (ii) reduction of the transaction costs at the link-bank level; and (iii) reduction of financial market fragmentation, etc. However, linkage banking has significant weaknesses, among which are the following: (i) possible lack of professionalism in NGOs with regard to financial intermediation; (ii) participating link-banks or leading agencies may be unstable and/or exert political pressure on the implementing agencies; and (iii) the mal-functioning of the joint group liability concept in a given socio-cultural context.

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