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BGD 031 - COMMENTS TO GRAMEEN BANK PHASE III COMPLETION MISSION REPORT

Reference is made to your memo of 9 Dec 93.

1. We have gone through the Grameen Bank Phase III Project Completion Mission Draft Report, and feel in general that the report gives a good review of the phase III achievements, shortfalls and differences, compared to the projections at the appraisal stage.

2. We agree with the Mission's proposal that the expected small surplus of funds in the SVCF, R&D and M&E categories at end Dec 1993 is reallocated to Institutional Development, and finally unutilised funds at end June 94 to be used for G&C loans.

3. GB has opened up for a growth in lending during 1992 and 1993 which is so high, that most banking experience will dictate to put on the alarm lights, the risk being loosing control.

Between the beginning of 1989 and 30 Sep 1993 loans outstanding increased from Tk. 1,012 (USD 25 m) to Tk. 7,017 (USD 175 m).

By end Sep 1993 GB had disbursed for housing loans Tk. 2,460 (USD 61.5) m) compared to Tk. 338 (USD 8.45 m) at the beginning of Nov 1989. The Bank has no consolidated record of the unrepaid and overdue housing loans. The same is the situation for the newly introduced sesonal loans. HO is unable to monitor the unrepaid loans and overdues.

A growth rate of this size was not planned during Phase

III, and has been made possible through extensive borrowing from Bank of Bangladesh and commercial banks. New lendinmg schemes have been introduced, which also were not planned or discussed in advance with the donors. A statement in the draft report raises concern in this respect: "self-confidence may again be substituting for careful planning, testing, and execursion of the new seasonal and multiple loan programmes". This combined with absence of proper monitoring system and lack of commitment to budgeting and budget control, provide fertile ground for speculations by outsiders that something might be going wrong.

The confidence that GB has built up in the donor community, and elsewhere, through building solidly up their schemes "stone on stone", and through good control systems, could easily be eroded if the impression of relaxation of basic principles is alowed to fasten. GB management should take this challenge seriously soon.

4. One issue of particular great concern in this respect, which could be interpreted as a typical result of too rapid growth, is the absence of data at HO on repayments of housing loans and seasonal loans. The Mission is stating that with the considerable contribution of these loans to the rapid growth of the outstanding loans, this absence of data suggests a growth rate that is out of control. "After more than five years there is still no housing loan delinquency report (although one is now scheduled for introduction in January 1994). In the absence of reliable data the mature mind must assume that invisible portfolio problems are multiplying daily."

During our visit to GB in July/Aug 93 we got data from GB from a special survey undertaken by HO for housing loans as at end March 93. A total of 72,795 loans had been looked at, and for 9,303 of these loans there had been no repayments made over the last three months. For an additional 7,335 loans half of the amount that should have been paid was still oustanding, and finally for another 3,015 loans, one quarter of due amounts was unpaid. A total of 27% of the number of loans researched was affected with considerable defaults, which is far below GB standard for G&C loans.

After such findings one would have expected that GB's management should be the ones most interested in establishing a proper monitoring system. When this has been given surprisingly low priority by GB management, it should now be considered to put it as a condition for further funding in phase IV, that systems for continuous monitoring of all loans are in place, and have proved to provide the data needed for loan portfolio monitoring.

It is, however, not surprising that housing loans, which in most cases are not creating any additional income for the members, will be less punctually repaid than loans for productive purposes. The surprising part of it is rather that GB management try to give the impression that this is not so for GB housing loans, without establishing a proper monitoring that could have provided documentation.

5. Another area where donors' experience and GB managements practice seem to be in disaccord, is the differing views on budgeting, budget control and reporting.

The 15 conditions set by donor consortium during phase III with which GB was either partly in compliance or not in compliance related largely to project reporting, budgeting and monitoring, and consultations with the donors concerning the use of the SAF.

Semi-annual and annual reports provided little analysis or explanations of the trends in the Bank's operations and performance. A comparison with targets and previous periods was also sometimes lacking. GB does not seem to use the budget as a management tool to guide the Bank's managers when lending. (1992 and 1/2 1993: 383 and 206% exeeding of budget figures respectively). The absence of any ratio analysis makes it impossible to monitor effectively the performance of over 1,000 branches and is a serious weakness in GB's HO monitoring system.

Total project expenditure by the end of June 1993 was 192% of the expected phase III expenditure and 162% of the MTR targets. GB has had to borrow extensively on the money market to finance the shortfall in funds for on-lending. None of the Semi-Annual or Annual Progress Reports contained any explanations for divergences from planned targets.

We tend to agree with the Mission's conclusion that the absence of any apparent outside control, independent influence or regulation must be a cause for concern. All successful systems require an appropriate set of checks and balances. How this should be organised in phase IV has to be discussed with GB management. The magnitude of the operations and the donor assistance, combined with the steady increasing international interest in the concept, could indicate the need for some kind of "international panel of experts" to observe and have a continuous dialogue with GB management and the donors in phase IV, for instance through quarterly meetings, based on information prepared by a secretariat.

6. Another major concern is the lack of information about the extent to which parts of new loans directly or indirectly are used to repay parts of old loans. The mere fact that interest is only supposed to be repaid after the full principal has been repaid (for G&C loans) opens up for a situation in which all interest can be paid through

new lending, via short term borrowings from other members of the group/center, from money lenders or in other ways. Lack of control with what the money is used for ("the members know best") is facilitating this practices.

In fact a recent survey done by David Gibbons and Helen Todd of 40 women with 10 years' membership, found that almost all borrowed privately to pay the interest. If this finding is taken to be representative for the institution, it means that most of GB's income has been paid my donors through new money for lending, and not by surplus from members investments. As lending has increased a gradually larger part of the new loan will have been used to repay the old loan, reducing the effect of the new loan, and creating need for bigger new loans.

We do not agree with the Mission that the question of refinancing is linked to the introduction of new lending schemes. The possibility of extensive refinancing has been there all the time for the G&C loans, via short term outside lending for finishing existing loan, and repayment from part of new loan. To quote the Mission: "For GB the problem can be perpetually concealed, untill and if credit rationing has to be imposed and new loan funds are unavailable to cover previously due payments. Then, if pyramiding has occurred, defaults cascade and compund throughout a system which has also experienced rapid growth. the result can be institutional collapse".

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Lack of continued supply of ouside capital could therefore represent the biggest "threat" to continued operations, but continued supply could also compound indebtedness of the members, to GB and to outside.

It should be in both donors and GB management's interest to try to uncover this "grey zone", the sooner the better, for as the Mission states: "informal refinancing of existing loans may be the most insidious threat to GB's continuing viability" and "GB has created a fertile environment for credit pyramiding in which a new loan can always be used to partially repay an existing debt. The problem is insidious because it creates an environment for credit addiction wherin members become perpetually indebted".

The success or the failure of the GB concept is very much determined by what is going on at group and center level. We therefore agree with the Mission that there is a need for more research of these activities, inclusive the extent of refinancing, members indebtedness and accumulation of productive assets. The World Bank study on GB, which have been awaited for six months now, might give some answers.

7. The most crucial question for GB is the question of sustainability. How should sustainability be considered,

how should it be achieved? The Mission has touched on the issue, but not done a comprehensive work on it.

The Mission appears sometimes very opitmistic about this issue, stating for instance about Phase III:

"GB appears to have achieved a self-sustaining level of operation during the final year of Phase III project. The successful introduction of new loan schemes, increased loans outstanding, increasingly efficient utilisation of employee and physical assets, control of staff numbers, higher interest rates on G&C loans, and strategic use of borrowed funds to improve investment income have all contributed to a solidly profitable operation on a current basis.",

and about the future:

"The performance and the financial projections (Section III) show that GB could be a financially viable institution while growing at an annual rate of 10-12% per annum without any additional outside funding over and above the proposed Phase IV funding for housing loans, R&D, M&E and institutional development. Under these assumptions GB could repay all the BB borrowings and would not need the proposed OECF loan."

These opitimistic statements do not reflect the doubts about important assumptions which are given in other parts of the report, and can give an iompression of contradictory statements. The crucial points of whether potential losses are steadily beeing pushed forward and accumulating, how interest income is calculated, and - as have been discussed above - how interest income actually originates under the special GB environment, will determine wheather the above statements give a realistic analysis.

8. The Mission is in most aspects considering Grameen Bank from a banking point of view, with the aim that the institution shall become profitable and self financing, like a commercial bank. GB Management has, however, variously asserted that member loans are too risky an investment for the meagre savings of poor members, and prefer therefore to deposit the "group fund" money in a commercial bank. The acknowledgement of this magnitude of risk is not based on the actual repayment performance presented by GB, and used for the profitability analysis referred to above, but is from a common sense point of view easy to accept.

The Mission goes on to say that:
"As a result it could be argued that GB is a "bank" in name only; it does not engage in financial intermediation. That argument would assert that GB is better conceptualised as two separate financial enterprises

operating under a single identity:

a) a members' savings club or credit union which pools member savings for group sanctioned credit advances, and

b) a revolving loan fund which utilises externally generated monies to fund its general, seasonal, and housing loans.

Such an enterprise would never sustain itself and operate independently of donor support or external borrowings to fund member loan demand. It could, however, earn a sufficient spread between the aggregate cost of funds and its interest income to cover employee and other operating expenses independent of donor contributions."

In our view the question of how GB is to be understood as an institution could be discussed in more debth, because it is a crucial one, especially from the point of view of further donor support. The dilemma is the choice between pushing for viability which could gradually change GB to become more and more like an ordinary commercial bank, at the cost of the original target group, the poorest, and the alternative to continue subsidising operations and accept that the GB concept includes so much more than a bank, that it cannot be run profitably without support from outside the institution. It can be argued that such support is justified by the sustainable impacts GB operations have on the members.

The dialogue with GB management on this should continued, even if this dialogue could be impeded by the Mission's observation:
"At the close of Phase III GB continues as a most rare commodity; it is an institutional social entrepreneur which has now earned a place on the world stage. Like most entrepreneurs, it prefers to play by its own rules and disdains advice and criticism. But like a successful entrepreneur, it is unusually skilled at calculating and taking manageable risks. It enjoys "living at the edge", and when it finds itself too far removed from the edge, it moves there quickly. As a result, the audience is more anxious than the actors."

From our experience with GB, we do not find this last statement to carachterise the institution or the management very good.

9. The Mission states on the socio economic impacts, that: "GB's credit programme does make a significant improvement to the income and standard of living of the membership." This is the most important finding when we look at the true ideas behind development coopertion. Sustainably increased standard of living at the final target group level is the ultimate aim, and if this can be achieved through subsidising the institution providing

this impact, that proves that the funds have been well used. One reservation for a potential latent indebtedness has to be taken though, as elaborated above.

10. In conclusion we will try to summarise the overall situation as it appears after the Mission's report and as we see it now:

i) Grameen Bank has during all its years of operations been working in a situation of liquidity surplus, made available by donors. This has made it possible for GB to pass on funds to the members through guaranteed granting of new and bigger loans, once the old loans have been repaid. This reward system has probably been the major attraction for members to join GB and has given motivation for repayments of loans.

ii) We know that this practice has stimulated members to "make arrangements" for repayments of loans, including to borrow money from other sources in order to repay old loans and become elegible for new loans. However, we do not know to what extent this is practiced, and GB management does not seem to know either. Full stop in new lending could turn out to create a dramatic situation for many members, and lead to an exodus of members with unpredictable consequences. Continued lending made available from supply of funds from outside sources could delay the surfacing of the problems, but also escalate the magnitude of them.

There is on this background a need to start a comprehensive research into this issue to uncover the real situation.

iii) Lack of monitoring of housing loans and seasonal loans at GB's HO is of great concern. Only immediate action from GB to rectify the situation can avoid a drop in donors' confidence in GB's management's ability to control the operations. A comprehensive monitoring system must be in place before further disbursements under Phase IV is done.

iv) Until the questions raised in ii) and iii) are answered, all analysis of the viability of the banking concept and the sustainability of the operationsat this popint of time will be based on uncertainty, which makes the outcome of such analysis less significant.

v) GB seems to have come to a cross road where a decision has to be made whether the overall focus forward shall be to become a viable, selfsustained commersial development bank, or whether the institution shall remain faithful to the original approach to poverty alleviation and accept that some element of susidies have to be part of the concept. Both choices involves weighing of many arguments and considerations, and both directions are problematic. From a donor point of view the second option, combined with the same strict repayment discipline towards the members as has been practiced up to now, could be preferable. The consequences of this option, i.e. the question of graduation, should be discussed between donors for Phase IV and GB management.

vi) One reflection after reading the mission's reportis that there is a need for close dialogue with GB in Phase IV. It is difficult to see how this dialogue can be fruitful without a donor liaison officer of some sort, which could keep donors up to date with information and analysis of the developments, as basis for the dialogue. Without this in place, donors will easily be left uninformed about major changes, and the ability to have any influence on the project will become illusory.

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