

# Financial Sector Development – The role of effective local banking structures

Background paper for the 2019 UN Inter-  
Agency Task Force Report on Financing for  
Development

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## Table of Contents

|   |           |
|---|-----------|
| <b>Part I. Introduction</b> .....   | <b>3</b>  |
| <b>Part II. Saving/Financial Access/Inclusive Finance and Growth</b> .....  | <b>5</b>  |
| <b>II. 1. Is diversity in financial sector structure conducive to fostering savings and credit opportunities for all?</b> ..... | <b>5</b>  |
| II. 1.1. Savings.....   | 5         |
| II. 1.2. Credit.....  | 6         |
| II. 1.3. Financial sector structure .....   | 7         |
| <b>II.2. Macroeconomic effects of financial inclusion</b> .....   | <b>10</b> |
| <b>II. 3. Conclusion</b> .....  | <b>12</b> |
| <b>Part III. Sparkassen and cooperative banks in Germany—lessons from their history for financial sector development</b> .....  | <b>12</b> |
| <b>III.1. Similarities and differences between Sparkassen and cooperative banks in Germany through history</b> .....            | <b>12</b> |
| <b>III. 2. Economic effects of the Sparkassen business model today</b> .....  | <b>16</b> |
| <b>III. 3. Conclusion</b> .....   | <b>17</b> |
| <b>IV. Country examples/case studies</b> .....  | <b>19</b> |
| <b>IV. 1. Credit cooperatives in Vietnam</b> .....  | <b>19</b> |
| IV. 1. 1. Structure and governance .....  | 19        |
| IV. 1. 2. Network.....  | 19        |
| IV. 1. 3. Savings and credit.....   | 20        |
| IV. 1. 4. Business success and resilience.....  | 20        |
| <b>IV. 2. The micro banking units of Bank Rakyat Indonesia (BRI)</b> .....  | <b>21</b> |
| IV. 2. 1. The genesis and business concept of the micro banking units .....   | 21        |
| IV.2. 2. Savings and credit .....   | 21        |
| IV. 2. 3. Funding and profitability .....   | 22        |
| IV. 2. 4. Crisis resilience and business success .....  | 22        |
| <b>IV. 3. Peru Cajas Municipales de Ahorro y Crédito (CMAC)</b> .....   | <b>23</b> |
| IV. 3. 1. Origins.....  | 23        |
| IV. 3. 2. Governance and ownership.....   | 23        |
| IV. 3. 3. Business model.....   | 24        |
| IV. 3. 4. The CMAC system’s evolution since the 1990s.....  | 24        |
| IV. 3. 5. Resilience and support to MSMEs during the crisis.....  | 25        |
| <b>IV. 4. Rwanda’s Umurenge Savings and Credit Cooperatives (SACCOs)</b> .....  | <b>26</b> |
| IV. 4. 1. Origins.....  | 26        |
| IV. 4. 2. The 2011 Rwanda Financial Sector Assessment Program (FSAP) Update .....   | 27        |
| IV. 4. 3. The Financial Sector Development Program II (FSDP II) .....   | 28        |
| IV. 4. 4. The development of the Umurenge SACCOs since 2011/2012.....   | 29        |
| IV. 4. 5. Current Challenges .....  | 30        |
| <b>V. Success factors and policy conclusions</b> .....  | <b>30</b> |
| <b>V.1. Limitations and a Caveat</b> .....  | <b>30</b> |
| <b>V.2. Key success factors</b> .....   | <b>31</b> |
| <b>V. 3. Policy conclusions and recommendations</b> .....   | <b>32</b> |
| <b>REFERENCES</b> .....   | <b>34</b> |

## Part I. Introduction

**1. Recognizing that private business activity, investment and innovation are key drivers of economic growth and employment, the Addis Ababa Action Agenda on Financing for Development (henceforth the Addis Agenda) highlights the importance of creating an enabling environment for the mobilization of private capital, domestic and international, in ways that further sustainable development.**<sup>1</sup>

The Addis Agenda rightly emphasizes the role of policy—macroeconomic and structural—as well as that of institutions, governance and capacity building at all levels. Moreover, it underscores the need for more inclusive finance as well as policy and regulatory frameworks that encourage access to finance and financial market stability in a balanced manner. The importance of financial inclusion is also highlighted in several Sustainable Development Goal (SDG) targets, in particular the specific call to “strengthen the capacity of domestic financial institutions to improve access to banking, insurance and financial services for all” (SDG target 8.10).

**2. There is no doubt about the critical contributions of micro, small and medium-sized enterprises (MSMEs) to sustained growth and employment.** Because they are nimble, they can adapt more swiftly to changing market conditions, also making them an asset for economies, which face structural change. Yet surveys among MSMEs across the globe continue to identify a lack of adequate financing as a major constraint on growing their business. Hence, the Addis Agenda rightly stresses the importance of promoting affordable and stable access to credit and financial services to MSMEs.

**3. Institutionally diverse financial systems that include effective local banking structures are likely to help advance individuals’ and small firms’ access to finance and thereby contribute to more inclusive and geographically-balanced growth.** Such structures include microfinance institutions, public savings and postal banks, microfinance institutions (MFIs), and savings & credit cooperatives. National financing frameworks for the SDGs should include the promotion of such institutional diversity in domestic financial sectors.

**4. Emphasizing the crucial role of local banking for development does not imply a lesser role for international banking.** As highlighted by the World Bank’s recent Global Financial Development Report, international banking activities in developing countries can contribute to faster growth, greater welfare and stability, by bringing capital, expertise, and new technologies into these economies. This also may help their banking systems become more efficient and competitive and help foster risk sharing and diversification. However, cross-border banking can also bring with it additional stability risks and spillovers. Therefore—in order to reap the benefits and contain the potential downsides—developing countries need to pursue appropriate macro- and micro-prudential policies, including home-host supervisory cooperation. With good governance and strong institutions in place, healthy competition

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<sup>1</sup> IATF Inaugural Report 2016, Chapter II.B

between foreign and domestic banks to attract new customers can lead to improved access for previously excluded households and MSMEs (World Bank, 2018).

**5. The contribution of local banking to more sustainable growth and development is often underappreciated.** Therefore this paper aims to shed further light on the issue by presenting and examining:

- Findings from a range of micro- and macro-level studies about the drivers of financial inclusion, which show that financial institutions and banking business models that are focused on local economies and their communities have a positive impact on financial access for individuals and firms and thereby ultimately on economic development and growth (Part II).
- Evidence from the historical evolution of the German savings banks and credit cooperatives, which were created two centuries ago to provide the poor as well as MSMEs and farmers with access to financial services. The evidence will show that adherence to the key tenets of their business model and governance—in particular, the focus on their local region, the prioritization of savings mobilization, the pursuit of profitability rather than profit maximization, and drawing added strength from working as a network of autonomous institutions—was instrumental for their success to the present day (Part III).<sup>2</sup>
- Examples of experience with financial institution building in several developing economies, where governments created or promoted the development of locally oriented banks, cooperatives and/or MFIs. While the examples presented reflect diverse historical, cultural and political backdrops in different parts of the world, they have a number of success factors in common—factors which have also driven the success of the German savings banks and credit cooperatives (Part IV).

The paper then concludes that it is possible to create successful financial institutions, which don't have profit maximization as an objective, but rather have a mandate that includes the support of local economic development and social objectives, and still manage to achieve long-term economic and financial viability. In order to flourish, such local banking institutions must emphasize the mobilization of savings; foster trust and long-term banking relationships with the firms and households in their communities through fair and transparent business practices, sound governance and effective oversight structures; enhance staff skills through regular training; develop innovative products and techniques that are well suited to the needs of their local clientele; and secure economies of scale via the establishment of effective networks and apex institutions (Part V).

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<sup>2</sup> Special thanks for the valuable assistance in developing this part of the paper, including the provision of data, are owed to the German Savings Banks Association [DSGV—Deutscher Sparkassen- und Giroverband], the Savings Banks Foundation for International Cooperation [Sparkassenstiftung für Internationale Kooperation], and the Department for Research Promotion of the Savings Banks Financial Group [Wissenschaftsförderung der Sparkassenfinanzgruppe e.V.]

## Part II. Saving/Financial Access/Inclusive Finance and Growth

“ To design more appropriate savings services, institutions must actively work to better understand poor people’s needs. ”

(The Consultative Group to Assist the Poor <http://www.cgap.org/topics/savings>)

### II. 1. Is diversity in financial sector structure conducive to fostering savings and credit opportunities for all?

#### II. 1.1. Savings

**6. Thrift lies at the heart of savings and capital accumulation, and when savings are effectively transformed into enterprise financing and put to productive use, it will generate economic growth and development.** The promotion of saving is critical not only at the macroeconomic level, but also at the individual level, including among the poor. Savings help low-income households and the poor to smooth consumption and provide a degree of ‘self-insurance’ to cope with unforeseen problems, including illness and temporary inability to earn a living. As individual or family income grows, savings can help finance investments in education or with starting a micro or family businesses.<sup>3</sup> At the aggregate level, an increasing accumulation of savings is strongly predictive of future economic growth (Karlan et al 2104). Yet, despite the progress over the past decade in improving access to finance, many people with bank accounts do not necessarily use a banking institution for their savings. As shown in the World Bank’s Global Findex Database 2017, only 31 percent of account holders in developing countries reported in 2017 that they have saved at a financial institution during the past 12 months. A considerable share of people saves semi-informally, for example through a village savings club or simply by holding cash at home or in the form of jewelry. Saving informally still meets consumption smoothing and self-insurance needs, and to a certain extent such savings get fed back into the economy eventually. But money ‘parked’ at home or outside the financial system is not available for the professional intermediation of savings deposits into credit.

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<sup>3</sup> It is worth noting that, according to the Global Findex Database 2017, saving for a business was especially common in Sub-Saharan African economies. In Ethiopia, Kenya, Liberia, Nigeria, Uganda and Zambia, for example, 29 percent or more of the adults surveyed reported having done so. This is twice the global average.

## II. 1.2. Credit

**7. Individuals as well as firms depend on reliable access to credit no matter how advanced an economy's stage of development, and studies find that bank credit is generally associated with higher growth rates** if one controls for other factors (Ayyagari, Demirgüç-Kunt and Maksimovic, 2011). But all too often there is a mismatch between demand for and supply of credit, which is especially problematic when it comes to small firms and start-ups. According to studies cited in a 2010 expert group report to the G20, formal SMEs contribute up to 45 percent of employment and up to 33 percent of GDP in developing economies and these numbers are significantly higher when taking into account the estimated contributions of SMEs operating in the informal sector. Research also shows that the availability of external finance is associated with greater innovation by MSMEs, and business start-ups. However market information asymmetries, high transaction costs, lack of movable collateral frameworks and credit information systems as well as other weaknesses of the financial sector infrastructure and legal environment often constrain access to finance for these firms, in particular in developing economies (World Bank, 2014).

**Chart 1: Share of Firms Identifying Access to Finance as a Major Constraint**



Source: Enterprise Surveys (database), International Finance Corporation and World Bank, Washington, DC, <http://www.enterprisesurveys.org>. (as published in World Bank, 2014).

Chart 1 above shows more than one-third of small firms in developing countries cite access to finance as a major constraint. Even among large firms, that number is significant (25 percent). The numbers in the chart are based on a sample of 137 countries from 2005-2011. More recent country-by-country data from the 2017 Global Findex Database report show that as much as 40 - 50 % of small firms, in particular in Sub-Saharan African economies, still report lack of access to be a major constraint.

**8. Credit is not always the most suitable instrument to finance a business, but for many firms it may be the only available external source of finance.** Start-ups as well as micro and small firms usually have no other options but to rely on banks in order to add external capital to complement internally generated finance. And it is often only at

the local level, where they can overcome their financing challenges. This is because, if anywhere, it is at this level that the age-old “know your customer” banking rule tends to work to the mutual benefit of both the lender and the borrower.

**9. Small firms have more of a chance to establish trust and build sound relationships for the longer term with a local banking partner that is familiar with the local business environment.** From the perspective of the lender, relationship banking that is focused on local clients affords the lending institution a superior risk assessment, based on local, soft information (Petersen and Rajan, 1994). Such a ‘commonality of interest’ between local banks and local businesses becomes even more obvious for banks with a business model that specializes in MSME financing and/or includes a mission to support the local/regional economy (Behr, Foos and Norden, 2013). This type of local business financing by banks has been shown to be effective and sustainable. It is also more sustainable than lending induced by government interventions via directed lending.<sup>4</sup>

### II. 1. 3. Financial sector structure

**10. Market finance and bank finance play different and complementary roles in the growth and development process.** The highly positive correlation between financial depth and economic growth is uncontroversial, although there is some disagreement in the literature about the direction of causality. Some studies have shown evidence of a positive effect of financial development on growth, while others argue that financial development advances when economic growth leads to greater profits for financial institutions (see Levine, 1997). In practice, and as the sections below with country examples will show, both effects can be observed at different stages in time. However, while the pros and cons of bank finance versus market finance have been the subject of much research and discussion for a long time, there has been a relative dearth of literature on the relative benefits of different types of banking institutions or banking models. Of particular interest for the purpose of this paper is the question whether some financial institutions or certain banking business models are better suited than others to help improve access to finance for businesses, especially for MSMEs and start-ups.

**11. With regard to the European banking system, a series of innovative studies has assessed the performance of various groups of banks and their lending behavior through the economic cycle.** The ‘Banking Business Models Monitor’ emphasizes the ownership structures and assesses the financial and economic performance, resilience and robustness, across retail, investment, and wholesale oriented banks (Ayadi et al, 2014). Although the focus here is more on stability risk and regulation, the analysis finds *inter alia* that that the contribution to the real economy of the locally focused retail bank model has been significantly higher than other business models; and banks that engage more in traditional retail banking activities with a mix of funding sources fared well during the different phases of the financial crisis compared to other bank models. In a similar vein,

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<sup>4</sup> Directed lending often has been associated with market distortions and financial stability concerns. The risk of such problems materializing is even greater in countries suffering from poor governance and weak institutions.

studies by Butzbach and von Mettenheim (2012, 2014) find that ‘alternative banks’ (including cooperative, savings, and special purpose banks) often equal or outperform joint-stock banks. These types of banks have similar business models that are based on sustainable returns with longer time horizons and include social and public policy goals.

**12. At the global level, the World Bank’s Global Financial Development Report 2014—in the context of an analysis of financial inclusion and its drivers—also includes a review of the role of different types of financial institutions.** This review presents useful data about regional variations in the relative importance of financial institutions other than commercial banks. For example, in Latin America and East Asia and the Pacific, there is a high ratio of cooperative banks, whereas in Sub-Saharan Africa—at a ratio of MFIs to bank branches of almost 1:2—MFIs are much more prevalent than anywhere else. Interestingly, the ratio of cooperatives to commercial bank branches is highest in the advanced economies of Western Europe; Germany and Austria actually have more cooperative than commercial bank branches. Based on the World Bank staff’s literature review, it can be shown that a higher share of savings and credit cooperatives, credit unions, and MFIs results in improved access to finance in low-income countries. That literature review, however, finds no evidence that smaller institutions are better in providing access to finance than larger ones (Beck, Demirgüç-Kunt, and Singer, 2013). In fact, there are good examples of larger banks that have profitably managed to provide greater access to finance. One of these is Banco Azteca in Mexico (see for example Ruiz, 2013). What appears to matter more than the size or ownership structure of banks in improving access to finance in a commercially successful manner is the special lending technique that such banks have developed and/or the business model of relationship banking. Research also confirms that competition in the financial sector is a key factor in enhancing firms’ access to finance (Love and Martinez Peira, 2012). The World Bank analysis concludes that a financially diverse landscape, featuring a variety of financial institutions and improved competition in the financial sector, can be associated with improved access to finance and provide a better basis for growth and recommends: “... improving competition within the financial system, but also allowing a variety of financial institutions to operate (from specialized lenders and low-end institutions to banks with lending technologies or business models that reach out to new clients in responsible ways).”

**13. New research also suggests that an institutionally diversified banking sector can be more conducive to financial stability than monolithically structured systems.** History is rife with banking crises that caused major economic turmoil; and serious efforts to strengthen crisis prevention by tightening bank regulation and supervision usually follow in the aftermath of these crises. However, such well-intentioned efforts to reduce systemic risk eventually tend to get watered down in the face of heavy lobbying by vested interests. The new regulations then turn out to be insufficient to prevent the recurrence of excessive risk taking at the systemically important large banks (‘Wall Street’). Yet they cause significant burdens for locally and retail focused banks (‘Main Street’), which did not cause the crisis in the first place. In fact, the latter are more resilient, while investment and wholesale banks tend to accelerate the accumulation of



risk at system level and to be less resilient to shocks (Ayadi, 2015).<sup>5</sup>

**14. Unfortunately, safer banking structures and business models that favor stable long-term bank-client relationships were increasingly considered to be outdated during the investment banking hype of the 1990s.** As a result, restructuring and privatization of state and public banks, consolidation of smaller decentralized banking groups into larger banks, and mergers with large commercial banks became the norm across many member countries of the OECD and beyond.<sup>6</sup> All the while, the ascent of investment banking and financial engineering, combined with the revolution in IT, ushered in an era of ‘financialization,’ i.e. an increasing disconnect of global banks and financial markets from the real economy. The shareholder value orientation pushed profitability benchmarks in banking to unsustainable levels. In fact, it was unrealistic for any bank with a business model focused on relationship banking and the financing of SMEs to achieve the strongly elevated targets for returns on assets (ROA) propagated by large investment banks and the capital markets. As a consequence, a number of mid-size regional banks sought to boost results by investing in the high-yielding complex structured products engineered from US mortgages.<sup>7</sup> With hindsight, therefore, the global financial crisis of 2007/08 is also a stark reminder of what happens when banks depart from their traditional business models and take excessive new risks.<sup>8</sup>

**15. Experience during the global financial crisis and recession demonstrates the stability and growth benefits of a diversified institutional structure of banking.** For example, the decentralized system of local banks in Germany, which has always focused on retail and SME business, has been much more resilient during the financial crisis than the large, internationally active commercial and investment banks. Their financial stability, coupled with their ability to maintain strong lending relationships with SMEs and trades and crafts people, has prevented an economy-wide credit crunch. This also explains at least partially why the crisis-induced recession was shorter lived in Germany, and its economy has managed to come out of it much better than that of other comparable countries. A study published by the ILO makes similar points for cooperatives in a number of countries (Birchall, 2013). Chart 2 below shows the divergent trend in lending between the large commercial banks on the one hand and the savings and cooperative banking groups on the other: The lending behavior of the former is rather volatile, and

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<sup>5</sup> This pattern has led to increased calls in Europe, for example, to stop pursuing one-size-fits-all regulation and introduce proportionality to better align regulation with business models: i.e. set more stringent rules for those bank business models which tend to accelerate systemic risks than for those which are more resilient to extreme shocks and have stronger links to the real economy.

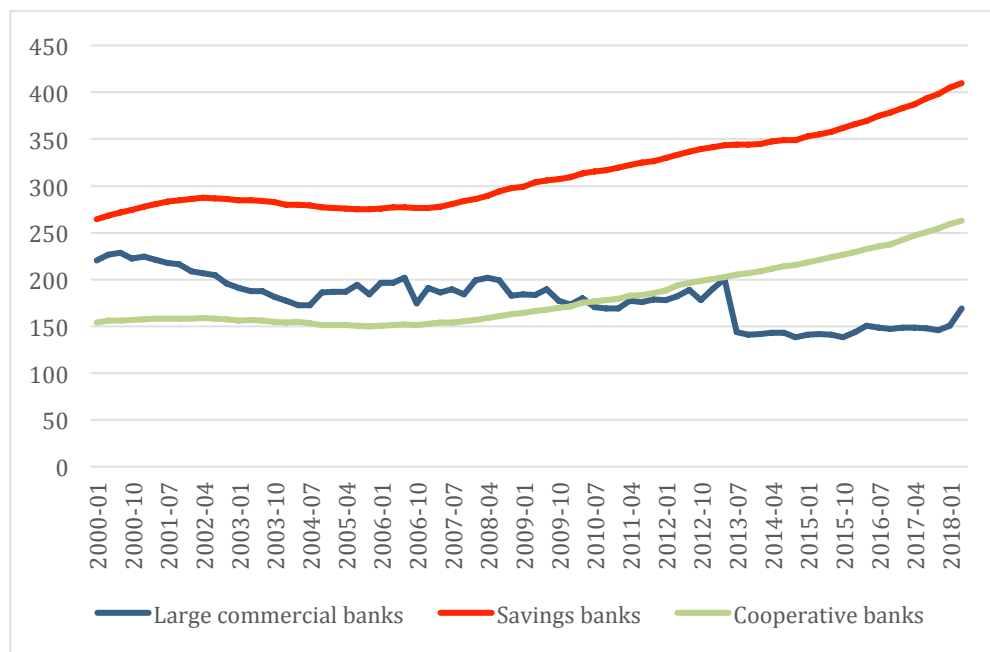
<sup>6</sup> The German government resisted pressures to privatize and restructure large parts of its banking sector and defended its decentralized networks of savings banks.

<sup>7</sup> One such bank—the first to fall in Germany in the wake of the global financial crisis of 2007-2008—was Industrie Kreditbank (IKB) in Düsseldorf.

<sup>8</sup> The renowned Asian regulator and scholar, Andrew Sheng remarked with hindsight: “I used to think that we should build Wall Street in Asia. I now think that is exactly what we should not do. I am still a firm believer that finance must be at the service of the real economy, not the other way around. I still believe that finance must look after the interests of the public first and foremost before its own interests. We change these beliefs at our peril.” Quoted from: Annual Ngee Ann Kongsi Distinguished Lecture, Singapore Management University, 28 October 2010 “Global financial reforms and its implications for Asia and its financial systems”

total credit outstanding declines during and following the financial crisis and economic downturn, whereas the total credit extended by either the savings banks or the credit cooperatives shows a steady increase during the same period.

**Chart 2: Total credit outstanding to domestic enterprises & self-employed (EUR billion)**



Source: Banking statistics of the Deutsche Bundesbank and calculations by the DSGV (German Association of Savings Banks)

## II.2. Macroeconomic effects of financial inclusion

**16. The promotion of financial inclusion and microfinance benefits poverty reduction and development**, according to recent analyses based on ex-post project assessments in countries with multi-year microfinance support programs (Demirgüç-Kunt, Klapper, and Singer, 2017). This confirms findings in earlier more general literature on the nexus of finance and growth, which describes the positive welfare enhancing influence of microfinance on broad, previously marginalized segments of the population and thus on economic development (for example Levine, 2005). Even those who later have argued that microfinance has promised more than it could deliver, agree that it has made a significant contribution to a more inclusive financial system by building robust, durable financial institutions to bring useful services to millions of people in need (Roodman, 2012, 2014).<sup>9</sup> Indeed, and more specifically, the micro-level evidence on the benefits of access to basic payments and savings, especially among poor

<sup>9</sup> Roodman also has commented quite positively on the “German school of institution building,” which shines through in much of the development of Germany’s savings and cooperative banks described in chapter III below; see D. Roodman’s Blog of October 17, 2012: <https://www.cgdev.org/blog/german-school-institution-building-microfinance>

households, is quite supportive. At the same time, the micro-level evidence of the experience with increased access to credit shows somewhat more mixed results (World Bank, 2014). As shown below, this variance may well be explained by the respective strength or weakness of the underlying institutional and legal framework and financial sector oversight in the sample countries examined. However, more rigorous analytical studies on the macroeconomic effects of financial inclusion were lacking for a long time because consistent macro-level data on financial inclusion were missing. This changed a few years ago, when the IMF began to devote more resources to assemble better data and to analyze macroeconomic issues related to income inequality and inclusive growth.

**17. The IMF staff's analysis shows that financial inclusion can indeed have a positive impact on economic growth, stability, and inequality** (Sahay et al, 2015a). Based on newly assembled cross-country data on access to and use of financial services, Sahay and a team of IMF staff shed more light on the macro-economic benefits and trade-offs of financial inclusion. Their findings can be summarized as follows:

- *Financial sectors that are not only deep but also provide broader access to finance appear more conducive to economic growth*, although, at high levels of financial development, the marginal benefits to growth of increasing financial inclusion begin to decline.
- *Sectors that are more dependent on external finance grow more rapidly in countries with greater financial depth, and even more so with greater financial inclusion*; also, financial inclusion is especially beneficial in sectors where pledging collateral is more problematic.
- *Financial inclusion can also enhance stability, through direct and indirect channels*. Directly, if more people use bank deposits, banks could have a more solid funding base especially in periods of stress. Indirectly, financial inclusion can provide clients of financial firms with better risk management tools, boosting their resilience. However, the impact on banking stability of broadening access to credit depends on the quality of supervision. In countries with weaker bank supervision, the negative effect of broadening credit access on bank buffers is more pronounced. Conversely, at sufficiently high levels of supervisory quality, credit inclusion is positively associated with higher bank buffers.
- *Closing gender gaps in account usage and promoting diversity in the depositor base would help to improve growth without impairing financial stability*. More inclusive financial sector governance can also be important for financial stability (see also Sahay and Cihak, 2018).

**18. Dabla-Norris et al (2015) provide additional analytical evidence on the impact of policies that foster financial deepening and inclusion on GDP and on inequality**. Their analysis uses a micro-founded general equilibrium model applied to Uganda, Kenya, Mozambique, Malaysia, the Philippines, and Egypt. While identifying a positive impact on growth and equality of financial deepening and inclusive finance, the

paper suggests that country-specific characteristics play a central role in determining the impacts, and trade-offs between macroeconomic variables and policies. Thus, understanding the specific constraints that generate a lack of financial inclusion in an economy is critical for tailoring policy recommendations. Moreover, the model simulations indicate that different dimensions of financial inclusion have a differential impact on GDP and inequality, and that there are trade-offs.

### II. 3. Conclusion

- Promoting savings is indispensable for sustained investment and growth. Greater access to financial services for all segments of the population and economic sectors contributes importantly to the mobilization of savings and the availability of sustainable financing, especially in rural and economically weaker areas.
- Whether in urban or rural areas, improved access to credit is a key factor for broadening the basis for economic growth and development at the local level as well as in the aggregate at the macroeconomic level.
- But credit alone is not sufficient. The provision of more credit opportunities has to be managed prudently; in particular the increased supply of credit requires an adequate legal framework, good governance, oversight & supervision and, more generally, a strengthening of the financial infrastructure.
- Particular types of financial institutions or banks and associated business models tend to be more effective than others at achieving financial inclusion and serve as safe and reliable banking partners to MSMEs.
- A competitive financial sector with an institutionally diversified financial landscape helps improve financial inclusion and fosters more inclusive growth. Decentralized and locally anchored banking structures can be more resilient and have countercyclical effect.

## Part III. Sparkassen<sup>10</sup> and cooperative banks in Germany— lessons from their history for financial sector development

### III.1. Similarities and differences between Sparkassen and cooperative banks in Germany through history<sup>11</sup>

**19. Conceived as ‘banks for the poor’ during the latter part of the 18<sup>th</sup> century, the Sparkassen idea spread across Germany in the first half of 19<sup>th</sup> century against the backdrop of the rapid industrialization and urbanization.** In 1778, the first original Sparkasse was established as a private foundation in Hamburg, and in 1801, the first municipal Sparkasse was set up in Göttingen.<sup>12</sup> It became a prototype for the

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<sup>10</sup> Given the uniqueness of German savings banks, this paper uses their German name ‘Sparkasse’.

<sup>11</sup> See also Schmidt, Seibel and Thomes, 2016; Deutsche Bundesbank, ed. 1976; Pohl, Rudolph, Schulz, 2005; Faust, 1977.

<sup>12</sup> It should be noted that in the early 19<sup>th</sup> century the territory described here as ‘Germany’ consisted of many independent states, and only in 1871 did Germany become a federal nation consisting of 25 states.

Sparkassen, which to this day have close connections to local authorities. The 19<sup>th</sup> century was an era of unprecedented economic modernization. But it was also accompanied by social upheaval, bouts of mass unemployment and rising poverty. With increasing parts of the population left behind, social unrest and political instability became a threat that the upper classes sought to address. Among other things, this situation motivated the creation of banks for the poor in the rapidly growing urban areas.<sup>13</sup> Success over the years bred popularity and turned them into a financial service provider for all ('Bank für Jedermann') by the end of the 19<sup>th</sup> century.

**20. The emergence of the cooperative banking idea is associated with initiatives to provide food aid to the poor during the last great German famine of 1847/48.**

Similar to the geographic origins of the Sparkassen, one strand of the cooperative banking model had its roots in urban areas. It is known to this day under the label of 'Volksbanken' (People's Banks). The origins of the other strand are in villages and farming communities. They were named 'Raiffeisenbanken' (after their founder Friedrich Wilhelm Raiffeisen). Like the Sparkassen, both strands of cooperative banks soon broadened their business reach to cover urban as well as rural areas.<sup>14</sup> Remarkably, while sharing a common mission and pursuing rather similar business objectives, the Volksbanken and the Raiffeisen groups formally united only in 1972.

**21. While the founding objective for the Sparkassen was the provision of a safe platform for poor people and low-income households to save, the cooperatives were initially intended to close a gap in the provision of credit.** In fact, for a period of time, Sparkassen and credit cooperatives' operations were complementary in the sense that the latter frequently used borrowing from the former as a source of funding for their loans. However, it didn't take long for both types of locally oriented banks to offer savings as well as credit products and to compete with each other for deposits and credit clients.

**22. The founders of both types of institutions came from the middle and upper middle classes and included civic leaders, affluent members of society—today's 'philanthropists'.** However, while by no means 'radical', their philosophical approaches differed depending on where they were situated across the spectrum of conservative and liberal, Catholic and Protestant, charity and self-help. The Sparkasse was the product of a top down approach aimed at fostering social stability and poverty alleviation by offering (initially) subsidized financial access to the poor and marginalized. That movement was quickly embraced and promoted by the various levels of government—municipal, county and state. In fact, the early municipal Sparkassen were often located in the city hall. By contrast, the cooperative movement reflected more of a bottom-up approach to addressing the problems caused by the mid-19<sup>th</sup> century socio-economic crisis through the principles of self-help, self-responsibility and self-administration in providing credit and savings opportunities for all. Against the backdrop of the revolutionary climate of the time, with

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<sup>13</sup> For a study of Sparkassen and their impact on savings and economic development in Saxony during the 19<sup>th</sup> century, see: C. Thol, 2016. "Poverty relief and financial inclusion: Savings banks in Nineteenth Century Germany." ESBG Research Series. Brussels.

<sup>14</sup> In the words of F. W. Raiffeisen, the founder of the rural cooperatives, "the Credit cooperatives [serve] as a means to mitigate the poverty of the rural population and of the municipal craftsmen and workers."

popular uprisings threatening the political order, the authorities initially were suspicious of the cooperative movement's solidarity-inspired grassroots character and tried to undermine it.<sup>15</sup> Eventually, however, the political establishment recognized that the credit cooperatives also contributed to political stability via their positive social impact, and subsequently adopted legislation—namely the Prussian cooperative law of 1867. That law helped pave the way for the growth of credit cooperatives, just as the Prussian legislation on the establishment of Sparkassen had done a few decades earlier.<sup>16</sup>

**23. While the progress of these small innovative financial institutions was not without occasional setbacks, they overcame the challenges and continued to flourish during the closing decades of the 19<sup>th</sup> and into the 20<sup>th</sup> century.** This owes much to the aforementioned enabling legislation. But it was also because they were able to play a stabilizing role during the boom and bust cycles associated with Germany's development into an industrialized economy. The Sparkassen in particular benefitted from the widespread cultivation of thrift in society, and, conversely, they were strong advocates of thriftiness, offering innovative savings and payments services. Incidentally, while initially serving as a means for low-income groups to insure against economic risks, savings remained strong even after the government introduced a mandatory social insurance system and continued to expand as the economy and incomes kept growing.

**24. Another crucial factor behind the lasting success of both banking groups was the formation of networks in the form of associations.** These facilitated cooperation and information sharing between the many individual banks. Affiliation also allowed the local banks to let these associations perform many essential functions that each one of them would not have been able to shoulder by itself: the regular professional auditing of individual member banks, the organization and management of group-wide joint liability and deposit guarantee schemes, the development of common new products in response to technological advances, as well as the creation of economies of scale for the entire group through setting up, over time, a number of subsidiary entities and companies in charge of providing employee training, printing services (and later in the 20<sup>th</sup> century, IT support, payments systems/electronic clearing house functions, etc.).

**25. At the same time both groups also managed to solve initial liquidity management issues inherent in their decentralized business model by setting up systems of apex banks.** The cooperatives established 'Genossenschafts-Zentralbanken' (Cooperative Central Banks) and the Sparkassen formed 'Landesbanken' (literally translated as 'banks of the states'). While the cooperative central banks are owned and controlled by their member institutions, it is the respective federal states and the Sparkassen (via their regional associations) that jointly own the Landesbanken. Step-by-step, these larger banks grew into wholesale banks that served the individual member

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<sup>15</sup> The year 1844 marked the uprising of the weavers in Silesia, and in 1848 Karl Marx and Friedrich Engels published the Communist Manifesto.

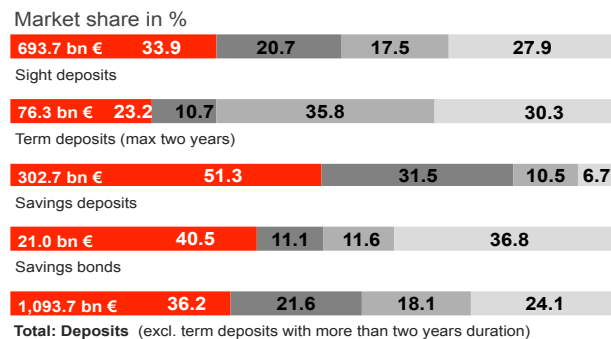
<sup>16</sup> The "Reglement, die Einrichtung des Sparkassenwesens betreffend" (regulation concerning the establishment of the savings banks), was rather farsighted, in serving as a model for later legislation; and it contained aspects also required in modern-day regulation of MFIs (see G. Ashauer 1999).

entities, including as bridges to the international financial markets.<sup>17</sup>

**26. Both the Sparkassen and the cooperative banks in Germany have successfully followed a self-sustaining business model over two centuries.** The Sparkassen sector and the cooperative banking sector form two of the so-called ‘three pillars’ in the German banking system, with the commercial banks (publicly listed or private) constituting the third pillar (Schmidt, Dilek Bülbül and Schüwer, 2013). Together, both of these two decentralized local banking groups have by far the largest market share in retail deposits and small business lending in modern day Germany (tables 1 and 2). Sparkassen have emphasized the virtue of saving across all generations until the present day, which may explain at least in part their long-lasting leading market share in savings deposits as well as deposits overall.

**Table 1**

Deposit market shares by type and by banking group (as per end 2017)



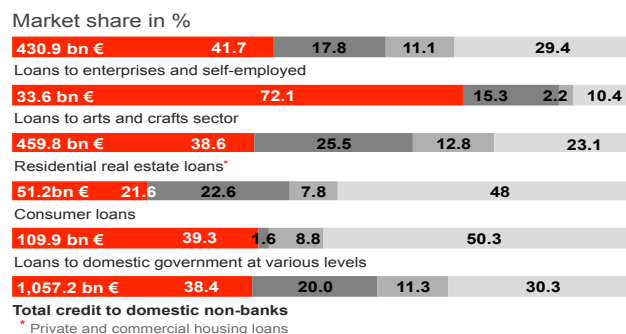
- Regional banks, specialized banks and other banks
- Large banks
- Cooperative banks
- Sparkassen-Financial Group

Source: Deutsche Bundesbank Banking Statistics and calculations by Finanzgruppe Deutscher Sparkassen- und Giroverband

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**Table 2**

Credit market shares by loan category and by bank group (as per end December 2017)



- Regional banks, specialized banks and other banks
- Large banks
- Cooperative banks
- Sparkassen-Financial Group

Source: Deutsche Bundesbank Banking Statistics and calculations by Finanzgruppe Deutscher Sparkassen- und Giroverband

<sup>17</sup> It needs to be noted that Landesbanken, too, were caught wrong-footed in the financial crisis, after attempting to mimic investment banks and improve their earnings by venturing into business operations that went beyond their traditional role within the Sparkassen system. After many of them suffered massive losses on their investments in ‘toxic assets’, they were subject to bailouts by their owners (Sparkassen) and the government and were forced to undergo management changes and major restructuring.

### III. 2. Economic effects of the Sparkassen business model today

**27. The institutional model of the German Sparkasse is rather unique today, not least due to its particular legal, governance and ownership structure** (see also Text Box 1 below). Cooperative financial institutions can be found today in many parts of the world, and the cooperative movement that started in the 19<sup>th</sup> century has inspired MFIs in many developing countries. By contrast, while savings banks were also founded in many other European countries in the 18<sup>th</sup> and 19<sup>th</sup> century, many have disappeared, were restructured into supra-regional banks or merged with other banks and lost much of their initial missions along the way (von Mettenheim and Butzbach, 2012). German Sparkassen, too, consolidated and reduced their numbers over time, but always with the aim of securing sustained local presence. And they have adhered to the key tenets of their structure and business model. Sparkassen continue to have close ties to local governments, pursue social as well as business objectives and a bottom line of profitability but not profit maximization. They are authorized to operate only in their local region. That creates commonalities of interests between the Sparkassen and the municipalities or counties as well as with the local communities and economies they serve.

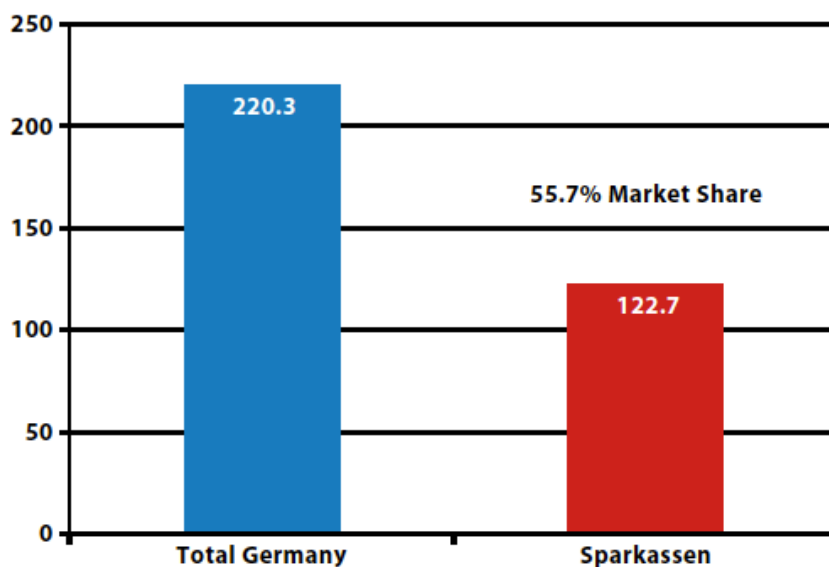
**28. The geographical constraint serves as an incentive to provide high quality financial services.** Sparkassen cannot move into other or more lucrative regions to expand their earnings potential; they have to try harder to retain customer loyalty. They also tend to maintain good banking relations with their local SMEs, the crafts and the trades people through the economic cycle, because the future commercial viability of the Sparkasse hinges on the economic success of the local business community. The cultivation of strong local ties also ensures greater familiarity by loan officers and bank management with the local firms and their businesses environment, which makes them better judges of the longer-term prospects of loan applicants. This facilitates risk management and gives Sparkassen an edge over branches of large commercial banks, which are more constrained by conditions imposed from far-away headquarters.

**29. This model of banking is more crisis-resilient and beneficial for the stabilization of local/regional economic development.** For example, according to surveys conducted among German businesses during that time (quoted in Ayadi et al, 2009), businesses that rely on the larger banks have suffered during and after the global financial crisis because of a reduction in lending by those banks. By contrast, the businesses that relied on the savings banks and the credit cooperatives did not witness similar restrictions in availability of credit. Hence, the Sparkassen have been shown to exert a countercyclical influence during the economic downturn (Behr, Foos and Norden, 2013 and 2015). The principle 'local deposits into local loans' provides resilient financing opportunities for economically weaker regions and counteracts potentially larger capital outflow from these areas. This can also be observed with credit cooperatives in other countries (see J. Birchall, 2013)



**30. The traditional partnership between Sparkassen and their trustees, the municipalities and counties, has also contributed significantly to local and economic development across all regions.** This link has helped finance communal investment into utilities, infrastructure and education during the industrialization and modernization of the late 19<sup>th</sup> and early 20<sup>th</sup> century. And in recent decades, this partnership has assisted in the process of adjustment to structural change, as Sparkassen have sponsored innovative local start-ups and business parks in cooperation with local authorities in the old mining and steel areas of the West or, after reunification, in structurally weak regions of the East.

**Table 3: Business start-up financing under KfW programs in 2010 (Euro million)**



Source: Simpson, C.V.J., Simpson Associates. 2013

### III. 3. Conclusion

**31. Both the Sparkassen and cooperative banking models have proven to be successful in a highly competitive banking sector.** The German economy has always benefitted from the secure and stable provision of financial services across all regions by these decentralized banking groups. The structure and assets of the Sparkassen and the cooperative banking groups have evolved and grown over a very long time. Of course such large and sophisticated organizations cannot be simply transferred today as a ‘blueprint’ to developing countries and become effective and competitive within a short time without major adaptations. But there are several important constitutive elements of this banking business model, which could be suitable for adaptation in financial sector development, namely: the mandate to serve the economy and people in the local region; a special focus on the financing of SMEs and start-ups;<sup>18</sup> the pursuit of economic viability rather than profit maximization; and a dedication to making skilled and professional financial banking services and advice available at the local level to everyone.

<sup>18</sup> 2010 report by the G-20 Financial Inclusion Experts Group’s (FIEG) SME Finance Sub-Group notes that the German savings banks model presents particularly high levels of scale, sustainability and track record and has been replicated successfully in other countries, such as Peru.

## **Text Box 1: Sparkassen today: Legal structure and governance, and network**

### Legal Structure and governance

German Sparkassen are neither privately owned or publicly listed commercial banks, nor are they state-owned banks in the commonly understood sense. They are incorporated under the respective savings banks legislation (Sparkassengesetze) of the German federal states (Länder), with most of them incorporated as so-called agencies subject to public law ('Anstalten des öffentlichen Rechts'). The respective municipality and/or county government serves as the formal trustee of the Sparkasse, which conducts its business as an inalienable independent economic entity, subject only to the parameters set by the Sparkassen legislation of the respective federal state and the local by-laws. The fact that any given Sparkasse is authorized to operate only within the region of its governing authority is referred to as the regional principle ('Regionalprinzip').

In addition to this geographic focus, the laws also prescribe a public mandate ('öffentlicher Auftrag'). In essence the mandate calls upon these institutions to orient their business towards supporting the economic development needs and the interests of the communities in their local region, while operating under commercially sound principles, i.e. to be profitable, but without subordinating the local region's economic and social well being to the goal of profit maximization. In line with the regional principle and the public mandate, a Sparkassen supervisory board is made up of representatives of the city and/or county councils, the local population and employees. The board chair is usually the city's Mayor or the County's Chief Executive. The supervisory board is responsible for the appointment and discharge of the management board, determines remuneration and any fundamental changes to the overall strategic orientation, but does not interfere in daily operations.

The management board, which is responsible for the day-to-day business, has to consist of at least two banking professionals, who meet the standards and requirements set by the German bank regulator (BaFin). Sparkassen are subject to the same banking regulation and supervision as all other banks and are fully licensed to conduct all normal banking business. However, while the Sparkassen sector competes with and is exposed to competition from the commercial banks and the credit cooperatives, individual Sparkassen do not compete with each other.

### Network affiliation ('Verbund')

Although Savings Banks operate independently in their respective regions and decisions made by their respective management boards remain autonomous, they are all members of the 'Sparkassen Finanzgruppe'. The group plays a key role in efficiently processing the essential downstream activities that any large banking organization requires, for example in IT, product development, dealing with regulatory requirements and in employee training. The structure is remarkable in that it is neither fully hierarchical, nor market based, nor voluntary, but it operates on the basis of common interest, and cannot be compared with a holding company or similar banking conglomerate. However, close cooperation between Sparkassen and other members of the group ensures efficiency. The Landesbanken provide services for Savings Banks, and the group also includes specialist providers for securities business, leasing, factoring, insurance, real estate finance and brokerage, etc.

### The Joint Liability Scheme (Haftungsverbund)

Sparkassen support each other at the regional or supra-regional level through a scheme designed as a 'safety net' to protect the individual member institutions in cases of economic difficulty. To this end, as well as to counter 'moral hazard', constant monitoring of all institutions is carried out within the group by auditing units under the auspices of the regional associations. The objective is to prevent any insolvency by determining when risk has reached an unacceptable level long before there is any potential for default. In the rare case of action being required, harsh penalties are levied on the responsible management. In the few cases in which the Joint Liability Scheme has been utilized, the funds not only provided the necessary liquidity, but also were also associated with the reorganization of the bank and its management. Since the inception of the Joint Liability Scheme in 1973, no member institution has ever defaulted on its financial obligations.

## IV. Country examples/case studies

[Note by the author: The following sections contain summaries of case studies on credit cooperatives in Vietnam and the BRI micro banking units in Indonesia, published in R.H. Schmidt, H.D. Seibel, and P. Thomes, 2016; special thanks go to the editors of that book, the Savings Banks Foundation for International Cooperation, in particular Dr. Ilonka Rühle-Stern, who made relevant material available for this paper. The Foundation's local representatives for Peru (Gerd Weissbach) and Rwanda (Britta Konitzer) also provided valuable inputs for the other two country examples, where the foundation supported extensive, multi-year projects. Their inputs are much appreciated. The case study published in 2013 by the ELLA Network on the CMAC in Peru and the case study published in 2014 by the Alliance for Financial Inclusion (afi), on Rwanda, also provided inspiration as well as useful insights and complementary information.]

### IV. 1. Credit cooperatives in Vietnam

#### IV. 1. 1. Structure and governance

**32. In the context of Vietnam's transition to a market economy, the country's government also enacted banking legislation, which paved the way for the establishment of a system of credit cooperatives, and in 1993 created the 'People's Credit Funds' (PCFs).** Interestingly, while inspired by the Raiffeisen model, the government didn't just copy the German cooperative model, but adapted it and added aspects of public sector control, exercised by the central bank on behalf of the government. The PCFs are autonomous and self-financed financial institutions. Their supervisory board is made up of respected members of society, who are appointed to serve on the board by the National Assembly. The board appoints the managing director of the PCFs, subject to approval by parliament and confirmation by the central bank, and decides on capital increases and interest rates, recruitment and budget. A supervisory committee, which is also elected by the National Assembly, exercises internal controls. The central bank is responsible for ensuring the soundness of the PCF system.

#### IV. 1. 2. Network

**33. A few years after the creation of the PCFs, an apex institution—the Cooperative Central Fund (CCF)—was established, which is jointly owned by the PCFs, four state banks and the central bank acting on behalf of the government.** Its main functions are the liquidity management and funding operations for the PCF system. Furthermore—and similar to the evolution of Germany's credit cooperatives and Sparkassen—an association was formed in 2006, namely the Vietnam Association of People's Credit Funds (VAPCF). In 2013 the CCF was restructured into the Cooperative Bank of Vietnam (CoopBank), which since then has served as the PCFs apex bank. And one year later, a safety fund was established for the support of PCFs that might run into financial difficulties. The fund has been managed since then by the CoopBank.

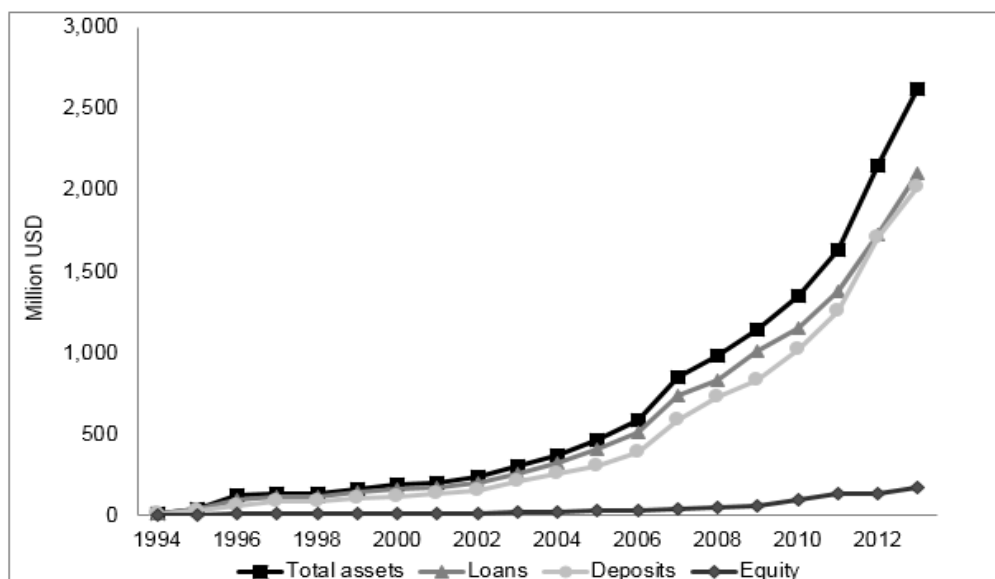
#### IV. 1. 3. Savings and credit

**34. The terms and conditions for deposits—which come from members and non-members, individuals and organizations—are attractive, and the transaction costs are low due to the PCFs’ proximity to their local clients.** The deposit and savings opportunities offered by PCFs are well tailored to the needs of the local customer base. As a result, deposits provide a reliable and stable foundation for the growth of the credit business. **The lending portfolios of the PCFs are broadly diversified, with the main focus on the agricultural production, in which most of the members are occupied.** This includes loans for agricultural production and processing as well as crafts and trades and other services. Up to 10 % may consist of lending to poor non-members. The PCFs also facilitate borrowing by women. Given their particular local client focus, PCFs followed a business policy of keeping deposit rates relatively high and lending rates relatively low, but still earning a sufficient spread to ensure self reliance.

#### IV. 1. 4. Business success and resilience

**35. The PCFs hybrid model of combing local autonomy with strategic guidance and supervision by the state via the central bank turned out to be quite successful in growing the cooperatives’ business and providing value to the local economy by offering financial services dedicated to agricultural production.** Over the two decades from the PCFs’ modest beginnings in the early 1990s to the middle of 2014, total loans outstanding have grown to US \$ 2.4 billion and deposits to US \$ 2.6 billion. The system also was crisis resilient. Neither the Asian financial crisis nor the global financial crisis appeared to have affected the PCFs, and members continued repay their loans very much on schedule: between 2005 and 2010 on average only 0.5 % of loans went into arrears.

**Chart 3: Key balance sheet data for the PCFs, 1995-2013**



Source: R.H. Schmidt, H.D. Seibel, P. Thomes, (2016)

## IV. 2. The micro banking units of Bank Rakyat Indonesia (BRI)

### IV. 2. 1. The genesis and business concept of the micro banking units

**36. The roots of BRI itself date back to the end of the 19<sup>th</sup> century with the creation of a first cooperative financial institution in Indonesia, bearing the Dutch name for savings bank—‘Spaarbank.’** The founding motives were similar to those behind the creation of savings banks and credit cooperatives earlier in Europe. When that Indonesian bank was first licensed in 1897, it was as a member-owned ‘Volksbank’ (Bank Rakyat—People’s Bank). Providing savings products and credit, it served as a model for a decentralized popular system of micro banking institutions. The evolution of the BRI spanned several decades and included the creation of an apex bank for the system. In 1968, the BRI was re-established as a commercial bank with a dual lending business: to provide loans on commercial terms to SMEs and to on concessionary terms to small farmers and micro enterprises in support of agriculture and rural development.

**37. In order to organize a delivery channel for the subsidized loans, an extensive system of ‘village units’ was set up.** However, major flaws—poor incentives for clients to repay loans, overly bureaucratic and costly procedures as well as corruption—ended up undermining the model’s viability. By the time of the early 1980s, the macroeconomic and policy environment changed in the wake of world oil price declines. With the government’s budget under pressure, policy shifted towards economic liberalization and deregulation. Against this backdrop, the government also decided to push for a major reform of the BRI and changed BRI’s management.

**38. A key element of the reform was to transform the village units into commercial microfinance units, detach them from BRI’s branches and have them operate under a separate administrative structure.** The units were designed to be small self-sustaining profit centers, and a new incentive structure in support of commercial viability was established for their employees, supported by extensive training programs. The units were no longer involved with government supported (directed) lending programs, and as a result shifted the focus from emphasizing loans to farmers to extending loans to all creditworthy local borrowers and to finance any income generating activity. In other words, they provided more inclusive finance.

### IV.2. 2. Savings and credit

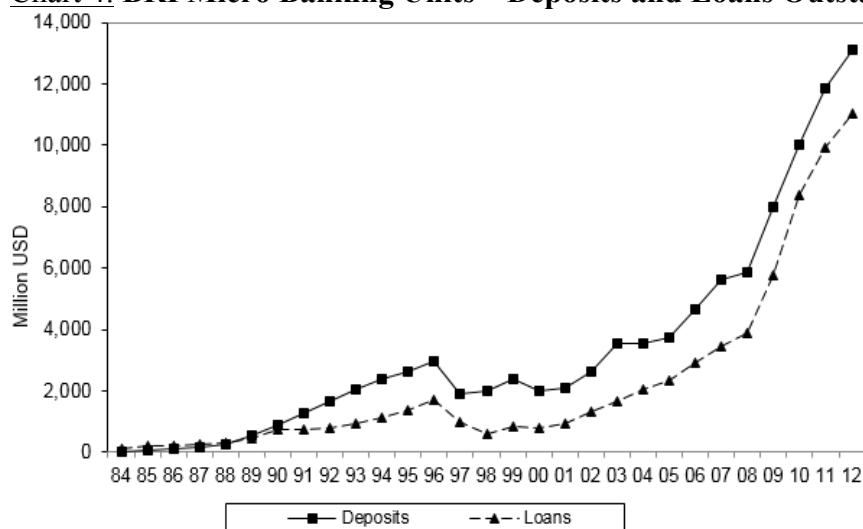
**39. Interest rates were brought in line with prevailing market rates and—except during the Asian financial crisis—were kept positive in real terms.** The units also developed innovative new savings and loan products, which were more suitable to the local conditions and client preferences and involved innovative incentives. The popularity of these products drove the units’ commercial success: New savings products boosted savings mobilization, and interest rate discounts and other incentives to reward the timely repayment of loans contributed to a strong decline in the arrears rate (from 5.4 % in 1984 to just over 1 % in 2005, and stable thereafter). The total outstanding loan portfolio of the micro banking units grew from the equivalent of US \$ 197 in 1985 to US

\$ 389 in 1990 and US \$ 611 in 1995. The growth was only temporarily interrupted by the Rupiah devaluation, but afterwards rose to US \$ 700 in 2005 and US \$ 2,005 in 2012.

#### IV. 2. 3. Funding and profitability

**40. Initial funding came from an injection of start-up liquidity by the government in 1984 and savings deposits.**<sup>19</sup> By 1986 the units started generating profits, which by 1988-89 accounted for 30 % of BRI's total net income, and in 1989, they began generating surplus liquidity. Since then the micro banking units as a sub-system of BRI have been self-reliant. In fact, the total surplus mobilized by the units and transferred to BRI's branches between 1989 and 2012 amounted to US \$ 32.5 billion, reflecting the units stellar performance in promoting savings among local customers.

**Chart 4: BRI Micro Banking Units—Deposits and Loans Outstanding 1984- 2012**



Source: R.H. Schmidt, H.D. Seibel, P. Thomes, (2016)

#### IV. 2. 4. Crisis resilience and business success

**41. When the Rupiah and the country's commercial banks, including the BRI, collapsed during the Asian financial crisis, the micro banking units turned out to be very resilient.**<sup>20</sup> Deposits placed with the units held up rather well even during the period from June to August 1998, when Indonesia suffered both from the financial crisis effects and from a drought.<sup>21</sup> Loan arrears and delinquencies rose only very moderately in stark contrast to the BRI (where NPLs increased to 53 % in 1998). The units remained profitable through the crisis, whereas BRI's large losses turned the bank insolvent.

**42. The BRI was finally restructured under Indonesia's program with the IMF, involving a reorientation of BRI's business model, an internal governance overhaul**

<sup>19</sup> A World Bank loan mostly for on-lending turned out not being needed for its initial purpose and was reallocated in 1989.

<sup>20</sup> The BRI's insolvency was primarily due to the failure of its large corporate loan portfolio.

<sup>21</sup> The interruption of the upward trend shown in chart 4 reflects the Rupiah devaluation

**and change of management, as a condition for recapitalization.** In 2003, the BRI was partly privatized and listed on the Jakarta stock exchange, with the government retaining a more than 50 % ownership. But it was the units' viable business model, which ensured the continued availability of critical internal funding for the BRI's other operations throughout. With cumulative net profits of US \$ 1.6 billion and a cumulative liquidity surplus of US \$ 15.9 billion over the period from 1990 to 2003, the units laid the basis for the BRI's survival of the crisis, its restructuring in 1999/2000 and its IPO in 2003.

**43. The micro banking units' success in offering inclusive financial services as autonomous parts of a decentralized network across the vast geographical stretch of Indonesia has been immensely popular domestically and also received much attention internationally.** The BRI of today continues to promote the aim of financial inclusion and meeting the needs of MSMEs. It is innovating by using banks on boats to reach clients on remote islands, and using mobile and satellite technology to reach out to clients everywhere. All this contributes to improved financial access: According to the World Bank's latest Global Findex Report, the share of Indonesia's adult population with a bank account has risen from 36 % in 2014 to 49 % in 2017.

#### **IV. 3. Peru Cajas Municipales de Ahorro y Crédito (CMAC)**

##### **IV. 3. 1. Origins**

**44. The history of the cajas municipales in Peru is closely associated with the partnership offered by the federal association of German savings banks ('DSGV' - Deutscher Sparkassen- und Giroverband).** A collaboration between the DSGV, the official German development agency (GTZ) and a then newly founded consultancy firm, IPC (International Project Consult) helped the initiators in Peru to launch a local banking system similar to the Sparkassen model. What started with a pilot project in one town (Piura) in 1982 was soon replicated in other towns and developed during economically and politically unstable times into the leading locally based provider of inclusive finance. Between 1982 and 1986 six cajas were created in five different regions of Peru. By 2013 the number doubled to twelve, with 514 branch offices throughout all of Peru's 25 regions.

**45. While Peru's economic and political system has traditionally revolved around Lima as the center of power, the cajas reflected a decentralized approach.** Ambitious town mayors took the initiative aimed at empowering the people in the local area by providing savings and financing opportunities for self-help and local economic development. The success of the caja municipal model played an important pioneering role for the evolution of microfinance in Peru: several features of the model, such as risk-management flexibility and graduated expansion, were adopted in Peru's microfinance legislation in the 1990s and since then form part of the business culture of the stronger microfinance performers in the country.

##### **IV. 3. 2. Governance and ownership**

**46. Similar to the German model, the cajas were created as local institutions under a public law regime —with the municipalities as trustees, rather than**

**‘owners’**. Not long after their creation, the government issued a special savings bank law. Another important governance feature was the inclusion of representatives of civil society in the supervisory boards of the cajas in addition to the representatives of the local government. The cajas also formed a network by establishing an association (today’s FEPCMAC—Federation of Peruvian Municipal Savings and Credit Banks). FEPCMAC’s role is to oversee and advise all cajas municipales and facilitate coordination among the individual member institutions with the aim of ensuring complementarity of their operations in the system rather than direct competition with each other. Each caja was allotted a specific geographic area for its operations,<sup>22</sup> with FEPCMAC regulating and monitoring the system. The FEPCMAC also facilitates the more efficient central organization of functions like training and auditing.

#### IV. 3. 3. Business model

**47. From the start, the cajas emphasized savings, while lending activity was carried out initially only in the form of ‘pawn loans’ to individuals who were able to pledge movable collateral such as jewelry.** Lending to MSMEs without access to loans from other banks followed only after some time. Subsequently both sides of the business were developed successfully: The cajas managed to attract an increasing amount of deposits despite the government imposed interest rate ceilings in a high inflation environment, They were also successful in building a profitable loan portfolio—including loans to MSMEs and the self-employed—while suffering hardly any arrears or loan losses. This may be explained by an important innovation in the approach to customer relations, namely the use of onsite visits and appraisal of prospective and actual clients’ homes, family settings and overall environment. Cajas reached out to the client, not the other way round. The cajas were also successful in departing from a then widely used methodology of group lending and focusing instead on issuing individual loans.

#### IV. 3. 4. The CMAC system’s evolution since the 1990s

**47. The 1990s brought a strengthening of the CMAC’s foundations through a more flexible legislative and regulatory environment that better catered to the needs of all types of MFIs.** In 1990, the cajas were authorized to lend without collateral and—depending on good performance— could gradually engage in more complex transactions. In 1996, the Financial System and Insurance Law placed MFIs as ‘financial enterprises’ on an equal footing with commercial banks and in 1997 new rules for MSME lending were adopted.

**48. The legislative changes of 1997 also affected one of the original governance features, by abandoning the public law regime and allowing the cajas to issue ownership shares instead.** However, in practice, this made little difference: While the municipalities no longer governed the cajas as ‘trustees’, they retained control by continuing to hold all the shares of the cajas rather than divesting to other parties. The legislative and regulatory changes helped place Peru’s microfinance sector on a sounder footing. In fact, by 2008, outside analysts of microfinance considered the Peruvian

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<sup>22</sup> Similar to the ‘regional principle’ of the German Sparkassen



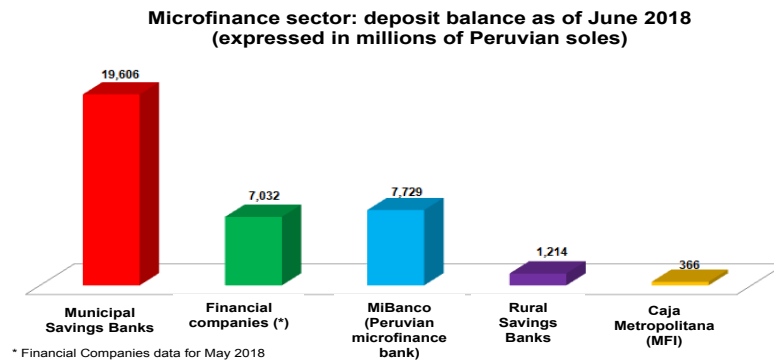
regulatory and legal environment the best for microfinance in Latin America. This environment also provided the cajas with more flexibility to expand their business.<sup>23</sup> But they also benefited from the strong turn-around in the Peruvian economy from the turn of the century, which supported a more rapid growth of their business. Within the MFI sector, they now hold the largest market share in deposits and loans (charts 5 and 6).

#### IV. 3. 5. Resilience and support to MSMEs during the crisis

**49. Peru’s financial sector felt the impact of the global financial crisis of 2007-08 especially in terms of rising NPLs and falling profitability.** But the CMAC system as a whole and its member cajas were able to absorb a temporarily decline in profitability and to repair their balance sheets quickly, while still upholding their provision of credit to their clientele: From 2006 to 2009 the volume of loans by the CMAC members almost doubled from the US \$ equivalent of 537 million in 2006 to US \$ 1056 million in 2009.

**50. While the CMAC system and its members continue to adapt to a changing environment and respond to new needs, the caja model still retains several original features:** the emphasis on saving; expanding the business only gradually towards more complex operations; a sophisticated system of professional training for managers and employees; basing credit assessments on direct, close interaction with clients in the field; creating economies of scale through affiliation in the context of an association.

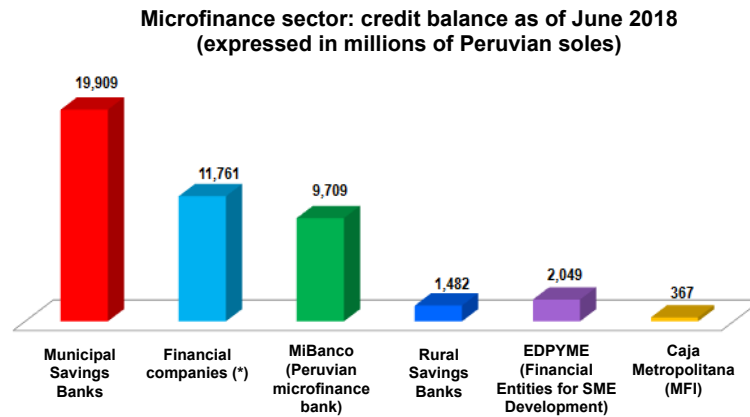
Chart 5:



Source: SBS Statistics Bulletin, June 2018  
Developed by: Advisory Department - FEPCMAC

<sup>23</sup> From 2002, the prohibition to open branches in regions where another caja already exists were lifted and cajas, and MFIs, were permitted to operate in Lima; from 2005 all MFIs including the cajas were permitted to provide financial services nationwide.

Chart 6:



\* Financial Companies data for May 2018

**Microfinance sector: investment balance**  
(expressed in millions of Peruvian soles)

| Agencies                         | June 2018     |               |
|----------------------------------|---------------|---------------|
|                                  | Balance       | Share         |
| Municipal Savings Banks          | 19,909        | 44.0%         |
| Financial companies              | 11,761        | 26.0%         |
| MiBanco                          | 9,709         | 21.4%         |
| Rural Savings Banks              | 1,482         | 3.3%          |
| EDPYME                           | 2,049         | 4.5%          |
| Caja Metropolitana               | 367           | 0.8%          |
| <b>Total microfinance sector</b> | <b>45,277</b> | <b>100.0%</b> |

Source: SBS Statistics Bulletin, June 2018  
Developed by: Advisory Department - FEPCMAC

## IV. 4. Rwanda's Umurenge Savings and Credit Cooperatives (SACCOs)

### IV. 4. 1. Origins

**51. A FinScope survey of 2008 showed that only 21% of Rwanda's adult population had access to formal financial services and 51% were completely financially excluded.** This prompted the government to launch a campaign to close this gap especially in the rural areas of the country, where more than half the population lives, by creating a Savings and Credit Cooperative in each of the administrative sectors.<sup>24</sup> The Umurenge SACCOs combine elements of the district savings bank model with that of the rural credit cooperative. For example, the priority focus at the outset was on savings mobilization, not on making loans.<sup>25</sup> Also, while created as member-based cooperative institutions, the SACCOs were not the result of a grassroots initiative. Rather, it was the government that took the lead via a cabinet decision in March 2009, and local authorities played a key role in mobilizing people to join the cooperatives.<sup>26</sup> The government provided SACCOs with offices or assistance to acquire plots and construct premises of

<sup>24</sup> 'Umurenge,' is the Kinyarwanda term for sector, hence their name Umurenge SACCOs, also distinguishing them from existing SACCOs that served certain groups, such as the military or teachers.

<sup>25</sup> SACCOs were a key element of the National Savings Mobilization Strategy launched in March 2009.

<sup>26</sup> Surveys among SACCO members showed that a significant percentage felt obliged to join.

their own. It also contributed to capacity building and training for SACCO staff and their elected boards and committees, and sponsored financial education programs for the public. Finally, during the first years, SACCOs received government subsidies. The National Bank of Rwanda (BNR) regulates and supervises the SACCOs.

**52. Six months after the cabinet decision that launched the program, and following the election of SACCO boards, the Rwanda Cooperative Agency (RCA) granted legal status to all 416 newly established Umurenge SACCOs.** The BNR's issuance of a provisional license to the SACCOs for collecting deposits followed in June 2010, and in May 2011 the BNR beefed up its MFI supervisory capacity, by installing two dedicated inspectors in each of the 30 districts of Rwanda.<sup>27</sup> This paved the way for the official launch of the Umurenge SACCOs in November 2011. And in January 2102, the BNR provided all of them with a license to begin lending operations. (See also Alliance for Financial Inclusion, 2014.)

#### IV. 4. 2. The 2011 Rwanda Financial Sector Assessment Program (FSAP) Update

**53. The joint IMF/World Bank mission to conduct the FSAP Update for Rwanda arrived in Kigali in early February 2011, right in the midst of the SACCO program's launching steps.** Unsurprisingly, the governor of the BNR and his deputy were not only keen to hear the experts' assessments of Rwanda's financial sector soundness and of the progress with the first Financial Sector Development Program (FSDP I) of 2005. They were particularly eager to discuss the SACCOs.<sup>28</sup> After listening carefully to the Rwandan authorities' explanations detailing the objectives and expectations behind the SACCO project, the FSAP team provided its advice on the way forward to secure the success in terms of safety & soundness of the SACCOs and in terms of achieving their objective of improving financial inclusion (IMF, 2011):

- “[...] Significant challenges and risks, however, remain. Users perceive these institutions to be owned by the government, and it is thus important to establish trust as well as to build an ethos of member ownership. [...]. An analysis of the capacity of both MFIs and SACCOs indicates that most lack essential skills, especially in the areas of management, IT, product development, pricing, and risk management, all of which contribute to poor governance and high NPLs. The Rwanda Cooperative Agency (RCA) and the Association of Microfinance Institutions in Rwanda (AMIR) have important roles to play by helping to ensure that the basic cooperative principles and governance arrangements are installed and observed, and that relevant training is provided to loan officers and managers. Finally, the supervisory void needs to be urgently addressed.”
- “[...] the BNR plans to establish supervision of SACCOs at the district level. In

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<sup>27</sup> Before the establishment of Umurenge SACCOs, the BNR had only 17 inspectors dedicated to the supervision of MFIs.

<sup>28</sup> The BNR plays a key role in financial sector development in addition to its other roles. It took the lead in the development of FSDP I, and in the implementation of many key policy actions. The BNR continues to play a broader role than most central banks in policy development, directly shaping the evolution of the Umurenge SACCOs and drafting financial sector legislation.

the near term, however, the BNR is also faced with the challenge of regulating and supervising institutions that themselves have little training and experience. To ease the burden on the supervising authority, [...] [the] most appropriate way forward therefore seems to be the creation of an apex institution without banking functions owned by the SACCOs. This institution could, in conjunction with RCA, provide training and capacity enhancement to SACCOs and also ensure that their members comply with regulatory requirements. Also crucial to the future viability of the SACCOs will be the development of affordable products tailored to the needs of the rural areas and a legal and regulatory framework that allows such development.”

Following the conclusion of the FSAP, the government—assisted by the World Bank—formulated a revised medium-term Financial Sector Development Program (‘FSDP II’).

#### IV. 4. 3. The Financial Sector Development Program II (FSDP II)<sup>29</sup>

**54. The FSDP II translated the 2011 FSAP Update findings and recommendations into a government-approved and country-owned document designed to guide the further modernization of Rwanda’s financial sector and align it with the overarching strategic objective of graduating from the status of low-income to middle-income country.** Its predecessor, the FSDP I, had focused on expanding access to credit and financial services; strengthening the legal and regulatory regime; enhancing savings mobilization; and mobilizing long-term capital for investment. The period covered by the FSDP I also witnessed an organic expansion of the banking sector, including the entry of specialized banks from neighboring Kenya,<sup>30</sup> as well as the transformation of the financial infrastructure through the introduction of electronic payments, ATMs, credit cards and point-of-sale (POS) terminals.

**55. The FSDP II focused more on (1) aligning the financial sector with the goals of the second economic development and poverty reduction strategy (EDPRS2)<sup>31</sup> and with East African Community (EAC) standards; (2) on increasing efficiency and innovation; and (3) on the expansion of outreach, financial inclusion and improving financial literacy.** The last point explains the important role of the Umurenge SACCOs in Rwanda’s overall financial sector development strategy, because the government and the BNR consider them vital to increasing financial inclusion, mobilizing savings and supporting economic development, particularly in rural areas not

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<sup>29</sup> For more detail see A.M. Andrews, K. Jeffries, R. Hannah and P. Murgatroyd, 2012

<sup>30</sup> Kenya Commercial Bank and Equity Bank entered the market in 2008 and 2011 respectively. With their innovative agency-banking model and a focus on SME finance, these banks contributed positively to greater institutional diversity of banking in Rwanda.

<sup>31</sup> One key element of the EDPRS2, the Program for Investment and Savings to Transform the Economy relates directly to the objective of increasing domestic credit to the private sector to 30 percent of GDP – It has three central objectives: increasing finance to small enterprises (which employ about one-third of the private sector work force), increasing agricultural financing (vital to rural development, economic growth and employment as the sector comprises almost 32 percent of GDP and 30 percent of exports); and increasing financing for housing.

yet well served by other institutions.

**56. Elaborating further on the IMF/World Bank recommendations, the FSDP II outlined a number of priority objectives and actions, including:** (1) The achievement of sustainability and financial soundness of the Umurenge SACCO system in the short term under the intensive oversight of the BNR; (2) Formation of 30 District SACCOs that serve as focal points for the development of standardized systems and policies, facilitated by the rollout of a shared information technology platform to support the sector; (3) Provision of training and capacity building for staff and board members with a focus on putting the required governance structures in place to safeguard member deposits; (4) Assistance to the District SACCOs to become financially sound and well managed; (5) Establishment of a ‘national structure’, which links the District SACCOs and provides products and services required by them to better serve their members; (6) Reorganization of BNR oversight and enhancement of the prudential regime for the SACCO and MFI sector, including through an increase of the number of supervisors stationed in every district from two to three; (7) Introduction of enhanced reporting requirements and analysis, as the District SACCOs develop their governance capacities.

#### IV. 4. 4. The development of the Umurenge SACCOs since 2011/2012

**57. Although Rwanda’s banking system is still considered relatively concentrated and dominated by foreign-owned banks, the Umurenge SACCOs have added value, in particular through their contribution to greater financial inclusion** (see also IMF, 2017, and Access to Finance Rwanda: FinScope Survey 2016). As noted above, the first FinScope Rwanda survey in 2008 revealed that 79 percent of Rwandan adults were not using any formal financial institutions. Since then, the percentage of Rwandan adults using at least one service or product from a financial institution had doubled to 42 percent in 2012 and more than tripled to 68 percent in 2016. While there has also been more usage of commercial bank services and products during this period, most of the strong growth in usage of formal financial services is explained by the increase in account openings with Umurenge SACCOs. From ca. 500,000 in 2010, the number of their members/clients increased to more than 1.6 million in 2013 and approximately 3 million in 2017/18.<sup>32</sup>

**58. The SACCOs also did rather well in terms of their operational results:** One year after their official launch, 305 SACCOs (73%) were breaking even before government subsidies, and by December 2013 that number had risen to 355, or 85 percent of all 416 SACCOs. While Umurenge SACCOs accounted for only 20 percent of total MFI deposits in 2010 (RWF 6.33 billion and RWF 31.7 billion respectively), they collected more than half of total MFI deposits by 2013 (RWF 36.9 billion of RWF 69.5 billion). A similar pattern emerged on the lending side of their balance sheet: At RWF 4.6 billion, net loans by SACCOs in 2011 accounted for only 12 percent of total net loans extended by MFIs (RWF 38.6 billion). By 2013, the SACCO net loan portfolio had increased to almost one third of total net loans provided by MFIs, i.e. RWF 20.8 billion of RWF 71.2 billion (Alliance for Financial Inclusion, 2014).

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<sup>32</sup> The total population of Rwanda in 2015 was estimated at ca. 11.3 million

#### IV. 4. 5. Current Challenges

**59. The Umurenge Sacco program also encountered a number of problems and setbacks, which are currently being addressed.** While weaknesses that were leading to cases of fraud and embezzlement prompted the BNR as early as 2013 to issue guidelines and procedures to strengthen internal controls, these problems continued to resurface. This has recently led to a renewed concerted effort by the authorities to address poor management at the SACCOs, including the replacement of managers, and providing more rigorous training and better monitoring by the elected oversight committees. Another major problem has been the long delay in shifting from manual accounting and financial control systems to an IT-based modern system shared by all SACCOs. The external company hired to help automate the SACCOs by designing accounting software and harmonizing its introduction across the SACCO system was incapable to deliver and is being replaced. This IT project was an essential aspect of the plan to create a network of 30 District SACCOs and setting up the national structure, i.e. apex institution, as prioritized in the FSDP II. Completion of this complex project is now only expected by 2019-2020.

**Table 5: Financial Indicators for all MFIs, including SACCOs (in billions of RW)**

| Indicator            | 2007  | 2008  | 2009  | 2010  | 2011  | 2012   | 2013  |
|----------------------|-------|-------|-------|-------|-------|--------|-------|
| Total Assets         | 47.94 | 58.83 | 77.96 | 45.28 | 77.42 | 101.02 | 128.7 |
| Liquidity            | 10.85 | 7.31  | 22.95 | 10.1  | 33.02 | 33.22  | 42.1  |
| Gross loans          | 27.39 | 42.58 | 50.14 | 33.61 | 40.72 | 59.19  | 73.5  |
| NPLs                 | 2.25  | 2.28  | 4.61  | 3.76  | 4.89  | 5.06   | 5     |
| Net loans            | 25.91 | 41.33 | 48.03 | 3.76  | 38.59 | 56.51  | 71.2  |
| Total deposits       | 28.67 | 39.29 | 48.93 | 31.72 | 45.87 | 54.47  | 69.5  |
| Equity               | 11.96 | 18.50 | 22.18 | 23.90 | 20.19 | 30.11  | 43    |
| NPL ratio (max. 5%)  | 8.2%  | 5.4%  | 9.2%  | 11.2% | 12.0% | 8.5%   | 6.8%  |
| Liquidity (min. 30%) | 38%   | 19%   | 47%   | 42%   | 72%   | 61%    | 80.5% |
| CAR (min. 15%)       | 25%   | 31%   | 28%   | 53%   | 26%   | 30%    | 33.4% |

Source: National Bank of Rwanda, as published in Alliance for Financial Inclusion 2014

## V. Success factors and policy conclusions

### V.1. Limitations and a caveat

**60. The preceding sections have showcased a small sample of experiences with the development of locally focused banking institutions in various countries—Germany, Indonesia, Peru, Rwanda and Vietnam.** Many more examples could have been selected. These include, for example, BancoSol in Bolivia, a commercial bank that specialized in microfinance, or the approach towards supporting small business finance applied in Russia by the European Bank for Reconstruction and Development (EBRD) through the Russia Small Business Fund, which was launched in 1993, and became so successful that the program was extended over and over again for a period of more than

20 years. The postal savings banks are another banking model with a very long history in many countries around the world. However, as always, space limitations require selectivity.

**61. Moreover, it is necessary to insert one caveat: The showcased examples should not be misconstrued as a blueprint that can be applied one-for-one elsewhere, because each example reflects particular country-specific circumstances and factors at play.** In addition to the economic environment, those factors range from history and politics to culture and tradition, even geography. Also, since alternative banks can be found in many economies around the globe, even where mainstream commercial banks are by far the dominant providers of financial services, it goes without saying that no one starts—figuratively speaking—with a blank slate today. Rather, the Addis Agenda follow-up process, which encourages countries to design strategic national financing frameworks, may serve as a framework for decision makers to take a step back, look at history, and reconsider what approaches might have the most promising potential going forward.

**62. That said, the examples chosen for this paper do provide a relevant cross section of experiences to highlight the value of local banking structures in the context of sustainable development.** And beyond the above caveat to avoid cookie-cutter approaches, it is possible to identify common success factors from all of the examples described in the earlier sections, which then can help to inform the design of policies seeking to promote such financial institutions.

## V.2. Key success factors

**63. The key factors for the successful development of local banks or bank-like financial institutions are:**

- (1) *A corporate mission/business model to focus on providing financial services within a limited geographical area.* This creates incentives to build bank-client relationships with a longer-term horizon and forges common interests with the local businesses and communities. It also fosters innovation in products and services that are better aligned with local needs and demand.
- (2) *Emphasis on the mobilization of local savings.* This is not only needed to provide otherwise excluded members of the community with opportunities to deposit money and transact safely. The growth of local deposits also secures a more sustainable funding basis for lending at fair conditions and ensures greater independence from more costly and less reliable external funding or state subsidies. A business model that concentrates exclusively on lending is more likely to run into difficulties or fail.
- (3) *Adherence to a ‘dual bottom line’ of profitability—rather than profit maximization—and support for the economic and social development of the local region.* This implies that the profits/earnings are reinvested and spent in the region in which they were generated, as far as possible.

- (4) *Maintenance of trust between the bank and the community.* This requires a well-qualified management and staff; the provision of regular training and smart incentives; and appropriate internal and external monitoring and accountability structures to safeguard the institutions' financial integrity.
- (5) *Affiliation through networks, associations and apex institutions.* This is important for individual local institutions to benefit from economies of scale, as a system of independent units. Such networks are also necessary for effective liquidity management, as well as for the organization of information sharing, critical back office functions as well as oversight and mutual protection in an economically efficient manner.
- (6) *Supportive legislation, a sound and flexible legal and regulatory framework and the development of an effective financial infrastructure.*

### V. 3. Policy conclusions and recommendations

#### 64. With these success factors in mind, policy makers are well advised to consider the following:

- *It is possible to develop an economically viable decentralized system of financial institutions with a mission to support local economic and social development, based on savings mobilization and the provision of access to credit at fair and transparent conditions. Developing such local banking structures takes patience—the time until they fully mature isn't measured in years, but in decades.*
- *It is not decisive whether the financial institution is introduced as a municipal savings bank, a credit cooperative, an MFI, or a privately owned bank. What is critical is the mandate or mission: Governments, development partners or private sector sponsors must ensure that the business model is aligned with the needs of the community and local economy. And the legal form and governance regime must take the local circumstances—political structure, cultures and traditions—fully into account in order to ensure local buy-in and ownership.*
- *It is essential to pass supportive legislation, develop an effective financial infrastructure, and put in place an appropriate prudential framework. Effective consumer protection measures are particularly important, because trust, once lost by the community, will be extremely difficult to win back. The prudential framework should be designed to protect the safety and soundness of the sector, while at the same time avoiding to impose excessive burdens and costs (i.e. apply the principle of proportionality).*
- *The licensing policy is important from both a macro and a micro perspective: It is advisable to have a strategic view regarding what type of new entrants into the sector are more likely to meet the country's financial sector development needs.*



*And it is critical to set appropriate conditions for authorizing lending and deposit taking. Depending on circumstances, it may be more prudent to authorize lending operations only with a time lag after issuing a license for deposit taking.*

- *Governments can provide strategic guidance, but ought not to interfere in the regular banking operations. Where possible, supervision and compliance monitoring should be organized at the sub-national/regional level. In addition, governments and development partners need to support the formation of networks/associations and apex institutions; encourage the development of peer-to-peer monitoring and auditing structures and promote the organization of joint liability schemes within these networks. Capacity building assistance for continuous training of management and staff will also be very beneficial.*
- *Initial subsidies should be gradually phased out. In general, this also applies to donor funding for lending operations. Subsidies and no-cost funding for lending operations risk weakening incentives to mobilize savings; they could also risk undermining the necessary discipline and prudence in the loan origination process. Moreover, customers have greater incentive to take ownership of 'their' local bank or cooperative if and when free external financing is removed. People borrow and repay their loans more responsibly if they know that their loan is financed out of their own or their neighbors' savings.*
- *There is a large need for capacity building at the local and sub-regional levels, in particular in low-income and least developed economies. Addressing this need as soon as possible should become a priority for development partners.*

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