Supporting Community-Managed Loan Funds

Donors support many community-managed loan funds (CMLFs) often designed as components of larger projects. Unlike microfinance institutions (MFIs) with professional staff, CMLFs rely on group members themselves to manage the funds. CMLFs can be attractive alternatives for areas and populations that are too expensive for formal MFIs to reach. Savings-based models have experienced promising results, but funding CMLFs with external capital at the outset almost always leads to poor repayment rates and fund failure.

What are community-managed loan funds?

CMLFs are operated by group members, with no professional management or supervision of lending and collection. Donor-supported CMLFs use diverse approaches. They may be referred to as revolving funds, self-managed village banks, self-help groups, or accumulating savings and credit associations. They can be fit into three models:

**Externally funded.** These CMLFs begin with capital infusion from a donor, usually with little or no savings requirements. The fund is expected to revolve indefinitely as members take and repay loans funded by the external capital.

**Savings based.** These CMLFs focus on building up savings. Savings are lent to members, and interest on the loans provides a return to savings. Donors provide promotion, training, and monitoring services, but not lending capital for loans.

**Self-help groups (SHGs).** SHGs, the dominant model in India, are separated out as a third model because they include aspects of both externally funded and savings-based CMLFs. SHGs usually begin using only members’ savings. After a period of successfully lending out and collecting their own resources, groups may approach a commercial bank for a loan to leverage internally generated funds.

How have CMLFs performed?
The performance of CMLFs varies greatly by model. Externally funded groups almost always decapitalize and collapse due to poor repayment. Savings-based groups generally have better results. Since these groups lend their own savings, the incentives to repay loans are greater and repayment rates are usually much higher. Indian SHGs that receive a loan from a commercial bank perform unevenly.

What advantages do stable and reliable CMLFs offer?

**Rural outreach.** CMLFs can operate in remote or sparsely populated areas where more formal microfinance services are neither cost-effective nor available. Costs are usually low because CMLFs do not have paid staff or the operational expenses of most MFI branches.

**Poverty outreach.** CMLFs can handle savings and loans that are too small for most MFIs. Groups decide their own transaction sizes—as small as $0.01. Once the fund has grown large enough, it can be lent in manageable amounts.

**Flexibility.** Because CMLFs are small and members usually know each other well, they can be more flexible in offering quick loan disbursement and individualized repayment schedules.

**Savings.** Informal CMLFs usually do not have to comply with regulatory requirements that prevent many formal MFIs from accepting voluntary deposits.

**Community development.** Some agencies use CMLF groups as conduits for other development objectives, such as health education or addressing community-wide needs.
What challenges do donors face when supporting CMLFs?

External capital distortions. Externally funded CMLFs almost always fail, usually because of poor repayment. People find it much easier to default on a loan funded by outsiders than on a loan funded by their neighbors’ savings. Once some members start defaulting, others usually follow suit, because a key motivation for repayment—continued access to future loans from the fund—is jeopardized.

Weak recordkeeping. CMLFs are at risk if members cannot keep and read accurate records. Some donor-supported projects, including PACT’s Women’s Empowerment Program in Nepal, incorporate literacy training as a part of the program. Others, such as CARE’s MMD program in Niger, instruct members to save by purchasing shares of a fixed amount that can be easily recorded by stamps that represent one unit of savings.

Inadequate training and support. Managing a loan fund can be complex, so members usually need training. Group members may not know how to calculate interest rates, determine loan schedules, collect repayments on time, or follow up with delinquent borrowers. In Uganda, DFID found that delinquency management training was vital to the success of its Financial Sector Deepening Project. Experience with a wide range of community-based finance suggests that groups are less likely to remain stable without some level of continuing external technical support.

Elite capture. More powerful group members can exploit the loan fund by taking more than their share of loans and by defaulting. When this happens, weaker or less informed members lose access to loans, and may even lose their own savings.

What strategies can donors employ to make CMLFs work?

Abandon up-front external funding. Providing initial external capital to CMLFs distorts incentives for members and almost always leads to default and collapse. Agencies that want to support CMLFs should use a savings-based approach.

Consider bank-linkage models. To provide groups with more capital than their savings can provide, explore promoting linkages with banks, as done with SHGs in India. Eligible groups should have a solid track record at collecting and lending out members’ savings and should be receiving the support they need to manage larger amounts of capital.

Provide strong technical support. Groups need competent external support and training for a range of functions, including governance, bookkeeping, and delinquency management. Donors can finance this support in the early stages, but should plan for structures that can provide it on a long-term basis, for example, through federations.

Insist on meaningful performance reporting. CMLFs cannot be burdened with elaborate record-keeping, but it is critical that projects report at least outreach—numbers of clients and groups, loan repayment, using industry-standard measures, and group survival.

Track CMLF projects. Agencies need mechanisms to flag CMLF components internally, to ensure adequate technical review and monitoring systems.

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